Jens Weidmann: The stability of the financial system within European monetary union

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the conference of the Bavarian Association of Cooperatives (Genossenschaftsverband Bayern), Munich, 11 July 2013.

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1. Introduction

Ladies and Gentlemen

Thank you very much for inviting me to this conference. I'm delighted to have the opportunity to speak to you here today.

First of all I would like to congratulate the Bavarian Association of Cooperatives on the 120th anniversary of its creation. Of course, the association encompasses many more types of business than the financial institutions which are the focus of my attention as a central banker and bank supervisor.

But I'm afraid a speech on the finer details of cooperatives would simply be too much for me. And, after all, the Bundesbank itself often warns against asking too much of central banks. So today I would like to focus on banks, the crisis and the role of monetary policy.

I would like to start by talking about the Austrian economist Joseph Schumpeter. He had three goals in life: to be the greatest economist in the world, the greatest horseman in Austria and the greatest lover in Vienna. He claimed to have achieved two of these aims, although he never specified which.

I wouldn't wish to speculate about Schumpeter's abilities as a horseman or a lover. But he certainly was an outstanding economist.

2. Banks, real economy and the no bail-out principle

And as an economist, Joseph Schumpeter had clear ideas about the role of banks. He viewed them mainly as partners and supporters of enterprises in the real economy.

I believe that cooperative banks also see themselves in that role. That and cooperative banks' regional ties were two factors which had a stabilising effect during the crisis – even though the cooperative sector was not entirely spared the repercussions of the financial crisis.

However, the public image of quite a few other banks has suffered significantly as a result of the crisis. Many people now doubt whether banks really do see themselves as partners and supporters of businesses.

Indeed, the public feel that the crisis was caused by ruthless bankers and out-of-control financial markets – who left the real economy and taxpayers to deal with the fallout. Recent revelations of deplorable conversations among certain Irish bankers have only made matters worse.

This impression is not entirely false, but neither is it entirely correct. It's true that financial markets tend towards excess, and that all too many financial market players neglected risk management. It's also true that the financial markets had moved away from their role as service providers to the real economy.

Yet blaming the crisis entirely on ruthless bankers and out-of-control financial markets would be simplistic. Bank balance sheets always partly reflect developments in the real economy. And they also reflect public finances.

I don't mean to talk down the excesses on the financial markets. But we must also look for the origins of the crisis in the real economy, and in economic and fiscal policy.

Of course, that doesn't make it any easier to solve the crisis. On the contrary: it only makes the tangled web of causes even denser and harder to unpick.

What helps is to identify a simple principle that can guide us in our search for answers. And that is precisely what I intend to do now.

The concept I'm referring to is the no bail-out principle. This means, essentially, that everyone should face the consequences of their own actions. Or, in other words, that those who are ultimately liable should also have the power to make decisions.

I'm sure that everyone here is familiar with this concept: many entrepreneurs stake their personal wealth on their business decisions. And, although cooperative banks also share liability through an institutional guarantee scheme, this "all for one" liability is balanced out by strict controls.

3. No bail-out principle, banks and public budgets

In the euro area, there hasn't always been a healthy balance between liability and control. The no bail-out principle was dangerously eroded for two major groups: governments and banks.

The losses of many banks were ultimately borne by the taxpayers of the countries in which they were based. And the taxpayers of some euro-area countries ultimately financed the budgets of others.

This is because these banks and governments were considered to be systemically important – it was feared that their financial difficulties could threaten the stability of the financial system. So it wasn't the decisionmakers – those in control – who were ultimately liable. And this undermines the incentives for responsible behaviour.

The Maastricht framework – the rulebook for European monetary union – is therefore founded on the no bail-out principle: no euro-area country should be liable for the debts of another. However, this principle lost its binding effect when the crisis began – if not before.

To strengthen the foundations of Europe's monetary union, we need to reinforce the no bail-out principle – for both governments and banks.

With this in mind, I would now like to discuss some specific reforms. It is important to look at both banks and governments at the same time, as there are close links between them.

And these links were a major problem during the crisis. So let's take a step back and consider where exactly the problem lies.

If many banks run into financial difficulties at the same time, that can threaten the stability of the entire financial system. Governments then often have no option but to bail out these banks to prevent the system from collapsing.

This doesn't just generate the wrong incentives, as I mentioned earlier. Above all, it costs a lot of money. Look at Ireland, for example: rescuing its banks raised the country's 2010 budget deficit to more than 30% of GDP.

By the same token, if government finances go awry, that causes problems for banks – firstly, because many banks have large government bond holdings and, secondly, because the general economic situation initially worsens when a government has to make savings.

Ladies and gentlemen, to safeguard financial stability in the euro area and prevent future crises, we have to loosen the ties between governments and banks as much as possible. And in doing this, we must ensure that the no bail-out principle applies universally again.

There are several possible points of departure for achieving this. We can make banks more resilient, make government finances more sustainable, and ensure that governments are shielded as far as possible from the effects of banks' problems – and vice versa. Some of the current reforms to the institutional framework are based on these three approaches.

Basel III, with its new capital and liquidity rules, will make sure that banks are better able to bear losses and that bank owners take on more liability. This will make banks less likely to experience financial difficulties and need government bail-outs.

The plans for a European banking union are in a similar vein. The first pillar of this union will be the single supervisory mechanism, which is also tasked with preventing bank difficulties at an early stage.

Yet neither Basel III nor the single supervisory mechanism will allow us to prevent all financial distress among banks. Nor would we want to do so. Indeed, the possibility of failure is vital for a functioning market economy. Joseph Schumpeter defined this concept as "creative destruction".

So it is important to be able to allow banks to fail without governments – and thus also taxpayers – having to foot the bill.

There are also plans to introduce a single resolution mechanism – the second pillar of the banking union – to ensure that the owners and creditors of a bank needing restructuring or resolution take a sufficient share of its losses.

This has to entail a clear sequence of liability: first the owners, then subordinated creditors, then depositors with balances above the threshold for the deposit guarantee scheme. If that is still insufficient to solve the problem, troubled financial institutions should then have access to a resolution fund financed by banks.

When a bank runs into difficulties, taxpayers should be the last port of call rather than the first. This sequence of liability is compatible with the no bail-out principle and strengthens market discipline for banks.

Two weeks ago, the EU finance ministers agreed on a liability framework of this kind. Plans have quite rightly been made to introduce legislation ensuring that a bank's shareholders and creditors are first in line to bear any losses.

However, I believe that there are still some weaknesses in this framework. It allows substantial scope for discretionary exemptions from such bail-ins.

The upcoming negotiations between the European Council and the European Parliament will provide an opportunity to correct such weaknesses. In my view, it is also important to implement the bail-in regulations ahead of the current schedule, by 2015.

There are thus two specific approaches applicable to the banking sector: Basel III and the single supervisory mechanism will make banks less likely to experience financial distress. If they do, the resolution mechanism and its clear regulations on the sequence of liability will help to ensure that taxpayers will not have to foot the bill again.

We can apply the same logic to public finances. There too, the first step is to ensure that governments no longer run into serious financial problems so easily. The new fiscal rules, for instance, will help to achieve this – provided that they are applied strictly in practice.

The no bail-out principle also needs to be reinforced for public finances. The potential for contagion among euro-area countries was underestimated in the run-up to European monetary union. However, if one country's public finance problems threaten financial stability throughout the euro area, limited assistance is justifiable – subject to strict conditionality. We have set up the ESM to perform this task.

Yet our goal must be for each country to rapidly regain responsibility for its own public finances. The government, parliament and electorate of each euro-area country must be responsible for ensuring that their economy is competitive and performs well, that the country generates growth and employment under its own steam, that its government finances are sustainable in the long term, and that excessive public deficits and debt are eliminated so that the country can absorb cyclical shocks without external assistance.

Far-reaching reforms are needed to achieve this level of stability. All this is challenging, but shouldn't it really be a matter of course? After all, these are the prerequisites for a stable monetary union.

To achieve these aims, to set the right incentives for sound policymaking, we need to lend more weight to the no bail-out principle again.

The collective action clauses on recently issued government bonds are a step in the right direction, enabling a bail-in of bond creditors in the event of serious solvency problems. Only then will the market have a disciplining effect on government budgets.

But as the crisis has shown, the success of this approach of national responsibility hinges on one condition: ensuring that public finance problems do not derail the whole financial system.

Two things can at least help to ensure that this condition is fulfilled: in the medium term, banks should be obliged to set aside sufficient capital to back government bonds, and they should also be subject to limits on large exposures to governments. Such limits have been applied as standard to corporate loans for a long time now.

This would make banks more resilient to public finance problems, encouraging them to adjust their demand for government bonds more closely to the level of risk involved.

Any government with an unsound fiscal policy would face rising interest rates on its bonds. Kenneth Rogoff, former chief economist at the IMF, even views adequate capital backing for government bonds as a far more effective debt brake than the rules of the fiscal compact.

Incidentally, putting an end to preferential treatment of government debt over corporate loans would also make lending to enterprises more attractive again. And you could all benefit from that, even though there are currently no signs of constraints on lending to enterprises in Germany. Quite the opposite: credit standards for corporate loans were actually loosened slightly in the first quarter of 2013.

However, bank balance sheets don't just reflect government finances but also developments in the real economy. The reforms I've described will therefore also make the banking system more stable. The road ahead is challenging, and decisionmakers will need enough resolve to face down opposition to such reforms and get them implemented.

4. How can monetary policy help?

Yet this must not entice politicians to go for what some view as the "easy way out". As you've probably already realised, I'm talking about the role of monetary policy.

The ECB Governing Council agrees unanimously that monetary policy cannot solve the crisis. At best, it can buy time – but that is not its job.

Monetary policy has already helped substantially in preventing an escalation of the crisis. However, this has taken it a long way into uncharted – and dangerous – territory.

It's no secret that I am critical of the ECB's government bond purchase programmes in particular. If Eurosystem central banks buy government bonds issued by countries with poor credit ratings, this will distribute the risks of unsound fiscal policy among all the euro-area states. This weakens the no bail-out principle and entails redistribution, which is really the prerogative of fiscal policymakers.

Alongside the government bond purchase programmes, the sustained period of low interest rates is also controversial. Incidentally, that is true of many countries outside the euro area, too.

Many savers find the low interest rates and negative real interest rates unfair. Some enterprises, prospective homeowners and governments, on the other hand, probably see them as a blessing. They help them to service their debt and to fund investments cheaply, thus boosting economic activity.

Given the subdued medium-term inflation outlook, which is due to the weak macroeconomic backdrop and muted credit growth, the low interest rates are justified from a monetary policy perspective.

Yet low interest rates are not without their side-effects. While they are currently justified from a monetary policy perspective, we must not blind ourselves to reality: they tempt decisionmakers to delay reforms and necessary structural changes. Risks to financial stability may build up, and these side-effects will increase the longer the phase of low interest rates continues.

All this means that the interest rate environment also poses a challenge for cooperative banks; a sustained period of low interest rates squeezes profit margins and means cost structures have to be adjusted.

Given the subdued medium-term outlook for inflation, the ECB Governing Council stated last week that it expected the key ECB interest rates to remain “at present or lower levels for an extended period of time”.

This does not constitute a change of strategy; it is an attempt to explain our monetary policy stance even more simply and clearly – so that it is understood; if possible, by all market participants. It outlines our likely monetary policy response based on current data and the Eurosystem’s two-pillar approach to analysing risks to price stability.

It is not a historical sea change in monetary policy communication; it is intended to provide more monetary policy guidance in times of heightened uncertainty.

However, it is important to remember that this guidance is conditional on economic developments. It does not lay out an unconditional, fixed path for key interest rates. The ECB Governing Council has not simply tied itself to a mast like a modern-day Ulysses.

This forward guidance should not, therefore, rule out a timely rise in key interest rates if there are signs of increasing price pressures in the future.

5. Conclusion

Ladies and Gentlemen, aside from the acute crisis measures it is vital that we create a more stable monetary union. This won’t be easy to achieve.

The current crisis has many different causes and combating it in the short term has taken a huge toll on the framework of Europe’s monetary union. Many different remedies will therefore be needed to find a lasting cure for this crisis.

I have discussed some of these remedies in detail here today; others I have only mentioned in passing. What many of them should have in common, however, is the aim of strengthening the no bail-out principle.

This applies to banking and financial market regulation, the creation of a European banking union and the treatment of government debt in a monetary union.

These are no easy tasks, and they sometimes involve a difficult balancing act – including for myself. But I promise that I will campaign forcefully and persistently to ensure that this promise is kept: that our currency, the euro, remains stable.

Thank you very much.