Jens Weidmann: Challenges for the euro area: what progress has been made – what still needs to be done?

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Swiss Institute of International Studies, Zurich, 9 March 2015.

*   *   *

1. Introduction

Dr Meyer, Thomas, Ladies and Gentlemen

Thank you for inviting me to this event. It gives me great pleasure to be here with you today in this beautiful city on the River Limmat.

Being a monetary policymaker is rather like trying to swim at a constant speed. If you dive into the water at the Upper Letten, you will simply be swept along by the current without any effort – in fact, you may actually have to actively slow yourself down.

If you take a swim in Lake Zurich, on the other hand, you can usually progress at your own pace in a leisurely breaststroke. But, of course, even there you may encounter more turbulent waters – waves churned up by a passing boat, for example.

I'm sure you'll agree, Thomas, that we central bankers are currently faced with a fairly strong countercurrent. Euro-area inflation has been below the target of just under 2% for months now, with another negative rate of –0.3% recorded in February. And the consensus is that the inflation outlook will remain subdued for some time to come.

The ECB Governing Council has therefore decided to make extensive government bond purchases, thus progressing to an even more expansionary monetary policy stance. In terms of monetary policy, the Eurosystem is undoubtedly facing a difficult situation at the moment. Failing to meet its inflation target for too long could have negative repercussions, as the various players in the economy have adapted to this pace of inflation.

As a case in point, both private and public borrowers have based their contracts on the benchmark of inflation of below, but close to, 2% over the medium term. If inflation remains below this level for a long time, it will become more difficult for them to service their debt. And that could have implications for price developments and the credibility of monetary policy. The dangers associated with inflation staying too low for too long therefore have to be taken seriously.

But is that really cause for us to loosen our monetary policy? I have my doubts. Despite the horror scenarios evoked in some quarters, the risk of a self-reinforcing spiral of falling wages and prices – of deflation, in other words – is very low, a view shared by the vast majority of the Governing Council members.

There are, at least, no visible signs of especially low wage settlements, either in Germany or the other large euro-area countries. Negotiated wages are likely to rise by around 3% in Germany this year; the increase just agreed for Germany's metal-working industry is around that size. And even in Spain, where inflation rates are negative, the Commission is expecting wages to rise by 0.7% in 2015.

As for the spectre of debt deflation, there are currently no signs in any of the crisis countries other than Greece that low inflation is hampering deleveraging in the non-financial sector. The primary reason why debt ratios in these countries are rising is that increased public borrowing is overshadowing the partial deleveraging that has occurred in the non-financial private sector.

When assessing the monetary policy situation, of course, it is also important to look at the cause of the low inflation rates. Plummeting energy prices are one of the main factors. But this slump is likely to be fairly short-lived. And although falling energy prices are slowing down inflation, they are also boosting consumers' purchasing power and cutting enterprises' costs. Falling oil prices are therefore having the effect of a small stimulus package.

This assessment is also reflected in the ECB staff macroeconomic projections published last Thursday. While the ECB staff lowered the projection for this year's inflation rate, they made perceptible upward revisions to the growth outlook for this year and next. Inflation is now expected to return to the desired range of "below, but close to, 2%" in 2017.

Another point to consider is that purchases of euro-area government bonds are not "just another" instrument. As the founding fathers of our monetary union were well aware, in a monetary union with a single monetary policy but continuing national sovereignty over fiscal policy, the easier it is to pass on the fallout of unsound budgetary policy to other member states or to the Eurosystem, the stronger the inherent incentive for countries to run up debt.

That is why the EU treaties forbid the Eurosystem from purchasing bonds directly from member states or giving them loans. Now the Eurosystem is buying government bonds not on the primary market but on the secondary market. That is not prohibited. Still, these purchases will make the Eurosystem the member states' largest creditor, thus further blurring the boundaries between monetary and fiscal policy to a significant extent.

Ultimately, the government bond purchase programme also means that all governments – regardless of their credit quality – can, in effect, fund a substantial portion of their debt very cheaply. As the central banks are only purchasing the government bonds of their home countries, the member states will recoup much of the interest payable on these instruments at a later date via central bank profits.

That can, of course, ingrain certain habits and ultimately encourage countries to put the necessary consolidation of their public finances on the back burner. And that, in turn, could increase pressure on monetary policymakers to keep interest rates low for longer than necessary – even if monetary policy considerations would call for a rise in key interest rates. The mere impression that monetary policy is no longer centred around the goal of price stability could erode its credibility, and central banks would have to make great efforts to combat this.

Ultimately, deciding whether to make bond purchases is about weighing up which risks are more pressing. On the one hand, we have the risk associated with blurring the boundaries between monetary and fiscal policy, combined with possible financial stability risks caused by very loose monetary policy. On the other, we have the risks to credibility caused by a phase of low inflation, which could engender the risk of a self-reinforcing deflationary spiral.

Given that the oil price slump – the main cause of the low inflation rates – is temporary and is also acting as a stimulus for the economy as a whole, I consider the former risks to be more pressing than the latter at present.

Ladies and gentlemen, the world would be a far simpler place for the Eurosystem's monetary policymakers if economic growth in the member states were stronger. When potential growth is low, a central bank will soon start to run out of options – interest rates cannot simply be lowered ad infinitum into negative territory.

One important reason why monetary policymakers have been forced to take ever riskier action is the weak growth outlook for the euro area. According to estimates by the European Commission,[1] the euro area's potential growth over the medium term – in other words, over the next ten years – is a mere 1%. And weak growth prospects mean not only a

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

comparatively small increase in living standards but also tighter budget constraints in the future.

What we need is a lasting increase in growth. Yet that can only be achieved if we decisively tackle our structural barriers.

2. What progress has been made?

It could be argued here that major progress has already been accomplished, especially in the countries hit hardest by the crisis. I share this view. Indeed, much has been done to correct the macroeconomic imbalances that were a root cause of the euro-area crisis.

Historian Harold James once likened the behaviour of member states before and after the start of monetary union to that of couples before and after getting married: "It was like what happens to couples who, once married, abandon some of their romantic and utopian intentions in day-to-day married life. At the most trivial level, men now leave unwashed socks lying around and women drop towels on the floor. In many cases, the situation then spirals from there …"[2]

Before the crisis, prices and productivity in some parts of the euro area had become increasingly divorced from one another. When the financial crisis hit and investors' risk-awareness grew, they refused to continue to bridge the resulting gap.

But a lot has happened since then. For example, wage bargaining has been decentralised in many countries and wage indexation abolished or, at the very least, reduced. Consequently, wages can better reflect the specific circumstances of individual enterprises. This and other measures have brought prices and wages closer into line with productivity. Member states' price competitiveness increased significantly, to the point where current account deficits were completely eliminated in all crisis countries except for Cyprus back in 2013. Cyprus, too, is expecting to record a current account surplus in 2014.

In addition, progress has been made in the consolidation of government budgets. The sustainability of public finances in countries such as Italy, Greece, Spain and Portugal has also been improved by adjusting pensions for demographic factors, with measures including an increase in the statutory retirement age. As a result, the pension system will be strengthened financially, much needed expertise will remain in enterprises and the demographically induced decline in the labour supply will be slowed down to a certain extent.

Germany took this path at an earlier point in time, which makes it all the more regrettable that it is now back-pedaling a little on these reforms.

3. What remains to be done?

The measures that have been introduced have helped improve the public finance situation and increase competitiveness. However, competitiveness should not just be the product of cost cuts. Prosperity ultimately hinges on productivity – and this is where efforts should be focused in the euro area.

What is now required are structural reforms that unleash innovative power and enhance productivity. We need these reforms right now not least because they play a part in raising income expectations. What is more, areas in which higher income is expected in future are receiving investment today. Supply-side reforms can therefore support demand, too.

Responsibility for some areas in which there is a need for reform lies primarily with the European Commission and the European Council rather than at the national level.

---

2 H James (2014), Finanzmarkt macht Geschichte.

3.1 The digital single market

Ladies and gentlemen, economic textbooks are in complete agreement on what drives productivity: technological progress.

In recent years, technological progress has been heavily influenced by IT. As is so often the case, economists cannot quite agree on the scale of the contribution made by digital technologies. But what they do agree on is that it is considerable.[3, 4]

However, the European markets for digital applications remain heavily fragmented, especially with respect to legal issues such as protection of privacy, contents and copyright. The liability of online intermediaries, electronic payments and electronic contracts are also regulated differently. There is still no digital single market in the EU; instead, there are 28 individual digital markets.

If the single market were to enter the digital age with no holds barred, this could significantly strengthen the forces of growth.

Studies[5] show that creating a harmonised and well regulated digital single market has the same potential as implementing the single market in its original form, which is to say an upturn in growth of as much as 4%. In Germany alone, as many as 420,000 new jobs could be created between 2015 and 2020.

3.2 Common market for services

The market for digital applications is not the only one in which integration remains incomplete.

The single market has proven extremely successful at simplifying trade in goods. As a result, competition here is intense. Enterprises' market power does not enable them to charge large mark-ups on top of their costs; levels are similar to those in the USA, for example.

Creating a transatlantic market – the TTIP is a keyword here – could thus provide even more stimulus in this regard. The USA is the EU's largest export market and its third most important import partner for trade in goods. As far as trade in services is concerned, the two regions share even closer connections.

And it is precisely in the area of services that the EU still has some catching up to do in terms of intensifying competition. Mark-ups on the cost of services are, on average, higher than in the USA. One could say that the European Commission's Services Directive has failed to live up to expectations. Thus, achieving a single market for services and ensuring the unhindered cross-border provision of services promise significant economic benefits.

3.3 Barriers to market entry

Obstacles to growth exist across individual member states in the form of red tape for business start-ups, to cite one example. Frequent administrative formalities, long approval periods and high fees make starting a business more complicated and expensive than necessary.

In the World Bank's Doing Business table, for instance, Germany ranks 114th in the "ease of starting a business" category. Speaking of which, Switzerland did not fare spectacularly well in this category either, coming in at 69th place. Other European countries also found

---

3 D T Jorgenson (2001), Information technology and the U.S. economy, American Economic Review, Vol 91, No 1, pp 1–32.

4 B Van Ark, M O'Mahoney and M P Timmer (2008), The Productivity Gap between Europe and the United States: Trends and Causes, Journal of Economic Perspectives, Vol 22, No 1, pp 25–44.

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

themselves in mid-table positions at best. In other words, there is plenty of room for improvement.

Even though an enterprise's direct costs may appear to be manageable at first glance, the economic cost of difficulties entering the market and, as a result, weaker competition should not be underestimated. For example, studies[6] indicate that the differences between the costs of entering the market in the USA and in the EU, while relatively small, could still account for 10% to 20% of the EU's productivity shortfall. The costs of removing red tape are comparatively low and could help strengthen growth.

3.4 Labour markets

Ladies and gentlemen, market entry barriers can severely hamper productivity. But productivity is not only subdued by regulations in the product market. In order for the economy to flourish, resources must be utilised wherever they promise the highest return. Of course, this is especially true of the most important resource of all – the labour provided by each individual.

Studies[7] show that innovative European firms are having a considerably tougher time recruiting the staff they need than their US counterparts.

As a result, allocative efficiency and, ultimately, productivity are reduced. It would appear that the reason for this is the "lock-in" effect produced by overly strict employment protection, meaning that it is not so easy for employees to change employers.

That which creates security also creates inertia. But can you have one without wanting the other? I think so. However, the answer cannot simply be to drastically cut employment protection. The advice of labour market economist and Nobel Prize winner Chris Pissarides could serve as a guideline here: "protect workers, not jobs".

In other words, the implementation of less stringent employment protection legislation linked to adequate financial support in the event of job loss would likely reduce the overall unemployment rate. But employees would be protected against the vagaries of the market.

The overwhelmingly high unemployment rate in many euro-area countries is reason enough alone to improve the functioning of the labour markets. Especially dramatic is the high level of youth unemployment, above all in Spain and Greece. The notion of a "lost generation" is devastating not only from an economic perspective.

Spain and Greece have already initiated reforms to surmount the divide between protected and precarious employment. Most recently, Italy has likewise passed reforms that head in this direction. These steps are encouraging. But it is also clear that reducing unemployment will not happen overnight – it will take time.

However, in countries where reform has been systematically pursued, such as Spain and Ireland, the results are already visible. Spain's unemployment rate has fallen by almost three percentage points from its peak during the financial crisis, while Ireland's unemployment rate is already down by five percentage points. It is therefore crucial that they not stop halfway.

Flexible labour markets also remain important in the euro area for another reason. Last but not least, the optimal currency area theory suggests that, in the absence of an exchange rate as an adjustment variable, the free movement of workers in the labour market is required to absorb economic shocks. Rendering the European labour markets more flexible would therefore have a threefold positive effect.

---

6 Markus Poschke (2010), "The Regulation of Entry and Aggregate Productivity", Economic Journal, Royal Economic Society, Vol 120, No 549, pp 1175–1200.

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

3.5 Capital markets union

Differences in language and culture would suggest, however, that mobility in the European labour market will not be as high in the foreseeable future as in other currency areas. This makes it all the more important for other buffers to function effectively.

Even in federal currency areas such as the United States, Canada or Switzerland, this buffer function is performed primarily by the capital markets. In the USA, for example, the integrated markets for capital cushion around 40% of total cyclical fluctuations between the US federal states. If a negative shock hits an industry or a specific region, then this loss is spread widely beyond the state. But in return, shareholders throughout the country also receive a share of the profits during the good times.

When compared with the equity capital markets, the significance of the credit markets as a buffer is lower: around 25% of cyclical fluctuations are evened out via the credit markets.

Fiscal cushioning mechanisms, however, are by far the least significant: only 10% to 15% of economic shocks are absorbed through public finances.[8] This last figure is similar in other federal systems. Only in Canada is the contribution considerably higher, at approximately 30%.

In terms of their performance, fiscal buffers thus correspond more closely to the traditional leaf spring; only integrated capital markets are capable of providing the cushioning comfort of modern air suspension systems. Here, the equity capital markets, in particular, are an essential component.

4. The fiscal framework

Although the role fiscal adjustment mechanisms play in absorbing asymmetric shocks appears to be limited, fiscal policy remains at the centre of the debate on the euro area's future development.

This is related to the incentives for running up debt mentioned earlier, created by the combination of a single monetary policy and national fiscal policies. As long as fiscal policies remain in national responsibility, the member states also need to bear the consequences of their policies themselves. Otherwise, incentives will be created to engage in unsound practices.

The rescue measures taken during the crisis prevented any further escalation of the crisis and stabilised the euro area in the short term. However, elements of joint liability have also increasingly been introduced as part of these measures, while fiscal policy has remained a matter for national policymakers. Hence, there is a growing divide between liability and control, which can lead to growth in incentives for government borrowing.

A frequently suggested solution to these euro-area stability problems is the introduction of a fiscal union with centralised intervention rights at the European level and joint liability. This is not a fundamentally new idea. Addressing the Bundestag in November 1991, for example, the then-Chancellor Helmut Kohl remarked that "the idea of sustaining economic and monetary union over time without political union is a fallacy".

But we ought to remain realistic: there is currently no sign of any willingness – either in Germany or in our partner countries – to transfer fiscal policy sovereignty to the European level. Therefore, we will have to make do with the regulatory framework agreed on at the time by all parties – which places liability and control at the national level.

[8] P Asdrubali, B E Sørensen and O Yosha (1996), "Channels of Interstate Risk Sharing: US 1963–1990", Quarterly Journal of Economics, 111(4), pp 1081–1110.

But the principle of individual national responsibility requires a double safeguard. First, strict fiscal rules that prevent the development of unsound public finances. Second, a reliable ban that prohibits countries from providing each other with aid in times of financial distress. Only a credible no bail-out clause results in risk-appropriate pricing of a country's government debt by financial markets. The more debt a government takes on, the more expensive it becomes.

The example of Switzerland shows that a combination of fiscal rules and individual financial responsibility can ensure sound public finances. A crucial element in Switzerland's fiscal framework is the no bail-out regime for local governments.

But up until ten years ago, no one was quite sure whether a canton really was exempt from the obligation to bail out a bankrupt municipality within its jurisdiction. The answer to this question was provided by the Leukerbad case: a court ruled that the canton of Valais was under no obligation to bail out the highly indebted municipality of Leukerbad. Ever since, the financial markets have also acknowledged the no bail-out regime as a credible policy, as indicated, amongst other things, by the fact that yields on bonds issued by cantons which are home to municipalities facing financial problems have dropped since the court ruling.[9]

Yet how can the principle of individual fiscal responsibility be reinforced among the member states of the euro area? A key starting point is to strengthen the financial markets' disciplinary function. This would require, in particular, an end to the preferential regulatory treatment of government bonds, which includes banks not needing to hold capital reserves against investments in government bonds.

This preferential treatment of sovereign debtors is based on the assumption that government bonds are free of risk, an assumption that contradicts the no bail-out clause and therefore reduces its credibility. When banks are not required to hold any capital reserves against government bonds, their solvency is directly threatened by a sovereign default, and a financial crisis cannot be ruled out. Hence, government bonds should be backed by adequate capital.

There is also another special treatment that should be ended. To avoid concentration risks, bank loans to a single private-sector borrower may not exceed 25% of the bank's liable capital. In future, large exposure limits should also apply to sovereign debtors.

From a financial stability perspective, particular problems are posed by the fact that banks often only have government bonds issued by a single country in their portfolio – those of their home country. Not only do the euro-area banks hold more government bonds on their books than ever before (€1.9 trillion), the home bias has actually become even stronger in the crisis countries in recent years. In Italy's case, for instance, 97% of the euro-denominated government bonds held by the country's banks were issued by the Italian government.

So, the banks not only have no capital backing for these government bonds but are also tying their own fate to that of their country. This will need to change to give credence to the no bail-out regime.

But even a credible no-bailout regime can only have the intended disciplining effect once doubts begin to emerge over a country's fiscal soundness. That is why it is also important to combat the particular incentives inherent in a monetary union to run up debt, so that things do not get out of hand in the first place.

Hence the need for effective fiscal rules. Switzerland has a wealth of experience in applying fiscal rules. Its national debt brake has been in force since 2003, since which time debt has levelled off, and the debt ratio has been on the decline. The debt brake was introduced by

9 Lars P Feld, A Kalb, M-D Moessinger and S Osterloh (2013), Sovereign Bond Market Reactions to Fiscal Rules and No-Bailout Clauses: The Swiss Experience.

way of referendum, which increases its binding force, as violations explicitly run counter to the will of the people.

Incidentally, we can gain even more detailed insights from the cantonal fiscal rules, which are now in place in nearly all the country's cantons. Available research reveals that stricter cantonal debt brakes also prove to be more effective.[10]

By revising the Stability and Growth Pact and the fiscal compact, the euro-area member states have also changed the rules. This served as a counterweight to the introduction of the substantial rescue packages.

However, it appears that little remains of the original intention to tighten the fiscal rules. Although it is now much more difficult for finance ministers to turn down the Commission's recommendations, the Commission's influence has also significantly increased. And that is not always a positive thing either. The rules, on the whole, have hardly any logic to them, and the Commission does not always seem to want to apply a narrow interpretation.

But we are learning from the Swiss example that the rules need to be strict. I believe that flexibility in interpretation should only be applied, if at all, in well-founded exceptional cases. For this ultimately weakens the structural consolidation requirements and defers them to the future.

5. Conclusion

Ladies and gentlemen, this brings me to the end of my speech.

With its decision in favour of substantial government bond purchases, the Eurosystem has once again provided ex ante assistance. Governments and the European Commission must now use the time to strengthen the long-term conditions for growth in the euro area. Friedrich Dürrenmatt once said, "The quickest way to clear up a matter is through dialogue". Therefore, I now look forward to our discussion.

[10] See Feld et al (2013).