Jens Weidmann: Outlook for 2014

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Tagesspiegel event "DeutschlandAgora 2014", Berlin, 16 January 2014.

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1. Welcome

Mr Döbler, ladies and gentlemen, I would like to thank you very much for your invitation.

I am delighted that so many of you have accepted the Tagesspiegel's invitation. Before I begin, let me wish you all a happy and prosperous New Year.

We are in Berlin. At the beginning of the year, the Governing Mayor announced what not to expect in 2014, namely the opening of the capital city's new airport. Today I would like to talk about what we can expect – and what we must resolve to do – to overcome the crisis in the euro area on a lasting basis.

In my speech I will examine the measures currently being taken to tackle the crisis – on which opinions are divided – and say a few words about the institutional reforms that are needed in the single currency area.

Blaise Pascal rightly said, 400 years ago, as he looked ahead to the New Year, that all the resolutions have already been made, and that all we have to do is keep them. So you will recognise many of the points I am going to make from the discussion about the establishment of monetary union. Having said that, a need for action does exist: but it took the crisis to show us how significant the need for action is.

First, however, I would like to start by examining the economic prospects for the New Year. And they don't look all that bad.

2. Economic prospects

The German economy regained momentum last year, and according to our forecasts this upturn will continue this year and next.

This upward trend has again stemmed primarily from domestic factors. Germany's domestic economy is therefore already significantly more dynamic than the modest rate of growth for 2013 as a whole might suggest.

Low unemployment, continued growth in employment and favourable financing conditions are supporting private consumption and driving housing construction. But German foreign trade is picking up again, too. And that is likely to continue if the recovery in the global economy and the euro area becomes more broad-based.

The Bundesbank's economists expect the German economy to expand by 1.7% this year and 2.0% in 2015. Those are our forecasts based on our tried and tested economic models. But of course, these are expectations, not certainties.

Making forecasts is a difficult business. In the mid-1800s it was predicted that the city of New York would be buried in horse manure by 1910 at the latest – but then came the automobile. And not everyone initially believed in the success of the motor car either. Kaiser Wilhelm II put his faith in the horse, playing down the automobile as "only a temporary phenomenon". And even Gottlieb Daimler predicted that "global demand for motorvehicles will not exceed one million – if only because of the lack of available chauffeurs."

What I want to say is that forecasts – long-term forecasts in particular – should always be treated with caution. But short-term forecasts, too, can quickly become worthless if unforeseen events occur – for forecasts are not prophecies.

If things turn out the way we expect them to, the German economy will grow considerably faster than the economy of most other euro-area countries. Nor are prospects brightening up for Germany alone. Most of the crisis countries, if they haven't yet put recession behind them, can at least see the light at the end of the tunnel.

Another positive factor is that the heterogeneity in the euro area as regards economic growth, which was still very pronounced in 2011, has declined significantly over the last two years. Going by the European Commission's 2013 autumn forecast, the growth disparities will continue to decrease substantially in the current year.

Amongst other things, the fact that the differences in economic growth rates have narrowed further of late is proof of the success of the adjustment measures in the crisis countries. However, the individual countries still differ in terms of their position in the economic cycle.

This represents a challenge for the Eurosystem, our common central banking system. This is because the ECB Governing Council, to which I belong as President of the Bundesbank, can only make one common monetary policy – for the entire euro area. In the deployment of our instruments we cannot make allowances for the economic situation of individual member countries. We knew that when we embarked upon monetary union, and that's why, for example, there can only be one policy rate for the entire euro area.

One consequence of divergences in the economic situation is the diversity of inflation rates in the euro-area countries. It is not surprising that consumer prices in Germany are rising somewhat more quickly than in the euro area as a whole. Nevertheless, according to our latest forecast, the German rate of inflation, too, will remain clearly below the 2% mark this and next year.

The outlook for price developments in the euro area as a whole, which play a key part in determining actions taken by the ECB Governing Council, will only gradually move in that direction again. And you know that the Governing Council defines price stability as an inflation rate of below, but close to, 2%. Eurosystem staff are expecting an inflation rate of 1.1% this year and 1.4% in 2015.

The risks of a significantly higher rate of inflation in the medium term are therefore low at present. That applies to the entire euro area as well as to Germany. I am in complete agreement with my colleague, Mario Draghi, that there is no reason for irrational fears of inflation. That is not to say that combatting inflation will no longer be an issue in the future. I would recommend analysing things rationally and keeping an eye also on long-term dangers to price stability.

But at the same time, in the current economic situation the risk that the euro area will experience broad-based deflation is also limited. This, too, is a spectre which, on sober reflection, vanishes in thin air.

This is connected, not least, to the fact that long-term inflation expectations are solidly anchored at around 2%. Above all, however, we are on the threshold of a phase of economic recovery – which will gradually push inflation rates back up.

The currently low inflation rates as an average for the euro area are the result, not least, of the adjustment measures undertaken by the crisis countries. These measures are unavoidable in order to make the economic structures more competitive and promote sounder public finances – in other words, for these countries to get back on their feet. Sustainable economic growth in the long term will not be possible with bloated construction or financial sectors.

Advocates for an even more expansionary monetary and fiscal policy often cite the risk of a Japanese scenario, warning that the euro area faces a similar fate as the Japanese economy, which has suffered from the effects of a deflationary trend during the last two decades. But the situations differ greatly.

First, the Japanese yen appreciated sharply at the beginning of the 1990s, with the result that receding import prices acted as a brake on the general price trend. The euro experienced no such strong appreciation during the crisis.

Second, deflation requires that nominal wages fall, or at least expand at a slower pace than productivity, over a protracted period of time. In Japan, labour income per employee dropped considerably over many years, whereas no such board-based development is to be seen in the euro area. Only in Ireland and Greece has compensation per employee fallen markedly to sharply.

Fear of a Japanese scenario is therefore misplaced.

Moreover, the notion of Japan's "lost decades" needs to be seen in perspective. The weakness of growth in Japan is partly a natural consequence of the country's demographic change, as the working-age population has been shrinking since the mid-1990s. And that, by the way, is an economic policy challenge that awaits Germany in the years to come.

A critical view therefore also needs to be taken of the discussion kicked off by former US Treasury Secretary Larry Summers and fuelled by Paul Krugman, about "secular stagnation". Mr Summers recently warned that the US faced the risk of weak growth similar to that in Japan, and called for an even more expansionary demand policy. In so doing, however, he fails to see that the weak real growth in Japan is primarily a long-term structural problem that cannot be remedied in a sustainable manner by demand-oriented economic policy.

The lesson to be learned from the example of Japan, however, is that the job of cleansing bank balance sheets of toxic assets should not be delayed.

Those were my remarks about Japan. Let me come back to the euro area.

A badly informed journal recently claimed that I was fighting against the policy of low interest rates. What it is true to say is that, for months, I have been repeatedly stressing that an expansionary monetary policy is appropriate at the moment given foreseeable subdued price developments and moderate economic growth in the euro area.

Against that backdrop, the Governing Council of the ECB recently confirmed its expectation that interest rates will remain at their present very low level for some time to come or in fact be going down even further.

3. Criticism of low interest rate policy

Ladies and gentlemen

I am not overlooking the fact that a critical view is being taken of the extremely low interest rates, especially in Germany. The most recent cut in the key interest rate in November caused considerable discontent in some quarters. Let me say something about this.

I am very well able to understand the fact that German savers, as well as savers elsewhere, are annoyed when their savings accounts lose value in real terms because the rates of interest on low-risk investments are lower than the rate of inflation. That means the loss of a key incentive to accumulate savings.

But please consider also that low interest rates are intended to give a boost to consumption and investment. That is the very reason why the central bank keeps them at a low level.

Apart from that, what should be remembered in this context is that, for many people, including in Germany, low interest rates are not just a drawback.

Homebuilders are benefiting from them when taking out a loan. Firms are enjoying favourable financing conditions, which is ultimately a good thing for employees, too. The government is paying less interest on its debt, which is bringing relief for taxpayers. Members of the general public are not just savers, they have other economic motives as well.

Besides, it simply isn't the task of the central bank to ensure a given minimum return on risk-free financial investments. Rather, I agree with Jean-Claude Trichet, who recently said in an interview that it was not the ECB's mandate to aim for an interest rate that pleases everyone; the mandate of the ECB is to maintain price stability.

For me, that is the crucial point in this debate: members of the general public should be able to rely on us fulfilling this mandate and not making it subordinate to other objectives. The Bundesbank stands by this unconditionally – no ifs, no buts.

However, we must not turn a blind eye to the fact that extremely low interest rates also harbour risks to financial stability and the efficiency of economic structures. These, in turn, can have an impact on price developments and the central bank's ability to achieve its primary objective of price stability. The crisis made this abundantly clear for us.

An ultra-loose monetary policy is a course of treatment with risks and side effects. For that reason, it must not become a long-term therapy, especially as its positive effects decrease the longer the treatment continues, while the risks increase.

There is a danger of economic agents – such as households and, in particular, enterprises, but policymakers, too – getting used to the ultra-loose monetary policy. Eventually, this might mean that a necessary structural change fails to take place or that enterprises without a sustainable business model are kept alive.

But the low interest rate setting also has directly negative repercussions for banks, building and loan associations and insurance companies.

In the case of banks, declining margins mean a deterioration in profitability. Banks whose earnings derive mainly from the interest rate differential between deposits and loans are hit especially hard by this, and that means not least savings banks and credit cooperatives. These institutions will find it an increasing problem in the long run to conduct risk provisioning for economically difficult times. And insurers as well, particularly life insurers, will have an increasingly hard time generating guaranteed returns, the longer low interest rates persist.

At the same time, there is a risk that low interest rates will prompt investors to embark on a "search for yield". An increasing risk propensity on the part of investors might lead to hazardous excesses in individual financial market segments and, as it were, sow the seeds of the next financial crisis.

The hype surrounding the "internet currency" Bitcoin also has to be seen in this context. I say "internet currency" in inverted commas, as Bitcoins do not nearly fulfil the essential criteria for a currency and are more an object of speculation, the risks of which should be fully understood by investors.

Over the long term, low interest rates can also encourage excessive behaviour in the housing market. In actual fact, house prices in Germany have been showing a marked rise since 2010, especially in urban centres. However, it is not yet possible to speak of a broadly based bubble. At the moment, price increases are concentrated on urban property markets. Real estate prices in fashionable downtown areas are not an indication of what is happening in the rest of the country. Still, it is a development we have to keep an eye on.

Claudio Borio, currently Head of the Monetary and Economic Department at the Bank for International Settlements (BIS) – in other words, the central banks' bank – says of ultra-loose monetary policy, in my view quite correctly, that "The longer these policies and measures last, the worse the cost-benefit outcome will be."

Monetary policymakers should therefore not only have an eye on the risks to price stability, which are indicated by the commonly used projection models, but also be aware of the fact that financial instability can also jeopardise price stability.

The monetary pillar in the Eurosystem's monetary policy strategy attempts to identify longer-term risks to price stability, although modelling the link between money or loans, on the one

hand, and the inflation rate, on the other, is anything but easy, especially in economically turbulent times.

Monetary policy, however, is not the most effective instrument for responding to financial market crises. One major lesson of the crisis was that there were no instruments available to counter the looming, principally national financial market excesses in time. This gap is being closed by the macroprudential instruments.

Ultimately, it is true to say that the causes of the crisis in the euro area cannot be eliminated with the resources of monetary policy. It is a matter for politicians to overcome the crisis permanently by strengthening the forces of growth and freeing monetary policy from its difficult position.

More than 90 years ago, Will Rogers said, "There have been three great inventions since the beginning of time: fire, the wheel, and central banking."

It should be mentioned that Will Rogers was a humorist; his comment was probably not meant as a compliment to central banks. I get the impression a little bit that some politicians think central banks hold the key to solving all pressing economic problems.

Not so long ago, Raghuram Rajan, former Chief Economist at the IMF and current Governor of the Reserve Bank of India, claimed that central bankers nowadays enjoy the popularity of rock stars.

Even though I think that is an exaggeration, it is reflection of the expectations that are now placed in central banks. I view this with a certain amount of concern, since the transfer of more and more responsibility can jeopardise central banks' independence. However, the experience of the 1970s and 1980s taught us that independence is a major prerequisite for central banks' ability to fulfil their price stability mandate.

4. The crisis in the euro area

What is true for others is also true for central banks – exceptional circumstances justify exceptional measures. But with a little prudence, please.

In the face of the crisis, the Eurosystem rolled out far-reaching conventional and unconventional measures to prevent an escalation of the crisis. Many of these measures had my support.

But it's certainly no secret that I view some decisions with a critical eye. In my opinion, purchasing bonds from crisis countries risks blurring the boundaries between monetary and fiscal policy. That might hinder the central bank's long-term capacity to perform its mandate of safeguarding price stability. Blurring policy boundaries in this manner undermines the fundamental framework of monetary union, which is founded on individual national responsibility and the principle of liability.

It is undisputed in the ECB Governing Council that the Eurosystem's crisis measures cannot replace either the adjustment measures that need to be implemented nationally or the essential reforms at the institutional level.

The peripheral euro-area countries have made impressive progress in adjusting their economies in recent years, and their efforts to implement structural reforms are gradually bearing fruit.

The peripheral countries have largely reduced their high current account deficits, and some are now running a surplus. Huge strides have been made in boosting price competitiveness, which is driving exports higher. Apart from Italy, the peripheral countries have seen their national unit labour costs diminish substantially. Structural budget deficits have contracted sharply.

All in all, it is safe to say that the adjustment process is in full swing, with some countries being further advanced than others. A leading group of countries is already within sight of the finishing line, while others still have quite a way to go. The crisis is not yet over for any of the peripheral countries.

The high levels of unemployment across many countries undoubtedly paint a gloomy picture. But the jobless figures at least appear to be levelling off, and they are already improving slightly in some countries.

High levels of unemployment certainly owe something to the economic adjustment process. Yet the notion that the labour market would be better off without adjustment does not hold water. The reforms form the basis for the economic turnaround and thus for an upturn in employment as well.

Incidentally, the improvement in the peripheral countries' current account positions was mirrored by a drop in German surpluses with these countries. So it is misleading for Nobel Prize-winning US economist Paul Krugman to claim that "Germany failed to make any adjustment at all; deficits in Spain, Greece and elsewhere shrank, but Germany's surplus didn't."

Germany's current account surplus of around 7% of GDP is still very high – that much is true. But these surpluses are now being generated predominantly outside the euro area. The current account surplus with other euro-area countries, meanwhile, is down by half compared to 2007.

So Germany is very much playing a role in rectifying imbalances across the euro area. But spurring domestic demand in Germany – something which has been called for on numerous occasions, most recently by the US Treasury Secretary last week here in Berlin – would be of no great benefit, given the minimal impact it would have on the peripheral countries. That applies to credit-financed spending programmes and an expansionary wage policy in equal measure.

Running a policy at the expense of fiscal credibility would endanger Germany's role as an anchor of stability in the monetary union, and would thus even yield a counterproductive outcome. And as for higher wages, Bundesbank calculations indicate that raising wages by two percentage points above the level justified by improved labour productivity, for example, would indeed trigger an expansionary effect on demand to begin with. Over the longer term, however, this would mostly act as a drag on German enterprises' competitiveness, particularly benefiting competitors outside the euro area such as China and the United States. At the end of the day, our European partners would probably be worse off.

So it cannot be a matter of merely redistributing economic competitiveness throughout the euro area. It is the competitiveness of the euro area as a whole which needs to be stepped up.

5. Reforming the operational framework of monetary union

If the monetary union is to be placed on a sound long-term basis, the adjustment measures in the problem countries are a necessary condition but not a sufficient one. Only by restoring a harmonious balance in the institutional framework of monetary union will the euro area be able to put the crisis firmly behind it.

In its current configuration, the operational framework is somewhat skewed. The fiscal assistance measures have put elements of mutualised liability in place, but the attendant powers of intervention have not been granted to the community.

What this means is that the relationship between liability and control has got out of kilter. And when that happens, there is a risk that prudent decision-making will go out of the window. This is a lesson which the financial crisis has taught us. As a case in point, banks could long rely on being bailed out with taxpayers' money if they ran into difficulties.

If we are to maintain the balance between control and liability, we essentially need to opt for one of two paths towards a more stable monetary union framework. Either we proceed towards deeper political integration – a fiscal union, say – or we develop the existing framework further and bolster the individual national responsibility of the individual member states as a constitutive feature of monetary union.

However, a fiscal union must not simply mean extending mutualised liability, because that would merely be a transfer union. A fiscal union that is worthy of the name would instead require member states to transfer national sovereignty to the community level, say by giving the community the necessary right to intervene in the event of unsound public finances.

Blending mutualised liability with decentralised decision-making powers on debt would be the wrong way forward. Policymakers might see this as an attractive "quick fix" for the crisis, but it is anything but a sustainable configuration for a monetary union. In fact, it provides an additional incentive for member states to run up debt without providing any effective control instruments. So anyone can get into debt at someone else's expense.

As I just mentioned, only two options are sustainable. Returning to the founding principles of the Maastricht Treaty, or evolving into a fiscal union.

The debate on choosing the right path towards a more stable monetary union – one which takes the people's concerns seriously – is an important one. Nor is it a debate which fuels anti-European sentiment, but one which lays the groundwork for popular acceptance and approval. Because I'm convinced that the people will ultimately only accept a union that is built on stability.

At the end of the day, far-reaching political decisions will need to be taken, no matter which path we choose. For instance, a credible no bail-out regime would need to be backed by a codified insolvency regime for member states which can be implemented without jeopardising the financial stability of the community as a whole.

For example, three years ago, the Bundesbank proposed reforming the standardised terms and conditions for sovereign debt with the aim of strengthening investors' individual responsibility, limiting the total liability for countries providing assistance and winning time for structural reforms. The Bundesbank suggested that a clause should be hard-wired into the terms and conditions for the issuance of euro-area government bonds that would automatically extend the maturity of a given country's bonds by three years if that country received loans from the ESM fund.

Automatically extending bond maturities in this manner would buy time for crisis countries to resolve their problems without private creditors withdrawing their capital. Thus, it would massively reduce the funding which the ESM would have to provide – and which the taxpayers of other member states would have to guarantee – to the level of net new borrowing. It would buy time to gauge, with a higher degree of certainty, whether the country in question was experiencing solvency or liquidity problems. This would allow a better balance to be struck between liability and control.

Now some might say that we have indeed strengthened centralised control mechanisms, and that this would permit at least a degree of mutualised liability. But we should be under no illusions. It is true that "Brussels" has been given greater powers to police member states' debt policies – by way of the reinforced Stability and Growth Pact, Fiscal Compact, European Semester etc – but when push comes to shove, member states still insist that they, and they alone, have the final say.

Time will tell whether the new rules will have the desired binding effect. If anything, things have become more complex and less transparent, opening up scope for interpretation. The first cases in which the new rules have been applied suggest that this scope is being used rather generously.

This shows that the willingness to cede fiscal policy powers to Europe on the part of policymakers and the public at large in the member states simply isn't strong enough to take the step towards greater integration and a bona fide fiscal union. All the more so, given that this would also necessitate far-reaching constitutional amendments in the member states.

So from a fiscal policy perspective, it looks as if toughening up the existing Maastricht framework is the more realistic way forward. In the long run, only a coherent operational framework can reliably ensure that the monetary union is a union of stability.

And maintaining a stability union is also fundamentally important for the single monetary policy. Otherwise, it might prove permanently ever more difficult for the Eurosystem to fulfil its mandate, particularly if it is increasingly being forced to act as the lender of last resort for governments.

That's why it's all the more important for the Eurosystem to eliminate any doubts that the central bank's task is to safeguard price stability. At the same time, sustainable public finances are a prerequisite for price stability which the Eurosystem itself cannot bring about. This is where the onus is on governments and parliaments.

6. On the European banking union

Allow me to touch on one last point: the European banking union.

The crisis has made it abundantly clear that the vulnerability of the financial and banking system is a key weakness of the euro area. It must be rendered more resilient and safer. This is where the banking union will make an important contribution.

The banking union incorporates a Single Supervisory Mechanism (SSM) as well as a single resolution mechanism.

Banking supervision is to be based at the ECB and will be launched in the autumn of this year. From a human resources perspective alone, this project is a Herculean task. Some 1,000 new staff will have to be recruited over the course of the year. However, it is also a major challenge to ensure that all banks in the euro area will, in future, be supervised according to the same high standards.

Before the launch of the single supervisor, a comprehensive balance sheet assessment will be conducted for the 128 "significant" banks that will, in future, be supervised directly by the ECB. If this assessment reveals that recapitalisation is needed, this is to be remedied before the launch of the SSM, primarily using private funds. Or, if that is not possible and the bank has a sustainable business model, by the respective government. Ultimately, it is a question of who is responsible for past failings in banking supervision – and that was the individual member states.

The second pillar of the banking union is the single resolution mechanism to deal with future bank failures, on which the member states reached a basic agreement shortly before Christmas. For European banking supervision also requires European banking resolution; otherwise, control and liability would diverge.

Where a bank fails, resolution costs must, as a general rule, in the future be borne first by shareholders and creditors. After that, a bank-financed resolution fund is to come into play, and only as a last resort are public funds to be used and the taxpayer made to pay.

The fund is to be built up over a period of ten years and reach a volume of €55 billion. Before the fund is fully capitalised, bank resolutions would be financed out of national "compartments", which we welcome in the interests of a balance between liability and control.

In the long term, Europeanisation of liability with a centralised supervisor is appropriate. However, as long as other factors with a key impact on the quality of bank balance sheets

remain under national control – for instance tax legislation, insolvency rules or economic policy – it makes sense for some liability to stay at the national level.

The same argument can also be applied to giving precedence to the use of national tax funds for a transitional period.

The banking union makes a key contribution to financial stability and to strengthening the institutional framework of the monetary union. Another essential prerequisite for a more stable monetary union is, however, stricter financial market regulation.

More has been initiated in this area than is generally acknowledged. At the beginning of this year, the Basel III capital rules became effective in Europe, which will gradually improve the quantity and quality of banks' capital. Moreover, rating agencies have been placed under supervision, inappropriate compensation systems have been corrected, computer-driven high-frequency trading subjected to stricter regulation and trade in highly speculative financial derivatives has been rendered more transparent and thus safer.

In order to break the disastrous nexus of banks and governments, the regulatory treatment of government bonds will, however, also have to be changed.

Currently, banks can invest unlimited amounts in euro-area government bonds. Under the current capital rules, a zero risk weight applies to these assets, which means that these government bonds can be fully funded with borrowed money, in other words, they do not require any capital backing. This constitutes preferential treatment, and has been a factor in banks in several peripheral euro-area states, in particular, raising their exposure to domestic sovereign bonds during the crisis; they have thereby tied their fate to that of their national government.

In my opinion, credit ceilings and risk-based capital backing would be a sensible way of breaking the nexus – that would basically mean applying similar rules to those for bank loans to private-sector debtors. Such rules would also promote bank lending to enterprises.

Support for this proposal is growing, its logic is compelling, but implementation is probably not on the cards for 2014, and I fear that Berlin Brandenburg Airport may be up and running first. In the longer term, however, such regulations are, in my opinion, an indispensable prerequisite for a stable monetary union and a healthy financial system.

7. Conclusion

Ladies and gentlemen

Considerable progress has already been made towards resolving the crisis, but there is still a long way to go. The aim must be a more stable financial system and a more crisis-resistant monetary union.

Important strategic decisions will again have to be taken in 2014, and it remains to be hoped that far-sighted agreements will be reached. Financial market regulation remains on the agenda, as do further structural reforms in the peripheral countries. In Germany, politicians should be careful not to jeopardise the achievements of the reform policies. The good state of the German economy can be attributed, in good part, to the structural reforms of the past decade.

Institutional reform of the monetary union must continue apace, with the objective of establishing stable long-term foundations. And in terms of monetary policy decisions, the needle of the compass should point clearly in the direction of long-term price stability; the risks associated with the current policy must be taken into consideration; the central banks must not be overburdened.

Every issue of the Tagesspiegel features the motto "rerum cognoscere causas" on the front page. Roughly translated that means to learn the causes of things or, a little less literally, to

get to the bottom of things. I hope I have done some justice to this motto. However, we will have the opportunity of exploring these issues in greater detail in the discussion to follow.

Thank you for listening. I look forward to the discussion.