Jens Weidmann: Responsibility and liability in a monetary union

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at a conference, organised by the Consiglio Regionale del Veneto, Venice, 5 February 2015.

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1. Introduction

Dear Mr Ruffato, Mr Palermo, Ladies and gentlemen.

It's a pleasure for me to be here in beautiful Venice to share some thoughts with you during today's conference. My thoughts today will focus primarily on Europe in general and on the European monetary union in particular. Let me start off by referring to a specific European anniversary that lies ahead.

1.1 The Schuman Declaration – almost 65 years later

Almost 65 years ago – more precisely, on 9 May 1950 – then French Foreign Minister Robert Schuman put forward a proposal which became known as the Schuman Declaration. It proposed creating a European Coal and Steel Community, whose members would pool their production of coal and steel.

The Coal and Steel Community was the first of a series of supranational European institutions which would ultimately become the "European Union" of today. For this reason, the date of the Schuman Declaration is commemorated each year as "Europe Day".

Back then, the Schuman Declaration stated that "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements ..." As we know with the benefit of hindsight, this statement predicted with remarkable accuracy how Europe has evolved over the past six decades and more.

Indeed, since Robert Schuman's statement there have been outstanding political and economic achievements in Europe which are unprecedented when viewed from a historical perspective. These achievements have enhanced mutual understanding within Europe and safeguarded peace and freedom among an ever-growing number of countries that have become part of the European Union.

Of these achievements, the European monetary union (EMU) is likely to be the most outstanding, not least because our common currency is probably more tangible than any other European project. Banknotes and coins bearing the European flag and circulating in 19 EMU member states can literally be seen as "Europe in everyone's pocket".

However, one should be fair: due to the crisis in the euro area, scepticism has grown among the populations of some member countries as to the advantages of both the European Union and our common currency.

I sincerely hope that this kind of "Europe fatigue" will be overcome in the future. This will surely be easier if we tackle head on the difficult economic situation facing some euro-area countries today.

It is also important to bear in mind that both a stable euro area and a stable euro are, overall, beneficial to all member states – not just to a few, as some critics claim.

For instance, the common currency eliminates the exchange rate risk for goods and services traded within the euro area, which facilitates businesses' price calculations with respect to both imports and exports. Furthermore, the euro increases price transparency and allows easier price comparisons on the euro area's internal market.

As a result, the euro leads to higher competition within the euro area. Competition, in turn, is a prerequisite for economic prosperity, mainly because it drives both productivity and

innovation. If national governments create an environment in which entrepreneurial activity and inventive spirit can unfold, then, at the same time, intensified competition offers consumers a much broader range of goods and services to choose from.

Finally, the euro, as a stable currency, is without doubt beneficial to all inhabitants of the euro area. Prices which are predominantly stable are beneficial particularly to the socially deprived, who are unable to protect themselves from inflation.

Ladies and gentlemen, despite these economic considerations, it is clear to me that Europe and the monetary union have always been more of a political project than an economic one. The overwhelming European solidarity with the French people after the hideous terrorist attacks in Paris have impressively shown that the Europe of today is the result of shared values with regard to human rights, democracy and the rule of law, to name just the most essential ones.

I am quite confident that common values will help us to proceed towards a more prosperous European monetary union. In the end, however, political determination cannot compensate for the need to pay due attention to economic laws. Economic convergence, competitiveness and sound public finances are, among other things, of the utmost importance as preconditions of a stable monetary union. And such a stability union, in turn, is a prerequisite for the public acceptance of European integration in the long run.

During my talk, I would like to focus on those aspects of the European monetary union which are especially important in terms of making it more stable and prosperous.

2. Individual fiscal responsibility of member states as the fundamental concept of EMU

2.1 Asymmetry between monetary and fiscal policy

In this context, I would like to recall the set-up of the European monetary union. It is remarkable for its asymmetry: whereas monetary policy has been communitised at the European level, fiscal policy has remained a matter of national responsibility.

This is by no means a bad thing in itself, as it does have lots of merits. In particular, it grants member states sufficient leeway to preserve their diversity, that is, to establish their own business models or to tailor economic and social institutions and policies to their own national preferences.

But to make sure that such an asymmetrical set-up of a centralised, single monetary policy and decentralised fiscal policies works well, fiscal discipline is absolutely essential. Past experiences have shown that monetary unions are rather like any normal family – if there is a quarrel, then it will be about money.

This becomes particularly relevant as the set-up of the European monetary union can further compound the tendency of governments to finance their spending through debt because the consequence of bad policy choices can more easily be externalised to neighbouring countries.

In addition, if market participants tend to see the monetary union as a system of mutual financial assistance in the event of serious trouble, doubts about a country's solvency could spread more quickly to the other member states.

This is why common fiscal rules are an integral part of the Treaty establishing the monetary union. ECB president Mario Draghi once aptly summed up the rationale behind these rules as follows: "The consequences of misguided fiscal policies in a monetary union are too severe to remain self-policed."

The importance of sound fiscal policies from the perspective of a central banker also stems from the ability of monetary policy to accommodate high levels of public debt. This, however,

could threaten price stability in the longer run. Thus, the higher public debt becomes, the greater the pressure that might be applied to monetary policy to respond accordingly.

This once prompted Mervyn King, the former Governor of the Bank of England, to quip 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.” This “obsession” holds even truer for a stability-oriented central bank within a monetary union.

Against this backdrop and in order to keep monetary union on track despite these dangers, the founders of the European monetary union drew up the fiscal rules enshrined in both the Maastricht criteria and the Stability and Growth Pact.

The Stability and Growth Pact is not the only safeguard against excessive government debt, however. The second one is the rule that member states remain fully responsible for the consequences of their own autonomous fiscal decisions. In other words, making a decision autonomously – which means being in control of it – and, at the same time, being liable for the consequences are two sides of the same coin. This nexus can be referred to as the liability principle or the principle of individual responsibility.

The liability principle is simple and straightforward, but at the same time, it is of fundamental importance, as it fosters responsible behaviour and prudent decisions that do not produce results that come at the expense of others. This will be a well-known truth for all the entrepreneurs among you.

The liability principle is a constituent element of a market economy. It also implies that enterprises must be allowed to fail and, in consequence, to exit the market. The US economist Allan Meltzer once put this idea as follows: “Capitalism without failure is like religion without sin. It doesn’t work.”

In the context of European monetary union, the liability principle is the reason why the Maastricht Treaty explicitly rules out the assumption of any member state’s debt by the European Union or by other member states – that’s the so-called “no bail-out” clause – or even by the Eurosystem, which would constitute prohibited monetary financing.

Only a credible no bail-out clause and the prohibition of monetary financing enforce the liability principle, which itself is the cornerstone of market discipline. And market discipline is, in addition to the fiscal rules, the second safeguard of sound public finances in a monetary union.

Ladies and gentlemen, as we have seen, however, all the precautionary measures did not prevent public debt from rising and the sovereign debt crisis from materialising.

In this crisis situation, only the European fiscal rescue packages and the Eurosystem’s stabilising measures prevented the crisis from escalating. Nevertheless, these crisis measures permanently weakened the principle of individual responsibility. In other words: although the rescue measures helped to stabilise the euro area, they caused a redistribution of risk and put elements of mutualised liability in place. As a result, while fiscal policy decisions are ultimately still made at the national level, joint liability has been considerably expanded.

This imbalance, however, undermines the idea of individual fiscal responsibility, and with it, the necessary foundation for a stable and prosperous monetary union.

2.2 Strengthening the liability principle as the way forward

The key question now, therefore, is how the framework of monetary union needs to be changed to provide the common currency with a more solid base in terms of public finances.

It is in this context that calls for a true fiscal union or, as the ultimate consequence, a true political union are often put forward as a way to make the European monetary union more stable. It was the former German chancellor Helmut Kohl who famously told German

parliament in 1991: "It is absurd to expect in the long run that you can maintain economic and monetary union without political union."

Indeed, the idea of a fiscal union completes the monetary union in the sense that it puts individual responsibility and liability in balance. If common European debt were matched by common European control of public expenditure, incentives could be aligned.

Nevertheless, a genuine fiscal union would require member states to cede sovereignty – in particular, budgetary control and intervention rights – to the European level. Looking at the current national discussions in the European states, I doubt that the electorates or the governments and parliaments would be willing to take this leap – either now or in the foreseeable future – despite the common values I have just mentioned.

And the decision of the newly elected Greek government to stop cooperating with the Troika shows how unpopular sharing sovereignty rights with foreign creditors is, even in cases in which national expenditures are largely dependent on external financial help. It shows how difficult it is politically to accept European influence on national economic policy.

But then, because a true fiscal union – which would also require extensive changes to the European Treaties – seems not to be on the cards, we should be careful not to take the second step before the first: we should not broaden joint liability before ceding budgetary sovereignty.

To cut a long story short, I see no viable alternative to reinforcing the original set-up of the monetary union. This means that we have to strengthen the incentives to stick to the fiscal rules, and we have to make sure that the disciplining effect of the financial markets is not weakened.

One thing we have learned from other common currency areas with autonomous fiscal policies – like Switzerland or even Germany – is the need for effective fiscal rules. Experience in Germany shows that fiscal rules that are not implemented strictly enough are unable to prevent excessive indebtedness of at least some of the German federal states. In this context, State Secretary Weyland from the German federal state of Hesse will, during the course of this symposium, shed some more light on certain aspects of the financial relations within the German federal system.

And if we look closely at Switzerland, we find that stricter cantonal debt brakes prove to be more effective – the debt brake being in any case quite a strict form of fiscal rule. However, in this context, one has to bear in mind a key component of Swiss fiscal policy: the principle of direct democracy. This concept gives the general public a say in fiscal decisions, especially at the cantonal and local government level, and studies suggest that cantonal referendums tend to curb spending. One lesson the euro area can learn from the Swiss experience is this: if direct democracy as a safeguard for responsible fiscal policy decisions is not given, fiscal rules have to be stricter.

With respect to the European situation and in order to reinforce the liability principle, the euro-area member states have already tightened the ground rules by rolling out the revised Stability and Growth Pact and the Fiscal Compact, making it much more difficult now for finance ministers to turn down the European Commission's recommendations. The Commission therefore plays a central role given its important responsibility in enforcing the fiscal rules.

The tougher fiscal rules are heading in the right direction, but they must now be implemented as well. Unfortunately, the rules have latterly become significantly more complex. A great deal of scope for interpretation and discretion has now been opened up. This is in contrast to one of the leading ideas regarding the stiffening of the rules, namely that the imposition of sanctions under the Excessive Deficit Procedure should be "semi-automatic" in future.

Moreover, greater emphasis has recently been placed on the use of "flexibility". And the European Commission's comments three weeks ago with regard to its future interpretation of

the fiscal rules unfortunately indicate that these tendencies are likely to become even stronger.

For example, in future, the Commission even plans to broaden its acceptance of investment and structural reforms as an excuse for weaker consolidation efforts. In the end, however, the binding effect of the rules is likely to be diluted further instead of being strengthened, and sound fiscal policy is more likely than ever to take a back seat to other political considerations.

But sound public finances are by no means at odds with robust and sustainable economic growth: quite the opposite is true. Sound public finances in conjunction with structural reforms are a key precondition for growth.

The reason is that people's concerns about an increasing debt burden and ensuing adjustment needs in the future will affect their spending and investment today. Thus, it is important that governments adhere to the consolidation plans they announced. This will inspire confidence, which is an important prerequisite for the economy to grow.

As Jean-Claude Trichet once said: "When you've lost confidence, when households have no trust, when businesses have no trust, when savers have no trust, then the best way to find growth and jobs is to recreate confidence."

In my view, this is true not just for the countries at the heart of the crisis. Thus, my appeal for consolidation does not stem from a desire to punish past sins. Rather, the goal should be to make all euro-area countries stronger, to regain fiscal and economic policy scope for the future and to be better able to cushion adverse cyclical developments.

In the current context some critics claim that such a stability-oriented fiscal policy was choking economic growth in the euro area. However, the fiscal policy stance in EMU is expected to be broadly neutral in the years 2014 to 2016, not restrictive. Therefore, adhering to the fiscal rules would only imply a very moderate tightening but it would offer a chance of a massive gain in credibility.

Ladies and gentlemen, besides this, regulatory changes should also be considered in order to make the liability principle more effective. The euro-area crisis has shown that failing banks and stumbling states pulled each other down.

Yet, until now, the insolvency of governments and systemically important banks has practically not been permitted because of the – probably quite realistic – fear that this would threaten the stability of the financial system throughout the entire euro area.

So what needs to be done is to break the potentially disastrous sovereign-bank nexus. Only this would ensure that sovereigns and banks can fail without creating a systemic risk for the financial system. And in this respect, the Basel Committee on Banking Supervision has an important role to play.

First, it tightened the capital rules for banks, which are designed to enhance financial sector resilience and so naturally contribute to achieving this goal. Second, it has to change the regulatory treatment of sovereign bonds – a topic which is now on the Basel Committee's work programme.

Why would this be an important step forward? Because it would help to enforce the credibility of the no bail-out clause.

The international capital rules stipulate that government bonds issued by developed countries in their own currency be valued as risk-free assets. This means that banks do not have to back them with capital, and that large exposure limits are not in place for government bonds.

This preferential treatment of government bonds as opposed to loans to businesses or households has made banks in crisis-hit countries invest massively in sovereign bonds of their own country instead of providing credit to the private sector. Furthermore, this

preferential treatment of government bonds robs the no bail-out rule in the Maastricht Treaty, even today, of some of its credibility.

And finally, the experience with Greece, amplified by the current discussions, shows that the underlying assumption of government bonds being risk-free is false.

Undisputedly, putting an end to zero-risk weighting and, in particular, applying a large exposures regime to sovereign bonds could give rise to substantial repercussions. These repercussions, however, would be manageable if they were phased in over a transitional period – which would undoubtedly need to be granted.

3. Individual national responsibility also applies to economic policy

Ladies and gentlemen, the concept of autonomous decision-making at the level of EMU member states does not apply only to their fiscal policies, but to their economic policies as well. And rightly so. Member states know best what kind of economic initiatives suit their national preferences.

Notwithstanding joint initiatives at the EU level to foster growth, in the end it is primarily the task of each individual member state to make its economy competitive, to spur economic growth and to facilitate job creation – not only in its own interest but also in the interest of the whole monetary union.

In my view, all euro-area member states are responsible for ensuring that their economies are in good shape and are able to live up to the challenges that result from their euro-area membership. This also implies sufficient leeway to absorb economic shocks without risking the sustainability of public debt or ending in high rates of unemployment.

With respect to shock resilience, studies have shown that a deeper integration of European capital markets could also make a key contribution to improving the absorption of macroeconomic shocks and the impact of heterogeneous economic developments in the euro area. The more the capital markets exercise this buffer function, the less fiscal policy is needed to stabilise the economy, which has a knock-on impact on government debt.

Most important is a more integrated capital market for equity. This would make it easier for companies to find investors. New, innovative firms, in particular, need better access to equity. This is where the venture capital market comes into play. For the venture capital model to work, however, there has to be a minimum market size so that investments can be spread among a sufficiently large number of start-ups.

But in Europe, the markets for venture capital have been segmented along national borders. While the Single Market Act of 2011 set out to harmonise venture capital regulations and to create a more integrated market, many areas relevant to venture capital funds, such as investor protection and insolvency law, remain fragmented. This issue needs to be resolved – and it would come without imposing a financial burden on European countries.

Conversely, in the event that a company were to fail, the loss would be spread throughout the euro area. Studies for the US show that this regional distribution effect is much more important than fiscal policy measures.

Ladies and gentlemen, you might remember that not so long ago, Germany was labelled “the sick man of Europe”, not least because of its weak economic growth and high level of persistent structural unemployment. Other euro-area countries rightly expected Germany to set about resolving its economic problems. But unsurprisingly, the enacted reforms did not restore full employment overnight.

The conclusion to be drawn from the German labour market experience is that implementing reforms requires quite some perseverance, but efforts do finally pay off – overcoming a crisis is more of a marathon than a sprint. The same conclusion can be drawn from the reform

measures which have been put in place in Spain and Ireland, for example, over the past few years.

However, it should be noted that, despite the improvements in the past decade, not all economic challenges in Germany have been eliminated. For example, even though the employment level continues to rise, it is still clear that the number of employed people in Germany will decrease due to a strong demographic effect. That's why it is essential that economic policy in Germany carries on striving to further enhance the labour market, and does not take today's favourable employment situation for granted and reverse past reforms.

Policies in Germany, like the option of long-term contribution payers drawing a full pension at the age of 63, do not only pose an additional financial burden on the pension system, which will have to cope with mounting demographic pressure pretty soon. Such policies might also reduce the potential growth rate of the German economy due to adverse effects on the supply of skilled labour.

Ladies and gentlemen, just as Germany is rightly asked by its European partners to resolve its economic problems, all the other euro-area member states are responsible for their economies, too.

Because the economic problem differs from one country to the next, tailored and country-specific solutions need to be found for each individual country's problems. And it is up to governments, parliaments and their advisors to assess what can be learned from other countries' experiences.

The labour market reforms in Italy and Spain, for example, seek to reduce labour market segmentation so as to prevent workers on temporary contracts from having to bear the brunt of the adjustment during the economic downturn.

Indeed, when exploring avenues to make labour markets more flexible and efficient, the Nobel Prize-winning labour economist Chris Pissarides points in the right direction when he states: "Protect workers, not jobs." In other words, less stringent employment protection coupled with adequate financial support in the event of job loss is likely to reduce overall unemployment, while still shielding workers against the vagaries of the market.

Prime Minister Renzi's reform agenda for the Italian labour market takes these considerations into account, and his efforts to establish a single labour contract, among other things, deserve every support. Passing the relevant law and the thorough implementation of the envisaged measures will now be of crucial importance.

4. The role of monetary policy

Ladies and gentlemen, for quite some time now, the Eurosystem's monetary policy has been pretty much at the centre of public attention amid the search for a solution to the euro area's debt and unemployment crisis. However, nobody should be under any illusions that the Eurosystem can solve the severe structural difficulties the euro area is facing. Structural problems require a response in the form of structural measures.

In other words: as monetary policy simply does not have the necessary instruments at hand, it remains primarily the task of economic policy to provide lasting solutions to the deep-rooted debt and unemployment crisis. There is still truth in what Wim Duisenberg, the first President of the ECB, once said: "Don't ask for monetary policy to perform tricks it cannot deliver."

Two weeks ago, the Governing Council of the ECB embarked on additional measures to further loosen its monetary policy stance and announced the launch of an extended asset purchase programme, commonly referred to as quantitative easing. As you know, I am sceptical about this decision.

I thought that there was no urgent need for this measure – not least because government bond purchases are not a monetary policy instrument like our policy rates, for instance.

It is true that inflation in the euro area has been very low for quite some time now, and the outlook for inflation is weak. However, the low level of inflation is mainly due to sharply falling energy prices, notably the plummeting oil price. This should not be confused with a self-reinforcing deflation and its negative consequences. The risk of broad-based deflation continues to be very limited.

The decline in oil prices works rather like an economic stimulus to the euro area, not like a harbinger of an imminent deflationary threat, as the lower oil price reduces the energy bills of both households and businesses. It therefore frees up financial means which can now be used for other purposes – for consumption, investment or the reduction of debt. All of this is good for the economies of the euro-area countries.

Without signs of second-round effects – and I do not see any – monetary policy need not take steps to counter the favourable oil price decline. In addition, all forecasts project inflation rates to rise over the medium term, albeit at a sluggish pace.

Another development has to be taken into consideration: low inflation in crisis-hit countries is a consequence of the necessary economic adjustment process. Cost and price adjustments are unavoidable in seeking to make the economic structures of the crisis countries more price-competitive.

In assessing the need for action one has also to consider the instrument at hand, which is government bond purchases. In the context of the European monetary union, however, massive purchases of government bonds are not just another instrument in the Eurosystem's regular monetary policy toolbox.

They bring with them specific risks and side-effects which are, in my view, not outweighed by the expected effect of the bond purchases. The high volume of government bond purchases will make the Eurosystem the biggest creditors of euro-area member states. In the end, the strong inter-linkage of fiscal and monetary policy might lead to intensified political pressure on the Eurosystem and might, as a result, put the independence of monetary policy at risk.

Such a situation could become particularly relevant once monetary policymakers have to start raising the policy rate – especially if the highly favourable financing conditions of today have been taken more or less for granted.

The perception that monetary policy will always step in as the "ultimate problem solver" is dangerous as it could weaken the incentive to implement structural reforms and to ensure sound fiscal public finances.

5. Conclusion

Ladies and gentlemen, at the beginning of my talk, I quoted Robert Schuman as saying: "Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements."

I would like to take this statement further by adding that concrete achievements also require the concrete and constant efforts of all member states – for the sake of the common goal.

For good reasons and in order to allow diversity in unity, both EU and European monetary union respect national differences. But that is precisely why all member countries must live up to their responsibilities and ensure that their economies are competitive and their public finances are solid.

Following these rules to ensure that is not an end in itself, but the prerequisite for maintaining the monetary union as a stability union.

Thank you for your attention.