Jens Weidmann: At the crossroads – the euro area between sovereignty and solidarity

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at Sciences Po, Paris, 12 November 2015.

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1. Introduction

Ladies and gentlemen

Thank you kindly for inviting me here today. It is a great pleasure and a privilege to speak before such an international audience.

Even more so than my generation, you live a truly European life. Your studies have an international outlook, and, in all likelihood, you have done, or will do, part of these studies abroad. Some of you have started them at the Campus européen franco-allemand in Nancy. And you are the first generation that has come of age with our common currency.

Europe not only comes naturally to you. Your perspective on European matters is also invaluable because Europe is not yet your legacy – but it is your future.

To give credit where credit is due, the European legacy that you have come upon was shaped to a large extent by the efforts of French visionaries. Back in 1949, economist Jacques Rueff declared that "l'Europe se fera par la monnaie ou ne se fera pas." In 1962, a Commissioner penned a memorandum for a common currency for the first time – his name was Robert Marjolin. In 1969, the Commission made a second proposal for a monetary union that resulted in the exchange rate system known as the "snake" – here, the Commissioner in question was Raymond Barre, a graduate of Sciences Po. And the plan that finally served as a blueprint for our Economic and Monetary Union was developed by a committee of national central bank governors. But it was chaired by the then President of the Commission: Jacques Delors.

The euro was always a political project that sought to establish even closer ties between the nations of Europe. But of course, it was more than just a political project – it was also a promise of prosperity. In recent years, this promise has proven elusive for many in the euro area, prompting some to regard the requirements of our common currency not as an anchor of stability, but as a veritable straitjacket.

The rescue mechanisms that were put in place prevented the crisis in the euro area from coming to a head. But they did so by mutualising fiscal liability on a substantial scale. Fiscal and economic policies, by contrast, are essentially still a national prerogative, though the rules were admittedly stiffened somewhat.

As a result, the balance between liability and control has been thrown out of kilter. This approach might have been politically expedient at the time. But ever since the Greek crisis this spring, which is perhaps the most extreme manifestation of this issue, its limits have been laid bare for all to see. Invoking independence while receiving assistance has sparked political tensions and economic uncertainty.

There is no getting around the fact: the combination of national sovereignty and common solidarity can pose a risk for the stability of our monetary union. A high degree of solidarity certainly helps a country in crisis to cope in the short-run. But by allowing for a shift of a national fiscal burden onto the community of all member states, incentives for sound policy-making are weakened in the long-run.

The underlying economic problem here is known as the tragedy of the commons. Let's take the example of overfishing: Just as overfishing by one fisherman reduces the fish available for others and threatens its population in the long-run, excessive public debt harms the euro area as a whole. Rising debt in one member state drives up longer-term interest rates for all euro-area countries. And if excessive debt of one state threatens the financial stability throughout the euro area, the viability of the whole project could be called into question.

The point of the tragedy of the commons is that it is completely rational for one fisherman to overfish and so to destroy the basis for the economic activity for others and for future generations. So what we have here is a classical coordination failure – similar to the well-known prisoner's dilemma.

In one of its recent issues, *The Economist* took what at first glance appeared to be a surprising decision to write an obituary for a baseball player. The player in question was one of the most successful players of all time. But Yogi Berra rose to international prominence not only because of his prowess as a baseball player, but even more so because of his playful philosophical musings.

Apparently, *The Economist* thought his remarks offered insights into economic matters as well. And indeed, he once neatly summarised the problem of inflation with the words "A nickel ain't worth a dime anymore."

This, however, does not seem to be the most pressing problem facing the euro area these days.

But there's another Yogi Berra insight which does go to the heart of the conundrum Europe's monetary union currently finds itself in: "If you come to a fork in the road, take it". And indeed: After all the stopgap measures and quick fixes in recent years, the euro area has arrived at a crossroads.

This is what both Emmanuel Macron and Benoît Cœuré highlighted when they recently pushed for the urgently needed debate on the fiscal future of our monetary union. If we want to make lasting progress, we will need to resolve the tension between sovereignty and solidarity.

2. EMU's fiscal architecture

To find out which directions the euro area can choose to take, we first need to take a closer look at the special terrain Europe's monetary union occupies. What sets our monetary union apart from other currency areas?

I think the difference can be summed up in a single word: asymmetry. The Economic and Monetary Union united monetary policy. But, as already noted, fiscal and economic policies continue to be a national affair, albeit subject to coordination rules.

As I have already mentioned, this asymmetry can give rise to instability. If the consequences of an unsustainable national economic policy can be shifted onto others – for example, through bail-outs or via the conduit of a common central bank balance sheet – the incentives for prudent policymaking will be stunted.

Still, hopes were high that with sufficient safeguards in place, an asymmetrically integrated euro area could prove stable as well. As we now know, that hope was not fulfilled. The safeguards installed to ensure sound public finances, such as the Stability and Growth Pact and the no bail-out clause failed to keep public debt in check.

The framework also had its blind spots. It did not prevent economic imbalances from building up, nor did it provide for resolution mechanisms to deal with the financial fallout of private over-borrowing.

The question we are now facing is this: did the framework fail because the first draft needed some additional work? Or is an asymmetric monetary union fundamentally unworkable?

Asymmetry does not automatically have to translate into instability. Just take a chair: a chair with three legs never wobbles; one with four legs sometimes does. A chair with three legs, remember, is always stable because three is the minimum number of points to define a plane. When all points lie on the same plane, the chair will be stable. If you add another leg, its end must also lie on that plane, otherwise things get wobbly. So, it is not about whether the legs are arranged symmetrically; it is about whether their ends are on the same plane.

The same applies to monetary union. It is not necessary for all policy areas to be integrated symmetrically. What is needed is for control and liability to be situated on the same plane. Only if control and liability are aligned either at the national or at the European level are the incentives for sound policymaking in place.

Take the example of a credit card. If it draws on your account, and you are the only one using it, then you will feel the consequences of splashing out.

By the same token, if you share a credit card within your family that runs on a shared account, things should be fine as well. But if you give away your credit card without being able to rein in spending, the beneficiary might be unable to resist the urge to indulge. This is why the measures taken so far to contain the crisis have skewed the delicate balance between control and liability.

The crucial question is this: how can we restore that balance?

2.1 A fiscal union

Benoît Cœuré and Emmanuel Macron have made proposals that aim at creating a fiscal union – that is, centralised decision-making in the fiscal realm, combined with fiscal transfers or mutual liability in the form of Eurobonds.

A genuine fiscal union could indeed restore the balance between control and liability. If decision-making is shifted from the national to the European level, the deficit bias of the individual member states inherent in the current set-up of EMU would be mitigated. While this, in itself, is not a guarantee for sound fiscal policy choices, this framework is at least consistent with the concept of mutual liability.

What kind of sovereignty shift are we talking about? Last year, Michel Sapin declared that “la Commission, je le rappelle, n’a absolument pas le pouvoir de rejeter, retoquer ou censurer un budget, comme j’ai pu le lire. Ici, comme ailleurs, la souveraineté appartient au Parlement français.” In a fiscal union, that would change. A member state would have to follow through on the demands of a European fiscal authority.

As such, a common fiscal authority would be the biggest step in integration since the introduction of the euro. It would be a tall order that would entail treaty changes and referendums. But anything less than a comprehensive shift of sovereignty would fall short of what is required. This holds true regardless of whether we move to a common euro-area treasury with its own budget, or to a system allowing interventions in existing national budgets.

If Europe were to shy away from the political ramifications of a fully-fledged fiscal union, that would leave just one viable option – a decentralised approach based on individual responsibility.

In this case, economic and fiscal policy decisions would largely remain at the national level. But final responsibility would have to rest with the respective member state as well.

These are the only two paths at the crossroads before us.

2.2 A framework of individual responsibility

What would a workable decentralised approach look like in practice?

First and foremost, it would have to deal with a blatant inconsistency in the current framework which makes the system as it stands unworkable. While bail-outs and monetary financing are prohibited under the Maastricht treaty, sovereign debt is nonetheless treated as risk-free in the capital regime for banks.

I can only agree with Danièle Nouy here, who has said: “Sovereigns are not risk-free assets. That has been demonstrated, so now we have to react.”

Sovereign debt in banks’ balance sheets needs to be backed by capital, just as is the case for any private debtor. But perhaps it is even more important to put a lid on banks’ exposures to a single sovereign.

Sovereign risk is a cluster risk – that is, a risk so large that the default of a single debtor can bring a bank to its knees. To prevent this from happening, banks are subject to the large exposure regime, which means that they can only lend up to 25 per cent of their equity to a single debtor. This way, banks will have enough capital even if the debtor defaults.

Sovereigns, however, are currently exempt from the large exposure regime. As a result, banks often hold an amount of bonds of their home country alone that exceeds the total of their equity.

This is why a sovereign debt restructuring currently poses the threat of bringing down the national banking system in question. And this is why for a decentralised framework to function, the large exposure regime needs to apply to bank lending to sovereigns as well. Simply doing away with the zero-risk weighting will not suffice. Banks’ exposures to their respective sovereigns are often too large.

Capping the amount of debt issued by a *single* sovereign that a bank can hold does not necessarily mean that a bank will hold less sovereign debt in all. It can still buy the debt of other sovereigns, up to the individual limit. But what it does mean is that banks cannot put all their sovereign eggs into one basket, so to speak. And this will go a long way towards ensuring that a sovereign debt restructuring will not bring down a country’s national banking system.

Besides, there is no compelling economic argument why banks should be the main financiers of sovereigns in the first place. Banks’ long-standing ties with their private clients allow them to glean information about firms and managers. This information allows banks to allocate capital more efficiently than other intermediaries who lack this information. In so doing, banks create value for the economy as a whole.

However, banks do not have such privileged information on the debt of a nation – especially on the debt of central governments. It makes sense for banks to hold a certain amount of sovereign debt for liquidity purposes. But there is no reason why the financing of states should not be more of a matter for the capital markets.

Doing away with the regulatory privileges afforded to sovereign debt would force the markets to take more into account the differences in sovereigns’ risk profiles. For countries that pursue unsustainable policies, this would mean rising risk premiums. And as a last resort, a sovereign debt restructuring would be possible without bringing down the financial system.

However, changes are in order not only with regard to the capital regulation of sovereign bonds. In a framework of individual responsibility, we need to make sure that responsibility rests with those who assumed the risks in the first place.

As it is, a member state that loses market access can apply for an ESM rescue programme that combines financial assistance with economic reform. If things work out as planned, deficits are brought down, growth capacity is raised, and market access is restored.

However, if things do not work out as planned and the member state does not regain market access, the only way out might be a restructuring of the debt burden. But by then, the

European taxpayer has already picked up part of the check, as private bond holders have been replaced by the ESM.

One way to change this would be an automatic three-year maturity extension for all bonds, activated the moment a government applies for an ESM programme. This automatic maturity extension would allow the sovereign in question to tackle its fiscal challenges while preventing investors from bolting. The amount of official financial support via the ESM would be greatly reduced, and time could be bought to figure out if the problem is really one of temporary illiquidity or one of insolvency.

A framework of individual responsibility not only requires that creditors are fit to absorb the losses from a sovereign debt restructuring, but also that they actually do so if push comes to shove.

2.3 A fiscal council

Obviously, it is best if the need for sovereign debt restructuring never arises in the first place. This is where fiscal rules come in. Prior to the crisis the binding force of the euro-area fiscal rules was modest, to put it mildly.

Thus, when the crisis hit, many countries had little fiscal space to counter its impact. As a lesson of the crisis the rules were stiffened somewhat. But at the same time, the Commission was granted more leeway in interpreting the rules. So far, the Commission has made ample use of this additional leeway, thereby thwarting the original intention of the rule overhaul.

In my opinion, it would therefore be best if the application of the rules would be transferred to a new, independent fiscal council. The Five Presidents' report on the future of the euro area also envisages such a council, and recently, the Commission has followed up on the report and come forward with a proposal.

But as the ECB rightly points out in its current Economic Bulletin, the Commission's proposal suffers from a number of shortcomings. The proposal does not foresee that the evaluations of the fiscal council are made public in a timely manner. If the alarm is raised too late, it might be a case of trying to shut the stable door after the horse has bolted.

What is more, the Commission has dropped the comply-or-explain approach sketched out in the Five Presidents' report, according to which the Commission has to explain itself whenever it deviates from the recommendations made by the fiscal council.

This does not bode well for the aim of a more depoliticised application of the rules. For that, a fiscal council needs to be truly independent, and its recommendations need to carry weight.

3. The banking union

Ladies and gentlemen

A workable decentralised fiscal framework must be based on the same principle that guided the approach to financial reform: risk and reward need to be realigned – those who skim off the reward also have to swallow the losses.

With regard to banking reform, we have made substantial progress. Banks now need to hold more and better capital so they have more skin in the game. And if even those increased capital buffers were to come up short in the face of losses, the plan is now to wind down the bank by drawing on bank owners' and creditors' rather than taxpayers' money.

This way, sound incentives for bank owners and managers are supported rather than being stunted by government lifelines. But banks' balance sheets are influenced not only by the decisions of the individual bank, but also by economy-wide factors – such as insolvency laws, for example.

For this reason, insurance mechanisms, such as a deposit guarantee scheme, are established at the level that also decides on these questions. Otherwise, control and liability would not be in balance.

Euro-area-wide deposit insurance therefore only seems reasonable if the decisions that affect banks' balance sheets were to be shifted to the European level as well. Everything else would skew the balance required for a stable monetary union.

4. Public and private risk-sharing

The issues of bank capital and a common deposit guarantee scheme not only tie in with the question of how to balance liability and control. They also offer insights into how risks can be shared most effectively in the euro area.

The bail-in of creditors is crucial for realigning risk and reward. Equity and bail-in debt provide a buffer in a downturn, paid for by adequate risk premiums in the form of dividends and interest.

This form of risk-sharing is not only obviously superior to cost-free insurance provided by the taxpayer, which might encourage reckless behaviour. It might also serve as a blueprint for the sharing of risks within the euro area in general.

When it comes to absorbing shocks and sharing risks in monetary unions, fiscal transfers immediately come to mind.

But when we look at how risks are shared between regions in other monetary unions, the fiscal dimension is not as prominent as often thought.

In the US, for example, studies[1] show that fiscal policy cushions only 10–20% of an idiosyncratic economic shock, so that a local income shock does not translate into a drop in consumption to the same extent in this region.

Integrated capital markets, especially integrated equity markets play a far larger role (40%). A further share of around 25% is cushioned via the credit markets. Altogether, around three-quarters of a given economic shock in the US is absorbed before it can affect consumption. Studies for Canada yield similar results.[2]

The picture is somewhat different in Europe. Here, it is mainly credit markets that cushion economic shocks – and not particularly effectively at that. Altogether, less than half of a given shock is absorbed before it can affect consumption (only 40%).[3]

Moreover, not all private risk-sharing is created equal. In the case of equity, risk-sharing takes place on a constant basis via flexible payouts that depend on the profit generated by the firm in question. With equity, risk-sharing is a feature, not a bug.

With debt, things are different. In normal states of the world, risks are not shared. When a firm – or country – runs into trouble, however, risks can be shared via missed interest payments or haircuts.

And smoothing out income fluctuations via credit markets presupposes that credit is actually available when it is needed.

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

2 Balli, F S; Kalemli-Ozcan, S; Sørensen, B E (2012), Risk Sharing Through Capital Gains. In: Canadian Journal of Economics, Vol 45(2), pp 472–492.

3 Afonso, A; Furceri, D (2007), Business Cycle Synchronization and Insurance Mechanisms in the EU. ECB Working Paper No 844, December 2007.

A phenomenon known as the financial accelerator effect can broaden the availability of credit during a boom, as collateral, such as real estate, rises in value. But when the value of collateral diminishes, the supply of credit can tighten up.

If the financial system is really procyclical, relying on credit markets in the downturn might be a risky proposition.

Strengthening equity markets therefore seems to be the more promising route to take.

But if we want to fully reap the rewards of deeper equity markets, the measures currently on the table probably will not suffice. This is where the topic of taxes comes into play.

Currently, the tax regime still favours debt financing over equity financing. Removing this bias in taxation would encourage companies to strengthen their equity base and thus turn more to the equity markets as a source of funding. It could therefore be a game-changer in terms of strengthening private risk-sharing.

5. Conclusion

Ladies and gentlemen, let me conclude.

Today, Economic and Monetary Union does not look like other successful currency areas. Maybe it will never match their degree of symmetry with regard to policy integration. But perhaps some findings in the science of beauty can provide a little encouragement. While symmetry seemingly plays a role in whether we consider a face to be attractive, researchers have found that it is only part of the story. Apparently, it is the little deviations from the norm, the minor asymmetries, that render a face truly beautiful.

But for Europe’s citizens to perceive EMU as truly “beautiful”, we still have a long way to go.

Whatever option we ultimately choose, Yogi Berra has reminded us that the most important thing is to actually choose. But to be able to choose, we have to be mindful of another of his insights as well: “If you don’t know where you are going, you might not get there.”

I am therefore now looking forward to discussing the direction of our monetary union with you.

Thank you for your attention.