Jens Weidmann: Dinner speech

Dinner speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the 20th Dubrovnik Economic Conference, Dubrovnik, 12 June 2014.

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1. Introduction

Governor Vujčić, dear Boris

It is a great pleasure to be in this wonderful and picturesque Mediterranean town. So thank you very much for the kind invitation to give a speech at this conference dinner.

You will not need reminding that today marks the beginning of the World Cup football tournament in Brazil. Kick-off of the opening match between Brazil and Croatia is in less than two hours' time. With this in mind, I will try to be brief.

Over the next month, football will be at the centre of attention all over the world. National football teams are promoting their own national identity. According to a German sports economist, there is a high correlation between a national football team's performance and a country's reputation. The teams are contributing significantly to the "branding of nations".

For now, at least, nobody would even dream of fielding a European Union team, even if it were considered to be unbeatable. I am quite sure that people continue to feel as nationals rather than as Europeans – at least where football is concerned.

Rivalry in football, however, does not imply that there is no European team spirit. Nor does it suggest that the European project is not one of the greatest ideas in post-war times. The European idea is still an appealing one. And despite all prophecies of doom concerning the crisis in the euro area, European integration remains attractive.

This has been demonstrated, not least, by the accession of Croatia to the European Union as of 1 July 2013. By becoming a member of the EU, Croatia has also expressed its willingness to join the European Monetary Union one day, when the convergence criteria have been fulfilled. And the intention of Lithuania to introduce the common currency as of 2015 shows that joining the euro area is still considered attractive.

For the time being, the crisis in the euro area has slipped from the focus of public awareness. Nevertheless, it is too early to claim victory over the crisis in the euro area. Even though financial markets might suggest otherwise, the crisis is far from over.

In particular, the sovereign bond yield spreads of the euro-area countries most affected have decreased significantly over the past two years. The fall in long-term interest rates has reduced those countries' borrowing costs considerably.

Markets are rewarding adjustment progress in the stressed countries. It is clear to me, however, that the decline in sovereign bond yield spreads has also been supported by central banks' actions. The ECB's announcement of conditional but unlimited purchases of sovereign bonds has – unsurprisingly – calmed investors' fear of losing money.

You may know that I was not in favour of this measure. While sovereign bond purchases are a widely used monetary policy tool, they are not without risks. They bring monetary policy very close to monetary financing of governments, which could undermine the central bank's ability to maintain its mandate of price stability.

Monetary policy may face the danger of being dragged and driven by fiscal policy, and find it very difficult to free itself. The more so as governments become increasingly accustomed to bond purchases that keep the interest rates low. In this sense, sovereign bond purchases may act like a sweet poison for the governments. The rude awakening may come when the purchases are reduced or stopped altogether.

One particular problem with sovereign bond purchases in a monetary union is that they redistribute risks among the taxpayers of different countries. Any such decisions, however, should be taken by democratically elected governments and parliaments.

The rallying markets are also being sustained by exceptionally easy monetary policy conditions the world over. Nevertheless, there is a risk that market valuations may be running ahead of the adjustment processes.

The current long-term yields on some European government bonds already appear to have factored in the required adjustment to a large extent. This, however, creates a setback potential. It is therefore all the more important that policymakers ensure that the necessary economic progress is actually achieved. Their determination to implement reforms is pivotal. In any case, low interest rates do run the risk of creating incentives to postpone necessary reforms. Thus, the current environment necessitates an even stronger political will.

There is no question of there being a quick fix to eliminate the causes of the crisis. Considering that the risk potential built up over many years, it is obvious that it will also take time to reduce it.

2. How to make EMU more resilient

The question is: How do we best go about making EMU more resilient?

As a starting point for the analysis of the crisis, it is helpful to recall the institutional set-up of the European Monetary Union.

When EMU was established, monetary policy was centralised while fiscal and economic policies remained in national hands. This set-up created vulnerabilities.

It gave rise to a deficit bias, allowing the costs of fiscal imprudence to be partially shifted to other countries. If the fiscal situation in one country is unsustainable, this implies repercussions for the monetary union as a whole.

Moreover, abandoning the national currency in favour of a single currency has two major implications. First, member states cannot regain lost price competitiveness by depreciating their currency against their trading partners' currencies and internal devaluation as a substitute is much more painful.

And second, each member state issues debt in a currency not of its own making. Fiscal discipline is therefore of the essence and even more important than in a country that has its own national currency. This applies to an even greater extent, as there are no explicit fiscal transfers among governments.

However, although fiscal transfers were deliberately ruled out, the central banks' balance sheets can serve as a conduit for shifting risks among national taxpayers. This undermines both the countries' individual fiscal responsibility and the central banks' independence.

The founding fathers of the euro clearly foresaw the risk of unsustainable public finances for a stability-oriented monetary policy. Therefore, precautions in terms of fiscal rules were put into place to safeguard sound public finances. They took the form of the no bail-out clause, the Stability and Growth Pact and the prohibition of monetary financing of government deficits for the reasons I have just mentioned. As it turned out, however, these precautions were not sufficient to prevent the crisis.

The introduction of the euro and the associated disappearance of exchange rate risks led to strong capital flows to countries which previously had high interest rates. Unfortunately, the capital inflows were not always put to productive use; banks and capital markets failed in many cases to allocate the money efficiently.

Instead of financing productive investment, they shifted money into booming real estate sectors, for example. And the governments of some member states missed the opportunity

of lower interest rates to consolidate public finances. Instead they enjoyed a more relaxed budget restriction.

Capital inflows also enabled higher wages while, at the same time, productivity growth was weak. This resulted in rising unit labour costs and so undermined price competitiveness. Economies became less competitive on export markets, leading to large and persistent current account deficits.

They suffered from a sudden halt in external funding during the financial crisis when lenders reined in their risk appetite and fled from risky investments to safe havens. Current account deficits as well as budget deficits became hard to finance – so hard that private funds had to be substituted by public funds.

Fiscal stabilisation measures by the euro area countries, the EU and the IMF as well as central bank operations by the Eurosystem helped the stressed countries to bridge the finance gap and to prevent the financial system of the euro area from collapsing. However, while this bridge saved the economies from an immediate and tough adjustment process, it did not remedy the underlying problems of the crisis.

In order to foster the groundwork of EMU, three challenges have to be met.

The macroeconomic adjustment process has to be continued. This adjustment process has to be accomplished primarily in the deficit countries, but the other countries – including Germany – face challenges, too.

Regarding the adjustment of the euro-area periphery countries, remarkable progress has been made so far. Current account deficits and public deficits have been reduced significantly and structural reforms on labour and product markets have been implemented. Nevertheless, the necessary adjustment has not been completed yet.

In footballing terms, I would say “the half-time whistle has been blown” but there is no time for a break. And let’s not forget that the second half is usually more exhausting than the first, and we may even have to go into extra time.

Actually, there are signs of growing reform fatigue and rising reluctance to implement further austerity measures. However, it is crucial to stay on the ball.

In this respect I also wish to look at the large euro-area economies which have significantly lost competitiveness. Both France and Italy need to implement structural reforms to make up for these losses and thereby act as a role model for the crisis countries as well as for all other EU countries.

The second requirement for a stable monetary union is a more resilient financial system.

Owing to regulatory weaknesses, the financial system acted as an amplifier of the crisis. It has become apparent that the financial system is the Achilles’ heel of European monetary union. Without a sound banking system there will be no stable monetary union.

The establishment of a banking union including a single supervisory and a resolution mechanism provides the opportunity to make the financial system more resilient and to boost investors’ confidence.

At the current juncture, the ECB together with the national supervisors is comprehensively assessing the balance sheets of the banks which are candidates for direct ECB supervision. I agree with Jaime Caruana, the General Manager of the BIS, who recently said, “The asset quality review is a great opportunity to spur the necessary balance sheet adjustment. This chance must not be missed.”

The banking union closes a vulnerable gap faced by EMU in helping to strengthen the financial system. However, the banking union is not sufficient to strengthen the institutional architecture of EMU.

Rather, we need a fundamental reform of the EMU framework. And this is the third challenge that has to be met to make EMU more resilient. Let me elaborate on this point.

The implementation of the Maastricht framework was not able to save the euro area from the crisis. One of the underlying reasons for this insufficiency is that the rules were too strongly focused on fiscal policies, while their implementation was too weak.

It should be kept in mind that Germany and France were the driving forces behind the Stability and Growth Pact reform about a decade ago which turned the Pact into a toothless tiger. With hindsight, they scored an own goal with their efforts.

Another flaw in the framework was the restricted credibility of the no bail-out rule. If the markets had believed in the rule, we would not have experienced such a strong convergence of sovereign bond yields as we saw prior to the crisis.

When the EMU framework was established in the early 1990s, the risk of contagion among euro-area member states was clearly underestimated. Financial markets were significantly less developed at that time. The credit default swaps market, for example, did not even exist back then. That may help to explain why fiscal firewalls were not deemed necessary when the EMU framework was established.

While the rescue measures that were established later, such as the EFSF and the ESM, managed to contain the fallout somewhat, they weakened the principle of individual responsibility. Fiscal decision making has essentially remained national, while liabilities have been partially mutualised. In other words, the balance between liability and control has become lopsided. This balance, however, is fundamental to the stability of the monetary union.

But how do we restore that fundamental balance, and put monetary union on a more solid footing?

In principle, there are two options. The first way is to create a genuine fiscal union; the second way would be to confirm the Maastricht framework, which essentially means making the principle of individual responsibility work better.

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

Such a giant step towards a fiscal union would require considerable changes to the European treaties and the national constitutions as well. To be honest, however, I do not see the willingness of national governments to let Brussels have a say in fiscal matters, and the results of the recent elections for the European Parliament suggest that the electorates do not support such a shift either. Against this backdrop, 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 tightened and enhanced by an early warning system for macroeconomic imbalances. A fiscal compact was introduced according to which member states committed to incorporate balanced budget rules into their national legislation.

Regarding the effectiveness of those changes, I would refer to the English proverb “the proof of the pudding is in the eating”. In other words, it is not clear yet whether the new rules do really bite.

It will be crucial that the European Commission applies the stiffer rules strictly and consistently. Unfortunately, fiscal policy rules have become highly complex and, in turn, the scope for interpretation has grown. The assessment procedure gives the Commission greater and more discretionary leeway.

However, if France for example were allowed, for the third time, to postpone the correction of its excessive deficit, this would severely undermine the credibility of the new Stability and Growth Pact. If I may use another football metaphor, the Commission should stick to its role as referee and not try to move the goalposts mid-game.

To make EMU more resilient, a confirmation of the Maastricht framework goes beyond tightening fiscal rules. Making the principle of individual responsibility workable means making governments, banks and investors feel the consequences of their own actions. Hence, a credible no bail-out rule is needed.

A credible no bail-out rule, however, would ultimately require that an orderly insolvency regime for governments exists. As long as a sovereign default is impossible owing to the implied risk for the stability of the financial system, investors in sovereign bonds can expect to be bailed out.

In order to make such a state insolvency bearable, we need a robust financial system with sufficient loss absorption capacity and one which is not too closely tied to the government.

The so-called sovereign-bank nexus is a huge obstacle to permanently overcoming the crisis in the euro area. During the crisis, many banks, notably in the euro-area periphery, raised their exposure to domestic government bonds; in doing so they tied their fate even more closely to that of their national government.

This development was assisted by the preferential regulatory treatment of government bonds. It includes the zero risk-weighting of government bonds issued in local currency and the lack of exposure limits.

In order to strengthen the banking union and the monetary union, I believe we need to end this preferential treatment of sovereign debt over a reasonable period of time. Sovereign bonds should be adequately risk-weighted, and exposure to individual sovereign debt should be limited, as is already the case for private debt.

3. Conclusion

Ladies and gentlemen,

The French writer François Fénelon said, “The more you say, the less people remember.” Moreover, I promised to be brief. So let me conclude.

According to econometric studies on the history of World Cup football tournaments, the advantage the home team has is statistically significant – no surprises there. Looking ahead to tonight’s match, this is bad news for the Croatian team, since it is playing against the host country of the World Cup.

It is further shown that a positive relationship exists between a country’s population and its performance in World Cup tournaments. So these statistics are against Croatia, too. What’s more, Brazil leads the World Cup all-time table, while Croatia is ranked 27th. Brazil is the favourite to win the competition.

On the other hand, football is incalculable. You never know how a match is going to end. That’s what makes it so appealing. There are plenty of surprises in the history of World Cup football tournaments. I remember, for example, when Germany was beaten 3–0 by Croatia in the quarter final of the 1998 World Cup in France. So there are reasons to be optimistic.

Pope John Paul II said, “Amongst all unimportant subjects, football is by far the most important.” But even if football is basically unimportant, as John Paul II claimed, it is nevertheless enjoyable for the players and it entertains the spectators greatly.

In contrast to that, the resolution of the crisis in the euro area offers an enjoyment factor of close to zero and its entertainment value is also limited.

If European policymakers succeed in overcoming the crisis and making EMU more resilient, it would certainly not trigger the same euphoric celebrations as a World Cup victory. Nevertheless, it would be hailed as an important achievement, not only from a central banker's perspective, and it would be for the benefit of all.

In particular, it would finally allow central banks to shed their role as decision makers of last resort and, thus, to return to their normal business. Moreover, it would help to preserve the independence of central banks, which is a key precondition to maintaining price stability in the long run.

Thank you very much for your attention.