Jens Weidmann: Of dentists and economists – the importance of a consistent economic policy framework

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, before the Juristische Studiengesellschaft, Karlsruhe, 11 February 2014.

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1. Introduction

Ladies and gentlemen

Paul Samuelson once said, “I don’t care who writes a nation’s laws, or crafts its treatises, if I can write its economics textbooks.”

Paul Samuelson wasn’t just one of the foremost economists of the last century, he was also a master of the punch line. And I can well imagine that this knack made him a firm favourite among fellow economists.

Yet in my opinion, this viewpoint fails to consider important links between economic theory and legislation. The economic analysis of law provides a large number of examples of the extent to which legislation affects economic life. And a good proportion of legal rules are ultimately based, among other things, on economic insights such as that independent central banks are the best guarantors of price stability, or that the monetary financing of governments undermines a stability-oriented economic order.

Thus, economists ignore the consequences of legislation and jurisdiction at their own peril. I would say that a lively exchange of ideas between lawyers and economists not only makes sense: it is absolutely imperative. I am therefore delighted to be able to carry this dialogue forward with you here today, and I thank you for your invitation.

2. Economic policy: regulations or leeway?

Just how fruitful an exchange of ideas between economists and lawyers can be is illustrated by a concept that has had a lasting influence on German economic policy: that of regulatory policy.

It was a most odd coincidence, as the legal scholar Franz Böhm later put it, that brought himself, his colleague Hans Grossmann-Doerth and the economist Walter Eucken together in 1933 at the Faculty of Law and Political Science at the University of Freiburg. It is here that the three set about researching and teaching, and that was when German ordoliberalism, the “Freiburg School”, was born.

Shaped by the experiences of the global economic crisis and of a totalitarian command economy, the core element of ordoliberalism is competition, yet no longer competition in the classic – unbridled – sense, but a protected, orderly competition. Or, as Federal President Joachim Gauck described it in his speech at the Walter Eucken Institute a few weeks ago: “Neither is it an order that subjects the individual to state paternalism, nor is it a market in which the strong can become so big that they themselves dictate the rules.”

Ordoliberalism, then, is about more than striving for economic efficiency. As the Federal President also pointed out: “By breaking long-standing privileges and cemented power structures, competition offers scope for more participation, more inclusion.”

What is crucial with regard to ordoliberalism is an appropriate framework within which orderly competition can take place. According to Walter Eucken, such a framework can be described as what he called “constitutive and regulative principles of a competitive order”.

Of central importance in this respect is a smoothly functioning pricing system. This is because, in a market economy, prices play a decisive information and steering function, regardless of whether they are the prices for goods, services or assets.

Walter Eucken adds to this fundamental principle six other principles which together characterise a competitive order: open markets, freedom of contract, constancy (in the sense of consistency or reliability) of economic policy, liability for one's own actions, private ownership and the primacy of monetary policy, the latter being of particular interest to me as a monetary policy maker.

Thus, economic policy must fulfil two tasks. First, it has to spell out these principles in the form of suitable rules to ensure that they become operable – which in some circumstances may also mean justiciable –, that they can be set in relation to each other, and that they actually develop a binding force. Second, economic policy must align the requirements of a competitive order with other political ends, for example if the results of market processes are undesirable from a social-political perspective.

Keeping an eye on the social consequences of market processes is an important supplement to regulatory policy and the hallmark of a social market economy. The relationship between market forces, their social consequences and interventions to correct them is often complex. This means that obvious measures aren't always the best ones, and sometimes they aren't even effective: it is indeed true that good intentions do not always produce good results.

It's for policy-makers to weigh up different objectives, and economists cannot take that responsibility from them. But economists can and should point out the economic costs and side-effects of the different courses of action available.

A cursory consideration of this job description perhaps seems to suggest that the Keynesian ideal of the economist as a dentist might become reality. To quote Keynes: "If economists could manage to get themselves thought of as humble, competent people on a level with dentists, that would be splendid."

I am afraid, however, that this notion of the economist's role will remain a pious hope. Most economists are indeed humble or competent people – and sometimes they are both.

But in the past few years, insights gained in the field of economics have probably experienced more ardent debate than the latest findings on dentistry. For given the complexity of reality, the dynamics of an increasingly interlinked global economy and the uncertainty that upheavals like the financial and economic crisis in particular generate, there are often no simple answers to economic policy questions. What is more, these answers may change with time.

On the one hand, the specific set-up of an efficient competitive order is subject to constant change. As the framework conditions shift, so the regulatory principles I have just mentioned may have to be re-operationalised. At the same time, it is important to weigh other social policy objectives anew against the requirements of a competitive order, if necessary. On the other hand, not even a rule-bound, regulatory policy-driven economic set-up can do without discretionary decisions.

Generally speaking, therefore, rules are needed to give validity to regulatory principles such as the principles of competition and liability. They have to narrow the scope for action of participants in the economic process in such a way that market forces produce better economic results – results which are also more sustainable and more socially just than those of unbridled competition or of a centrally planned economy.

To this end, the appropriateness of a given regulatory framework must be constantly reviewed, and adjustments made where necessary.

One such example is Agenda 2010. At that time, the rules laid down in employment and social welfare laws had shown themselves to be major obstacles to labour market entry,

even in times of an economic upswing. In consequence, unemployment continued to rise across the business cycles until it reached a level that was no longer sustainable.

The measures that were then taken boosted flexibility, lowering the barriers to entering the labour market. For example, the liberalisation of temporary employment makes it easier for employers to hire job-seekers. Moreover, the amalgamation of unemployment assistance and social assistance and the shortening of the period of entitlement to unemployment benefits increased the incentive to take up employment.

Competition on the labour market has tended to become stiffer as a result, and no doubt also tougher for some. But it has also helped the labour force in Germany to swell to around 42 million – more than ever before. Moreover, the number of persons registered as unemployed has dropped from a high of more than 5 million to just under 3 million at present, and the chances of an unemployed person finding a new job are far greater than they were before the reform.

Further evidence of the success of the reforms is that, in the wake of the upturn, not only atypical jobs were created. For instance, from 2003 to shortly before the crisis, the number of temporary workers advanced by almost 400,000. At the same time, however, the number of jobs subject to social security contributions posted an increase of around 1,250,000. Nor has this picture changed since the economic slump.

But this outcome also owed a great deal to the fact that the social partners could respond to the shift in the economic setting with a degree of leeway, notably by concluding more employment-friendly wage agreements as well as the liberalisation clauses designed to safeguard employment which have been a standard feature of collective agreements ever since the "Pforzheim agreement" back in 2004. Research findings suggest that these measures were key contributory factors in restoring competitiveness[1] and in keeping the increase in unemployment[2] to a minimum during the economic downturn brought about by the financial crisis.

The financial crisis likewise showed us just how important it is to have the right setting for a functioning competitive framework. The central regulatory tenet – that those who enjoy the benefits must also bear the costs – was neutralised for major banks who could count on being rescued by the taxpayer because of their importance for the economy.

Keeping profits in the private realm, but expecting taxpayers to foot the bill if a crisis arises undermines responsible behaviour. Rules that are consistent with the principle of liability and which ensure that banks, say, take a leaf out of the business community's book and shoulder their losses themselves in future without jeopardising financial stability, are vitally important for a functioning economic order.

This is a prime example of the tensions I was referring to earlier on in my speech between the regulatory framework and discretionary economic policy intervention. Principles-driven policy action and a set of clearly defined rules which limit the scope for economic policy discretion make economic policymaking more predictable and can help to defuse many problems such as that of time inconsistency, which is a topic I shall return to later in my speech. Questions were even raised during the crisis as to whether complying with this regulatory framework was always necessary or even possible in the first place.

Insolvency law fleshes out the principle of liability. But had it been rigorously applied, without exception, to systemically important financial institutions, many fear that this would have

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[1] C Dustmann, B Fitzenberger, U Schönberg and A Spitz-Oener (2014), From Sick Man of Europe to Economic Superstar: Germany's Resurgent Economy, Journal of Economic Perspectives 28(1), pp 167–188.

[2] M C Burda, and J Hunt (2011), What explains the German Labor Market Miracle during the Great Recession? In: Brookings Papers on Economic Activity, pp 273–319.

come at a prohibitively high cost as a result of the risk of contagion to other financial market participants and the escalation of the crisis.

If I may, I would now like to look into a number of selected policy spheres to give you a rough idea of how rules-based and ad hoc decision-making ought to interact in principles-driven policymaking – and where the strict limits of discretionary policymaking need to lie.

2.1 Monetary policy

I will kick off with a policy area which is especially close to my heart, and not just for professional reasons – monetary policy.

Walter Eucken believed that monetary policy was crucially important: "All endeavours to realise a competitive framework are in vain unless a certain level of monetary stability can be assured. Monetary policy thus has primacy for the competitive order," he wrote in his Principles of Economic Policy. You won't be surprised to hear that as a central banker, I share Eucken's views on the importance of monetary policy.

A key problem in the sphere of monetary policy – one which is a factor in many other areas of economic policy as well – is that of time inconsistency. Let me illustrate this phenomenon using an example originally created by the US economist Professor Alan Blinder.

Imagine a professor who is pursuing two goals. First, he wants his students to study as hard as possible; second, he wants to spend as little time as possible marking examination papers, say. The professor then announces that he intends to set an examination at the end of the semester. This, he hopes, will provide the students with an incentive to acquire the necessary knowledge.

However, once the students have studied for the end-of-semester examination, the professor has an incentive not to set an examination after all because he does not want to mark the examination papers. But because the students are aware of the professor's incentive, they will study insufficiently or not at all.

How can this problem be solved? By stating in the examination regulations that an examination will be set at the end of the semester, come what may. In other words, the university binds itself in advance to a fixed rule.

In their renowned paper "Rules, discretion and reputation in a model of monetary policy", the US economists Robert Barro and David Gordon[3] explain why the time-inconsistency problem gives rise to an inherent inflation bias.

In the short term, monetary policy can impact not just on inflation but also on economic activity and hence on employment, although the monetary policy I am talking about here is not mandate-consistent expansionary monetary policy in times of weak economic growth and low inflation rates, but additional monetary policy stimulus.

Expansionary monetary policy surprises drive inflation higher but real wages decrease, prompting enterprises to hire more staff, and briefly boost employment and growth. Politically, this can be quite an attractive outcome that will initially be welcomed by the general public.

Yet the macroeconomic outcome looks quite different if employees are expecting this kind of monetary policy move – inflation again begins to climb, but real wages remain static because employees – anticipating a more expansionary monetary policy stance – have already managed to secure higher wages.

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[3] Barro and Gordon. 1983. Rules, discretion, and reputation in a model of monetary policy. Journal of Monetary Economics 12: pp 101–121.

And that's the worst of all possible worlds – higher inflation but no stimulus for the economy. This phenomenon, otherwise known as stagflation, plagued many industrialised countries in the 1970s.

Now the crux of the matter is that precisely this poor outcome will transpire as long as monetary policymakers gear their stance towards short-term sentiment about their policy. Because economic agents will always expect an expansionary policy measure and factor it into their expectations – just like students who anticipate that no examination paper will be set and give up studying.

As a consequence, the only way to resolve this dilemma is for monetary policymakers to make a credible commitment to a stability strategy – and thus to credibly forgo the option of using expansionary monetary policy surprises to give the economy a short-lived shot in the arm.

Tying central banks to a very strict set of rules, that is, to an automatic system for regulating the money supply, was something that Milton Friedman had in mind. True to his belief that "money is too important to be left to central bankers", Friedman put forward a proposal back in the 1960s that central banks should be required to increase the money supply by a constant percentage so as to counteract the inherent incentives to pursue an inflationary monetary policy.

But this would only work if there was a stable correlation between monetary growth and inflation, and the central bank had a sufficiently reliable degree of control over the money supply. But the correlation between the money supply and inflation is not always sufficiently stable over time, least of all in times of crisis, so one of the key prerequisites for managing the money supply is lacking.

This is why Barro and Gordon saw central bank independence and a commitment by monetary policymakers to maintaining price stability as a suitable means of achieving price stability while at the same time granting the central bank a degree of monetary policy leeway. And so it was. A host of empirical surveys including those by Alesina and Summers[4] and by Grilli, Masciandaro and Tabellini[5] confirm the success of independent central banks which are mandated to maintain price stability.

And to get an idea of just how beneficial it can be to incorporate a degree of flexibility into a clear commitment to the primary goal of price stability, we only need to look at the role played by central banks in stabilising the global economy when the financial crisis was at its worst in the autumn and winter of 2008.

But how can we make sure that a degree of monetary policy leeway does not distract us from the goal of price stability? In two ways: by embracing the primary goal of price stability and central bank independence; and by fostering public confidence and thus underpinning the credibility of the central bank's stability strategy.

Central banks can build up credibility in two ways. First, by successfully safeguarding price stability for years. A track record like that also protects their independence. As Harold James once put it, confidence is the hard-won "core working capital of central banks" which it would be very costly to jeopardise.

Another way in which central banks can bolster the credibility of their stability strategy is by committing to an appropriate monetary policy strategy and interpreting their mandate

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[4] Alberto Alesina and Lawrence H Summers (1993), Central Bank Independence and Macroeconomic Performance: Some Comparative Evidence Journal of Money, Credit and Banking, Vol 25, No 2, pp 151–162.

[5] Vittorio Grilli, Donato Masciandaro and Guido Tabellini (1991), Political and Monetary Institutions and Public Finance Policies in the Industrial Countries, Economic Policy 13, pp 341–392.

narrowly. Indeed, what the Economist wrote back in 1990 remains true to this very day: “The only good central bank is one that can say no to politicians”.

Independent central banks need strict limits to their flexibility, such as a ban on monetary financing, so that their independence is not ultimately called into question, especially so in a framework that is as complex as the European Monetary Union. Only this will ensure that the goal of price stability does not take a back seat to preserving government solvency, even in times of crisis.

2.2 Fiscal policy

Both theoretical analyses and historical experience show that sound public finances are key to a successful, stability-oriented monetary policy – especially in a monetary union. This is one reason why it also makes sense to create rules for fiscal policy.

However, it is clear, too, that these need to be different to monetary policy rules, because fiscal policy involves a much greater degree of redistribution, which requires democratic legitimacy. Because the parliaments have fiscal sovereignty, an independent staff is hardly possible, though limits on the room for fiscal policy manoeuvre are – through a debt brake, for instance.

Of course, this also depends on how the rule is structured. An effective rule should leave enough room for policy makers to accommodate the economic situation or extraordinary events such as natural disasters. In the conflict between binding force and flexibility, the actual binding effect of the rule should be the deciding factor.

On the one hand, a nominal debt ceiling such as in the United States appears to be binding if it can be used time and again to push the government to the brink of insolvency in political power struggles stemming from a lack of consensus on a medium-term consolidation strategy. On the other, the ceiling has so far always been raised at the last minute following difficult political negotiations, which implies that it must be possible to design a more effective fiscal rule that is binding in the long term.

We have had similar experiences in Germany – under Article 115 of the Basic Law, the government has usually been able to extend the limits on new borrowing – which were, in any case, fairly generous – simply by diagnosing a “disruption of the macroeconomic equilibrium”.

The lessons from the European debt crisis have also taught us that, in practice, the binding effect of our rules was not very strong. Since the start of monetary union, Germany, France and Italy have exceeded the deficit limit of 3% in seven, eight and even nine years respectively.

Whether the reforms will put real teeth into the Stability and Growth Pact and the Fiscal Compact in this respect depends heavily on the European Commission and how it uses its extra scope for discretion.

The first time the Commission applied the new rules, it showed itself to be very flexible, 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 postpones them until a later date. Making exceptions for a large number of countries simultaneously undermines the disciplining effect of the fiscal rules.

In view of past experience with fiscal rules, in particular, I strongly believe that the euro area can only be maintained as a stability union in the long run if its framework sufficiently embodies a key principle of regulatory policy: the principle of liability.

In the context of public finances, this means that those who make decisions on spending must also take responsibility for them. In other words, there must be a balance between control and liability.

In principle, the Maastricht framework assigned both liability and control to national governments. During the crisis, the EFSF and ESM bailout funds stabilised the euro area but also increased the mutualisation of liability for previous national errors.

To restore the balance between control and liability, I only see two plausible options: either we shift powers to monitor and intervene to European level by creating a fiscal union, or we strengthen the member states' individual liability and responsibility in a return to the Maastricht framework. This also ultimately means that sovereign insolvencies cannot – and must not – be ruled out. They must be possible without also causing the financial system to collapse.

The current balancing act between individual responsibility and mutualised liability is likely to lead to new strains in the long run. To exaggerate slightly, as Adorn said, "there is no right life in the wrong one".

2.3 Financial market regulation

In order to make the financial system more resilient to crisis, and thus to restore greater validity to the principles of competition and liability, changes will also need to be made to financial market regulation.

A particularly severe problem which arose during the crisis was one I mentioned earlier, the "too-big-to-fail" problem: whenever banks become too large or interconnected to be would up without jeopardising financial stability, this undermines the liability principle and ultimately disrupts competition, and represents an invitation to act irresponsibly. That has to change!

Recent developments in the financial sector, such as increased indebtedness and the burgeoning growth of the shadow banking sector, require new rules as well. There must three primary objectives behind these new rules. First, banks have to become more resilient; in other words, they have to acquire a higher quantity of higher-quality capital to protect themselves against potential losses. Second, we need effective resolution mechanisms so that, in a worst-case scenario, banks can exit the market without endangering financial stability. Third, we need to ensure that these rules cannot be circumvented by taking business elsewhere, such as, for instance, to the shadow banking sector. The rules of the game have to apply to all alike.

I would like initially to discuss in more detail the objective of improved capital buffers. The new international rules, generally referred to as Basel III, have already taken us a great deal further in this respect. Banks now have to hold more capital and higher-quality capital.

However, there are some who believe the Basel III risk-based approach to be fundamentally wrong. The discussion is ultimately about whether capital adequacy rules should be simple or complex. Thus far, capital rules have been complex rules: the capital to be held is determined according to the risk profile of each individual bank's assets.

Critics such as University of Bonn economist Martin Hell wig, however, assert that "material risks are not captured at all" by the risk weighting. And he adds that "banks use the risk weighting to expand their business to, in some cases, one hundred times their capital."

And yet the fundamental theory behind risk weighting is quite plausible: if the same percentage of capital is to be held for all assets across the board, this gives banks an incentive to invest particularly in riskier assets in order to increase their return on equity. That will do no favours to financial stability, either.

Mark Carney, Governor of the Bank of England, therefore favours a pragmatic approach, saying that sometimes both a belt and suspenders are needed to keep one's trousers from

slipping. Therefore, in his view, a one-size-fits-all rule, in the form of a uniform debt ceiling, should coexist with the current risk-weighting rules.

I think this approach makes sense: where there is a threat of major losses that could bring the financial markets even to the brink of meltdown, there is justification – or even a need – for installing multiple security systems. What's needed for nuclear reactors, for instance, does not seem like a bad idea for the financial system, either.

It is also important, though, that these security systems cannot be circumvented by moving assets to less regulated areas such as the shadow banking sector. Much remains to be done in this regard, starting with the enforcement of extensive reporting requirements.

To strengthen the liability principle, it is crucial, too, that a bank which, for instance, does not have a sustainable business model be able to exit the market without putting financial stability at risk. Otherwise, competition in the banking sector will be undermined.

The implications are shown by a study published as a Bundesbank Discussion Paper[6] Absent an effective bank resolution mechanism, banks could become overly generous in their lending decisions and efforts in terms of ongoing loan monitoring could fall short. Capital would then no longer be allocated to its most productive use; instead, there is a danger that particularly risky lending would tend to be overfunded for too long. And that would weaken the forces of macroeconomic growth.

An effective resolution mechanism thus strengthens not only financial stability, but also economic growth. The decisive factor here is not to make the taxpayer foot the bill for resolution – indeed both shareholders and providers of loan capital should bear the losses incurred.

This is exactly the approach underlying the work conducted at European level on a new Banking Recovery and Resolution Directive (BRRD). However, there may also be reasons why the BRRD, adopted at the end of last year, gives countries the option of departing from the directive's strict liability cascade in cases where financial stability is under threat. This is possible, for instance, by exempting certain liabilities or by permitting the use of public funds in the context of a "Government Financial Stabilisation Tool" as a last-resort measure.

However, the market can only impose discipline on the banks in full measure if such exemptions are tightly restricted.

3. Conclusion

This foray through various areas of the economy has shown that the economists' toolkit is more likely to be the topic of contentious public debate in the future than the dentist's drill.

Keynes' hope is therefore unlikely to come to pass, too.

Although economists are not dentists, they are seen by many as the economy's doctors, as has been recently noted by Dennis Snowier, President of the Kiel Institute for the World Economy. At the core, what this means is that, if a new crisis emerges, the best possible therapy needs to be found quickly.

In full keeping with evidence-based medicine, we should therefore not lose sight of principles which have withstood the test of time in economics and have been proven by empirical evidence – including, above all, the concept of an independent central bank committed to monetary stability.

I now look forward to our discussion!

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[6] Joseph Korte (2013): Catharsis − The real effects of bank insolvency and resolution. Deutsche Bundesbank Discussion Paper No 21/2013.