Jens Weidmann: The euro area caught between individual responsibility and joint liability – might Switzerland point the way?

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Swiss-German Chamber of Commerce, Basel, 11 November 2013.

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1. Introduction

Ladies and gentlemen, thank you very much for your invitation. I am delighted to have the opportunity to speak to you today.

The title "birthplace of the euro" has not been officially given, but in the public perception there is probably one clear favourite. If an opinion poll were held, the Dutch city of Maastricht would surely have the best chance of taking the title. After all, the treaty was signed in Maastricht in 1992 and has since been the foundation underpinning European Monetary Union.

Yet the Maastricht Treaty was the result of long and intensive negotiations which, in turn, were largely based on the report presented by a group of high-level experts under Jacques Delors, then President of the European Commission. Between June 1988 and April 1989, the Delors Committee, as it was called, met here in Basel – on neutral ground, as it were. Thus, Basel would also have some justification in calling itself the "birthplace of the euro".

Up until then, the birth of the euro was the pinnacle of the process towards European unity, a process which many did not imagine possible following the devastations of the Second World War. Yet the inconceivable became conceivable as a result, amongst other things, of a speech which Konrad Adenauer later described in his memoirs as giving "decisive impetus" to European unity. That celebrated "speech to the academic youth" was delivered by Winston Churchill at the University of Zurich in September 1946.

After reminding his audience in vivid terms of the horrors of the Second World War, he painted a vision of a united Europe: "Yet all the while there is a remedy which, if it were generally and spontaneously adopted by the great majority of people in many lands, would as if by a miracle transform the whole scene, and would in a few years make all Europe, or the greater part of it, as free and as happy as Switzerland is today. What is this sovereign remedy? It is to recreate the European Family, or as much of it as we can, and to provide it with a structure under which it can dwell in peace, in safety and in freedom. We must build a kind of United States of Europe."

True, Switzerland is not a member of the European Union, but on a number of occasions it has proved itself to be the midwife to European ideas – and when we compare Switzerland with the euro area it soon becomes obvious that it can continue to play this part.

The debt crisis has laid bare cracks in the architecture of monetary union. The founders of the single currency area were only too aware thatexcessively high public or private debt levels or a lack of competitiveness on the part of individual countries could jeopardise the stability of monetary union as a whole. But as we discovered the hard way, the precautions that had been taken to ward off these dangers were insufficient.

By contrast, Switzerland shows itself to be remarkably stable – even though the Swiss fiscal policy structures in particular resemble those in the euro area in many respects. This is the case, for instance, with regard to the high degree of autonomy the Swiss cantons enjoy in defining their fiscal policy.

That is why I want to talk today about what the euro area can learn from Switzerland. My speech is composed of two parts. In the first part I will look at the institutional framework of European Monetary Union and examine what caused the euro area to flounder. In the second part, based on my comparison with Switzerland, I will make some suggestions as to how European Monetary Union might be strengthened. So let me begin with the architecture of monetary union.

2. The flaws in European Monetary Union

The introduction of the euro was, at that point, the most significant step towards economic integration in the history of the European Union. Given its vast implications, it was a leap rather than a step. The remarkable thing about this jump is its asymmetry. In ski jumping one would speak of a Telemark landing, for whereas monetary policy was communitised, fiscal policy remained a matter of national responsibility.

This is not necessarily a bad thing in itself – after all, the Telemark landing has become an established standard in ski jumping. But to be sure of a safe landing and to maintain control after landing, certain points have to be heeded.

And so it is with monetary union. The combination of a single monetary policy and decentralised fiscal policy can further compound the tendency of governments to finance their spending through debt, thereby undermining the stability of monetary union.

If all the other countries were to leave their fiscal policy unchanged, the additional debts of one country would have the effect of increasing the overall demand for loans, and with it the level of capital market interest rates in the euro area, only slightly. Nevertheless, the increase would affect all the countries because part of the cost of debt would be passed on to others, producing a greater incentive to take on more debt.

To keep monetary union on track in spite of these dangers, the founders of European Monetary Union drew up the fiscal rules enshrined in the Stability and Growth Pact, which cap deficits at 3% and total debt at 60% of GDP.

However, these rules had only a limited effect. If one country breached the rules, it was down to the finance ministers of the other euro-area countries to decide on possible sanctions. Game theory leaves us in little doubt as to the outcome of such an arrangement. Or to be more blunt, we might use the words of Otmar Issing,former chief economist of the ECB, who described the situation as one in which potential sinners pass judgement on actual sinners.

The Stability and Growth Pact was not the only safeguard against excessive government debt, however. National responsibility also means that member states be held responsible for the consequences of their own decisions. That is why the Maastricht Treaty explicitly rules out the assumption of debt by the European Unionor by other member states. This liability principle was intended to have a disciplining effect in that member states running unsound fiscal policies or dubious economic policies would only be able to borrow at worse terms, since investors would demand compensation for the risk they were taking.

However, the disciplining by the markets which, it was hoped, would result from the no bail-out clause failed to materialise. For many years, Greece was highly indebted, but paid little more for its debt than Germany or France. Why that should be is quite easy to explain. And this is where Basel again enters the scene to play an important role.

At around the same time as the Delors Committee, another committee was meeting in Basel – the Basel Committee on Banking Supervision – and made what proved to be a momentous decision for the euro area. The new common set of international capital rules stipulated that government bonds issued by developed countries in their own currency be valued as risk-free assets. This meant that banks did not have to back them with capital.

The European Union, too, translated these rules into European law, despite the no bail-out clause anchored in the Maastricht Treaty. That, of course, robbed the no bail-out rule of some of its credibility. After all, classifying government bonds as risk-free and therefore default-proof is at odds with the no bail-out rule. And if banks do not build up any kind of buffers against sovereign exposures, sovereign default will pose a direct threat to their solvency: a financial crisis cannot then be ruled out.

That is why the principle of individual national responsibility has so far only been applied to a limited extent. Nor did the measures that were taken to combat the crisis exactly bolster this principle. It was in response to the risk of contagion which emerged when the crisis broke out – and which was probably underestimated when monetary union was created – that the rescue packages were set up.

Although they have helped stabilise the euro area, the balance between liability and control has been thrown even more out of kilter because of them. While fiscal policy decisions are ultimately still made at the national level, joint liability has been considerably expanded. Rather than the Telemark landing, this increasingly invites comparisons with performing the splits – which does not make a safe landing any more likely.

3. Might Switzerland point the way?

Ladies and gentlemen, so what can the euro area learn from Switzerland about restoring the balance between control and liability? Before I look into this question, it is worth remembering that for all the structural similarities between these two currency areas, Switzerland and the euro area differ considerably in a number of respects, one of which is fiscal policy.

A key component of Swiss fiscal policy – albeit one which cannot be readily transposed to the euro area – is the principle of direct democracy which gives the general public a say in fiscal decisions, especially at the cantonal and local government level.

Studies[1] suggest that cantonal referendums tend to curb spending. This effect is hard-wired into their very design – referendums can only be used to reduce spending, not increase it. In some cantons, they are mandatory for projects costing more than a certain threshold; in others, they are optional.

Yet one thing remains consistent throughout. The taxpayer, who ultimately foots the bill, has a direct say in how much money is spent. In my view, this way of striking a balance between control and liability is not a model which can be transposed to the euro area. But its general thrust does point the way.

Referendums are not the only instruments which Swiss cantons and local governments use to strike a balance between control and liability. Another crucial element in their fiscal policy toolkit is the no bail-out regime for local governments.[2]

But up until ten years ago, no one was quite sure whether a canton really was exempt from the obligation to bail out an insolvent municipality within its jurisdiction. The answer to this question came in the court ruling handed down in the Leukerbad case, which stated that the canton in question, Valais, was not obliged to bail out its highly indebted municipality Leukerbad. Ever since, the financial markets have also acknowledged the no bail-out regime as a credible policy, as indicated, amongst other things, by the fact that yields on bonds issued by cantons which are home to municipalities facing financial problems have dropped since the court ruling.

Yet how can the principle of individual fiscal responsibility be reinforced among the member states of the euro area? It is a journey which begins in Basel, or, to be more precise, with the

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[1] Kirchgässner, Gebhard (2013): Fiscal Institutions at the Cantonal Level in Switzerland University of St. Gallen Discussion Paper no. 2013–04.

[2] Feld, Lars P, A Kalb, M-D Moessinger and S Osterloh (2013), Sovereign, Bond Market Reactions to Fiscal Rules and No-Bailout Clauses: The Swiss Experience, Centre for European Economic Research (ZEW), Discussion Paper No.13–034.

preferential regulatory treatment afforded to sovereign bonds. As I mentioned earlier in my speech, this preferential treatment not only sends out conflicting signals about whether a sovereign insolvency is even a permissible concept for legislators. It also makes such a scenario appear unrealistic not least because a sovereign default without appropriate capital buffers at banks would quite likely trigger a financial crisis.

So first, government bonds should be adequately backed with capital, and second, banks should hold loans to individual sovereign debtors only up to a certain level. In a nutshell, over a medium-term horizon, government bonds need to be treated just like other bonds or loans to enterprises.

From a financial stability perspective, particular problems are posed by the fact that banks often only hold government bonds issued by a single country in their books – those of their home country. The consequences of this are two-fold. Not only do banks have no capital backing for these government bonds; their risk is also concentrated in just one country. This will need to change to give credence to the no bail-out regime.

The bottom line of national responsibility is that sovereign insolvencies and insolvencies of large banks should also be possible without jeopardising the stability of the European financial system as a whole. The tightened capital rules for banks, which are designed to enhance financial sector resilience, naturally also contribute to achieving this goal. So this is another area in which Basel plays a crucial role. But this time, it is Basel III which I am talking about. No less important is a stricter supervisory regime like the one which Europe is looking to achieve by establishing the banking union.

But even a credible no-bailout regime will only have the intended disciplining effect when doubts begin to emerge over a country's fiscal soundness. That is why it is also important to combat the particular incentives inherent in a monetary union to run up debts – a goal which the monetary union's founders had originally sought to achieve – so that things don't get out of hand in the first place.

Hence the need for effective fiscal rules. Switzerland has a wealth of experience in applying fiscal rules. Its national debt brake has been up and running since 2003, since which time debt has roughly levelled off, and the debt ratio has been on the decline. But we can glean more detailed insights from the cantonal fiscal rules, which are now in place in nearly all the country's cantons. Available research reveals that stricter cantonal debt brakes also prove to be more effective.[3]

Bearing this in mind, a rule allowing potential sinners to pass judgement on actual sinners would have little prospect of success. The euro-area member states have already tightened the groundrules by rolling out the revised Stability and Growth Pact and the Fiscal Compact, making it much more difficult now for finance ministers to turn down the Commission's recommendations.

So it is now mainly up to the Commission to make the next move. The first time the Commission applied the new rules, it showed itself to be very elastic, granting Spain, France, Slovenia and Cyprus longer deadlines to make adjustments than those actually envisaged in the Stability and Growth Pact.

I believe that such exemptions should be made only in well-founded exceptional cases. For this ultimately weakens the structural consolidation requirements and pushes them into the future. Making exceptions for a large number of countries simultaneously undermines the disciplining effect of the fiscal rules.

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3 See Feld et. al. (2013).

So it remains to be seen how, and to what extent, the new Stability and Growth Pact will actually reinforce fiscal discipline. Perhaps enshrining debt brakes in national legislation, as envisaged by the Fiscal Compact, can provide a further impetus in that direction.

4. Conclusion

Ladies and gentlemen, the crisis may be widely dubbed the "sovereign debt crisis", but excessive public sector debt was not its only cause. A lack of competitiveness on the part of some member states, and excessive developments in the banking sector also played a decisive role in bringing about the crisis. But if I were to now discuss the macroeconomic imbalance procedure which was set up in response to the excessive economic misalignments, or the banking union, I would take all evening.

That's why I have confined my speech to just a few aspects of the regulatory framework, not least because these are precisely the areas in which Switzerland can offer valuable insights into how existing weaknesses can be rectified. While it is true that not all the components of Switzerland's fiscal federalism can be transposed to the euro area, the concept at the heart of the Swiss model – striking a balance between control and liability – can, and should, offer us some guidance for reforms in the euro area.

Restoring a regulatory framework that can stand the test of time is a challenging task. But I am certain that we will only bring about a more stable monetary union once this task has been overcome. Or, as Winston Churchill once aptly put it, "difficulties mastered are opportunities won".

Thank you for your attention.