Jens Weidmann: Speech at the German-British Chamber of Industry & Commerce Annual Dinner 2014

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, to the German-British Chamber of Commerce Annual Dinner 2014, London, 23 July 2014.

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1. Introduction

Ambassador, Sir Nigel, Dr Fouquet, ladies and gentlemen, I thank you for the invitation and for the opportunity to speak here today.

According to geological surveys, around 7,000 years ago, Europe looked quite different from what it looks today. A single land mass, known as Doggerland, stretched from Britain's east coast to the Netherlands and the western coasts of Germany and Denmark. Britain was not an island, but an integral part of continental Europe.

The end of the Ice Age seems to have ushered in the end of Doggerland as well. The melting ice caused the level of the North Sea to rise until the land mass was fully submerged.

An alternative hypothesis suggests that Britain's separation from Europe came with a bang rather than a whimper. A huge tsunami triggered by a sub-marine landslide off the coast of Norway, the Storegga Slide, is supposed to have cut Britain off from mainland Europe.

Whatever the ultimate cause, the fact remains that today Britain and Europe are still divided geographically by the English Channel. But human enterprise has managed to bridge this divide, or rather, it has tunnelled it. And just as the resolve of the Eurotunnel engineers has shortened the journey from Paris to London to less than two and a half hours, so the dedication of post-war statesmen has overcome the political and economic divisions that had troubled Europe for so long.

Almost to the day a hundred years ago, Kaiser Franz Joseph of Austria-Hungary declared war on the kingdom of Serbia. That marked the start of the first of two global wars, which together cost the unfathomable number of more than 80 million lives.

In 1946, only a year after the atrocities originated by Germany had ended, a European statesman proposed a remedy to this tragedy of Europe. The proposal was as simple as it was bold – to "re-create the European family".

What sounded utopian at the time is reality today. Rarely has a political vision been more vindicated than the one laid out by Winston Churchill in Zurich in 1946. Europe has finally found the peace that had eluded it for so long.

The recent tensions in the Ukraine, however, serve as a strong reminder that we should never take peace for granted, not in Europe, nor anywhere else in the world.

2. The benefits of European integration

Churchill's vision was a political one. But the re-creation of the European family was advanced largely by the integration of national economies. And while peace and stability are rightly the most celebrated achievements of the European Union, economic integration has produced remarkable results in its own right.

Economic integration raises welfare through two mechanisms: first, via increased trade, and second, via increased competition, which in turn strengthens innovation and productivity. Judging economic developments against a non-existing counterfactual, in this case non-integration, is obviously a tricky business. But the studies available show that the effect is

sizeable in any case. Europe is wealthier because of economic integration, with estimates of the output boost ranging from 5 % to more than 25 %.[1, 2, 3]

And it seems that Britain, too, has gained. Half of its trade is with the European Union, and studies suggest that EU membership has boosted Britain's trade in goods with other EU countries by more than 50 %.[4] The Center for Economic Performance[5] at the London School of Economics has found that the immediate benefits of increased trade amount to 1¼% to 3 % of GDP. And if the longer-term effects of strengthened competition and increased productivity are taken into account as well, EU membership is estimated to have provided a boost of up to 10.5 % of GDP.

But as much as the UK gains from being part of the EU, so the EU gains from having the UK as a member. The EU is stronger today because of Britain's contribution to it. The European economy is more open and dynamic as a result of Britain's commitment to open and flexible markets – a position very much in tune with the Bundesbank's, I might add.

3. EU's and EMU's unfinished business

And that commitment to open and flexible markets holds the promise of even bigger returns. A lot of the potential inherent in our most important European catalyst for growth, the single market, is still untapped.

The single market has been very successful in facilitating trade in goods. Hence, competition in this area is intense. The mark-ups that firms are able to charge in addition to their costs due to market power are low and are comparable to those in the US, for example. When it comes to services, however, the picture looks different. Mark-ups are higher, on average, than in the US. It is probably safe to say that the Services Directive has fallen short of expectations.

Britain, in particular, with its advanced services sector stands to gain from dismantling the existing barriers to cross-border trade in services. Originally, the Services Directive was designed to establish the so-called "country of origin principle" that already holds for EU trade in goods. This principle states that a services firm should no longer be hampered by regulation in the import country if it has already complied with the national regulations in its home country.

However, the final version of the directive did not include this principle. Simulations carried out by the Netherlands' Bureau for Economic Policy Analysis[6] show that by dropping it, the expected output boost as a result of the Services Directive is reduced by some 40 %. Completing the single market for services therefore holds the promise of substantial economic gains.

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1 Badinger, H. (2005), "Growth Effects of Economic Integration: Evidence from the EU Member States", Review of World Economics 141, 50–78.

2 Nauro F. Campos, Fabrizio Coricelli, Luigi Moretti (2014), "Economic Growth and Political Integration: Estimating the Benefits from Membership in the European Union Using the Synthetic Counterfactuals Method", IZA Discussion Paper No. 8162.

3 Boltho, Andrea and Eichengreen, Barry (2008), "The Economic Impact of European Integration", CEPR Discussion Paper No. 6820.

4 John Springford, Simon Tilford, Philip Whyte (2014), "The economic consequences of leaving the EU", the final report of the CER Commission on the UK and the EU single market.

5 G. Ottaviano et. al. (2014) The Costs and Benefits of Leaving the EU, CEP Discussion Paper.

6 Roland de Bruijn, Henk Kox, Arjan Lejour (2008), "Economic benefits of an Integrated European Market for Services", Journal of Policy Modeling 30, 301–319.

The same goes for bringing the single market into line with the digital age. When it comes to the digital economy, fragmentations still abound, in particular with regard to legal issues such as privacy and data protection, content and copyright, liability of online intermediaries, e-payments and electronic contracts. The EU is still comprised of 28 individual digital markets rather than one single digital market.

This is holding back innovation, growth and, ultimately, jobs. Studies[7] suggest that establishing a harmonised and well-regulated digital single market holds the same potential as the introduction of the original one, raising GDP by as much as 4 %. In Germany, for example, this could imply an additional 427,000 jobs over the period 2015 to 2020.

Some steps have already been taken towards a true single market for the digital economy, but we are not there yet. Continuing to the end would provide a major boost to European competitiveness. It is therefore more than worth the effort.

Ladies and gentlemen, the field of policy which has seen the most far-reaching centralisation in Europe is clearly the field of monetary policy, at least for the 18 member states of the euro area. But the mutualisation of monetary policy is not only an issue for the euro-area member states but for all European countries. Our extensive trade links imply that developments in the monetary union reverberate in the non-euro-area countries as well, as the crisis has shown very forcefully.

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 sufficient leeway to preserve their diversity, that is, to establish their own business models or to tailor institutions and policies to their own national preferences. 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, a combination of this kind 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. You can compare this to what economists call the “tragedy of the commons”. Just as overfishing creates negative externalities for other countries, excessive public debt harms the euro area as a whole. Excessive debt in one member state drives up longer-term interest rates for all euro-area countries.

And second, each member state issues debt in a currency it cannot create. Hence, a high level of fiscal discipline is needed to ensure that solvency concerns do not spiral out of control.

For monetary policymakers focussing on maintaining price stability, the question of how to safeguard public finance is thus of particular concern. As so often, Mervyn King put it most aptly when he said that “Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy.”

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

But the precautions taken in the Maastricht Treaty to ensure sound public finances have proven insufficient. The rules of the Stability and Growth Pact have been broken numerous times in the past, not least by Germany, France and Italy. And the no bail-out clause failed to

[7] Copenhagen Economics (2010), The Economic Impact of a European Digital Single Market, Final Report.

exert the expected disciplining effect on governments in the run-up to the crisis, as markets did not account enough for different macroeconomic developments in the countries concerned. In this way, the markets might have anticipated that concerns about financial stability would deter the euro-area member states from rigorously applying the no bail-out clause. And that is precisely what happened when the crisis broke out.

The rescue packages provided to countries which lost market access did help to calm the situation. But at the same time, they have thrown the balance between liability and control out of kilter. While spending decisions essentially remain a national prerogative, liability has become partially mutualised. The tendency to incur further debt is thus strengthened, not weakened.

What is to be done? Some necessary steps have already been taken. The fiscal rules have been stiffened, with greater automaticity in the Stability and Growth Pact and the introduction of the fiscal compact.

However, as we have learned in the crisis, rules have to be applied to fulfil their purpose, and they can only be the first line of defence. They need to be complemented by a functioning market discipline to counter the temptation not to observe the rules. Sound public finances will only be achieved if we rigorously set about restoring the balance between liability and control.

One way to do this would be a genuine fiscal union. If common debt were matched by common control, incentives could be aligned. But this would require a quantum leap in terms of ceding sovereignty to the European level, a leap neither the electorates nor the governments of the member states seem willing to take.

If a true fiscal union that requires extensive changes to the European Treaties is not on the cards, then we need to take the second avenue. That implies taking concrete steps towards restoring a balance of individual control and individual responsibility within the existing Maastricht framework. A framework which is in line with what Margaret Thatcher once said in her famous speech at the College of Europe – that improving the workings of the European Union does not automatically require stronger centralisation.

Individual responsibility requires that sovereigns, banks and investors bear the consequences of their decisions. This means that it is primarily up to the respective government and its citizens to come up with the revenue needed to repay 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. The amount of official financial support would be reduced, and time could be 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 sovereign insolvencies are possible without bringing down the financial system as a whole.

To that end, doing away with the preferential treatment of sovereign debt in banks' balance sheets is of the essence. The current regulatory framework permits preferential treatment of sovereign exposures in various forms.

While bank exposures to a single counterparty are limited, in principle, to a quarter of their eligible capital, exposures to sovereigns are exempted from that large exposures regime. Thus, many European banks hold bonds from one sovereign only – their home country. But a high level of undiversified sovereign exposure is what makes sovereign default a potentially systemic event. For this reason, the large exposures regime needs to apply to sovereigns as well.

Moreover, sovereign exposures are privileged by low or zero capital requirements. 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.

If additional capital requirements for European banks were imposed to cover sovereign exposures, the additional capital would be rather small on aggregate – albeit with substantial differences between banks. The inclusion of sovereigns in the large exposures regime might lead to more substantial repercussions. But these would be manageable if introduced over a transition period – which without question has to be granted.

Obviously, establishing a sustainable fiscal framework and consolidating public budgets are only two of the numerous challenges facing the euro area in becoming more stable. Equally important is to correct macroeconomic imbalances – through the restoration of competitiveness in those countries that have fallen behind and through a further reduction of indebtedness in the private sector there.

Declining unit labour costs and reduced current account deficits due also to increasing exports show that we have already come a long way in regaining competitiveness. At the same time private debt declined somewhat, reducing the burden on households' and enterprises' shoulders a bit.

But as in a marathon, the last kilometres are always the hardest. What remains especially challenging is the intended increase of growth potential. Additional structural reforms are certainly needed – and, by the way, not only in the countries under stress but in Germany, too.

By the same token, further work has to be done with respect to financial regulation, and that applies not only to the euro area, but globally. Some key objectives in this respect are: spelling out international standards on the loss-absorbing capacity of systemically important banks, achieving cross-border acceptance of a bank resolution, peer reviewing measures regulating the shadow banking sector and establishing saver derivative markets.

4. Conclusion

Ladies and gentlemen, let me come to a close.

Britain and continental Europe may not be connected by Doggerland anymore, but there are myriad other ties that bind us together to form a common Union.

And it is precisely because our views sometimes differ that we are, together, more than the sum of our parts. If Britain continues to make its voice heard in Europe, I am confident that the Union will become more outward-looking, open and prosperous for that.

To those who think Europe would be better off giving in to the temptation of insularity, let me say it in the words of the Beatles: "You say goodbye, and I say hello."

Thank you for your attention.