Jens Weidmann: Monetary union as a stability union

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Duitsland Instituut, Amsterdam, 7 April 2014.

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1. Introduction

Dear Professor Nijhuis,

dear Dr Plecher-Hochstrasser,

dear Dr Ullersma,

dear Klaas,

ladies and gentlemen,

I thank you for the invitation and for the opportunity to speak here today.

The Duitsland Instituut's mission is to increase knowledge of Germany and disseminate this knowledge to a wide audience in the Netherlands. I am glad to join in this effort today, though I will confine myself to the Bundesbank's take on matters of the Economic and Monetary Union. Adding more issues to that would probably constitute an overburdening of the monetary policymaker you see before you. And overburdening monetary policy is of course anathema to the Bundesbank.

To me, it seems particularly befitting to talk about the challenges of the intricate construction that is our monetary union here in Amsterdam.

As you know better than I do, up until the 12th century, the area of what is today known as the Province of Holland was basically considered uninhabitable. The area consisted mostly of swampland and morass, and was traversed by many rivers. It took the erection of a dam to protect a small patch of land from the Amstel River and the tireless effort of pushing countless wooden piles up to 18 meters deep into the ground to lay a foundation that proved solid enough. Solid enough to pave some roads and to build the first houses of what would later become the city of Amsterdam. Nobody would claim now that it was not worth the effort. Amsterdam is both unique and beautiful.

And this is where the European monetary union comes in. There are surely more obvious places to build a currency union than in Europe. Without a doubt the euro area lacks some of the characteristics of an optimal currency area. Labour mobility, for instance, is much lower than in the US; plus the business cycles are not synchronised, nor is there any central fiscal stabiliser. At the end of the day, the decision to create the European monetary union was a political one, not an economic one.

But I am positive that if we learn from the sovereign debt crisis and do not falter in our efforts to push enough piles into the right parts of that tricky ground, the European monetary union can be preserved as a place of stability that is worth living in. In the first 15 years since the euro was launched, people have enjoyed a stable currency. The average euro-area inflation rate was 2.0%, which is very close to the ECB Governing Council's definition of price stability ("below, but close to, 2%").

In the next 30 minutes, I will present my views on which additional piles are required and how they will need to be arranged in order to preserve the European monetary union as a stability union. In doing so, I will first look into what still needs to be done at the country level. From there, I will go on to address the weaknesses in EMU's institutional foundation.

But before talking about what needs to be done, let us take a step back and consider what went wrong in the first place.

2. The origins of the crisis

For many euro-area member states, the introduction of the euro ushered in a new era of abundant capital, due to the elimination of exchange rate risks. And standard economic reasoning suggests that capital should flow from capital-rich to capital-poor economies, where returns should be higher.

However, the favourable financing conditions in the euro-area countries with previously higher interest rates mainly stimulated their domestic consumption, thereby raising prices and wages in the non-tradable sector. To put it in a nutshell: inflowing capital was not always put to productive use.

Overinvestment in real estate as well as public and private consumption failed to raise productivity in some member countries. Unit labour costs soared, competitiveness declined. And the rigidity of labour and product markets meant that this process gained even more momentum.

When the financial crisis broke out in 2007, the vulnerabilities became apparent: investor sentiment began to shift, and interest rates for the countries in question started to rise sharply, triggering a crisis that is still far from being fully resolved.

How could it go so wrong? Here is where the euro area's unique institutional set-up comes in.

The euro area teams up one common monetary policy with 18 national fiscal and economic policies. This approach reflects a currency area composed of sovereign member states. It grants member states enough room for manoeuvre to preserve their diversity, that is, to establish their own business models or to tailor institutions and policies to their own national preferences. Such preferences can differ, for example, with respect to income redistribution or the role of the state in the economy. At the same time, it leaves the consequences of such decisions with the respective member state and consistently rules out the option of mutualising public debt with other euro-area states.

But this set-up also creates vulnerabilities.

First, such a combination gives rise to a deficit bias, as it allows the costs of fiscal imprudence to be shifted partially on to others. An unsustainable fiscal situation in one country has repercussions for monetary union as a whole.

And second, each member state issues debt in a currency it cannot create. Thus, a high level of fiscal discipline is needed to ensure that solvency concerns do not spiral out of control. This notwithstanding, the central banks' balance sheets can serve as a conduit for shifting risks among national taxpayers, even if there are no explicit fiscal transfers and irrespective of the approval of national legislatures – thus undermining countries' individual national responsibility and hence the very foundations upon which responsible decision-making is built.

However, if central bank independence is used for purposes other than price stability, it is only a question of time until central bank independence is challenged.

The founding fathers of the euro clearly foresaw the risk of unsustainable public finances for a stability-oriented monetary policy. Therefore, precautions were put in place to safeguard sound public finances. They took the form of a prohibition of monetary financing of government deficits, the no bail out clause and the Stability and Growth Pact.

Barry Eichengreen and Charles Wyplosz wrote in an article in 1998: "The most compelling rationale for the Stability Pact rests on the need to buttress the no-bailout rule of the Maastricht Treaty". And having a good sense of what might happen, the two economists continued: "That need will be most pressing where debt problems place banking systems at risk and where bond market contagion is pervasive."

At the time, it was assumed that by constraining governments' ability to fiscally stimulate demand – and by shifting monetary policy to the European level – governments would have no choice but to implement structural reforms, improve their supply side, and strengthen their potential for sustainable growth.

It was also thought that the financial markets would enforce fiscal discipline. As we know now, things did not exactly work out as expected. So, in a sense, the piles on which monetary union was built turned out to be unsound. The fiscal rules were breached numerous times, not least by Germany and France.

In addition, investors made hardly any distinction between the bonds of individual member states. From 1999 to 2007 the average difference between EMU government bonds, excluding Germany, and German government bonds, for instance, was a mere 14 basis points. Just for comparison: at the end of March that spread stood at 123 basis points.

I leave it to you to decide whether this was because investors were neglecting the growing differences in economic fundamentals or because they never really believed that the no bail out clause would hold when the going got tough. In any case, the strong convergence in financing conditions set the wrong incentives: governments' purses were loosened, not tightened, structural reforms were postponed, not pushed.

By the same token, banks and capital markets in many cases failed to allocate the inflowing capital efficiently. Instead of financing productive investment they shifted money into ballooning real estate sectors. As a result, banking systems in some euro-area countries were subsequently hit hard by a severe crisis.

In sum, this is what, to me, largely explains the unsustainable developments in the run-up to the crisis. Hence, work is needed on three levels.

First of all, the countries have to correct the macroeconomic imbalances and to boost the potential for sustainable growth by regaining competitiveness, by consolidating public finances, and by catching up on long-delayed structural reforms.

Second, we need to address the weaknesses in the monetary union's institutional architecture.

And third, we need a more resilient financial system. Owing to regulatory weaknesses, the financial system acted as an amplifying transmitter of the crisis.

Due to time constraints, I would like to focus primarily on the first two issues. Let's have a look at the state of play in the member states.

3. Reforms at the national level

In many countries, structural reforms to remove rigidities in product and labour markets are now underway. A number of labour market reforms have been introduced to foster employment and reduce adjustment costs during economic downswings. In addition, the retirement age has been raised as well. Product market rigidities that weaken competition, produce regulatory red tape, and inhibit growth, are also being addressed.

And according to the World Bank's Doing Business Report, progress has been made in this regard as well: Portugal, Italy, and Spain have climbed up the ranking ladder by 17, 13, and 10 positions respectively over the last four years. Greece moved up by 37 positions. Unit labour costs and current accounts of deficit countries have improved – not only because of shrinking imports, but also because of expanding exports.

Factors of production are being reallocated to sectors with a strong focus on exports. The construction sector in Ireland accounted for over half of the decrease in aggregate employment; in Spain, Italy and Portugal, it accounted for around two-fifths. In industry, by contrast, either far fewer jobs have been cut or – as in Ireland – new jobs have recently been created.

Real value added, in particular, far exceeded its pre-crisis level in the export-intensive information and communications sector in Spain and Ireland as early as in 2012. In Ireland, other business-related services also showed substantial growth. Compared to its pre-crisis level, real value added in trade and tourism increased in Portugal and remained virtually unchanged in Spain.

Progress has been uneven, though, and further reforms are needed to facilitate this shift from the non-tradable to the tradable sector and, therefore, to strengthen sustainable growth.

Overcoming the crisis is still an uphill struggle; if you don't go forwards, you go backwards. With regard to reforms, governments therefore have to keep the pedal to the metal. In footballing terms, I would say "the half-time whistle has blown". However, there is no time for a break.

Without doubt, adjustment has to happen primarily in the deficit countries, but countries with a current account surplus, such as the Netherlands and Germany, face challenges as well. While the Netherlands is still dealing with the aftermath of a housing bust, demographic trends require Germany to raise its potential for sustainable growth.

Germany's overall investment ratio was 16.7% in 2013, compared with 22.3% in the year 2000. This low level of investment is attributable to numerous factors, many of them cyclical in nature. However, improving the conditions for investment in energy, transport and communications networks – like fast and efficient implementation procedures – would raise Germany's long-term growth potential, as would further investment in research and education.

In order to counter the demographic challenges, Germany should improve pre-school education and support educationally disadvantaged young people in order to foster their employability.

Furthermore, we should reduce, rather than create, incentives for early retirement, and we need a systematic approach to attract skilled labour from abroad, whose expertise is needed. And I am not talking about all the world-class footballers from the Netherlands and many other countries who play in Germany's Bundesliga.

When looking at sectoral developments in Germany, one fact is striking. For the last 20 years, productivity growth in services has lagged markedly behind growth in manufacturing. In fact, while productivity in manufacturing has grown by more than 30%, productivity growth in services has barely budged. Why is that?

The data point to a higher degree of competition in the manufacturing sector: Mark-ups, an indicator of the pricing power of firms, have gone down following the launch of the common market. By contrast, mark-ups on services have stayed high in Germany, higher even than in many other European countries. Opening up closed professions, cutting red tape and improving access to financing for nascent digital firms would serve to improve the functioning of the services sector.

But while there is room for improvement in Germany especially when it comes to the efficiency of its services sector, the fact is that European mark-ups are elevated in general, compared to the US, for example. It is therefore high time to fully harness the forces of the market for Europe, by making the most of its main catalyst for competition and growth, the European single market.

In his report to the European Commission, former Commissioner Mario Monti estimated the potential growth effects of creating a digital single market, which is largely services-based, to be about 4%, on a par with the gains made since 1993.

Further benefits would ensue from a reduction in the vast number of exemptions in the Services Directive. Reforms that strengthen competition in the services sector therefore hold the promise of delivering stronger and more balanced growth. More balanced growth is likely to translate into a moderation of the current account as well.

This would come without weakening the competitiveness of Germany's export sector. This would be the case, however, if Germany would accept the economic advice to excessively boost its wages to stimulate domestic demand. This would harm employment in Germany and, as a consequence, the economic situation in the entire euro area.

So, while considerable progress has been made at the national level, in the deficit countries in particular, much remains to be done. And reforms at the national level could be reinforced by European efforts to strengthen competition, especially in the services sector.

4. Strengthening EMU's institutional architecture

However, when it comes to taking action at the European level, other challenges for monetary union are probably even more crucial. The safeguards originally put in place for the stability for the monetary union, the Stability and Growth Pact and the no bail-out clause, failed to prevent the crisis.

It also turned out that other macroeconomic imbalances likewise pose a threat to the stability of the euro area: a steady loss of competitiveness, persistent current account deficits, or high levels of private debt.

Ultimately, the risk of contagion between countries was also underestimated when the monetary union was established.

In response to the crisis, rescue mechanisms such as the EFSF and ESM were put in place, and they did manage to contain the fallout somewhat. But at the same time, the rescue mechanisms have weakened the principle of individual responsibility, as fiscal responsibility has essentially remained national, while liabilities have been partially mutualised.

In other words: the balance between liability and control has become lopsided. Yet I believe that this balance is fundamental to the stability of Europe's monetary union. To put it rather bluntly: you would certainly not want to share your bank account with your neighbour if you were unable to control his or her spending.

But how do we restore that balance, and put monetary union on a more solid footing? In principle, there are two ways: first, by creating a genuine fiscal union, or second, by making the principle of individual responsibility work.

The first option, a genuine fiscal union, would require the member states to relinquish their fiscal sovereignty and cede it to the European level. In such a setting, the mutualisation of future liabilities would be consistent.

This step would require a change of the European treaties as well as a change of national constitutions. 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.

This leaves us with the second option, making the principle of individual responsibility work better. In order to do so, the Stability and Growth Pact was stiffened and the fiscal compact was introduced.

These are steps in the right direction. But the mere existence of these rules will not suffice. As Erasmus of Rotterdam once said: "A nail is driven out by another nail. Habit is overcome by habit."

Strict and consistent application of the stiffened rules is therefore important. Here, the Commission has a special responsibility. In this context I am worried that the fiscal policy rules have become ever more complex and, in turn, so has monitoring compliance with them. It has now become almost impossible for experts, let alone the general public, to determine whether or not countries are complying with these budget rules.

This naturally reduces the binding force of the rules. The binding force of the rules can also be diminished if there is the impression that they are not being strictly interpreted by the

Commission. And the assessment procedure gives the Commission greater and more discretionary leeway. Metaphorically speaking, we need to make sure that the Commission does not go beyond its role as a referee and move the goalposts mid-game.

Based on past experiences it is clear to me that stiffening the rules alone won't suffice to enforce the principle of individual responsibility. At its core, this principle requires that sovereigns, banks, and investors bear the consequences of their decisions.

This implies that it is primarily up to the respective government and its citizens to come up with the revenue required for repaying public debt. This holds, in particular, since high levels of public debt often go hand in hand with substantial private assets. But it also implies that the risk of non-repayment ultimately lies with the investors, since they are the ones who reap the return when things go well. And if the fiscal limit has been reached for real, public debt needs to be restructured without posing a systemic threat to financial stability.

The introduction of collective action clauses into sovereign bonds was a first step in that direction. But more steps are needed.

The Bundesbank has put forward a proposal for sovereign bonds to include an automatic maturity extension of three years in case a sovereign accesses the European rescue mechanisms. This automatic maturity extension would allow the sovereign in question to tackle its fiscal challenges while preventing investors from bolting. Liability and control would be brought better into balance. The amount of official financial support would be reduced, and time is bought to figure out if the problem is one of temporary illiquidity or insolvency.

But ultimately, all these questions boil down to the quip of American economist Allan Meltzer: "Capitalism without failure is like religion without sin. It doesn't work." For the above proposals to work, we need to make sure that the insolvency of both banks and sovereigns is possible without bringing down the financial system as a whole.

At the moment, the insolvency of a sovereign or of a systemically important bank is perceived as an unpredictable risk. What do we have to do to make that risk manageable?

At the core of the problem lies what is now known as the sovereign-bank nexus. In the crisis, this sovereign-bank nexus developed into a vicious circle: Tottering banks and teetering sovereigns lean towards each other for support, but are in fact pushing each other over.

If a large bank or one which is strongly interconnected with other banks runs into difficulties, this can pose a threat to the stability of the entire financial system. 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"? The strengthened Basel III capital rules are a first step in that direction, as they increase capital buffers and therefore the capacity of banks to absorb losses.

The banking union, with its Single Supervisory Mechanism, is another such step. Strict and stringent supervision ensures that tough rules are applied equally to all.

In retrospect, heeding Wim Duisenberg's advice when he argued in favour of a European banking supervision in the late 1980s would have paid us all a handsome dividend. The establishment of the SSM 25 years later is testament to his prescience. The SSM is important for severing the link between banks and sovereigns. But to make sure that banks cannot pass on the consequences of their actions to the public, more is needed.

As a natural complement to the SSM, an effective restructuring and resolution mechanism has to establish a bail-in regime that clearly assigns how losses are distributed, making sure that shareholders and creditors are first in line. In this regard, the agreement on the Directive establishing a framework for the recovery and resolution of failing banks (BRRD) and the agreement on the Single Resolution Mechanism three weeks ago constitute progress.

But it would be better still if the bail-in regime were to take effect at the time the SRM starts – not one year later as is currently envisaged.

The sovereign-bank nexus, however, works both ways. We also have to make sure that worsening public finances do not infect the financial system. The banking union still has a sovereign virus, as Daniel Gros from the Centre for European Policy Studies put it. To strengthen the banking union's immune system, we need to end the preferential treatment afforded to sovereign debt. At present, sovereign bonds are treated by European regulators as being risk-free – an assumption that stands in contradiction both to the no bail out clause and to recent history.

We should therefore put this regulatory fiction to rest. 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 sending a disciplining signal to the sovereign.

But sovereign bonds pose a threat to financial stability not only because of preferential risk-weighting. The most important rule in risk management is diversification.

Yet when it comes to sovereign bonds, banks all too often seem to neglect this principle. In many cases, European banks hold bonds from one sovereign only – their home country. During the crisis, many banks, particularly weak ones, used the low refinancing costs to buy even more sovereign debt; they made a sort of "carry trade". However, a high level of undiversified sovereign exposure is what makes sovereign default a potentially systemic event.

Hence, the large exposure regime which caps investments in a single debtor has to be applied correspondingly to sovereigns as well. This might trigger substantial repercussions, but these would be manageable if they were phased in over a transitional period – which would undoubtedly need to be granted.

5. The role of monetary policy

Consistently applying the stiffened rules and ending the preferential treatment afforded to sovereign debt will be instrumental in strengthening the stability of our monetary union. So will the banking union.

Currently, much of the support provided to the whole structure hinges on one pillar alone: monetary policy. But this will work only for so long; monetary policy has already done a lot to absorb the economic consequences of the crisis, but it cannot solve the crisis. To say it once again in Wim Duisenberg's words: "Don't ask for monetary policy to perform tricks it cannot deliver."

Therefore, the best contribution the Eurosystem can make to a lasting resolution of the crisis is to fulfil its mandate: that of maintaining price stability.

To avoid potential conflicts of interest between the ECB's mandate to safeguard price stability and its role in banking supervision, changes to the European Treaty will be needed in the medium term in order to strictly segregate these two functions.

Klaas Knot said recently in an interview with the German daily "Handelsblatt" that it was sensible to make use of the ECB's credibility to establish the SSM, but that it should be considered to eventually outsource the SSM from the ECB and to establish a separate institution. And I can only agree with his view.

6. Conclusion

Ladies and gentlemen, let me conclude.

The crisis has laid bare shortcomings at the national level as well as weaknesses in the monetary union's institutional architecture. Repairs at the national level have seen considerable progress, though there is still a long way to go.

Like in a marathon, the second half of the course always feels tougher than the first – and one major challenge is to not give in to the growing reform fatigue. But at this point, the weaknesses in EMU's architecture probably pose a more fundamental challenge.

The balance between liability and control has got out of kilter. We need to regain that balance if we are to put EMU on a more solid footing.

Since a genuine fiscal union is not on the cards – and to me it does not seem to be for the foreseeable future – we need to make the principle of individual responsibility work. Therefore, we need to break the sovereign-bank nexus in both directions. The banking union is an important first step.

But we also need to put an end to the preferential treatment afforded to sovereign debt in order to immunise the financial system against sovereign default.

To me, these are the piles we still need to push into the ground to provide for a lasting foundation of our monetary union.

I now look forward to Governor Knot's take on EMU's most pressing challenges. Klaas, the floor is yours!