Jens Weidmann: Aspiration and reality – the situation in the European monetary union

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the Institut Ökonomie der Zukunft, Karlsruhe, 15 September 2016.

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1. Introduction

Professor Weibel

Professor Sloterdijk

Professor Puppe

Ladies and gentlemen

Linguists tell us that the name “Europe” comes from the ancient Greek word “erebos” meaning “dark”. Europe therefore denotes the Occident – the place where the sun sets. And the sun indeed does not seem to be shining brightly over Europe at present.

According to the investor George Soros, the European Union finds itself in an “existential crisis” following to the UK vote to leave the EU. The political scientist Herfried Münkler, too, declared in the wake of the debate on the refugee crisis that “this time we are dealing with a crisis as understood by Aristotle and the medical profession: the patient either recovers – or will die.”

Up to now, said Münkler, it was held that the EU was growing with every crisis and that it was only thanks to such crises that any progress was being made at all. As Münkler sees it, Jean Monnet’s claim that “Europe will be forged in crises,” is no longer valid.

In my view, two things can be said about that: talk about the end of the EU somehow reminds me of Mark Twain, who responded to a newspaper report that he had passed away with the words “The report of my death was an exaggeration.” Nevertheless, the mode of operation for European integration does indeed seem to be coming under close scrutiny.

Jean Monnet, one of the founding fathers of the European Union, described this mode of operation as a chain reaction. As he envisaged it, the integration of one area of the economy, specifically the coal and steel industry, would entail an ever stronger economic and, subsequently, also political integration.

The launch of the euro was based on quite similar ideas. On the occasion of the adoption of the Maastricht Treaty, for example, Helmut Kohl stated that “It cannot be said often enough: political union is the indispensable counterpart of economic and monetary union.”

For him, too, the euro was a catalyst for the ongoing process of European unification. The merging of European currencies was ultimately designed to unify the countries of Europe politically.

The theory that European integration is a self-reinforcing process in which the integration of individual sub-sectors will necessitate the integration of other areas has become known as the “locomotive theory”.

But this theory was being called into question even at the time. The Bundesbank – for example – was a proponent of what was known as the “coronation theory”. The idea was that monetary union should stand at the end of the European integration process because, if the economies have not integrated and converged sufficiently, a single monetary policy would not be suitable for all countries and the monetary union would be prone to crisis. The fact that this fear was not entirely unrealistic has been shown by the euro-area crisis.

Proponents of the locomotive theory see such crises less as a threat than as an opportunity. That is because, according to the locomotive theory, crises, first and foremost, open up the possibility of implementing those steps of integration that have not yet been taken. Accordingly, even now there is no lack of proposals that the appropriate response – not only to the Brexit vote but also the euro-area financial and sovereign crisis – should be even more integration.

Given that the design of monetary union in its present state is evidently fragile, and in view of the not inconsiderably diverging ideas about the fundamental policy stance – just think of the almost irreconcilable positions on communitising liability – such a knee-jerk call for integration is making many people anxious. Surveys show that many citizens of the EU doubt whether the existing process of integration is still sustainable.

In my following remarks, I do not intend to address the undoubtedly important question of how policymakers might reignite enthusiasm for Europe through projects to create a sense of common identity and interest or other measures. Instead, I shall concentrate on that which is my focus as a central banker, but which is no less important for the general public.

Essentially, I will discuss what can be done to make the monetary union, in particular, work better for everyone as well as the role of the single monetary policy in this context.

2. Europe as a promise of prosperity, convergence and integration

Looking at the countries of Europe, Jean Monnet concluded as long ago as 1954 that the countries of Europe had "become too small for today's world." Given the possibilities of modern technology, he felt that primarily about the economy. But he also believed it was true of foreign policy. In this respect, he was thinking mainly of the major role being played by the United States of America and the Soviet Union, as well as the growing importance of China and India.

In this sense, the EU can indeed be seen as a political response to increasing globalisation – as an attempt to establish a strong regional pole in an increasingly multipolar world.

In economic terms, the members of the EU were, among other things, "to achieve the strengthening of convergence of their economies" and "advances in economic integration".[1] The EU thereby gave a threefold promise to its citizens: to increase prosperity, achieve convergence in standards of living, and deepen integration. And, in actual fact, numerous studies come to the conclusion that the single European market has led to more prosperity in Europe.[2, 3, 4]

Looking at the big picture, real economic output in the EU countries has gone up by one-third since 1995 despite the financial and sovereign debt crisis. The fact that the increase in the USA, Canada and Japan has been just as strong as on an average of the EU countries when looking at the per capita growth of the working population does show, however, that other factors have also played a part in economic growth in the EU.

In a large single market, differing preferences and skills mean more opportunities for specialisation – for firms and thus, ultimately, also for the employees. In a large market, it is

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1 Lisbon Treaty, preamble.

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

3 N F Campos, F Coricelli and L Moretti (2014), Economic Growth and Political Integration: Estimating the Benefits from Membership in the European Union Using the Synthetic Counterfactuals Method, IZA Discussion Paper No 8162.

4 A Boltho and B Eichengreen (2008), The Economic Impact of European Integration, CEPR Discussion Paper No 6820.

easier to do what one does best. At the same time, the range of goods on offer becomes more diverse. All of that is potentially for the benefit of all.

Admittedly, this does not mean that everyone benefits equally from the stronger economic integration in Europe and worldwide. Technological advances, especially in information technology, enable the highly-skilled to make even more effective use of their capabilities and demand higher wages accordingly. And the globalisation of the economy makes competition more intense precisely for the medium and low-skilled. That dampens wage growth in this segment of the labour market.

Taking the long view, wage differentiation – in other words, the ratio of very high to very low gross wages – has therefore increased; however, this trend has come to a standstill over the past few years.

This flipside of globalisation undoubtedly also played a part in the Brexit vote in the UK. The EU became a target for voters to vent their frustration about the downsides of globalisation and migration. And there are many who now see the monetary union as a drain on their country's economy rather than as a guarantor of growth. After all, the countries of the euro area can no longer use exchange rates to cushion economic shocks.

Given all the disappointment about Europe and its institutions, what is often overlooked is that, in the existing institutional structure of the EU, responsibility for releasing the forces of growth by means of economic reforms still lies primarily with the individual member states. In doing so, they have pursued different approaches in the past few years, which are also reflected in varying rates of economic growth.

Along with a sustainable economic policy at the national level, however, it will also be vital to strengthen the forces of growth at the Community level. I am thinking here, for example, of the completion of the single market for services or a single market for digital services.

Studies suggest that the digital market alone could raise economic output in the EU by a further 4%.[5] Not only would that mean more prosperity, it would also create additional jobs – more than 400,000 in Germany alone. And more jobs are the best antidote to economic anxieties about integration.

3. The liability principle: a cornerstone of the market economy

Ladies and gentlemen

One area of the domestic market, however, has revealed serious weaknesses until recently: I mean the financial services market, and the banking market in particular.

This is because no rules existed, either in Europe or in other economic regions such as the USA, to guarantee that the shareholders and creditors of large, interconnected banks would be on the hook for potential losses. These institutions could count on being bailed out by the taxpayer, since the failure of such a bank would inevitably entail severe economic disruptions.

The bank bailout not only cost billions, but also fuelled the perception that the market economy had changed in character, to the benefit of the few at the expense of many: "Privatising the gains while socialising the losses."

However, the liability principle is absolutely central to a market economy, as the prominent ordoliberal Walter Eucken already knew: he described this "market economy constitution" very aptly, saying: "Those who benefit from it must also carry the loss."

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

In order for the market economy to function, but also to preserve trust in the rules of the game and therefore in the EU as a whole, it is essential that shareholders and creditors actually do bear any future losses on bank investments, rather than the taxpayer.

This is precisely the aim of the more stringent capital rules which were introduced and are summarised in the Basel III framework, and particularly the European banking union with its Single Supervisory Mechanism and rules on bailing in shareholders and creditors in the event of bank failures.

However, we can only attain this goal if the joint rules on recovery or liquidation of banks are consistently applied. Only then will the banks' shareholders and creditors adjust their future behaviour appropriately to avoid excessive risk-taking.

Strict application of the principle of ownership is absolutely essential, not only for reasons of fairness, but also for concrete economic reasons. If economic players do not have to bear the consequences of their actions, flawed incentives are set. They will take excessive risks, which is precisely what led to the last financial crisis – and to similar crises in the past.

4. Enhancing the monetary union

Action and liability go hand in hand – this is not only important for the future of the financial sector, but also pivotal in enhancing the entire monetary union.

The construction of the European monetary union is unique in the world. A single monetary policy is set against 19 largely autonomous economic and fiscal policies.

This construction makes the monetary union potentially vulnerable, since the crisis has shown that, ultimately, the community may have to foot the bill for unhealthy developments in individual member states in order to prevent the stability of the entire structure from being threatened.

The prospect of being able to spread the consequences of unsustainable policy over the entire monetary union can weaken the incentive towards sound budgetary policy. This is why institutional precautions were taken before launching the euro: the Stability and Growth Pact, the "no bail-out clause" and the ban on monetary financing of governments. Unfortunately, however, these safety precautions were unable to prevent the crisis.

Why did we not, at that point, choose the path taken by other currency areas, such as the USA or Canada, and transfer economic and fiscal policy to the European level?

Ultimately, Berlin, Paris, Rome and others opted to go it alone in economic and fiscal policy rather than take these decisions together in Brussels; they were unwilling to consent to such an extensive transfer of sovereignty rights.

A common policy is, after all, different from a common market.

In a common market, all the participants can produce whatever they do best. The interplay of supply and demand and the equilibrium provided by the price mechanism ensure that every product finds its buyer.

A common policy has no price mechanism to bring the different interests into balance. Instead of the invisible hand of the market, a far more complex, political negotiation or coordination process is required to provide this balance. The economist Enrico Spolaore,[6] for instance, has pointed this out.

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6 E Spolaore (2013), What Is European Integration Really About? A Political Guide for Economists, Journal of Economic Perspectives, American Economic Association, 27(3), 125–144, Summer.

As a result, therefore, only monetary policy was communitised – in the full knowledge that certain economic adjustment problems might arise despite the existing safety precautions and coordination mechanisms.

The monetary union likely puts some people in mind of the quip, attributed to Woody Allen, that “marriage is an attempt to solve problems together which you didn’t even have when you were on your own.”

But like marriage, the monetary union is also potentially a wonderful thing: its physical manifestation as a single currency is the most visible symbol of the process of European unification. This unification process has, without doubt, contributed to Europe’s becoming a continent of peace and human rights, for which the EU even won the Nobel Peace Prize in 2012.

Going even further, however, the monetary union has concrete economic advantages as a union of stability. EU citizens no longer have to change money when they travel, entrepreneurs no longer have to fear exchange rate fluctuations, and everyone can compare prices better. This increases competition, which is conducive to growth.

That is why it is worth solving the existing problems.

There are basically two options open to us. We could take the path of other monetary unions and communitise economic and fiscal policy as well as monetary policy. Proponents of the locomotive theory are looking at this option, arguing that incomplete integration makes it necessary to take further steps towards integration.

However, we come up against the same roadblock faced by the architects of the monetary union when it was founded: member states are still disinclined to abdicate rights of sovereignty to the European level.

This is evident in the ongoing discussions about enhancing the monetary union: for example, the informal meeting of EU finance ministers and central bank governors which took place in Bratislava last weekend, where, among other things, proposals going in the direction of a fiscal union were discussed, with the aim of providing a fiscal instrument to cushion large macroeconomic shocks. The ideas discussed therefore included a joint unemployment insurance and a European investment fund.

On the other hand, the suggestions contained little in the way of specific measures which would enable genuine joint control. On paper, strengthening of the fiscal rules is mentioned. However, the past few months and years have shown how much this is worth. Fiscal surveillance has already been “strengthened” before, in return for the establishment of the bailout fund in 2011. However, the rules are still being interpreted very flexibly. The binding force of the budgetary rules is weaker than ever before, as we can also see in the decisions made concerning France, Spain and Portugal.

In any case, nobody is suggesting a genuine transfer of sovereignty, for example to an independent fiscal authority which could reject national budgets that do not meet stability requirements.

If further political integration is not possible, the only remaining option is the decentralised approach which is already provided for in the monetary union’s existing Maastricht framework.

But how do we ensure that unhealthy developments in one part of the monetary union do not jeopardise the stability of the whole?

In a nutshell, it must be possible in future for heavily indebted states to default as a final resort without bringing the financial system to its knees and forcing the international community to come to the rescue.

This option will hopefully mean that capital markets exercise their disciplinary function for fiscal policy better in future, so that if at all possible, government default never occurs.

In the July edition of its *Monthly Report*, the Bundesbank described what needed to be done to ensure that sovereign debt restructuring does not jeopardise stability.

It is crucial, first of all, that banks hold sufficient capital to be able to absorb any losses on government bonds. Regulation currently does not require that of them. Not only that: banks are allowed to purchase an unlimited quantity of government bonds – something they cannot do with other investments. That, too, will have to change.

But other action is needed over and above that.

At the moment, the purpose of the European Stability Mechanism (ESM) is to bridge any funding difficulties that a government may experience. This means that, during the programme, the ESM steps in not only to fund budget deficits but also to provide money to enable the country to redeem maturing bonds in the proper manner. This would prevent a situation in which European taxpayers pay off creditors. For it is they who are ultimately behind the ESM.

But if, following an ESM assistance programme, the debts were still too high, the haircut that would then become necessary would be made at the expense not of the original creditors but of European taxpayers. This does not exactly foster willingness on the part of the member states to agree to restructure their debt. Instead of a truly viable solution being reached, when push came to shove, a strategy of muddling through would win the day.

That is why the Bundesbank proposes adding a clause to the government bonds of euro-area countries whereby the maturity of the bonds is automatically extended by three years if the member state applies for ESM assistance.

This would keep creditors on the hook. Then, if a haircut really does become necessary, the ESM can act as mediator between the government and its creditors.

A procedure of this kind would make it possible, as a last resort, to restructure debt in an orderly manner without putting financial stability at risk. This means it would benefit both the ailing member country and the euro area as a whole.

But we need to be clear about one thing. It will take more than just the possibility to restructure government debt to curb government debt effectively without jeopardising financial stability. It will also be necessary to tighten fiscal policy rules.

This calls, first, for transparent fiscal rules and, second, for their rigorous enforcement.

I am convinced that an independent fiscal authority would then be better equipped than the European Commission is today to effectively enforce limits on the ever-increasing government debt in the euro area. This is because, on the one hand, the Commission must act as the guardian of the treaties and ensure that the rules are implemented. On the other hand, it is also a political institution whose task it is to strike a balance between widely varying interests.

Measures to rein in government debt effectively are urgently needed. Although the indebted countries' debt ratios will decrease slightly over the next few years, the gradual improvement in the economic situation and the very favourable funding conditions mask a loosening of the fiscal stance in the euro-area countries. In terms of the guidelines on medium-term budgetary planning, three-quarters of all euro-area countries will still be far removed from a sound fiscal position in 2016. That is not what fiscal consolidation looks like.

5. Monetary policy

Ladies and gentlemen

I would like to close by turning to the question of monetary policy.

Monetary stability is good for everyone – let me count the ways. First, price stability means being able to pay one's way tomorrow on today's income. Second, it also makes retirement saving easier to plan.

Third, it is important from an economic perspective that businesses can reliably calculate what an investment will cost and what return it will deliver. The more money fluctuates in value, the more uncertain investment income becomes and the lower growth will be in the long run.

All these reasons convinced the euro-area member states to opt for an independent central bank system committed solely to price stability that was modelled on the Bundesbank.

And with inflation averaging just under 2% since this system was created, it has been roughly as successful in maintaining price stability as the Bundesbank.

But the inflation outlook in the euro area has been very muted for quite some time now. Inflation has been discernibly below the ECB Governing Council's inflation rate target of close to but below 2% since mid-2013. In fact, it has been hovering around the zero mark for the better part of two years.

Euro-area prices in August were only around 0.2% above the previous year's level. Price inflation in Germany, incidentally, stood at 0.4%.

In particular, it was the sharp drop in oil prices that pushed inflation down during the last two years. This effect on inflation will gradually peter out once the year-on-year decrease in oil prices comes to a halt. This should already become clear by the end of the year.

However, the low inflation rates in the euro area are not driven purely by oil price developments. Core inflation, which is to say the price index excluding energy and food prices, is likewise relatively low, hovering at around 1%.

The latest ECB staff projections indicate that the economic recovery in the euro area will continue – despite the United Kingdom's decision to leave the EU. Growth will be dampened to only a comparatively minor extent; however, price pressures will gradually rise. At the end of the projection period, inflation will be largely consistent with the ECB's definition of price stability.

The expansionary monetary policy will undoubtedly play a part in that.

But it's no secret that economic policy measures can produce more than the desired effect: they can also entail side-effects and risks. The monetary policy measures that have been adopted are no exception.

And whereas the effects of expansionary fiscal policy decline the longer it lasts, the associated risks and side-effects rise.

One side-effect of the highly accommodative monetary policy is that unviable enterprises, too, are benefitting from the very favourable financing conditions and are being kept afloat. One could say, then, that monetary policy plays a part in braking structural change in the corporate sector. This tends to harm the productivity of an economy.

A further side-effect is that the banking sector's profitability suffers the longer monetary policy remains in ultra-easy mode. This is because most banks find it difficult to pass on the negative interest rates to their depositors. And while this is good news for depositors, it has a detrimental effect on banks' costs. And because, above all, the Eurosystem's bond purchases depress long-term interest rates, income that banks may generate through their investments decreases.

Of course, as a central banker, I am not concerned here with the profits that the banks make. From a monetary policy perspective, however, it is crucial that banks transmit monetary policy stimuli – and this depends partly on their capital base. For only banks with sufficient capital can issue loans to enterprises and households.

This makes it important for banks to gear their operations towards sustainable profitability even in a persistent low-interest-rate environment. Failing this, they may find it difficult to retain profits with a view to further strengthening their capital base.

Particularly the German banks often suffer from structurally weak profitability – all the more reason to continuously review their business models, get their balance sheets in order and harness any available scope for consolidation in order to cut costs.

Yet another side-effect of non-conventional measures – one I consider to be especially problematic in light of the experiences during the sovereign debt crisis – is that government bond purchases blur the boundaries between monetary and fiscal policy. That is something I've be saying over and over again.

Central banks are becoming countries' biggest creditors. And once finance ministers get used to the favourable financing conditions, there is a danger that monetary policy will be harnessed to fiscal policy and will be put under pressure to make high levels of debt sustainable through low interest rates. That would make it increasingly difficult to exit the ultra-easy monetary policy.

Monetary policy measures that seek to improve the situation in individual member states in a targeted way are particularly problematic. That would be the case, for instance, if central banks were to buy only bonds issued by the governments of crisis countries, as was the case with the Eurosystem purchases in 2010 to 2012.

Such purchases may cause a redistribution of fiscal risks through central bank balance sheets, as, ultimately, taxpayers in the member states are on the hook for potential central bank losses.

I have already explained that redistributing fiscal risks is alien concept to the existing regulatory framework of monetary union, which is based on the principle of individual national responsibility, and would probably be counterproductive.

If, however, decisions on redistribution are to be taken, then at least they should be taken by those with the legitimacy to do so. Those people sit in governments and parliaments; they do not work at central banks.

Otherwise, the independence of the Eurosystem could be called into question; an independence that the Eurosystem was expressly granted as a central prerequisite for price stability in the euro area.

Let me be clear about one thing. The current public sector purchase programme does not provide for targeted purchases of bonds issued by the governments of individual crisis countries. All central banks buy only bonds issued by their government in line with the size of their country. We should maintain these basic parameters of the existing programme to avoid getting the Eurosystem into hot water.

Ladies and gentlemen,

in the public debate about the expansionary monetary policy, it is often asserted that this policy is leading to the expropriation of savers.

I believe judging monetary policy solely on the inflation-adjusted returns on particularly safe savings deposits fails to capture the whole picture.

There have, in the past, frequently been periods where savings deposits have yielded negative short-term real interest rates; indeed, they have often even been significantly lower than they are today.

Granted, the situation is a little different in terms of real long-term interest rates. They are, indeed, exceptionally low at present. However, this is not just down to monetary policy; the muted longer-term growth expectations for the euro-area countries are also to blame. It is up to national governments to conduct an economic policy which is conducive to a lasting increase in growth. While monetary policy can use the instruments at its disposal to smooth the economic cycle, it is unable to bring about sustained growth.

And we must not forget that citizens are generally not just savers, they are also employees, shareholders, taxpayers and property owners.

And from that perspective, low interest rates are not all bad news. The expansionary monetary policy aims to nudge the rate of inflation towards the definition of price stability by stimulating economic activity. In a situation characterised by slack in the economy, that secures jobs, increases tax revenues and gives enterprises opportunities to expand. And there may even be the odd person here in this room who is happy about the low interest rates for their mortgage loan.

In other words, the central bank performs an important stabilisation function when it smooths the business cycle in an attempt to guide price developments. It must not, however, labour under the misapprehension that it is able to steer both perfectly. Equally, central banks must be aware that interventions in individual markets may result in evasive action. However, I get the impression that central bankers are less susceptible to the illusion that they can micro-manage everything than some analysts who would like to see central banks take on even greater responsibility and demand increasingly far-reaching interventions into the markets.

For "smoothing" even to be conceivable, the central bank naturally requires room for monetary policy manoeuvre. And that depends, in part, on its long-term inflation rate target.

If it is aiming for a slightly positive rate, central bank rates, too, will be somewhat higher. This means that they can be lowered more sharply when the economy slows. That is one reason why the Governing Council of the ECB aims to keep inflation below, but close to, 2 per cent over the medium term.

There are, incidentally, further arguments in favour of a slightly positive rate. Potential errors in measuring inflation are one argument that comes to mind.

The consumer price index measures the average price of the things people buy. However, there is a delay before statisticians become aware of changes in purchasing behaviour. They therefore tend to overstate inflation.

Another reason why an inflation rate of zero isn't a sensible target is because industries or entire economies that need to claw back a loss of competitiveness would face the daunting prospect of having to push through real wage cuts. That means, wages must rise more slowly than prices. But if prices do not rise at all, nominal wage cuts are necessary. That, however, is pretty much a non-starter.

Finally, another argument for a slightly positive inflation rate for the euro area is that an average of close to 2 per cent allows differences in the rates of inflation within the currency area, without prices having to drop in individual countries. Differences in inflation rates will be the norm as long as member countries' economies don't move exactly in parallel. If monetary policy sought to hit an average inflation rate of 0%, there would always be some countries in negative territory.

There are, therefore, good reasons why all major central banks target an inflation rate of around 2 per cent. There are, moreover, good reasons not to give in to calls to raise the inflation target. If the academic literature on the optimum inflation rate shows anything at all, it is, in my opinion, the large degree of uncertainty associated with such estimates.

The ECB Governing Council's definition of price stability does not, incidentally, demand that the inflation rate target of below, but close to, 2 per cent must be met at all times. It expressly states that it should be met over the medium term. In this context, the medium term does not mean "sometime in the distant future", nor does it mean "as fast as possible and at all costs".

6. Conclusion

Ladies and gentlemen,

the idea that the name “Europe” comes from the Greek word “erebos”, meaning “dark”, is not linguists’ only theory. According to another interpretation, Europe comes from Greek mythology and means “the far-sighted woman”. A more optimistic interpretation, indeed.

The objective of the reforms proposed by the Bundesbank is to remedy deficits in the architecture of monetary union and thereby to make it more stable. In particular, they help redeem the promise politicians gave the public back when the euro was introduced: namely that the euro would be as stable as the D-Mark and that the monetary union would therefore be a stability union.

Keeping promises and being reliable and credible is a central precondition for regaining political confidence in Europe.

I now look forward to the discussion.