# Jens Weidmann: The financial assistance can only buy time but does not address the root causes of the crisis

Interview with Dr Jens Weidmann, President of the Deutsche Bundesbank, in *Corriere della Sera* (IT), *Público* (PT), *Kathimerini* (EL), *El País* (ES), conducted by Ms Marika de Feo, Ms Ana Rita Faria, Messrs Tom Ellis and Claudi Pérez and published on 15 June 2012.

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The interview was conducted in English.

***Do you think 100 billion is enough to rescue Spain, given the path of the recession and the link between banks and sovereign bonds?***

I generally don't speculate about numbers. Regarding the assessment of financing needs, I am relying on the IMF and the external evaluators. For what we know now, the amount discussed seems to contain a sufficient safety margin. The decision by the Spanish government is an important one because it reduces uncertainty about the solvency of Spanish banks; it thereby contributes to the stabilisation of financial markets. I also welcome the fact that the Spanish government no longer hopes for financial support that comes without conditionality. Conditionality should be a core element of any financial aid.

***In the last two years Spain has applied reforms in labour market, pensions, financial system, cuts in the expenditure and tax increases. What's next? What are the reforms you have in mind?***

The key message is that the banking system is a mirror image of the economy. It reflects the situation of public finances through the link with sovereign bonds. It also reflects the competitiveness of the economy and imbalances that have built up in the past, such as the bubble in the real estate sector. An encompassing solution comprises reforms and solutions in various areas. Particular challenges are transparency and control of budget execution in regions, and addressing the segmentation of the labour market. Together with the labour market reforms already announced, this could give new hope to unemployed youth.

***But the Spanish Government is talking about exactly the opposite: that there is only conditionality with banks. What will be the real conditionality of the rescue for Spain?***

Because of the interconnectedness of the different policy areas, I think that conditionality should be broad. The impression that this is a rescue with no conditionality outside the financial system is already eroding the commitment to the terms of the existing programmes.

***Is there the risk that other countries, like Ireland or Portugal, could ask for the same conditions and adjustments?***

That's exactly the key problem. There is a discussion about relaxing the conditionality emerging in Ireland and Portugal, and also in Greece this debate is gaining new traction. But foot-dragging on addressing the structural problems will perpetuate the crisis, and the market reaction reflects this concern.

***Why not change those principles and make a softer adjustment?***

Once more, the financial assistance can only buy time but does not address the root causes of the crisis. It is like a painkiller. If you do not ensure that you cure the illness you will be worse off once the effect wears off. I would also doubt that public support for the necessary reforms increases if they are spread even more over time, not to mention public support in the countries guaranteeing the rescue mechanism.

***In Greece, there's a lot of debate on the need to renegotiate parts of the program. Is there space to make some changes?***

The key point is that there is an agreement that all involved parties including the Greek government have signed. If the agreements were now seen as being open to renegotiation, then for instance the Portuguese prime minister would have difficulties facing his parliament and explaining that he is to implement reforms. I think that would be a very dangerous strategy. It would harm those countries that are implementing reforms very quietly.

***Greece is usually described as a special case. Could that be so in this case, in a positive sense, allowing Greece to adjust the program?***

Greece is already receiving special treatment. Adjustment will be spread over a much longer time. Greece benefitted from an exceptional debt relief. You see, Greece got much more support than any other country. Relaxing this already softened framework even further cannot be an option.

***One of the leaders of the two parties that could win says that the Greek government would request a total change of the program. What response would a unilateral move from Greece create?***

Who will be elected in Greece is a democratic decision that we all have to accept. But also the newly elected Greek government is bound by existing agreements. If it unilaterally opted out of the programme, it would mean that in my view the basis for more financial help will no longer be given. Greece would have taken its decision but would also have to bear the consequences. We will all be affected, but my assessment is that Greece will be worse off than everybody else.

***Have you prepared any contingency plans for a Greek exit?***

I don't talk about contingency plans. I will just reiterate what I have already said. The repercussions of such a decision in Greece would certainly be worse for Greece than for everybody else. The result of potential contagion effects cannot be that one accepts whatever a government has unilaterally decided.

***Would a decision from a new Greek government not to fulfil all the agreements mean an exit of Greece from the Eurozone?***

It certainly has the potential to escalate to such a situation.

***So, if they don't fulfil the agreement, this leads to an exit?***

Not fulfilling the agreement leads to the end of funding. And this may have repercussions on their chances of remaining in the euro.

***Looking back, do you feel that the introduction of the euro in Greece was a mistake?***

You certainly remember the very controversial debate at that time, with some scepticism in Germany. But it was definitely a mistake that Greece did not make wise use of the benefits of our common currency. The progress observed especially in public finances in the run-up to EMU proved treacherous.

***Some say that Greece can go bankrupt, but stay in the euro. How does the Bundesbank view such a scenario ?***

The fact of the matter is only Greece can decide on leaving the euro, despite this not being foreseen in the EU treaty. As I said before, it will be very difficult for an insolvent country that is cut off from financial support to remain in the EMU.

***But if Greece leaves the euro, what happens to Portugal and the whole euro area? Isn't that a bigger risk than continuing to finance Greece without conditionality and having the risk of the Portuguese government asking for the same?***

I think we agree that both risks are substantial. Of course, I don't want to speculate about any country leaving the Eurozone; we haven't seen this yet and this would be a very grave event. And that's why I'm counting on the Greek government to stick to its agreements. That's my preference.

***And which are the other risks?***

One major risk is that the stability foundation of the monetary union, that we have agreed on and enshrined in the articles of the EU treaty, will erode further. This has the potential to undermine the confidence in the solidity of the monetary union. And it would put monetary policy under pressure even more to inflate away the problems. Already now several voices are asking the ECB to break its rules and bail out with no conditionality.

***Does the European Union have enough firewalls in place to deal with a Greek exit?***

I don't want to speculate about a Greek exit. The firewalls we have been building and strengthening are there to prevent contagion effects. And I will not be a party to the endless debate on their size. In any case, we must not allow ourselves to be blackmailed by a country because of the contagion effects.

***Is there a good scenario and a bad scenario for Greece?***

Again, my preferred scenario is that the Greek government recognises the importance of fulfilling its obligations and implements what has been decided. It is the goals which should be non-negotiable, not the means by which you achieve them. If Greece, say, found an alternative way to provide a certain amount of revenues, other than the one that has been agreed, there would certainly be room for flexibility.

***Is a one year extension of the program acceptable?***

That's a political decision that would have detrimental consequences for the Union at large.

***Regarding Portugal, it seems to have the image of the good student in the bailouts program, but it's also an hostage from what happens in Greece and Spain. What message would you leave to the Portuguese government?***

The key message from Portugal and Ireland is that adjustment programmes work. The reforms that have been implemented there have contributed to reducing unit labour costs and stopped the decline in competitiveness. We also see the first benefits of this in the current account deficit. And according to our forecasts, growth should pick up again in these countries. No serious forecast sees a downward spiral that doesn't end anywhere.

***There are already talks about a second bailout to Portugal, because the country may not be able to return to markets next year. How do you regard this?***

We are dealing with a crisis of confidence, and lost confidence cannot be regained overnight. But the important message is that Portugal is on the right track.

***But isn't the whole of the euro at stake?***

Confidence has also been lost in the functioning of monetary union as a whole. This brings us back to the debate about whether we want to return to the Maastricht framework, which relies on national fiscal policies that are responsible only for themselves, or whether we want to take a quantum leap forward, regarding integration. We cannot say that, on the one hand, we rely on national fiscal policies and on the other hand, we progressively communitise risk without control, thereby undermining the existing legal framework. In the end, it's always a question of the balance between common liability and control.

***You're saying that, if there is control, we can have Eurobonds?***

I'm saying that common liabilities are only compatible with a completely different framework, and this framework would have to be proven to ensure fiscal discipline and sound macroeconomic fundamentals. You can't take the third step before the first.

***But who controls? Is the fiscal compact enough?***

Of course, it's not enough. The Bundesbank welcomed the fiscal compact because it strengthens existing rules. But it is not tantamount to abandoning sovereignty. For me, a fiscal union is something where you cut into the budgetary rights of parliaments, at least if rules are violated. And we see how difficult it is to abandon fiscal autonomy: even under enormous pressure it is very hard, for instance for Spain, to subject itself to conditionality. It's perceived as a matter of national pride.

***What do you mean exactly by common liabilities?***

We already have common liabilities through the rescue mechanism. If you wanted to extend it – be it via Eurobonds, be it via a banking union – this would mutualise liabilities to an extent that is no longer covered by the EU treaties and national constitutions. When we really want to advance towards a political union, we have to acknowledge that this is a completely new setting and that means that we would all have to give up substantial national sovereignty. It means that you have a central level that can interfere directly with your budget, your taxes, to enforce the agreements. We have to honestly ask ourselves: are we ready to give up that much national sovereignty?

***Would the Germans accept this?***

At least according to the polls, the public in Germany would be more willing to embark on more political integration than in most of the other countries. The latest Pew research poll shows that in Germany, 58% are in favour of more political integration. In other countries, the mood is more negative, especially in those that are asking most loudly for communitisation of risks and liabilities, like Italy, Spain or France. We have to be honest in this debate. It will take years and years. We would have to change the EU treaties, we would have to change our constitutions, even in the sense of having a referendum, for instance in the case of Germany.

***Would they rather go back to the D-Mark?***

No, the German public is clearly committed to a stable common currency.

***But in the periphery the house is burning. And some are asking what is the ECB doing? Why can't it be a lender of last resort?***

The ECB has already gone a long way towards preventing an escalation of the situation. It has cut interest rates. It continues to provide almost unlimited liquidity at very generous terms and decided several non-standard measures. By doing so, it has stretched its mandate considerably. If it acted as a lender of last resort to governments this would redistribute solvency risks among national taxpayers, for which there is no democratic legitimacy, and is hence strictly forbidden in the EU treaties.

***Do you consider that Spain hesitated too long before asking for help?***

I think the Spanish government hesitated, hoping that there would be other means of financing with no conditionality attached.

***Are you afraid of hyperinflation?***

It is not a question of German "Angst" of hyperinflation, it's the lesson of our more recent European history in the 1970s and 1980s when countries like Italy, Spain and France experienced intolerably high inflation rates. I don't want to reopen the debate with our Italian friends on the marriage between the Bank of Italy and the government until 1981. But I think this was clearly not a system to serve as a role model for Europe's future. All these calls for monetary financing, for the central bank to step in as the only actor able to do something, would take us back to the 1970s.

***But if a price stability mandate, there is an other mandate of financial stability because there's no financial stability in Europe.***

There is a clear pecking order. The overriding goal of the Eurosystem is to maintain price stability, and in the long run this is the best contribution we can make to financial stability. But as I said, the Eurosystem has also contributed to preventing an escalation of the crisis in the sense that we cut interest rates to historical lows, provided almost unlimited liquidity to banks, and decided on numerous non-standard measures. The problem is that if politicians have the feeling they can pass their responsibility on to somebody else, then they will choose the easy way out. And this undermines the independence of central banks.

***How do you asses President Obama's emphasis on the need for growth and a more expansive policy?***

We have to recognise that the recession we are seeing in many countries is the result of a lack of confidence in public finances in combination with an erosion of their competitiveness. There is no easy way out, unless you address the root causes of these problems. And addressing this situation by adding further debt through fiscal stimulus is certainly not the solution.

***Is the US totally wrong?***

Sometimes one has the impression that all of a sudden some realised the importance of growth. But the adjustment programmes are all centred around growth. We have to be honest in this debate. What the protagonists of this discussion mean is publicly financed stimulus packages. And this is something different. Perhaps it will lead to a short-lived expansion. But it will aggravate our problems in the future, because it will create additional debt, and there are already doubts about debt sustainability. Credit-financed excessive demand was part of the problem, for example when we talk about the housing boom in Spain.

***What about the growth compact. The Chancellor has spoken about it.***

Our problem in Europe is raising the growth potential. If we debate a growth compact it should be focussed on long-term growth and therefore on structural reforms. This is also what Mrs. Merkel has in mind.

***And what about project bonds?***

To do what?

***For infrastructure, for example.***

For infrastructure? I am not convinced that Spain and other countries suffer from a lack of infrastructure. What I am missing is an adequate analysis. If there is an impediment to investment, for instance in Greece, it is rather too much red tape and an inefficient tax system. I don't believe in further stimulus programmes to cushion the adjustment process.

***But why not? We have 25% unemployment in some countries.***

To give a perspective to the younger generation, you have to tackle the roots of the problem. Spain, for instance, had double-digit unemployment rates before the housing boom. It's about the structure of the economy, not about some temporary stimulus.

***But you don't have only one country in recession, but many countries and actually the whole euro area. So how can we look for growth in the long run?***

But look at Portugal's forecast, for instance. It is forecast to have a positive growth rate without any further stimulus.

***We can discuss if that is realistic. In Greece and elsewhere, forecasts are changing to the worse.***

Some effects from the reforms that have been implemented are already showing – in unit labour costs, in competitiveness, in export growth. I would not endanger this by deviating now from the course and jeopardise the confidence in the long overdue policy change.

***On Italy, are you satisfied about the way it is tackling the reforms? And trying to improve the situation, when there is a negative 0.8% growth rate, and getting worse and worse. Do you also see improvements there?***

Mario Monti embarked on important reforms just a few months ago. Now they have to be forcefully implemented. It will of course take time before they bear fruit.

***Is it time for an exit strategy of the ECB?***

We have to think about an exit, we have to know how to exit, but certainly this not the time to start an exit.

***Is it the time for additional measures, maybe?***

What for?

***If the conditions get worse these days?***

We never precommit, but I cannot see how more liquidity would change the situation, given that the liquidity lent out to Spanish banks ends up in Germany.

***The programme to buy government bonds is excluded?***

The programme is inactive. As you can see, we are not in the market anymore. It is no secret that I am sceptical about this instrument. Take Greece, for example. We are the largest holder of Greek debt. Did it help?

***How long should the ECB provide liquidity to the Greek banks?***

Our statutes say that we provide liquidity to solvent banks against adequate collateral.

***Then, if the economic situation is going to worsen, would you accept cutting the rates further, or is the 1% boundary a sort of a taboo because you might go into a liquidity trap?***

You have seen that we have very few taboos in the Eurosystem, but again, we never precommit. Financial market instability stems from political uncertainty about the programme execution in Greece, about the future of the monetary union in more general terms, and that is not something you can fix with a rate cut.

***But the euro would nominally devalue and this would help European exports.***

We don't have an exchange rate target. Our goal is price stability. And what helps exports are the structural reforms countries are implementing, not an artificial price decrease through the exchange rate. So, our goal at the Eurosystem is not to foster exports by manipulating the exchange rate.

***What could Germany do to help rebalance the Euro area?***

A rebalancing is already taking place: the current account surplus has halved from 2007 to 2011, and what we are seeing now is to some extent a reversal of the pre-crisis situation. In the first decade of monetary union, Germany embarked on structural reforms and wage moderation. Now in Germany we have above-average growth rates, employment is the highest we've ever seen, and effective wages are increasing faster than in the past 20 years. This will translate into purchasing power and help rebalance the current account. But we are not living on an island. Our main competitors – like the US and China or other emerging economies – are outside the euro area, so that it is very important that Europe as a whole becomes more competitive.

***Are you not afraid of a very high inflation of 5–6% and high wage increases?***

In the short term we may even see declining inflation rates because of falling energy prices. If Germany's economy continues to gather steam, we might see above-average inflation rates as we have seen below-average rates in the past. But we are talking about decimal points here. In the Governing Council we ensure price stability for the euro area as a whole. This precludes runaway inflation in Germany as the German economy accounts for the biggest share of the euro area aggregate.

***Apart from the political union there is a banking union which is waiting to be discussed at the end of June. What do you think of the three points: a paneuropean supervision, a deposit guarantee fund and a banking restructuring fund? The Commission has put forward a proposal, are you satisfied with this proposal?***

I welcome the bank resolution proposal of the Commission which still needs a lot of debate, because it is very technical and very complicated. But over and above that, there are the issues of common regulation and common supervision; and there are two elements which imply common liabilities: a common deposit insurance scheme and a common restructuring fund. These are areas in which we currently have a national fiscal responsibility. If we were to mutualise liabilities in these areas, we would face the same questions regarding liability and control as in a fiscal union.

***But not for now?***

There is the question of balance between control and liability. And the liability side, when it comes to figures, is impressive: if you think about insuring the deposits, those numbers are well beyond what we decided for the European rescue mechanisms. This is really a big step and that's why we have to have centralised control and then we can talk about the liabilities. I don't think you can really separate the banking union from the rest, especially as long as the banks are the biggest holders of government debt. We have to make sure that through a banking union we don't introduce through the back door a sort of Eurobond system, guaranteeing the banks and in this way funding governments. So you need strong rules to prevent this. Another related question is would supervision really be better if it were centralised?

***But also central bankers say that there is a need to break the vicious circle between the sovereign and the banks. And one way to do it is to have a common supervision, because, e.g., the supervision in Spain didn't discover the risks of 100 billions euros in the banks.***

I agree, the nexus between the sovereign and the banks could be broken by a banking union. But again, this is not a quick fix, as it requires similar legal changes to a fiscal union, because you take on a considerable amount of common liabilities. And this would interfere greatly with the national sovereignty and the rights of national parliaments. That's why it requires fundamental change and won't come overnight. Nobody would guarantee 11 trillion euro of deposits without having the insurance that at the end there is control.

***What about using the gold reserves of each central bank to guarantee the deposits?***

Our gold reserves are currency reserves. They are independently managed by the Bundesbank and the other Eurosystem central banks. And as far as the Bundesbank is concerned, we have absolutely no intention of contributing to an insurance scheme. Moreover, this is not possible for legal reasons.

***But we need a common guarantee for bank deposits.***

I see no way to do this now. Eventually, each parliament would have to assume liability for deposits in all of Europe. If some of these risks materialise, this would jeopardise the possibility of national parliaments to control their budget. If you don't have safeguards that the risks are under control, this would be a reckless undertaking.

***The "wise economists" in Germany launched the idea of a European Tilgungsfond (amortisation fund), which met the enthusiasm of the European Union. What do you think of it?***

It doesn't change our assessment that it is legally not feasible and that it inverts the sequencing of liability and control. In practice, it backs the guarantee for all debt over 60% of GDP, assuming that everybody sticks to the rules and pays back his part of the debt later on. But we have seen in the past how flexibly our rules were interpreted. And I think mutualising debt by only hoping the rules are adhered to is very dangerous. All this requires constitutional change.

***But Germany cannot be completely isolated from the rest of the Eurozone.***

We carry the largest burden of the rescue packages, which all benefit from Germany's AAA rating. So Germany is the stability anchor and without it, it wouldn't work. And it is assumed that it is Germany's responsibility to do that. So it is all too easy to say that Germany always says "no". That's why it is unjust to say that Germany doesn't play a constructive role.

***But the problems between Germany and France on the interpretation of how to go on, can endanger the euro?***

Well, first of all let's wait for the electoral noise to fade. And then we will see how the collaboration really works. My point is that you have to be realistic about the solutions. And if you only talk about Eurobonds without talking about control, then this will just distract attention. If France were to start a debate about giving up national sovereignty, this would really move the debate forward. The German government is now pushing for fiscal union, trying to find a solution. I would very much welcome it if President Hollande faced this debate and discussed both common liability and giving up sovereignty – and the path towards this new political union. But just asking for Eurobonds doesn't get us anywhere.

***In order for the Greek debt to be sustainable, economists say that there will need to be a haircut of the official sector too.***

The peak of the Greek debt is still to come and it will take a very long time to bring it finally to a sustainable status. But here I have to rely on the debt sustainability analysis that has been carried out by the Troika.

***Economists say behind Spain there is Italy, we have to stop contagion, so that's why everybody is happy that Spain agreed to ask for help. Now do you think that Europe is going towards a more stable time, so that the Greek elections won't have such an impact?***

I don't believe in the next-in-line theory. Every country is different and if you look at the data for Italy, there are very significant differences. For instance, Italy is close to a fiscal primary surplus. I'm sceptical about the fixation on the Greek election as if it were the only issue. But it determines how the Union deals with a country that fails to live up to its commitments.