Jens Weidmann: Pressing ahead – priorities for 2013

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Deutsche Börse Annual Reception, Eschborn, 21 January 2013.

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1. Introduction

Dear Mr Faber,
Dear Mr Francioni,
ladies and gentlemen,

I am delighted to be invited to speak to you once again at Deutsche Börse's Annual Reception.

First of all, I have some good news to impart: the end of the world, announced for the latter part of December, proved not to be. Which is further demonstration of just how difficult long-term forecasting is.

But now another disaster looms: a year with the number 13 in it. Whilst the number 12 is associated with harmony and completeness, 13 has a harder time of it.

For many, the number spells disharmony and is a harbinger of misfortune. Many aeroplanes have no 13th row, and floor 13 is frequently missed out in high-rise buildings in the United States. However, it may interest you to know that the Deutsche Bundesbank's Executive Board meetings are held on the 13th floor. Superstition about numbers appears to have passed us by.

And that is just as it should be, because central bankers do well to maintain a rational relationship with numbers. Figures, data, statistics, balance sheets and the like are our daily bread.

That applies to central bankers just as it does to stock exchange traders and other financial market experts. What we also have in common is that we are interested both in the figures that describe past economic events and in those which enable us to glimpse into the future. Although forecasts and expectations are by their very nature uncertain, they nonetheless provide a basis for important decisions

"Not only do expectations about policy matter, but (...) very little else matters."

These words about monetary policy from macroeconomist Michael Woodford point up the importance of expectations in the economy.

And ultimately these expectations come to be traded on the stock exchange. Deutsche Börse's Annual Reception is therefore a perfect occasion to review the past year and then to take a look at expectations for the new year.

Let me begin with our host: for Deutsche Börse AG, 2012 was an eventful and not entirely harmonious year. With the plans to merge with NYSE Euronext having come to nothing, Deutsche Börse now needs to focus on growing organically. But I believe that the conditions are favourable for achieving growth under your own steam, and that Deutsche Börse is well positioned in the marketplace.

Deutsche Börse is of central importance to Germany as a financial location. A highly developed economy like Germany's, with its innovative and internationally successful companies, needs a broad range of top-quality financial services if it is to continue to achieve sustained growth. Deutsche Börse makes a decisive contribution to ensuring this is the case.

The German financial system has also been spared excessive behaviour of a home-made nature. This is a very good environment for a major financial location – and for Deutsche Börse.

It must be added, of course, that the financial crisis has laid bare weaknesses in the financial system and in regulation which need to be rectified, and which are currently in the process of being rectified.

The purpose of the reforms is not to strangle the financial system but to render it more stable. To achieve this, the risks in the system have to be made more transparent, and these risks need to be borne by those that entered into them.

These are key prerequisites for ensuring that excessive risks are not taken on board and that the financial system can properly fulfil its essential economic functions.

The stock exchanges, as organised trading venues, have a central role to play in these reform efforts. They ensure transparency, efficiency, reliability and market liquidity.

The way in which modern regulatory standards have been swiftly implemented, making stock market trading even more robust and stable, provides Germany with a key advantage as a financial location. Deutsche Börse has established a very sound position for itself in this respect, including in relation to the hot topic of high-frequency trading. It is able to offer a trading infrastructure which is modern and reliable – think of circuit breakers – and it already meets most of the forthcoming requirements.

2. 2012 – review of an eventful year

Deutsche Börse were not the only people for whom 2012 was an eventful year. The debt and financial crisis continued to prevail. Allow me to cast a roving spotlight over some of the key events and decisions in the crisis, just to remind you.

- Potentially unlimited bond buying was announced, a monetary policy move which surprised the financial markets and has so far brought greater calm to these markets.
- Banking union was decided on in principle, with a single supervisory mechanism at the ECB.
- Collective action clauses will be attached to all government bonds issued in the euro area from the beginning of this year.
- Three-year tenders led to an unparalleled expansion in central bank liquidity.
- The ESM was established as a permanent provider of assistance.
- The fiscal compact, aimed at strengthening budgetary discipline in the monetary union, was ratified in 2012.
- Greece, where the sovereign debt crisis began, received a second rescue package in February, which had to be untied and modified in the autumn.

Mention should also be made of the island state of Cyprus: it requested financial assistance shortly after Spain did, and is currently still negotiating the details.

Thus, 2012 was indeed a highly eventful year. Some now believe the depths of the crisis are behind us. Whatever the case, we still have a long way to go: many of the measures I have just mentioned will not rectify the causes of the crisis. The measures are aimed at dealing with the symptoms, and may create new problems of their own.

So let us now look forward, to 2013. What should we expect, what it is reasonable to anticipate, what should we seek to achieve?

3. Economic situation and outlook

Germany's economy has made a weak start to the new year. Gross domestic product (GDP) appears to have contracted appreciably in the final quarter of 2012, and the economy is likely to be listless in the current quarter too. This is attributable not least to the crisis in the euro area and the uncertainty it is generating.

Nevertheless, there is a realistic prospect that this phase of weaker momentum will not persist for all that long and that it represents no more than a blip. As a result of the sluggishness experienced in the last quarter of 2012 and the first quarter of 2013, our projection puts average GDP growth for the year at "just" 0.4%.

However, this paints somewhat too gloomy a picture of the economy, which is likely to pick up appreciably as the year progresses, achieving a year-on-year rate – ie the difference between the final quarters of 2012 and 2013 – of 1.1%.

Overall, then, one might say that, although the economic outlook is modest, it is in no way a poor one, despite the prevailing uncertainty. The German economy remains in good shape.

4. Economic policy challenges in the new year

In order to be able to say the same thing for the euro area as a whole, we need to make decisive progress in tackling the financial and sovereign debt crisis in 2013.

The financial crisis has been upon us for more than five years now, and the sovereign debt crisis for three years. Many people are weary of the crisis and would rather not hear about it. This crisis fatigue narrows people's focus so that they are concerned only with smoothing the waters in the short term. But we all know from our own experience that problems have a habit of not going away until the root causes are dealt with.

Of course, a lot has already been achieved, and I would not wish to downplay these achievements. Significant progress has been made, for instance, in regulatory reform at an international level – think Basel III.

Global current account imbalances have shrunk noticeably since their high point in 2007.

And there has also been some improvement in the crisis-hit countries of the euro area: current account and budget deficits have fallen, competitiveness has improved, and work has been done on important structural reforms.

I have already mentioned some of the progress achieved in the euro-area framework, such as the fiscal compact and the agreement on banking union.

However, these advances represent milestones en route, rather than the final destination. There remains plenty to do, in all the areas I have just mentioned.

4.1 Regulation

On the question of regulation, I would like to highlight three areas as examples of where we now need to move forward. First, the new Basel III capital requirements. These should now be transposed into national law worldwide, including in the United States.

Second, in Germany as elsewhere, we need to make further improvements to the arrangements for shielding deposit-taking credit institutions from the risks of speculative proprietary trading and high-risk lending.

This involves more than just tighter capital rules. A requirement to establish trading units which are legally, organisationally and economically independent can help protect deposit-takers, while at the same time allowing the advantages of Germany's universal banking system to be retained. Indeed, there is no call to forfeit these advantages, since banking systems with fully segregated functions did not prove to be in any way superior in the financial crisis.

Care must then be taken in defining the lines of business which need to be set apart. Customer-driven business and hedging transactions should not be included, and de minimis limits will ensure that small deposit-takers can also undertake proprietary trading and derivatives transactions to an appropriate extent.

A third area where progress needs to be made on the regulatory front is high-frequency trading. The Bundesbank expressly welcomes the objectives of the relevant draft legislation. Computer-based high-frequency trading can enhance the efficiency of financial markets, for example by increasing market liquidity. Equally, though, high-frequency trading is susceptible to error and brings certain dangers with it.

The plans to improve transparency through expanded information requirements are therefore appropriate. The installation of a "kill switch" would be advisable, to enable erroneous or market-damaging algorithms to be deactivated.

And it is to be hoped that Germany's proposed legislation will serve to speed up the work at EU level on revising the Markets in Financial Instruments Directive.

4.2 Budget consolidation and structural reforms

Among the economic policy tasks for 2013, I include pressing ahead with structural reforms and budget consolidation. These are challenges not just in the euro area.

You were no doubt also relieved that US policymakers were able to thrash out a deal between New Year's Eve and New Year's Day to prevent, initially, the US economy from falling off the edge of the fiscal cliff.

Nevertheless, that compromise still falls short of a long-term solution to the existing fiscal problems. The necessary raising of the US debt level and the spending cuts that have only been deferred could very soon lead to the next face-off. What is required here is acting more resolutely in the general interest, as the Europeans are regularly called on to do.

Instead of that, thoughts and minds were focused on the suggestion – which some even meant seriously – that the US government should simply exploit a legal loophole and mint a platinum coin with a face value of one trillion US dollars and then pay this in at the Federal Reserve in order to acquire the money needed to cover current expenditure.

The apparent aim of this proposal was to lever out the debt ceiling, but ultimately it amounts to solving debt problems by means of money creation.

It now seems that this suggestion is no longer up for discussion, but I am still amazed to see onto what strange paths and byways unbridled pragmatism can lead when applied to crisis management.

In the final analysis, there is no smooth, straightforward and quick way out, either in the United States or in Europe. The processes of adjustment in putting public finances and economic structures in order again are not going to take a matter of months or a few years.

The losses of competitiveness in the countries in crisis, for example, were also built up over a decade. A great deal of perseverance will be required to make good those losses.

Debt reduction by governments, enterprises and households will also be an arduous process. In the case of sovereign debt, that process has not yet even really begun as only less new debt is being taken up initially.

It is obvious that, in many countries, pre-crisis growth rates will not be matched any time soon.

4.3 Framework of monetary union and banking union

Nor has the journey's end been reached with regard to a new, consistent framework for European monetary union. Moreover, so far there is still no consensus on what the final destination should be. To put a positive spin on it, there are a number of a diverse spirited opinions on the subject. A somewhat less positive take would be that national interests are plain to see, while the goal of a stable and functioning monetary union is sometimes lost from view.

The future architecture of monetary union therefore remains unclear. Progress is nevertheless being made in one specific but important area – the financial market architecture with the project of a European banking union.

Properly designed, the banking union will strengthen financial stability in the euro area. It will then close up an unguarded flank of monetary union, thus helping to safeguard it as a union of stability. For that reason, the Bundesbank emphatically supports this project.

The creation of a banking union is a case of major institutional work in progress and is, in essence, a matter of much the same complexity as setting up a monetary union. And even if it will certainly take less than the whole decade needed for EMU, it is a project that must not be rushed. It is too important for that. Nor should it create any new conflicts of interest which divert monetary policy from its primary objective of safeguarding price stability.

Nevertheless, the easing in the financial markets must not dampen the zeal for reform in this area. Our guiding principle should be to act "as quickly as due caution allows".

A banking union entails not only a joint supervisory mechanism operating in accordance with the strictest uniform rules and standards possible. A resolution and restructuring mechanism, too, has to be an integral part of a banking union. A few days ago, Commission President Barroso rightly described this intention as a matter of the highest priority.

Such a mechanism should ensure that, in the event of a bank encountering difficulties, it is, first and foremost, the owners and creditors who are liable for their investment decisions, followed by a fund supported by the banks, and only then – in exceptional cases – the taxpayer, with mutualised liability being possible only in the case of jointly supervised institutions.

The banking union additionally requires regulatory underpinning. Besides a generally better backing of risk positions with capital, as had already been decided in the case of Basel III, the risk arising from claims on the government also has to be backed with capital, at least in the medium term. This is the only effective way to break the vicious circle of tottering banks and teetering governments instead of merely shifting it to the European level by mutualising liability.

We must not forget that the banking union is a project that is geared to the future. It cannot solve the current crisis and is not intended to clear up its legacy burdens. Rather, its purpose is, above all, to make the European financial system and thus the monetary union permanently more resilient to new adverse developments and crises.

If this succeeds, the banking union will protect the single monetary policy, the member states and their taxpayers alike.

5. Central bank independence at risk

Transferring responsibility for banking supervision to the ECB nevertheless fits in well with an impression that is becoming increasingly difficult to shake off outside the euro area as well. Central banks are having more and more responsibility thrust on them, even for tasks which lie outside their core mandate.

My colleague James Bullard of the St. Louis Fed (at the Annual Meeting of the American Economic Association) recently bemoaned the fact that a creeping politicisation of central banks has been taking place worldwide in the wake of the financial crisis. One medium-term implication of this development might also be that price stability, as the main objective of monetary policy, is increasingly called into question with independent central banks going out of fashion.

Stephen King, chief economist at HSBC, is perhaps right in predicting that "The era of independent central banks is coming to an end."

Even now, some worrying encroachments can be observed, say, in Hungary or in Japan, where the new government is involving itself massively in the affairs of the central bank, making forceful calls for an (even more) aggressive monetary policy and threatening an end to central bank autonomy.

One consequence, whether intentional or not, might also be an increasing politicisation of the exchange rate. So far, the international monetary system has come through the crisis without competitive devaluations and I hope very much that things stay like that.

Now, in Japan of all places there may be more obvious problems than inflation and a weak currency. It is not without good reason, however, that central banks have been given independence and a narrow mandate. This was a lesson of the 1970s and early 1980s – a time when many countries had high inflation rates, sometimes in double digits.

In the United States, this era is called the "great inflation", which was followed in the mid-1980s by the "great moderation", a period of moderate inflation rates and dampened economic cycles. And, then, along with the "great financial crisis" came the "great recession".

"Great" is a famously popular, not to say overused adjective on the other side of the Atlantic. The experience of the great inflation was, in any event, that independent central banks with a narrow, credible mandate enjoyed greater success in combating inflation.

As a result, many central banks worldwide were given independence in the 1980s and 1990s. When the Bank of England was granted independence in 1997, Gordon Brown, then Chancellor of the Exchequer, said "The previous arrangements for monetary policy were too short-termist, encouraging short but unsustainable booms and higher inflation, followed inevitably by recession."

The depoliticisation of money and central banks' stability orientation undoubtedly made a key contribution to the great moderation.

The decline in inflation during this period was, admittedly, also assisted by other developments, such as globalisation. To that extent, the great moderation can be seen as halcyon days for monetary policy.

Since the outbreak of the crisis, the environment has become noticeably less favourable for central bankers. The growing demand for energy and raw materials on the part of the up-and-coming economies has tended to make the inflation-dampening impact of globalisation flip over into rising pressure on prices.

In the wake of the financial, economic and sovereign debt crisis, central banks are being urged to take measures to support the financial system, stimulate economic activity, reduce government funding costs and even safeguard government solvency.

Overburdening central banks with tasks and expectations, however, is certainly not the right way to achieve a lasting solution to the crisis. The central banks, in turn, will best protect their independence by adopting a narrow interpretation of their mandate.

In summary, it can be said that "Today most central banks are independent, headed by non-elected officials, and quite powerful. This set-up is acceptable only if independence is limited by the mandate. That's the framework the legislators have given us […]. That is why we are so keen about respecting the mandate, because that's the true guarantee of our independence, which […] is crucial for our credibility. And credibility is essential for delivering price stability."

Those words are not mine, by the way, but come from a recent interview with Mario Draghi, who put the point most succinctly.

6. What matters now

The key to resolving the crisis therefore does not lie with the central banks.

Rather, permanently overcoming the crisis will now be a matter of rapidly implementing the regulatory reforms that have already been agreed in principle – above all Basel III – and governments implementing budget consolidation and the necessary structural reforms in a controlled, creative but consistent manner – and not just in Europe. Similarly, it will be important to put in place a coherent framework for the monetary union – a framework in which, despite the communitisation of risks, liability and control are not thrown out of kilter – with everything based on the Maastricht principles as long as there are no majorities for a genuine fiscal union. In this connection, too, the banking union should be designed in such a way that it really does become a primary pillar of a stability union.

This year will probably not mark the end of the crisis. As I have already said, the processes of adjustment will take time. But decisive steps can be taken in 2013 to overcome the crisis on a lasting basis.

Of course, I said the same thing at the last annual opening with regard to 2012. Still, that is not my own personal mantra, but rather a reminder that there is no more time to spare. Those steps being now taken, however, would be good news for us all, not least for Frankfurt as a financial centre and for Deutsche Börse.

For all of us, I want to see these steps being implemented and, with that in mind, I wish you all the best in the new year.