Jens Weidmann: Europe's Monetary Union – making it prosperous and resilient

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at Harvard University, Cambridge, 25 November 2013.

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1. Introduction

Dear Hans-Helmut Kotz,

dear Professor Friedman,

ladies and gentlemen,

I would like to thank you for the opportunity to speak here today.

President Harry Truman is famously said to have asked to be sent a one-armed economist. He was tired of having exponents of the dismal science proclaiming "On the one hand, this" and "On the other hand, that".

Today, it sometimes seems like the opposite is true. In the eyes of many politicians, economists, at least if they are central bankers, cannot have enough arms now – arms with which they are to pull all the levers to simultaneously deliver price stability, lower unemployment, supervise banks, deal with sovereign credit troubles, shape the yield curve, resolve balance sheet problems, and manage exchange rates.

It is probably safe to say that this change in attitude is not just due to a sudden surge in the popularity of economists and central bankers. Rather, it reflects the widespread view that central banking has come to be the only game in town. And quite a few economists seem to agree with this notion.

To some, the notion that the primary goal of central banks is to keep prices stable has become old-fashioned. Against the backdrop of the financial crisis, they argue that financial stability has become just as important, if not more so, than price stability.

Consequently, many contend that the central bank's role as a lender of last resort applies not only to banks, but to sovereigns as well. This demand is aimed particularly at the European Monetary Union (EMU).

But such a move would run counter to the current institutional framework, under which fiscal policy remains a national responsibility – and under which, for this and other reasons, the Eurosystem is forbidden from financing European institutions or member states.

To others, the idea of central bank omnipotence is illusory and fraught with risk. If financial and fiscal concerns dominate central bank decision-making, it is no longer independent in its decisions on how to keep prices stable. Omnipotence then turns into impotence.

So the question remains: How do we make the EMU robust and resilient? In my remarks, I wish to argue that by piling more and more stabilisation tasks on to monetary policy, stability will prove ever more elusive. What seems to be true in general holds especially within the specific setting of the EMU. Rather, we need to make sure that the functioning of EMU as a whole is shielded from the failure of a constituent part – be it a bank or a sovereign.

2. Monetary policy and the art of separation

Former Italian Prime Minister Mario Monti once said: "Germans view economics as a branch of moral philosophy." I am not sure whether he meant this as a compliment. But John Maynard Keynes probably would have taken it as one. For him an economist must "possess a rare combination of gifts… He must be mathematician, historian, statesman, and philosopher“.

So, at the risk of confirming Mario Monti’s suspicions, I will seize this opportunity to be a Keynesian. I will try to illustrate the economic rationale behind the Bundesbank’s approach to monetary policy by borrowing from political philosophy. And maybe Mario Monti will let me get away with it after all, since it is a concept from political, rather than moral, philosophy.

The concept I am referring to is Michael Walzer’s “art of separation”. According to Walzer, liberties are created by walls – walls between the different spheres of society. In pre-liberal times, “church and state, church-state and university, civil society and political community, dynasty and government, office and property, public life and private life, home and shop: each pair was, mysteriously or unmysteriously, two-in-one, inseparable.

Confronting this world, liberal theorists preached and practiced an art of separation. The wall between church and state creates a sphere of religious activity, of public and private worship, congregations and consciences, into which politicians and bureaucrats may not intrude. Similarly, again, the separation of civil society and political community creates the sphere of economic competition and free enterprise, the market in commodities, labor, and capital”.

The walls of liberty concept can be applied to explain the success of independent central banks in fighting inflation as well. Assigning central banks a specific responsibility and granting them independence gave central banks the freedom to concentrate on the one objective for which they had the tools to achieve it.

Many scholars, among them Alberto Alesina and Larry Summers[1], have shown empirically that having an independent central bank amounts to one of the rare free lunches in economics: benefits in the form of low and stable inflation, but no costs in terms of growth.

By tearing down the walls between monetary, fiscal and financial policy, the freedom of central banks to achieve different ends will diminish rather than flourish. Put in economic terms: Monetary policy runs the risk of becoming subject to financial and fiscal dominance.

Let me explain these mechanisms a bit more in detail, starting with financial dominance.

The financial crisis has provided a vivid example of how financial instability can force the hand of monetary policy. When the burst of an asset bubble threatens a collapse of the financial system, the meltdown will in all likelihood have severe consequences for the real economy, with corresponding downside risks to price stability.

In that case, monetary policy is forced to mop up the damage after a bubble has burst. And, confronted with a financial system that is still in a fragile state, monetary policy might be reluctant to embrace policies that could aggravate financial instability.

This underscores the importance of a well-capitalised and tightly-supervised financial system, a precondition for stable prices which monetary policy cannot establish, and which is the responsibility of other policy makers instead. The contribution of monetary policy is by seeking, through conducting a more symmetric monetary policy, to prevent financial turbulence, which could pose a threat to price stability.

But often, the interest rate might prove too crude an instrument – it might not be efficient to punish the whole economy for the exuberance of a single sector. Therefore, financial policy needs its own toolbox.

According to the first Nobel Prize winner in economics, Jan Tinbergen, every economic policy objective requires its own instrument, otherwise success will be uncertain. By heeding his advice, we are practicing the art of separation.

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1 Alesina, A. and L. Summers (1993): Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence, Journal of Money, Credit and Banking 25, 151–62.

Strict financial regulation and supervision is needed to increase the resilience of banks and the financial system as a whole. And macro-prudential instruments provide solutions more tailored than the interest rate can offer.

Unconventional monetary policy measures, such as the very long-term provision of liquidity to banks or forward guidance that the central bank interest rate will not be increased within a foreseeable timeframe, cannot eliminate this problem. Their contribution to monetary policy is that they represent possible actions even in cases where the boundaries of interest rate policy have been reached: if interest rates are near the lower zero bound, or if the stimulus from interest rate cuts is not transmitted to the real economy.

To avoid any misunderstanding: This does not mean that central banks have no role to play in financial stability. The necessary separation pertains to the policies, not to the institution.

But it does mean, for example, that the decision-making body responsible for monetary policy should not be in charge of supervising banks as well. In Europe, under current plans ultimate responsibility for the new European banking supervision mechanism will rest with the ECB Governing Council. To avoid possible conflicts of interest, this should not become a permanent solution.

A change of the European treaties is required to allow for a body within the ECB other than the Governing Council to have the final say in supervisory matters. If this avenue is not taken, an independent supervisory institution will become necessary, in my view.

When it comes to monetary and fiscal policy, however, the separation should go a little further, even. Mervyn King once quipped that “central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy.”

Let us delve a bit into the origins of this obsession. Public debt and inflation are related on account of monetary policy’s power to accommodate high levels of public debt. Thus, the higher public debt becomes, the greater the pressure that might be applied to monetary policy to respond accordingly.

Suddenly it might be fiscal policy that calls the shots – monetary policy no longer follows the objective of price stability but rather the concerns of fiscal policy. A state of fiscal dominance has been reached.

Technically, fiscal dominance refers to a regime where monetary policy ensures the solvency of the government. Practically, this could take the form of central banks buying government debt or keeping interest rates low for a longer period of time than it would be necessary to ensure price stability. Then, traditional roles are reversed: monetary policy stabilises real government debt while inflation is determined by the needs of fiscal policy.

For monetary policy to deliver price stability, it is ultimately dependent on sustainable fiscal policy. This is why acting as a lender of last resort for governments can prove a slippery slope. If governments can expect to be bailed out by central banks, chances are that they will adjust their behaviour accordingly.

And in the euro area, a lender-of-last-resort role for the Eurosystem does not square with the institutional architecture. The monetary union differs from other currency areas in one crucial aspect: While monetary policy is a common undertaking, fiscal policy remains a national prerogative.

Evidently, the unsound fiscal policies of one member state can have repercussions on the union as a whole. Conversely, the negative consequences of bad policies can be better externalised to the rest of the currency area, thereby undermining incentives for sustainable policies.

To mitigate this risk, precautions were taken in the form of fiscal rules, the no-bail-out clause and the prohibition of monetary financing. The guiding principle was self-responsibility:

Member states are free to pursue their own fiscal policies. But they are subject to common rules and market discipline – and they are liable for their decisions.

A lender-of-last-resort role would violate this principle of self-responsibility – in that same way as Eurobonds in this setting are at odds with it. Therefore, it would aggravate, rather than alleviate, the problems besetting the euro area.

3. Separating banks and sovereigns

If monetary policy cannot disentangle the euro area's fiscal and financial conundrums, what can?

Central to any stable framework is a balance between liability and control: Those who act must also be liable for their actions.

Substantial measures were taken to contain the sovereign debt crisis. These measures – notably the two European stability mechanisms, the EFSF and the ESM – stabilised the euro area in the short term by offering financial assistance in exchange for structural reforms. This approach of buying time for adjustment is bearing fruit: current account imbalances have improved structurally and fiscal deficits have been significantly reduced.

But in the process, the balance between liability and control has been thrown out of kilter. While fiscal policy remains essentially a national domain, liability has been increasingly transferred to the European level. Going forward, the balance between control and liability has to be restored – otherwise the hard-fought gains in fighting the crisis will come at the expense of new vulnerabilities.

One possible option to balance control and liability would be a true fiscal union, i.e. a transfer of fiscal decision-making powers to the European level. In this scenario, control and intervention rights would be shifted to the European level. If this prerequisite were fulfilled, a greater mutualisation of liabilities would become feasible – and may be justified.

But judging by the reluctance of governments and electorates to let Brussels have a say in fiscal matters, this avenue seems blocked, at least for the foreseeable future. Therefore, the answer is to re-establish the principle of member states' individual responsibility. In other words, it is to practice the art of separation.

To strengthen the framework laid down in the European Treaties implies stiffening the fiscal rules, which were bent and ignored too often in the past, with Germany being one of the culprits. The new Stability and Growth Pact is a step in the right direction. But the mere existence of these rules will not suffice. We need to actually apply them. And the European Commission is responsible for enforcing them. However, up to now the Commission has adopted a rather lenient interpretation.

In addition to stronger rules, we need to make sure that, in a system of national control and national responsibility, banks and sovereigns can default without bringing down the financial system. Hence, breaking the "sovereign-bank doom loop" will be central to solving the euro-area crisis.

What does this mean? In the crisis, this sovereign-bank nexus has developed into a vicious circle. Wobbling banks and stumbling sovereigns clasp at each other to avoid falling but are in fact dragging each other down.

If many banks get into trouble at the same time, possibly due to the burst of a large asset bubble, financial stability as a whole is threatened. The state then often has no other option but to step in if it wants to prevent a meltdown of the real economy. But this rescue can be a huge burden on government finances – this is what happened in Ireland where the need to prop up the financial system pushed the public debt ratio up by nearly 30 percentage points.

Conversely, weak government positions can destabilise banks – directly through their exposure to sovereign bonds, and indirectly through worsening macroeconomic conditions. This was the case in Greece.

How can we break this “doom loop”? With regard to spillovers from banks to sovereigns, we need to make sure that taxpayers do not foot the bill when banks run into problems. The strengthened Basel III capital rules are a first step in that direction, as they increase equity buffers and therefore the capacity of banks to absorb losses. The banking union, with its Single Supervisory Mechanism, is another one. Strict and stringent supervision ensures that tough rules are equally applied to all. The Single Restructuring Mechanism currently under discussion is necessary in order to establish a bail-in regime that assigns a clear hierarchy of creditors. Only then will credit costs adequately reflect credit risk; and shareholders and creditors instead of taxpayers will be first in line to bear banks’ losses.

But the sovereign-bank nexus goes both ways. We also have to address spillovers from sovereigns to banks. We therefore need to end the preferential treatment for sovereign debt.

The Basel capital rules allow governments bonds issued in domestic currency to be given a zero risk weighting. But with regard to the euro area, the assumption that all sovereign bonds are risk-free means that all bonds are treated alike regardless of fundamentals. This calls into question market discipline, and is, obviously, not in line with recent history. Hence, sovereign bonds should be adequately risk-weighted, and exposure to individual sovereign debt should be capped, as is already the case for private debt.

An adequate risk-weighting of sovereign bonds would make banks more resilient if the fiscal position of the respective sovereign were to deteriorate; and it would bring spreads more into line with the underlying risk, thus giving a disciplining signal to the sovereign. In an interview with the German newspaper “Die Welt”, Ken Rogoff pointed out that the adequate risk-weighting of sovereign bonds constitutes a far more effective debt brake than any fiscal rule ever could.

Besides, many European banks hold bonds from one sovereign only – their home country. Large and undiversified exposure is what makes sovereign default a potentially systemic event. Hence, the large exposure regime which caps the investment in one single debtor has to be applied to sovereigns as well.

Ending the preferential treatment of sovereign debt would greatly reduce the risk of a financial crisis in case of sovereign default. It would therefore go a long way towards re-establishing the principle of individual responsibility in fiscal affairs.

4. Conclusion

Ladies and gentlemen, let me conclude.

The idea of monetary policy safeguarding stability on multiple fronts is alluring. But by giving in to that allure, we would likely end up in a world even less stable than before. This holds true especially for the euro area, where a Eurosystem acting as a lender-of-last-resort role for governments would upend the delicate institutional balance.

To disentangle the euro area’s fiscal and financial conundrums, we should practice the art of separation – especially with regard to the sovereign-bank doom loop. Or let me put it this way: Rather than for monetary policy to waltz with fiscal and financial policy, we need to erect walls between banks and sovereigns.

I would be pleased to answer your questions.