Jens Weidmann: "There is light at the end of the tunnel"

Interview by Dr Jens Weidmann, President of the Deutsche Bundesbank, with the newspaper *WirtschaftsWoche*, published on 22 December 2012.

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Mr Weidmann, Germany's Chancellor, Angela Merkel, is promulgating cautious optimism that the worst is behind us in the euro crisis. Do you share this view?

We have come a long way, but at the same time we must not underestimate the distance we still have to travel. The adjustment process in the countries affected by the crisis is a long way from being complete, and the work on the institutional framework of monetary union must be rigorously advanced. Above all, we first need to see whether new agreements like the Fiscal Compact will be turned into practical reality.

Do you see a recovery in the stressed economies?

There is certainly light at the end of the tunnel. The approach of providing assistance with conditions attached is bearing fruit: competitiveness has improved in many countries, and current account and government budget deficits are shrinking. Though this is being achieved in a recessionary environment, structural improvements are also playing their part. Obviously, there are major differences between the individual countries. Ireland is without doubt at one end of the spectrum, while Greece is at the other. And, with a long way still to go, we must not further weaken the incentives to adhere to the agreed conditions.

Further weaken?

The financial assistance measures have become ever more generous as time has gone by. This reduces the pressure to tackle government debt and competitiveness problems in a resolute fashion.

Do you have a solution for restoring Greece's competitiveness and putting the country's economy back on its feet?

That is just what the adjustment programme is intended to achieve. At the end of the day, every economy has to be able to stand on its own two feet financially without needing transfers from outside. An economy cannot consume more than it produces indefinitely. If European politicians should decide to disregard this principle and to permanently prop up member states, then they need to be clear about the consequences.

That may be correct from a technocratic point of view, but what about the political reality? The outbursts in the Berlusconi camp about Germany waging a third world war show that the community is more divided than united by its common currency.

Those who make scapegoats of others are merely seeking to deflect attention from their own responsibility. It goes without saying that economic adjustments bring major challenges for policymakers and, above all, for the populations affected. But other countries, too, face limits of political acceptability, not just the crisis countries.

Your spectrum extends from Ireland at one end to Greece at the other. Where do Italy and France lie between these two poles?

Italy is suffering the effects of weak growth, low productivity and a lack of ability to innovate. But under Mr Monti's government, Italy has set itself ambitious reform goals in an effort to restore investors' confidence, and has made progress. It would be disastrous if Italy were to give the impression that this progress might be reversed, depending on the outcome of the election.

Let us be clear: anyone who votes for Berlusconi makes the need for a bailout more likely. But the rescue shield should not be forced to provide funds because of Berlusconi.

I do not wish to speculate on the outcome of the elections. Whatever the case, Italy's present government has recognised the need for reform and has embarked on this reform in key areas. If the reform process were halted, then Italy would once again lose investors' trust.

When interest rates then rise again and Italy does not have a government capable of taking action, everything will start again from square one, will it not?

To say "when they then rise again" is going a bit too far for me. It is obviously in Italy's own interests to prevent that from happening. Pressure must not be put on the central banks again through irresponsible action. As guardians of the currency, we need to make clear that we are bound only by our primary objective of ensuring price stability. We are not there to clean up the politicians' mess.

Does this consensus still exist at the ECB?

It is very clearly our mandate.

Is the ECB the governments' bully or their bankroller?

The role of bankroller is expressly prohibited, and being a bully is good neither for the ECB nor for monetary union. If we, as central bankers, started trying to shove democratically elected governments around, people would soon be asking, and rightly so, whether the central bank was perhaps overstepping its remit.

The announcement of the bond purchase programme has finally brought some calm. Whereas critics claim the move goes beyond the central bank's mandate, your colleagues have lauded it as a great success.

It is obvious that central banks are able to influence markets in the short term simply by making announcements. But the question is: is that the right way to measure the success of our actions? We have started on a slippery slope, and the brake built into the programme, in the form of conditionality, will have little grip. The pressure of the markets increases at precisely the point when a country diverts from its reform path. And then the only options are to refuse to buy bonds, and accept the escalation of the crisis that we are seeking to prevent, or to allow the conditionality to fall by the wayside. We should interpret our mandate narrowly and not get ourselves into such a dilemma in the first place.

Is an announcement sufficient to calm the markets?

Even if an announcement were sufficient, that would not mean that my opinion on the programme would change.

What do you dislike so much about the bond purchases?

First, the programme entails a willingness to make huge and, in principle, unlimited use of the central bank balance sheet to reallocate insolvency risks among taxpayers in individual countries. In a monetary union with 17 sovereign member states, such decisions should be reserved for democratically elected parliaments. Furthermore, as a central bank, we should keep ourselves at a safe distance from monetary financing of governments. Finally, moral hazard comes into play – the risk that governments' willingness to reform will wane if, through the measures we take, we reduce the pressure on them to act.

Will the ECB tighten the monetary reins again – even if this means jeopardising financial stability?

Our primary responsibility is to ensure price stability. If inflation risks were to intensify, we would have to act. Obviously, this course of action may have feedback effects on financial stability. Some governments appear to be financing themselves on an increasingly short-term basis. This means that their budget position is more closely tied to current short-term interest rates. But the fact that the fiscal policymakers have manoeuvred themselves into this dependency cannot mean that the monetary policymakers should go easier on their primary task of ensuring price stability.

So, to be clear: if the ECB has to raise interest rates to combat inflation, it will drive governments so far into deficit that the sovereign debt crisis will start up all over again.

Budgetary positions should see fundamental improvement as a result of the reforms. But if some sovereigns should find it hard to access the capital markets, then the ESM would be there as the financial assistance mechanism which was created for just this purpose. However, in principle countries need to arrange their affairs in such a way that they can deal with the single monetary policy without assistance. Competitive economic structures and sound government finances are preconditions for a stable monetary union. Monetary policy cannot create those preconditions. That would be asking too much of it. This was entirely clear when monetary union was launched.

The speed of a convoy of ships is always set by the slowest ship.

The image is not the right one. It is not a matter of everyone proceeding at the same speed, but of every vessel being seaworthy enough not to need rescuing whenever storm clouds gather – and then to call on the central bank to keep them afloat. It will always be the case in a monetary union that some economies have more dynamic growth than others.

But it seems that Germany is sailing at a rapid rate of knots whilst the other countries are lagging ever further behind.

In the current transition period the distance will widen initially because the peripheral countries are being held back by their consolidation measures. But, first of all, that will change – many have forgotten that, just a few years ago, Germany was the economic laggard. And, second, Europe is not an island. We compete with the whole world. So the solution cannot be to hold back the most competitive country. To use another image: the strongest player in the team should not have to hop around on one leg to make things seem fairer.

A lesson that we have had to learn is that monetary union is not working because the differences in competitiveness and economic strength are so great. And then the politicians come along and say: we just need to cooperate more closely, then it will work. But no one wants common taxation and economic policies let alone a joint fiscal policy.

I share your assessment that there is not much political will or public support for surrendering national sovereignty. In fact, it is often lowest in those countries that are the loudest in calling for greater shared liability. So I see no great leap towards fiscal union. But that means sticking to what we agreed when monetary union was set up: the principles enshrined in the Maastricht Treaty, according to which each member state is responsible for itself. In any case, we should steer clear of the ever greater mutualisation of risks if this does not also involve surrendering national sovereignty – because if liability and control are not in step, the basis for monetary union will be undermined.

Will the ECB become a superpower if, from 2014 onwards, it has responsibility not just for price stability but also for supervising Europe's 200 largest banks?

Let me say first of all that we at the Bundesbank regard banking union in principle as a very important and appropriate step in the process of strengthening the future institutional framework of monetary union. The purpose, amongst other things, is to put in place effective supervision and a strict regulatory framework which will loosen the current close links between the risks arising in a country's public finances and the health of its banking system. When important decisions like this are being made, careful planning should take priority over speed. In our view it is particularly important to prevent conflicts of interest between banking supervision and monetary policy. I do not regard this issue as having been satisfactorily resolved yet.

Can the planned mediation panel resolve the problem?

There are to be three bodies looking after banking supervision in future, starting with the Supervisory Board, which will operate within the ECB and prepare decisions for the ECB Governing Council. The Governing Council will only be able to simply reject or accept these decision-making proposals – it will not be able to amend them. I find this curious: if I am to bear political responsibility, I have to be able to shape the decisions. But that is not all: if the ECB Governing Council rejects a proposal from the Supervisory Board, and one country does not agree with this decision, then a third body comes into play – the mediation panel. This mediation panel then decides by simple majority. But the panel's decisions cannot be binding: under the relevant EU legislation the ECB Governing Council has to have the final say.

Sounds like a complex construct that makes little sense. Why are things being done this way?

It is an attempt, using a legal basis which is not really suitable, to erect a Chinese wall between monetary policy and supervisory tasks. But it is more like a Japanese wall or a room-divider. All this leads to is a very complex system in which the lines of responsibility are blurred. In my view, it would be preferable to amend the EU treaties with a view to putting in place robust separation between monetary policy and supervisory decision-making structures.

Isn't such a separation at the ECB just theoretical anyway? What is the use of a Chinese wall on floors five to twelve, if the monetary policymakers and bank supervisors have lunch together in the same canteen?

The exchange of opinions between specialists and the bundling of expertise are wholly desirable. That is why the Bundesbank is part of the German banking supervisory framework. The problem does not arise potentially until one body is making binding decisions for two areas of responsibility. In this respect, Germany's dual system has its advantages, in that the Bundesbank undertakes ongoing supervision while BaFin in Bonn makes sovereign decisions.

So you do not want the ECB to decide that a bank should be wound up.

This bundling of responsibilities has been decided on for the time being, we now need to minimise conflicts of interest. As an organisation which is already up and running, the ECB could act as a midwife for the supervisory set-up. But I would like the current construct, in which final responsibility lies with the ECB Governing Council, to be no more than a transitional solution. Banking supervision should be transferred to an entirely independent body to make the decisions. This is the only way that doubts about the independence of the ECB Governing Council in its monetary policy decisions can be dispelled.

The French wanted to get going with the single European supervisor at the beginning of next year. Now March 2014 has been agreed. Is that enough time to create a functioning supervisory set-up with sufficient staff?

It is certainly an ambitious timetable. The practical requirements placed on a supervisory set-up should not be underestimated, even if it will initially cover only the large, systemically important institutions. Supervisors have to be familiar with the language, the legal regimes, the corporate structures and the particular features of the national markets. And, of course, they also need to bring with them a great deal of experience in banking supervision. Therefore, supervision of the systemically important institutions, too, can only succeed if the present national supervisors are heavily involved.

What will happen if the European supervisors find that a bank requires additional capital?

Then the bank will have to obtain the capital. If it is not able to do so, it will have to be restructured or wound up. It is for such cases that we need a recovery and resolution mechanism at European level financed by the banks. Such a mechanism has to ensure that liability is borne first by the banks' shareholders, then by other creditors, then by a fund financed by the banks, and only lastly and exceptionally by taxpayers. We should create this mechanism swiftly, otherwise the banking union will be incomplete. And even then, the banking union must not act as a cover for shifting responsibility for problematic legacy assets in individual countries to the European level. The problematic assets which are currently stuck on bank balance sheets stem from unhealthy developments at national level and the mistakes of national supervisors, and should therefore be borne by the owners and creditors of the relevant banks or by taxpayers in the country concerned.

Does it make sense for the ECB to have responsibility only for banks with total assets of €30 billion and above?

It is certainly a clear criterion which enables those banks subject to single supervision to be separated out easily from the others. However, a somewhat smaller number of banks could have been covered than the 200 which are planned. After all, according to the plans, the ECB can extend its supervision to smaller institutions anyway if it deems this necessary.

The compromise is a first step towards a European banking union. Is the next step a joint deposit insurance scheme, in which German savers will be liable for Spanish banks?

No. As I mentioned, the next step is a recovery and resolution mechanism. I do not think a deposit insurance scheme is necessary. Adding a further element of liability would require considerably greater powers of intervention in member states' fiscal and economic policies.

Is it not unfair that banks have higher refinancing costs just because they come from a country with unsound government finances?

Just as fair or unfair as higher car insurance premiums if you live in a region with a large number of accidents. The reality is that we have differing government solvency risks. The fact that sovereign solvency and national economic performance are also reflected in banks' balance sheets and refinancing costs is not a dysfunction, it is plain logic. The conclusion we draw from this must not be that these risks need to be negated or spread across the whole of Europe, but that states need to be forced to stick to the rules, to ensure they have sound finances and to restore their economy's competitiveness. It is the causes of the solvency spreads that need to be tackled, not the symptoms which are reflected in banks' balance sheets.

Other countries will soon be joining the euro, then the national representatives will start rotating on the ECB Governing Council. At some point, Germany will not be at the table when decisions are made.

I regard such an alarmist scenario as exaggerated. In any case, rather than adjusting the voting mechanism, it would be better for the Eurosystem to confine itself once again to its proper and primary task: managing monetary policy with the aim of ensuring price stability. The redistribution of risks is a task for fiscal policymakers, who have the necessary democratic legitimacy and are answerable to parliament and, ultimately, to the voters.

That is straight out of the central banking text book. But in reality, risks will be redistributed and our representative will be outside the room.

What matters is taking part in the meetings where decisions are made – all members of the ECB Governing Council are always present and entitled to contribute to the discussion. And the concerns that many people express – the implications of central bank measures for us as taxpayers and for price stability – cannot be allayed by changing the voting mechanism.

You have often been a lone voice anyway in many of the decisions made by the ECB Governing Council. Why have you not been able to make your views prevail in the past?

In such a fundamental debate about the role of monetary policy, a number of factors play a role, one of which is doubtless the national traditions and history that shape each and every one of us. But nor can one always escape the influence of the economic situation in one's own country. It makes a difference whether 50 per cent of young people are out of work back home or whether there is almost full employment. However, I do not have the feeling that my arguments are not coming across in the discussions. Many of my concerns are shared by colleagues on the Governing Council.

You are the only one voting against!

That is far from being true of all decisions. However, when it comes to measures which might be seen as monetary financing of governments, I believe it is particularly important to take a principled stand. But even then the majority on the Governing Council factors into its decisions concerns which I have put forward.

And if you want to mop up the flood of money, the others say: we would rather have five per cent inflation than five per cent unemployment?

You seem to be suggesting that my colleagues are not sticking to our mandate. We all feel duty-bound to price stability. And according to our most recent projections, the inflation rate is likely to fall back to below 2 per cent in the next two years. To ensure continuing price stability thereafter, we will have to tighten up the ultra-loose monetary policy in good time. But no one can say at the moment when that will be.

What steps have you taken off duty to protect your family from inflation? Have you bought some gold?

No, I have not bought any gold. Besides, my investment options are deliberately restricted so as not to give the slightest appearance of any conflict of interests.

That sounds reassuring. But the Bundesbank is often accused of sowing disquiet with its alarmism.

Such an accusation is baseless. Our positions are well argued, the German public is well informed, and it appreciates the Bundesbank's clear stance. In such an exceptional situation in which the ECB Governing Council is acting at the outer edge of its mandate, there is bound to be a plurality of views – we are not a politburo.

Politicians grumble about you all the same.

A politician once said to me that the two camps on the ECB Governing Council are like mountain guides. And when they argue, they cause anxiety and disquiet in the whole climbing party. I answered that I find it strange that politicians, who should be leading the way and making the decisions, wish to file in behind us and be guided by us. And if they do want to do that, then it is probably better for the mountain guides to discuss their route through uncharted territory rather than deciding resolutely on a particular path which might lead to them into the abyss.