Jens Weidmann: Reforms for recovery and resilience

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Bank of Latvia Economic Conference 2014, Riga, 17 October 2014.

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1. Introduction

Ladies and gentlemen

I thank you for the invitation and for the opportunity to speak here today. Latvia is the latest member of our Economic and Monetary Union. But in a sense, Latvia's capital could also be considered part of the vanguard.

The history of European integration has been a process of back-and-forth, marked by spectacular advances and equally huge setbacks. However, when we did witness progress on the road to integration, more often than not it was driven by one single factor: trade. And when it comes to trade driving integration in Europe, one early example immediately springs to mind: the Hanseatic League.

Prior to the foundation of the league, trade in the Baltic Sea was for the adventurous only. Raids and piracy made it a risky endeavour. The scale of international trade in the Baltic area remained insignificant.

The growth of the Hanseatic League changed that. From the 13th to the 17th century, stretching from the Baltic to the North Sea, the league protected trade routes and sheltered its members from tariffs and customs restrictions. As a result, trade soared, and with it the wealth of the members of the league.

The Hanseatic cities had their own legal system, and they maintained their own armies for mutual protection and aid. But the league did not constitute a federation – similar to the euro area today.

Riga's membership in the league dates back to 1282. So when it comes to taking an active role in European integration, Latvia is clearly a leader, not a laggard.

Unfortunately, the economic association of which Latvia is now a member does not seem to be leading in terms of economic growth.

What will it take to change that? What reforms are needed to spur sustainable growth and enhance stability? What are the respective roles of monetary, fiscal and structural policy in this context? In the next 20 minutes, I wish to lay out my perspective on these questions.

2. Current situation and monetary policy

But first, let us have a look at where the euro area stands at the moment.

Euro-area GDP is still 2.4% below its pre-crisis level, and growth stalled in the second quarter of this year. The biggest three economies – Germany, France and Italy – did not provide any growth impetus, with Germany and Italy contracting by 0.2% and France's economy stagnating.

Although the decline of German GDP in the second quarter must be seen in the context of the strong increase in the first quarter due to the mild winter weather, indicators for the euro area suggest that growth will pick up only at a moderate pace. This is confirmed by the latest data, notably in Germany, which have been rather disappointing.

In sync with the subdued pace of the recovery, inflation in the euro area has been low as well. Still, the risk of becoming enmeshed in a deflationary scenario is considered to be low – I think in this respect we share a common view in the Governing Council. Rather than fearing broad-based deflation, the Governing Council is more concerned about a too prolonged period of low inflation.

But so far, the low inflationary pressure is for a large part due to the decline in energy prices and the adjustment processes in some euro-area countries – factors beyond the direct influence of the Eurosystem's monetary policy and to which the monetary policy should react – simply speaking – only in the case of second-round effects.

Monetary policy in the euro area, then, is facing difficult times – especially as it has reached the lower bound on interest rates. Further accommodation can therefore happen only through unconventional measures.

And unconventional measures are what the Governing Council decided on in its June and September meetings with the launch of targeted long-term refinancing operations and two asset purchase programmes, the details of which were presented two weeks ago.

The asset purchase programmes have triggered a debate, as their justification insinuates a shift from programmes specifically aimed at credit easing towards a quantitative easing philosophy.

One should bear in mind that even before these decisions were made, the monetary policy stance was already very accommodative. The Governing Council therefore has to judge whether additional stimulus is needed or would be effective, and what unintended side-effects would come with the measures.

The declared goal of expanding the balance sheet of the Eurosystem poses challenges for another reason, too. Purchases of Asset Backed Securities (ABS) are problematic when they imply a transfer of risks from banks to the balance sheet of the central bank.

In the end, this could amount to a transfer of risks from banks to the taxpayer. And this would run counter to everything we have strived to achieve in banking regulation over the last years.

The higher the target for the expansion of the Eurosystem's balance sheet, the higher the risks of overpaying for the assets. The pricing mechanism that is currently being determined needs to pay special attention to these risks. In any case, monetary policy accommodation can only do so much, and the longer it stays ultra-expansive, the higher could be the corresponding risks to financial stability.

What monetary accommodation definitely cannot do is tackle the root causes of low growth potential in the euro area – the structural barriers that hamper competition, innovation, and hence productivity. Addressing these structural deficiencies would also go a long way towards improving the transmission of monetary policy impulses.

3. Reforms for recovery

In many member states, particularly in those worst hit by the crisis, substantial efforts have already been made towards that end. In order to unleash productivity, labour markets have become more flexible, and competition in goods and services has become more intense.

And according to the World Bank's Doing Business Report, the efforts are starting to pay off: Portugal, Italy and Spain have climbed up the ranking ladder by 17, 13 and 10 positions respectively over the last four years. Greece has moved up by 37 positions.

But it is obvious that ample room remains for further improvements. While Portugal, Spain, Italy and Greece have moved up the ladder in the Doing Business Report, they are still a considerable distance from the top, with Portugal ranking 31st, Spain 52nd, Italy 65th and Greece 72nd.

Accordingly, recent estimates[1] by the European Commission suggest a medium-term growth potential (2014–23) for the euro area of only 1%.

The potential gains from structural reforms therefore remain especially large. A study[2] by economists from the OECD suggests that a comprehensive package of labour, product, tax and pension reforms could raise GDP per capita in the EU by about 11% after ten years. For the US, the potential GDP increase of structural reforms is 5%, less than half that of the EU.

And by no means are gains to be reaped in the peripheral countries only. Ranked 111th in the World Bank Doing Business category "ease of starting a business", for instance, Germany has ample room for improvement here as well. And this also goes for other economic policy areas where some reforms have even been rolled back recently.

By the same token, growth-enhancing reforms are not confined to the national level. 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. Completing the single market for services therefore holds the promise of substantial economic gains.

This could be achieved by finally establishing the "country of origin", as is already the case in the common market for goods. This principle states that a firm should no longer be hampered by regulation in the importing country if it has already complied with the national regulations in its home country.

The same goes for bringing the single market into 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[3] 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 along this path to the end would provide a major boost to European competitiveness. It is therefore more than worth the effort.

Another push to EU GDP could potentially stem from an EU-US trade agreement. The US is the EU's biggest export market and its third most important import partner for trade in goods. The ties between the two regions are even closer in terms of service trade.

Given the already low average tariff rates, non-tariff barriers are probably the greatest still-existing impediment to bilateral trade. In the first round, the effects on trade and GDP,

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1 European Commission (2013), "The euro area's growth prospects over the coming decade", Quarterly Report on the Euro Area 12(4).

2 Bouis, R and R Duval (2011), "Raising the Potential Growth after the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond", OECD Economics Department Working Paper No. 835.

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

however, are level effects, and it is only through increased competition that growth could follow.

Furthermore, many aspects of the deal are still highly controversial. The European Commission now hopes to reach an agreement within “a couple of years”.

Ladies and gentlemen

An increase in investment is a precondition for higher growth rates. Durable growth requires reforms that cut red tape, spur innovation, and make labour costs more calculable.

This is not only conducive to higher growth potential in the future: it acts as a nearer-term stimulus in its own right. Investment is not only tomorrow’s supply: it is also today’s demand.

How does public investment come into this equation?

Various commentators have called on euro-area countries with perceived fiscal space, notably Germany, to seize the opportunity presented by low interest rates and increase investment. Olivier Blanchard, the IMF’s Chief Economist, has argued that this would also help the euro-area periphery. He argues that in the current situation, spillover effects could be particularly high due to monetary policy being constrained by the lower bound on interest rates and the prevalence of liquidity-constrained households.

But even if this were the case, the periphery’s share of German imports is very low, which suggests that spillovers would remain very modest – all the more as the import content of public investment is especially small. The boost to the peripheral countries from an increase in German public investment is therefore likely to be negligible.

What is more, the argument that Germany should seize the opportunity of low interest rates does not hold up to closer scrutiny, either. Debt totalling more than €2 trillion and the huge demographic burden Germany faces in the coming years will weigh on its growth and public finances. In that light, pursuing a balanced budget makes perfect sense for the country.

And with the economy operating at normal capacity utilisation, Germany is not in need of stimulus either – and this will remain the case with the revised forecasts that still foresee growth in line with potential. On the contrary, in the face of coming demographic challenges, costly stimulus measures could even backfire via negative confidence effects.

Is the case for higher investment therefore completely without merit? No, but arguments in favour do not stem from cyclical considerations: they stem from structural considerations. Where Germany’s growth potential is concerned, there is agreement that higher public investment does have a role to play.

With regard to the size of the investment gap, however, there is probably no agreement. It is important that all investment measures are judged on a case-by-case basis, as we have seen in the past that not all public investment measures have been money well spent.

And we should focus on shifting priorities in public expenditures. There is no need for a debt-financed fiscal stimulus, but for a structural shift of government expenditures from consumption to investment. Reforming the financial arrangements between the federal, the state, and the municipality level could encourage that shift.

Somewhat more autonomy with regard to revenues might alleviate the problem of lacking funds to some extent. At the same time, however, it has to be ensured that the overall tax burden does not increase.

4. Reforms for resilience

Ladies and gentlemen

The reforms laid out so far, together with other widely discussed structural measures and sound public finances, would allow the euro-area economy to shift gears and accelerate. But they do not in themselves guarantee that the engine will run more smoothly and reliably.

This is where reforms addressing the euro area's institutional architecture come 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 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. Thus, a high level of fiscal discipline is needed to ensure that solvency concerns do not spiral out of control.

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 exert the expected disciplining effect on governments in the run-up to the crisis, as markets did not take sufficient account of the different macroeconomic developments in the countries concerned.

The rescue packages provided to countries which lost market access did help to contain an escalating crisis. 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 from the crisis, rules can only be the first line of defence and they have to be applied to fulfil their purpose. Thus, the current debate in Italy and France about their fiscal stance is not reassuring. This underscores the need to buttress the rules with functioning market discipline.

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. This avenue implies enhancing the original Maastricht framework that is based on the principle of individual responsibility.

This principle requires that sovereigns, banks and investors bear the consequences of their decisions. We need to make sure that sovereign debt restructuring is possible without bringing down the financial system as a whole.

To that end, more than three years ago the Bundesbank proposed automatically extending government bonds' maturity by, say, three years if the member state is granted financial support from the European Stability Mechanism. This would help to figure out if the country's problem is one of temporary illiquidity or insolvency.

Additionally, 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.

5. Conclusion

Ladies and gentlemen, let me come to a close.

The biggest bottleneck for growth in the euro area is not monetary policy, nor is it the lack of fiscal stimulus: it is the structural barriers that impede competition, innovation and productivity.

If these barriers were torn down by all euro-area countries, the growth outlook would shift considerably – and this would instantly give rise to higher investment. Complementary reforms on the European level aimed at the services sector could provide a further boost. Taken together, these measures are expected to lift growth by as much as 15% above the current baseline level after ten years. To me, that sounds like a goal worth expanding some political capital to achieve, as do efforts to bring liability and control further into balance.

The resolve the Latvian government showed in securing the joining of the euro has set a shining example in that regard – an example that reminds us of the collective efforts more than 750 years ago, and an example that can serve as a lodestar for the challenges of today.

Thank you for your attention.