# Jens Weidmann: Towards a more prosperous monetary union

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Asociación de Mercados Financieros Annual Financial Convention, Madrid, 24 November 2014.

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## Introduction

Ladies and gentlemen

Thank you for the invitation and for the opportunity to speak here today.

A popular proverb in Madrid goes as follows: "De Madrid al cielo y un agujerito para verlo." My pronunciation is poor, but this certainly doesn't mean that the saying doesn't resonate with me – after all, this is already my second visit to Madrid in four months. And on both occasions, I actually had a choice in the matter, which is not always the case.

In a way, the proverb also captures nicely what I'm attempting to do today – to come to Madrid in order, well, not to ascend to heaven, but to take a bird's eye view of the situation the euro area is facing. In my opinion, taking a longer-term perspective is crucial when analysing the problem that looms largest in our monetary union today: the euro area's weak growth prospects.

To a certain extent, the problem is one of subdued demand, owing mostly to the macroeconomic adjustments in the countries that have been under stress over the last few years. And the subdued demand and inflation outlook are the reasons for an "unprecedented degree of monetary accommodation", as Mario Draghi has put it.

However, while monetary policy can influence short-term demand, it cannot permanently boost growth prospects. And the same is true, unfortunately, for fiscal policy – even if additional fiscal space would be available.

When we shift our focus forward, the structural picture does not seem very bright: The European Commission estimates[1] that the euro-area medium-term growth potential – in other words, for the next ten years – is only 1%. And a lower growth outlook not only means a comparatively lower standard of living, but also tighter future budget constraints.

What is needed is a sustainable increase in medium-term growth. This will only come about, however, if we tackle our structural shortcomings decisively.

## What has been achieved – reforms for reducing macroeconomic imbalances

At this point, you might argue that a lot of progress has already been made in this regard, especially in the countries worst hit by the crisis.

And I would agree with you on that. A lot has indeed been done to correct the macroeconomic imbalances that are at the root of the struggle the euro area is facing.

Abstracting from important cross-country differences and taking a bird's eye perspective, the divergence between prices and wages on the one hand and productivity on the other was the driving factor behind the external deficits that ultimately proved unsustainable – in addition to the precarious levels of public and private debt.

When markets refused to finance the deficits any longer, the gap had to be closed. The financial support provided under the rescue mechanisms and our common monetary policy

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

have smoothed the adjustments – without these measures, the adjustments would have been far more abrupt.

Still, even in a currency union with an accommodative monetary policy and fiscal support mechanisms, national gaps between prices and productivity had to be closed – sooner rather than later.

The reforms undertaken so far have made these adjustments possible. Wage negotiations, for example, have been decentralised and wage indexation has been abolished or reduced – Spain is a case in point. This makes it possible for wages to take the specific situation of each firm into account.

Through this and other measures, prices and wages have been brought more in line with productivity, in a process which erased the external deficits in all crisis countries except for Cyprus in 2013. And for 2014, Cyprus is expected to post a current account surplus as well.

What is more, fiscal sustainability has been improved by adjusting pensions more to demographic realities, mainly by raising the eligibility age. This strengthens the pension system financially, it preserves much needed expertise in the respective firms, and it reduces the demographic drop in labour supply to some extent. Germany has moved in this direction early on, which makes it all the more unfortunate that it now seems to backtrack somewhat on these reforms the rest of the euro area is moving towards.

As a result of the ongoing restoration of competitiveness, the euro area has now been placed on sounder footing. But while competitiveness is necessary for prosperity, it is not sufficient. Ultimately, prosperity hinges on productivity. This is where we now have to redouble our efforts.

Not doing so would mean "taking the pain but missing out on the gain", as Benoît Cœuré has aptly put it. The structural reforms we need now are the ones that unleash innovation and propel productivity. We also need them now because these are the reforms that can credibly raise expectations of a higher income in the future. And if income is expected to be higher tomorrow, investments will be made today. Reforms that increase supply will thus support demand as well.

In some areas in need of reform, it is the European Commission who is in the driver's seat. Other areas, such as labour markets, remain a national prerogative. But even with initiatives on the European level, national governments are on board via the European Council.

Political science teaches us that it can be an effective strategy in international negotiations to proclaim that your hands are tied because of domestic politics and it is either your way or the highway. But if everybody takes this "logic of two level games", as the American scholar Robert Putnam[2] has called it, to the extreme, nothing will get done. In the interest of a more prosperous monetary union, at times national sensitivities have to be put aside.

Which actions are required to brighten the euro area's growth prospects? I see three areas in particular where action is needed: the financial markets, product market regulation and the labour markets.

### Financial sector reforms for growth

Let me start with how financial markets can channel capital into innovative companies more efficiently.

Europe's biggest reform project, the banking union, is first and foremost a project about financial stability. But it is important to also see its potential ramifications for growth. By lifting

[2] Putnam, Robert (1988). "Diplomacy and Domestic Politics: The Logic of Two-Level Games". International Organization 42: 427–460.

the veil of uncertainty surrounding banks' balance sheets, the comprehensive assessment has helped to make the banking sector more stable. And I am quite confident that, prospectively, this will improve banks' ability and willingness to finance the real economy.

Additionally, a functioning bank resolution regime with a credible bail-in of shareholders and creditors strengthens incentives for banks to carefully select and monitor the firms they lend money to. This ensures that capital will be put to its most effective use. And studies[3] show that this is good not only for financial stability but also for growth. The evergreening of loans to non-viable firms is not a recipe to reinvigorate growth – this is the lesson of the Japanese experience in the 90s.

However, history has shown that fear of contagion is a strong deterrent when it comes to actually resolving an important bank. And whether bailing in creditors would lead to contagion naturally depends on who those creditors are – if they are other financial institutions, the chances are that regulators will shy away from resolution.

This is why two weeks ago, the Financial Stability Board (FSB) proposed minimum standards for the 30 global systemically important banks concerning both the quality and quantity of bail-in debt. In particular, it was agreed that if a bank were to hold bail-in debt issued by another systemically important bank, this would detract from its own bail-in buffer, in order to discourage banks from holding critical amounts of bail-in debt issued by other banks.

The euro area already has a minimum requirement for such eligible liabilities. But so far, these liabilities can be held by other institutions without restriction. In the interests of both financial stability and growth, we should adapt the standard proposed by the FSB as soon as possible.

Channelling credit into the most innovative and efficient companies is a crucial prerequisite for growth. But in their infancy, companies are usually not looking for credit, but for equity investors. When it comes to providing capital to innovative firms, the EU has much room for improvement. In the US, for instance, finding investors is not much of a problem for innovative companies. An innovative American firm is able on average to attract twice as much capital as an innovative firm in Spain, France, or Germany.

Investment in a new, innovative firm often takes the form of venture capital. The business model of a venture capital fund is based on developing expertise in a certain area and using this expertise to make informed bets on a number of promising firms in the industry in question. A high number of new firms fail, but the rewards to be reaped if they succeed are also high – on average, venture capital investments in the US have delivered a return of around 13% since 1990, according calculations by the Economist.

For the venture capital model to work there has to be a minimum market size in order to be able to spread out investments among a large enough number of start-ups. But in Europe, the markets for venture capital have been segmented along national borders. This may go some way to explaining why in Europe, investments by venture capital funds in technology companies are only one-fifth the size of investments in the US.

The Single Market Act of 2011 set out to harmonise venture capital regulations and to create a more integrated market. But many domains relevant to venture capital funds, such as investor protection and insolvency law, remain fragmented.

In order to make up for the lack of private capital, the EU installed a public venture capital fund at the EIB in 1997. Similar vehicles exist at the national level as well. The Economist estimates that up to 40% of European venture capital now comes from public sources. But the risk-return profiles of the companies targeted by these investments would appear to differ

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3 Korte, Joseph (2013): Catharsis − The real effects of bank insolvency and resolution. Deutsche Bundesbank Discussion Paper No 21/2013.

from those funded by US venture capital funds – the average return on venture capital since 1990 is no more than 2.1%.

This could suggest that public funds might not be able to make up for the fragmented market for venture capital in Europe. Instead, more integration seems to be the most likely way of making venture capital pay off, and of providing innovative companies with the funding they need.

### A digital single market

Ladies and gentlemen, more integration is not only needed with regard to the venture capital market, but also with regard to the markets their investments operate in.

When it comes to the market that arguably has the most sweeping consequences for overall productivity – I am referring to Information Technologies (IT) – fragmentation still abounds. This applies in particular to legal issues such as privacy and data protection, content and copyright, liability of online intermediaries, e-payments and electronic contracts. The EU still comprises 28 individual digital markets rather than one single digital market.

This is holding back innovation, growth and, ultimately, jobs. Studies[4] suggest that establishing a harmonised and well-regulated digital single market holds the same potential as the introduction of the original one, and could raise GDP by as much as 4%. In Germany, for example, this could imply an additional 420,000 jobs over the period 2015 to 2020.

A truly integrated digital market also implies higher potential rewards for investing in a digital European start-up. Together with the reforms outlined before, this might create a critical mass for venture capital in Europe. Bringing the single market into the digital age therefore could amount to a "buy one, get one free" scenario.

### Removing barriers to entry

A bigger market makes it more attractive for any potential entrant to compete on it. And more intense competition spurs innovation. In the long term, innovation due to increased competition is the main reason why market integration raises welfare.[5, 6]

But for newcomers to be able to challenge incumbents, they must not trip over red tape. Unfortunately, bureaucratic barriers to setting up a business are still high in many European countries – not least in Germany, which ranks 114th in the World Bank's Doing Business report in this regard. Spain does comparatively better, ranking 74th. But this still implies a considerable distance to the frontier of best practice.

How large is the impact of barriers to entry on the overall economy? Research suggests: quite large indeed. Increasing entry costs from very low levels such as those observed in Denmark, for example, to moderate ones like those in Spain can reduce per capita GDP and total factor productivity by up to 10%[7]. And the small differences in the administrative cost of

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

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

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

7 Barseghyan, L (2008), "Entry Costs and Cross-Country Differences in Productivity and Output", Journal of Economic Growth, 13(2):145–167.

entry between Europe and the US seem to explain 10 to 20% of Europe's lag vis-à-vis the US with regard to total factor productivity and the capital-output ratio.[8]

Removing barriers to entry therefore holds the promise of substantial gains in productivity and welfare. But these barriers can be tackled not only at the national level, but on the European level as well.

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. This could be changed by finally establishing the "country of origin" principle in the services sector, 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 import country if it has already complied with the national regulations in its home country.

Such a move would make services markets more open to competition. And reducing barriers to entry to more than two-thirds of the overall EU economy could provide a real boost to productivity.

**Labour markets and productivity**

Ladies and gentlemen, barriers to market entry can exert a powerful drag on productivity. But productivity is not only held back by product market regulations. For productivity to flourish, we need resources to flow – to the most innovative and efficient firms. This is why creating a working European venture capital market is very important.

Here, another factor comes into play: On average, bigger firms tend to be more productive and are better placed to compete in export markets. Unfortunately, the growth of small, innovative companies is hindered in some European countries by a plethora of regulations that kick in at a certain size threshold.

In France, for instance, many regulations become binding when a firm reaches a size of 50 employees. This causes some firms which would otherwise expand to stay below that level. Research[9] suggests that this distortion leads to a loss of 4–5% of French GDP. Other size-contingent regulations exist in other countries such as Portugal or Italy, where the threshold is 15 employees. What these regulations all have in common is that they deter firms from expanding. Therefore, they are a drag on growth.

These examples show that capital is not the only indispensable input for firms. Labour is equally crucial. Studies[10] indicate that, compared to the US, innovative European firms have considerably more difficulties in attracting the staff they need. This lowers allocative efficiency and, ultimately, productivity. The reason for this seems to be that overly strict employment protection exerts a "lock-in" effect: Workers do not move easily from firm to firm.

This not only hampers productivity, but is of particular concern in a monetary union. After all, the theory of optimum currency areas suggests that, in the absence of the exchange rate as

[8] Markus Poschke, 2010. "The Regulation of Entry and Aggregate Productivity," Economic Journal, Royal Economic Society, vol 120(549), pages 1175–1200, December.

[9] Garicano, Luis, Claire Lelarge and John Van Reenen (2013), "Firm Size Distortions and the Productivity Distribution: Evidence from France", CEPR Discussion Paper 9495.

[10] Andrews, D, C Criscuolo (2013), "Knowledge-based capital, innovation and resource allocation", OECD Economics Department Working Papers No 146.

an adjustment variable, we need the flexible movement of labour to absorb economic shocks.

How can we improve the situation? Simply slashing worker protection cannot be the answer. But when exploring avenues to make labour markets more flexible and efficient, we might heed the advice of the Nobel-winning labour economist Chris Pissarides: “Protect workers, not jobs.” In other words, less stringent employment protection coupled with adequate financial support in the event of a job loss is likely to reduce overall unemployment, while still insuring workers against the vagaries of the market.

The crushingly high unemployment levels – and especially youth unemployment levels – in some countries such as Spain are really a tragedy. These unemployment levels are more than enough reasons on their own to improve the workings of the respective labour markets. The spectre of a “lost generation” is economically indefensible and morally repulsive. In this situation, vested interests have to take a back seat.

And reforms that improve job prospects for the unemployed would have the additional upshot of making it easier for innovative firms to find the skills they need. This will make the overall economy more productive.

Scandinavian countries have led the way with “flexicurity”-type reforms. More recently, Spain has also taken some steps in this direction, and we can see that employment in highly productive industries such as manufacturing and in professional, scientific, and technical activities is growing.

Last month, Italy’s senate passed reforms that would go some way towards a single labour contract, advocated for example by this year’s Nobel Prize winner Jean Tirole[11]. Such a contract would improve protection for temporary workers while somewhat lowering protection for those with permanent contracts that have been almost impossible to terminate hitherto. This addresses labour market duality[12] and, coupled with unemployment insurance reform, resembles the reforms I have just outlined. But so far, the measures are still awaiting confirmation by parliament.

In any case, the scope for “flexicurity”-type reforms in Europe remains broad. If we want to emulate the productivity of the US and bring unemployment down to acceptable levels, we need to modernise our labour markets. Crucially, modernisation does not mean every man for himself. But it does mean that labour markets have to be more elastic.

## Conclusion

Ladies and gentlemen, let me come to a close. The biggest problem besetting the euro area today is its dim growth prospects. While weak demand does currently play a role, and this is why our monetary policy is more accommodative than ever before, we need to face up to our structural shortcomings to unleash innovation and propel productivity.

A financial sector that channels capital into the most innovative and efficient firms, reforms that make it easier for new firms to compete, and flexible labour markets that protect workers instead of jobs and allow firms to attract the skilled employees they need are the cornerstones that, if combined, have the potential to transform the growth outlook.

The OECD estimates that such measures have the potential to lift growth up to 15% above the current baseline level after ten years. And some of this would be felt instantly, as the expectation of higher incomes tomorrow triggers stronger investment today.

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11 Blanchard, OJ and J Tirole (2003), “Contours of Employment Protection Reform”, MIT Department of Economics Working Paper No 03–35.

12 Bentolila, S, T Boeri, and P Cahuc (2010), “Ending the scourge of dual labour markets in Europe”, Vox, 12 July 2010.

There is no single reform that will provide a silver bullet – and more needs to be done not only with regard to growth, but also in terms of the euro area's fiscal framework. But I already outlined why – from a stability point of view – it is so important to rebalance liability and control in Europe during my last visit to Madrid. And I do not wish to repeat myself.

Still, if we embark on a comprehensive overhaul in the way I have just described, I am positive that our monetary union will not only continue to fulfil the promise of price stability, but will live up to the promise of prosperity as well. Even that kind of euro area might not be heaven, but the view from above would be much nicer than it is today.

Thank you for your attention.