Jens Weidmann: A long-term regulatory framework for the euro area

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Economic Conference (Wirtschaftstag) of the Economic Council of the Christian Democratic Union (Wirtschaftsrat der CDU e.V.), Berlin, 3 July 2014.

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1. Welcome

Professor Lauk, ladies and gentlemen

I am delighted to be here at this year's Economic Conference and would like to thank the Economic Council of the CDU for their invitation.

The crisis has thrust monetary policy into the spotlight. The fact that not one, but two monetary policymakers have been invited to today's event reflects the growing importance attached to monetary policy.

Monetary policymakers nowadays are sometimes cast as superheroes. Some are dubbed "rock stars", others hailed as "alchemists", and there has even been mention of "new masters of the universe". Others, meanwhile, want to abolish central banking as a public institution altogether given their mistrust of what they see as an overabundance of power, supporting instead competition between private currencies.

An op-ed piece in the Austrian newspaper Die Presse once put forward the view that monetary policy was "a kind of soap opera – and a boring one at that. At least it was for the occasional viewer". On the other hand, the writer went on to say, monetary policy was "probably the world's most important soap opera". After all, it decided "the fate of the world economy".

Wikipedia defines soap operas as serial dramas in which the protagonists are usually in constant interaction with each other. And that is undoubtedly true for monetary policy – protagonists in the world of European monetary policymaking get together once a fortnight, most recently earlier today in the ECB Governing Council, as well as at many other joint occasions.

According to Wikipedia, other typical features of soaps are their trivial storylines, the fact that the protagonists are often more important than the events themselves, and that the roles offer sufficient potential for conflict. Judging by what the media says sometimes, it's easy to think that things are much the same in the world of monetary policy.

But I don't see myself as a protagonist in a soap opera, and I think my colleagues would certainly agree with me that monetary policy isn't designed to offer shallow entertainment. Its job is to safeguard price stability – in good times and in bad.

2. Crisis country in the euro area

Before I move on to talk about the future regulatory framework of the euro area, I would first like to quote the head of state of a crisis country in the euro area:

"Our country is facing gigantic challenges. Our future and that of our children are at stake. Millions of people are unemployed; many already have been for years. The (federal and state) budgets ... are in an unprecedented critical condition."

Have you got any idea who that head of state might be? The Spanish king, perhaps, or the president of Greece or Spain?

No, it was in fact Germany's federal president. Or, to be more specific, it was federal president Horst Köhler in his televised address on 21 July 2005, in which he announced early elections in Germany.

Seen from today's perspective, it might appear absurd to categorise Germany as a "crisis country". But a decade ago, this assessment was certainly not out of the ordinary.

The Economist magazine ran an article on Germany in 1999 under the heading "The sick man of the euro". The article made the following point: "... the biggest economic problem for Europe today is how to revive the German economy".

And the situation was to worsen still further in the early years of the new millenium. For many years, Germany recorded some of the worst growth rates in the euro area. Unemployment climbed to nearly five million in 2005.

It was only later that the economy emerged from its malaise, and it did so with a vengeance. The improvement in Germany's labour market – which was also dubbed "the German miracle" – was anything but a wondrous occurrence. In fact, it was the outcome of shrewd entrepreneurial decisions, moderate wage policy, greater flexibility in pay policy conditions, and not least fundamental labour market and social reform.

You don't need me to tell you that the title of "sick man of Europe" is an award which often changes hands. Other countries are currently the reigning champions in this discipline. Germany, meanwhile, is seen as an economic powerhouse at the heart of the euro area, making it one of the cornerstones of efforts to rescue the euro.

And this solidarity is not entirely a selfless act – after all, Germany has a vested interest in preserving the long-term stability of the euro area.

3. Press ahead with reform efforts

Ladies and gentlemen

It is crucial that we maintain the euro area as a union of stability. If the crisis countries fail to rectify the imbalances that have emerged, the euro area will remain vulnerable to crises. And if that happens, another comparison with a soap opera – this time by the Financial Times' Martin Wolf – might turn out to be true. He wrote: "The crisis of the eurozone is likely to be a very long-running soap opera".

If the euro area is to quickly put the crisis behind it, the sluggish and highly indebted countries will need to press ahead with their efforts to place their economies and public finances on solid ground.

Their endeavours have indisputably borne some fruit. Structural budget deficits have contracted sharply, as have current account deficits. Aggregate unit labour costs have fallen substantially, with the exception of Italy, not to mention France. This has sent price competitiveness sharply higher in many countries, boosting their exports.

Greece, to name but one example, is attracting an increasing number of tourists. 2013 was Greece's most successful year as a tourist destination, and the country is heading for another record number of tourists in 2014. In Spain, meanwhile, exports are back on an upward trajectory, growing by 8% over the past 12 months. Intermediate and industrial goods are some of the country's most important exports. Thus, exports have made an important contribution towards overcoming the recession.

That's the good news. But it should not mask the fact that the adjustment process is still far from over. Simply put, it's more of a marathon than a sprint. Tenacity and perseverance are called for, particularly in the second half of the course.

Yet a glance at the sovereign debt markets would suggest that the finishing line has already been crossed. Risk premiums on sovereign bonds issued by crisis countries have plummeted to such an extent that it has never been cheaper for Spain and Italy to raise capital.

Disregarding the fact that bond yields are being depressed by the loose monetary policy stance worldwide, the markets are “pricing in” the progress which the crisis countries will make in future in adjusting their economies. That is not without risk. First, there is real potential for a setback if this advance expression of confidence proves to be unfounded. Second, the relaxation in the markets and the expansionary monetary policy are dulling the enthusiasm for reform in the ailing countries.

That’s why it’s all the more important that expectations are met and that further reforms are not just announced but actually put into practice.

4. Germany as a role model

Germany is an important role model in this respect. What Germany has accomplished offers a vivid demonstration for its partner countries in the euro area that structural reforms pay off.

At the same time, I would like Germany’s current economic and social policy to set more of an example. I’m thinking particularly of the option allowing individuals who have paid into the pension insurance system for a long period of time to draw a full pension at the age of 63.

After all, the decision made just a few years ago to progressively raise the standard retirement age to 67 served as a model for countries in which the pension systems were likewise feeling the strain of an ageing population. Logically, raising the retirement age was part of the agreed stabilisation programme in three of the four programme countries.

So the signalling effect of retirement at 67 was blurred to a certain degree, and pension policy seems akin to the famous dancing procession of Echternach – two steps forward, one step back.

“Retirement at 63” offers a financial incentive to take early retirement – there is a financial upside of up to €40,000 for an average wage or salary earner, while higher earners reap even greater benefits.

“Retirement at 63” is something which favours age groups that are currently close to retirement and punishes younger generations. That reminds me of Groucho Marx, who once said: “Why should I care about posterity? What’s posterity ever done for me?”.

It’s true that the increase in pension payments will not directly raise contribution rates on account of the high level of reserves. But from a medium-term perspective, it will drive up non-wage labour costs as well.

Another outcome of “retirement at 63” is that workers that are still needed in the labour market will cease to be available. According to our calculations, “retirement at 63” will diminish the labour force potential by around 165,000 people by 2016.

Germany does not have enough workers going forward. In 2020, the number of workers available to the labour market will probably have shrunk by 1½ million compared with today’s figures. In 2020, this demographic effect will have depressed economic output by nearly €70 billion.

If Germany is going to address this problem, it will need more and better qualified workers in the future. One way of dealing with this challenge is to develop a systematic policy for attracting qualified foreign labour with the skills needed in the German economy.

Female participation in the labour force also needs to be boosted. Non-contributory inclusion in the statutory health insurance scheme, for instance, sets the wrong incentives here. Second, we need a policy aimed at raising employee productivity. Investment in pre-school education in particular promises to yield substantial rewards.

Yet “retirement at 63” is not the only initiative which poses a risk to the overall economy; the introduction of a statutory minimum wage – which was decided today by the Bundestag – is also problematic.

Even if experiences in other countries do not support the view that a minimum wage directly increases unemployment, it might nonetheless place a strain on employment trends. There is a risk that enterprises will take on fewer new staff in periods of economic upturn.

At the current juncture, 12% of workers in Germany earn less than €8.50 per hour; in eastern Germany that figure is as much as 17%. Many of them are low-skilled workers whose prospects in the labour market look set to deteriorate in the future.

Ladies and gentlemen

The need for reform in the sluggish countries should not blind us to the fact that there is a need for economic policy action here in Germany, too. A few months ago the Wall Street Journal ran a story entitled “Euro Zone’s Next Reform Candidate: Germany”.

A saying we know from the world of sport is equally pertinent in other walks of life: don’t rest on your laurels. We have seen that there is truth in this saying at the World Cup in Brazil, where some of the favourites have already come in for quite a nasty surprise.

5. Reform the euro-area framework

Unlike the World Cup, the euro area is not a knockout competition that can only be won by one team; it is about winning as a team and achieving success for everyone involved. But one thing that football and monetary union do have in common is that they both need a clear set of sensible rules.

Football is such a popular sport because its rules are relatively easy to understand. On the whole, the basic rules have not changed much, although the finer details have been refined from time to time. For instance, the current World Cup is the first to use goal-line technology.

The euro area, too, has a set of rules, an institutional framework. This framework needs to be reformed in order to make monetary union more crisis-resistant. It is not sufficiently stable as it stands.

While it is true that fiscal stabilisation programmes and effective assistance on the part of the Eurosystem have succeeded in preventing the crisis from flaring up, it was this very policy which brought about a precarious situation: liability for the crisis countries’ debt has essentially been communitised while fiscal policy remains a matter for national policymakers. That doesn’t augur well for the future.

Liability is a core element of our economic system. That’s something every entrepreneur knows – after all, doing business means picking up the tab if things go wrong.

That’s why I think the euro area has reached a kind of crossroads: either we proceed towards a fiscal union in the sense of establishing joint liability with centralised rights to intervene in fiscal matters at the European level, or we turn back to the original framework as specified in the Maastricht Treaty and reinforce the principle of individual national responsibility.

Both paths can put liability and control back on an even keel and bring risks and opportunities into alignment. Which path is the right one to take is a matter for policymakers to decide.

I believe that governments and the public at large are currently less than willing to take the step towards a bona fide fiscal union, seeing as this would mean ceding a great deal of national sovereignty in fiscal policy matters.

Those calling for greater mutual liability are often the very ones who reject recommendations from Brussels as meddling in national matters. Italian prime minister Matteo Renzi, for instance, likens the EU to an "old boring aunt telling us what to do".

It was a long-held belief, above all in Germany, that monetary union would, out of necessity as it were, culminate in political union. Addressing the Bundestag in November 1991, Helmut Kohl remarked that "the idea of sustaining economic and monetary union over time without political union is a fallacy".

The Bundesbank likewise stressed at the time that political union was crucial if monetary union was to prove durable. Viewed with hindsight, I would qualify that statement somewhat to say that monetary union can also function without political union provided that the principle of individual national responsibility is adhered to.

This view is supported by Udo Di Fabio, a former judge at the Federal Constitutional Court, who said that monetary union was only feasible if the prevailing principle of each member state bearing individual responsibility for its own fiscal policy was not undermined by collective liability.

Ladies and gentlemen

In a monetary union, there are negative repercussions for all other member states if one country has excessive debt – even if they are responsible for their own budgets. A monetary union therefore requires fiscal guidelines.

That is why the decision, taken in connection with the euro rescue measures, to tighten fiscal rules in a bid to promote individual responsibility was a step in the right direction. Ultimately, however, applying the rules is what counts, or, to put it in the words of a footballer ahead of tomorrow's important World Cup match: "It's what happens on the pitch that matters." You cannot put it more succinctly than Germany's football legend Adi Preissler.

As regards the proper application of the rules, some doubts are justified, as is evident from the current debate surrounding a flexible interpretation of the Stability and Growth Pact.

The Pact, which was reformed less than three years ago, allows much scope for discretion. Moreover, there is a risk that last week's decisions of the European Council will provide even more of a pretext for a lax interpretation. However, an excessively generous interpretation of this leeway would certainly undermine the credibility of the Stability and Growth Pact.

And let us not forget: in the medium term, the Pact stipulates balanced or close to balance budgets. The 3% mark that is frequently used as a yardstick is therefore a ceiling and is not intended as a regular target. This is, incidentally, also true of the 60% debt ratio that almost all euro countries breach.

The Commission should therefore apply a narrow interpretation to the rules, and the German government should lend it its decisive support. That, too, is part and parcel of being a role model.

Nor is consolidation a growth brake, but rather a precondition for sustainable growth. More debt is no precondition for successful structural reform.

Binding debt rules are a necessary, but by no means sufficient, condition for strengthening the principle of individual responsibility in a monetary union. To this end, the no bail-out principle would have to be more credible, amongst other things. Ultimately, that would mean allowing governments to become insolvent.

That, in turn, requires robust banks: going forward, neither a sovereign default nor the insolvency of a major bank must threaten the stability of the financial system.

Progress has doubtless been made on the road to a more resilient financial system: banks' capitalisation is better now than before the crisis, preparations for the Single Supervisory

Mechanism are in full swing, and a Single Resolution Mechanism for banks has been agreed.

Nonetheless, further regulatory measures are required to loosen the "doom loop" between sovereigns and banks. In future, banks should have to provide capital backing for loans to governments. And there should be ceilings for lending to governments, as there are for loans to the private sector.

Moreover, rapid regulation of the shadow banking sector is needed to stop regulation of the banking sector from leading to financial business increasingly being moved to unregulated market segments.

Bertolt Brecht said it all in the Threepenny Opera when he wrote:

> "There are some who are in darkness,
> and the others are in the light,
> and you see the ones in brightness,
> those in darkness drop from sight."

More light therefore needs to be shone into the financial system. And that is precisely the objective of many current regulatory initiatives. The Bundesbank and the German finance minister are pulling together to make them happen.

6. Easing the burden on the Eurosystem

A stable regulatory framework for the monetary union would also protect the Eurosystem from permanently acting as crisis manager.

The Eurosystem's crisis measures have helped prevent the crisis from escalating. However, some of these measures have, as I have repeatedly pointed out, taken the Eurosystem to the outer edge of its mandate.

Meanwhile, the comprehensive measures agreed by the Governing Council of the ECB at the beginning of June cannot, in my opinion, be compared with the crisis measures taken two or three years ago. The current measures do not provide for individual countries' liability risks to be taken onto the Eurosystem's balance sheet. The task now is to prevent too prolonged a period of low inflation. For that could paralyse the euro-area's economy.

Savers are understandably angry at extremely low interest rates that are more than eaten up by inflation. However, interest rates on savings have been lower than the rate of inflation on numerous occasions, even during the D-Mark era.

The June decision was preceded by much soul-searching as to how best to proceed. For these measures too are associated with risks and side-effects, which we would be wrong to play down.

In the long term, the ultra-loose monetary policy poses risks to financial stability. There is a danger of exaggerations on the asset and real estate markets – just think of the search for yield. Life insurers are finding it difficult to generate guaranteed returns.

I am also worried that the low interest rates will reduce the pressure on governments to tackle their countries' problems energetically. There is a danger that the low interest rates will be used not to consolidate budgets, but to finance additional spending.

And so it is particularly important to make it quite clear now that the Eurosystem will not put off a necessary normalisation of monetary policy out of consideration for public finances. Looking at the euro area, I therefore say that monetary policy has done its bit towards maintaining price stability.

We will observe very closely what impact the measures have, and it will be a while before they take full effect. I therefore believed it was wrong to speculate on further measures immediately after the decisions were taken. This is unnecessary and undermines the measures we have only just adopted.

Allow me to return to the comparison with soap operas: unlike soaps, monetary policy does not need cliffhangers to tempt the viewer to tune into the next episode.

Ladies and gentlemen

With Lithuania's accession to the euro area, the number of member states will swell to 19 next year. As a result, the rotation system, as it is known, will automatically come into force in the Governing Council of the ECB, which has met with some criticism in Germany.

Allow me to say only this much:

The best way of dispelling these concerns is to operate within the core area of our mandate and not to redistribute liability risks between the taxpayers of the individual countries on a large scale.

7. Conclusion

Ladies and gentlemen

Erhardt once said: "Pessimists are people who wear sunglasses when they look into the future."

The comedian Heinz Erhardt, that is, not the politician Ludwig Erhard.

I hope you will not consider me a pessimist when I say that the crisis in the euro area is not over yet. Much more needs to be done to overcome it permanently.

The member states must adapt better to the requirements of a monetary union. The institutional framework of the monetary union, too, must be improved in order to make it less susceptible to crises. Liability and control must be aligned.

Monetary policy must not allow itself to be misappropriated for fiscal policy purposes. In the long term, this would jeopardise the independence of the central bank. Yet the central bank's independence is a key precondition for keeping the value of the currency stable. And that is something we all benefit from.

Thank you for your attention.