Jens Weidmann: No time for complacency – current economic challenges in the euro area

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 Annual General Meeting for the Members of the Foreign Bankers' Association, Amsterdam, 3 November 2016.

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1. Introduction

Ms van Houwelingen

Klaas

Ladies and gentlemen

I am very pleased to speak here today at this Annual Meeting, so many thanks for the kind invitation.

I gave my last speech in Amsterdam 2½ years ago. Back then, I spoke about the crisis in the euro area and the ways to overcome it. Although some progress has been made in stabilising the euro area, this topic remains as relevant as ever, and I will return to it later in my speech today.

I am sure, however, that there is a good chance that the crisis will not become a defining feature of the euro area. At least not as much as the lovely "grachten" have become a hallmark of the townscape of Amsterdam.

As you all know better than I do, the "grachten" are an architectural feature dating back to the Dutch Golden Age in the 17th century – a period in which the economy, the sciences and the arts in the Netherlands were among the most acclaimed in the world.

Particularly the Dutch East India Company, then the biggest corporation in the world, made the Netherlands a powerhouse of world trade. And the economic prosperity at that time was not coincidental, but also depended on major financial innovations. These included not just the issuance of shares to finance the business of the Dutch East India Company, but also the evolution of a system of merchant banks.

A third important innovation was the establishment of the Amsterdamsche Wisselbank, a precursor of today's central bank in the Netherlands: De Nederlandsche Bank. The main task of the Amsterdamsche Wisselbank was to take in both foreign and local coinage at their gold and silver mint prices and to give clients transferable credits in its books known as "bank money" in return.

This helped to overcome the major uncertainties associated with the many different types of coins in circulation throughout Europe. Furthermore, it represented a state-backed deposit institution, which can be seen as an important cornerstone of Amsterdam's flourishing financial market and the prospering economy of the Netherlands at that time.

When the euro was introduced in 1999, the euro-area countries left behind the problem of many different types of currencies. That helped to tap the potential benefits offered by the world's largest common market.

However, if there was ever any hope that economic and monetary union in Europe would guarantee strong and steady growth, the Great Recession that followed in the wake of the

financial crisis and the fallout of the sovereign debt crisis would have shattered any such illusions once and for all.

Today, growth in the euro area is lacklustre and uneven. The economic consequences of the crises are still weighing on some euro-area countries. While the rates of expansion in the Netherlands and Germany, for instance, are quite fair, growth in Italy and Portugal is muted.

2. Monetary policy

But from a cyclical perspective at least, there is a ray of hope on the horizon. The medium-term economic outlook for the euro area as a whole isn't all that dull. In fact, the key economic and financial indicators echo the ECB's economic projection in pointing to an ongoing economic recovery. The ECB's latest macroeconomic projection exercise expects the euro-area economy to grow at a somewhat quicker pace than potential output in the next few years. And this implies that the output gap will gradually narrow.

Although it's true that inflation rates have been lower than the Governing Council's definition of price stability for quite some time, I see no danger of slipping into a deflationary downward spiral of declining prices, declining wages and declining output. And this view is shared by the overwhelming majority of experts: the latest Survey of Professional Forecasters showed that only 2% of respondents expect an inflation rate of less than zero in five years.

There is a clear majority that sees a gradual increase in the inflation rate up to levels that are broadly consistent with the Governing Council's definition of price stability. And this view also matches the baseline scenario of the ECB's medium-term inflation projection.

There are a number of reasons why inflation is currently so subdued in the euro area, including the low oil prices and the weak domestic price pressures caused by the adjustment processes in some euro-area member states. These factors have different lifespans, as it were, with some representing more of a temporary phenomenon and others having a more medium-term impact.

While the current economic situation justifies an expansionary monetary policy stance in the euro area, it is also appropriate, in my view, that the Governing Council, at its last policy meetings, refrained from loosening it any further. And we shouldn't ignore the fact that, even with monetary policy rates unchanged, the increase in inflation rates automatically leads to lower short-term real interest rates and, therefore, to a further loosening of the monetary policy stance.

Given the long and variable time lags in monetary policy, it is important to give the measures taken enough time to have an impact on the inflation rate. In this regard, we should bear in mind that the ECB's definition of price stability aims at an inflation rate of below, but close to 2%, in the medium term.

This focus on the medium term – alongside the fact that the euro area is still struggling to overcome the longer-term economic implications of the biggest economic shock since World War II – underscores the merits of patience – a position which was also taken up by Klaas Knot some weeks ago.

Adopting a longer-term perspective to monetary policy matters also allows financial stability considerations to be taken into account – insofar as they might impact negatively on the longer-term outlook for price stability.

And, by the way, this is precisely the idea behind the Governing Council's two-pillar monetary policy strategy. The monetary pillar, as it is known, covers, amongst others, credit developments which have a lower frequency than business cycles and which could signal price stability risks stemming from excessive credit growth.

There is one more thing that shouldn't be forgotten when monetary policy is in highly expansionary mode – and I never tire of emphasising this: the longer it persists, the less effect it will have and the more the risks will increase.

This is not just about the Eurosystem's government bond purchases, which are blurring the boundaries between monetary and fiscal policy. Central banks are becoming the largest creditors of the member states. This could lead to a situation where monetary policy becomes harnessed to fiscal policy and is pressured to make high levels of debt sustainable through low interest rates.

All the more so given that the low-interest-rate environment offers no incentive for governments to consolidate their public finances. Fiscal policy in the euro area has been loosened again noticeably over the past few years. What governments are saving in interest payments isn't being put towards the urgent goal of reducing debt, but spent for the most part. Germany is no exception here, by the way.

Furthermore, the low-interest-rate environment is impairing the profitability of banks and life insurance companies.

Admittedly, bank profitability and the sustainability of life insurance and pension companies' business models is not a target of a monetary policy geared solely to preserving price stability. But monetary policy cannot afford to ignore these developments if banks' health problems endanger the monetary transmission mechanism, or doubts about the stability of life insurance or pension companies prompt households to increase their precautionary savings, because both could depress the outlook for price stability further still.

Last but not least, low interest rates and unconventional monetary policies could drive up financial risk-taking in some financial market segments or the real estate market. While I currently see no sign of exuberance in the real estate market in the euro area as a whole, there's no denying that some national markets are at risk of overheating and the competent financial stability authorities of some euro-area countries – for example, Ireland, the Netherlands, and recently Finland – have introduced macroprudential measures to limit the risk of house price bubbles.

For me, it is key that concerns over financial stability or the sustainability of public finances do not lead to a postponement of the exit from the ultra-loose monetary policy. This decision should be based solely on expected price developments.

All in all, the risks of ultra-loose monetary policy are becoming increasingly clear. It's no surprise, then, that the tone on monetary policy matters has changed significantly. For example, there was a general consensus at the annual meeting of the International Monetary Fund in Washington four weeks ago that monetary policy is no panacea. The IMF, too, has now joined the chorus of these warning against overburdening monetary policy and pointing to its limits.

There was a broad consensus that monetary policy cannot create long-term growth and that governments need to step up their efforts to strengthen the growth prospects.

While it is clear that each country has its own economic situation and preferences – meaning there's no such thing as a "one size fits all" approach – I am quite confident that sound public finances as well as competition-based economic systems with flexible labour and product markets foster growth.

Taking the euro-area countries as an example, for some of them, this would mean reducing the existing labour market duality; for others, it would mean lowering the administrative costs of setting up a new business, or readying the economy to better cope with looming demographic challenges.

Ladies and gentlemen

Few global cities demonstrate what an important source of wealth international trade can be as impressively as Amsterdam with its historical townscape.

Today, however, there are some who mistrust the welfare-enhancing effect of international trade and who stress what they believe to be its negative effect on the distribution of income and wealth in society. National tendencies to turn inwards are becoming increasingly popular – the UK's Brexit vote is one example of this; another is the exhausting CETA negotiations which very nearly failed due to very fundamental concerns raised by the region of Wallonia.

Globalisation and international trade is by no means a zero-sum game. The gains of free trade far outweigh the costs. However, even if nations as a whole benefit from international trade, not every single person or company is necessarily better off.

If you live in an advanced economy and you are a low-skilled worker in a poorly competitive industry, your concern that you might lose your job probably won't be outweighed by the fact that you are benefiting from lower import prices for consumer goods and services.

To some extent, globalisation might have also contributed to the mounting income inequality.[1] Economic research suggests that the rise in the skill premium – ie the difference between the wages of skilled and unskilled workers – over the last decades can be attributed to international trade.[2]

But instead of curtailing international trade, investing more in skills and education and enabling labour markets to adapt flexibly to a changing world would be an appropriate answer. This would not only boost labour productivity but also make workers less at risk of losing their jobs.

An OECD study shows that focusing on the early years of life, as well as on the needs of families with children of school age, is crucial for addressing socioeconomic differences in education – and thus in income, too. It also proposes that greater efforts should be made, with the close involvement of businesses and unions, to promote a continuous upgrading of skills throughout the working life.[3]

So as for Europe, we do not need a less open market but a more open one. It would be counterproductive if the difficult political situation in Europe – caused not least by the Brexit vote – were to bring to a standstill Europe's efforts to complete the single market for services, achieve a digital single market, or build up a capital markets union.

The European Commission estimates that a digital single market would create an additional 3.8 million jobs in Europe and increase EU-28 GDP by 4%. Neither the euro-area member states nor the other European countries are in any economic condition to brush aside such a positive impact on their economies.

3. Reform of European monetary union

Implementing economic reforms at the national or European level as a way of strengthening the euro area and restoring trust in the agreed rules of European monetary union (EMU) is also important to improve the cohesion in the euro area, which has undoubtedly suffered from the financial and sovereign debt crises. What's also crucial, however, is to make the institutional setting of EMU more stable.

The financial and sovereign debt crises in the euro area bore one major characteristic in common: both saw a core economic principle being violated: the liability principle. German economist Walter Eucken, who was one of the founding fathers of Germany's social market economy, once said very aptly: "Those who reap the benefits must also bear the costs."

If banks assume they are too big to fail, they will be tempted to make the most of this implicit insurance and take on excessive risks, at the expense of society at large. This is exactly what happened before the financial crisis.

This kind of implicit insurance is not altogether unfamiliar to the framework of EMU, where a single monetary policy exists alongside 19 largely autonomous economic and fiscal policies.

As the crisis taught us, this set-up potentially exposes EMU to vulnerability because at the end of the day, the community may have to foot the bill for unhealthy developments in individual member states if it wishes to prevent the stability of the union as a whole from coming under threat.

The prospect of being able to spread the consequences of unsustainable policy across the entire monetary union might weaken the incentives to run a sound budgetary policy. This is why institutional safeguards were put in place before the euro was launched: the Stability and Growth Pact, the no bail-out clause, and the ban on monetary financing of governments.

Unfortunately, however, these safeguards were unable to prevent public debt from ballooning in some euro-area countries, since the fiscal rules were repeatedly violated and the capital markets didn’t sanction these breaches because the no bail-out clause lacked credibility.

When doubts about the debt sustainability of some euro-area member states surfaced during the sovereign debt crisis, the urgently-taken rescue measures helped to prevent the crisis from escalating. But they did so by mutualising fiscal liability on a substantial scale.

Fiscal and economic policies, on the other hand, essentially remained a national prerogative, though the fiscal rules have admittedly been adapted. As a result, the balance between liability and control has been thrown out of kilter.

However, striking an even balance between liability and control is crucial for the functioning of EMU – and that’s a point I made in my last speech in Amsterdam 2½ years ago. And I also said in my speech back then that there are two possible ways to restore the balance between liability and control: deeper integration, or more individual national responsibility on the part of the member states.

The first solution would be to create a fiscal union with centralised decision-making powers. Only within this framework would fiscal transfers and mutual liability via Eurobonds be consistent and put control and liability back on an even keel.

While a fiscal union would not guarantee sound fiscal policymaking, it could certainly mitigate the deficit bias of individual member states. And interestingly, even for Karl Otto Pöhl, the former Bundesbank President who was a member of the Delors Commission, the “fiscal union approach” was the intuitive one: “In a monetary union with irreversibly fixed exchange rates, the weak would become ever weaker and the strong ever stronger. We would thus experience great tensions in the real economy of Europe. For this reason alone, monetary union without the simultaneous integration in fields like fiscal policy as well as regional and social policy is completely inconceivable."

But let’s be honest here: a fiscal union approach was not on the cards 2½ years ago, and it has become ever more improbable since then.

The outcome of the Brexit referendum has laid bare the scepticism about the European project and a tendency to reject further integration steps. Surveys reveal that many citizens in the EU doubt whether the existing process of integration is still sustainable. This is possibly not unrelated to the fact that the ongoing debate over the right response to the crisis in the euro area has brought out into the open the persistent differences of opinion in fiscal and economic policy matters.

This is all the more astonishing because the euro-area countries had actually already established a consensus on the appropriate role of fiscal policy – as documented in the Stability and Growth Pact. So building trust in the rules we already have today is paramount before we engage in major new integration steps.

To cut a long story short: a fiscal union, which would require member states to surrender substantial national sovereignty, hardly seems feasible at the moment. And as long as there's no willingness to transfer national sovereignty to the European level, there will be no basis for mutualising sovereign risks – and that's why the proposal to establish a European Deposit Insurance Scheme (EDIS) isn't the right institutional response to restore the balance between liability and control in the euro area.

As long as actions taken at the national level, such as drafting insolvency law or very high stocks of government bonds on banks' balance sheets, can have a substantial impact on the health of financial institutions, EDIS would allow risks to be shifted to the European level. This would send the wrong incentives to banks and investors alike. The mutualisation of risk would not go hand in hand with the necessary mutualisation of control rights – irrespective of the Single Supervisory Mechanism that was put in place.

The second way of restoring the balance between liability and control, meanwhile, would be to strengthen the Maastricht approach based on individual responsibility. This would leave economic and fiscal policy, as well as ultimate liability for public debt, in the hands of the individual member states. But how could such a decentralised approach work better in future than it has done in the past?

One of the problems in the run-up to the crisis was that the fiscal rules were incapable of effectively limiting the increase in public debt. Although the rules were changed after the crisis, the European Commission was granted more flexibility in interpreting them. And it has used this flexibility quite a few times so far – and always to interpret the rules very loosely. As a result, the binding force of the budgetary rules is weaker than ever before, as we can see, for instance, in the budgetary developments in France, Spain and Portugal.

One way of ensuring that the rules are binding would be to install a new and independent authority, a fiscal council. This institution would not be exposed to the same political conflicts of interest as the Commission, which has to assess whether national budgets comply with the Stability and Growth Pact and hammer out political compromises between the interests of the different member states.

"Debt is a two-edged sword. Used wisely and in moderation, it clearly improves welfare. But, when it is used imprudently and in excess, the result can be disaster." This statement by former BIS chief economist Stephen Cecchetti and his colleagues Madhusudan Mohanty and Fabrizio Zampolli is directed not only at private debt but also at public debt.[4]

They show that excessively high private and public debt is not only a risk to financial stability but also to economic growth. According to their estimations, in the euro area we are already in the danger zone – at least with regard to corporate debt, at 105% of GDP, but also in terms of public debt, at 91%. And so this is one more reason why effective limits for government debt are urgently needed.

Even though the highly 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. The member states' medium-term budgetary plans reveal that three-quarters of them are far removed from a sound fiscal position in 2016, and that this share will rise further. That is not what fiscal consolidation looks like.

Binding fiscal rules and an institution that observes their adherence are just one component of a consistent reform agenda. Additionally, it is important for capital markets to resume their role of disciplining national fiscal policy. More deeply indebted countries ought to pay higher interest rates. This will only happen if the no bail-out clause in the Maastricht Treaty really has teeth. Therefore, it must be possible to restructure public debt without posing major risks to the financial system.

The July edition of the Bundesbank's Monthly Report describes what needs to be done to make this possible. There are two reforms I'd like to mention in the following.

First, we need to sever the sovereign-bank nexus. The European banking union already marks a huge step towards untangling this dangerous embrace. However, to this end, and to complement the banking union, it is also crucial to do away with the preferential treatment of sovereign debt in banking regulation. This implies that sovereign exposures will need to be backed by capital and also be part of a large exposures regime.

A second measure concerns the design of the European Stability Mechanism's financial assistance programmes. The ESM is there to provide resources to countries that apply for an ESM financial assistance programme. However, these funds are generally not only used to cover budget deficits, but also to redeem maturing sovereign bonds. By implication, when a programme is activated, European taxpayers are, in essence, bailing out the respective country's creditors. If a haircut ends up being the only way to restore a country's debt sustainability, taxpayers, rather than investors, would shoulder the bill.

This does not exactly foster any willingness on the part of member states to agree to restructure a programme country's debt. Instead of a truly viable solution being reached, when push comes to shove, a strategy of muddling through would win the day.

That's why the Bundesbank is proposing to add a clause to the government bonds of euro-area countries which automatically extends the maturity of bonds by three years if the member state in question applies for ESMassistance. This way, the initial creditors would remain liable, and if the government debt really does need to be restructured, that could be done in an orderly fashion without jeopardising financial stability.

Our proposals would help to sever one direction of the sovereign-bank nexus: banks would be better shielded from a deterioration in public finances. The financial crisis showed, however, that wobbling banks can lead to stumbling sovereigns. To cut this direction of the nexus, financial market regulation will need to be enhanced further.

4. Financial market regulation

In the mid-18th century, Amsterdam, then a global financial centre, had to overcome a series of bank crises. One of these crises occurred when the Seven Years War came to an end in 1763. In the aftermath of this event, one of the biggest Dutch banks (De Neufville) collapsed when commodity prices, unable to hold their inflated war-time levels, plummeted. Once it became clear that the core of the crisis revolved around a single financial institution, the bank was resolved by an ad hoc consortium of its various creditors.

Nowadays, no such ad hoc solutions should be needed any longer because of the reforms that were implemented in the wake of the financial crisis. In the euro area, a common restructuring and resolution regime (the Single Resolution Mechanism) and bank supervision body under the aegis of the ECB (the Single Supervisory Mechanism) were established.

The Single Resolution Mechanism and the Bank Recovery and Resolution Directive (BRRD), which assures the harmonised implementation of the rules throughout all member states, substantially strengthens the principle of individual responsibility in the banking sector, thereby

reducing the likelihood of public bail-outs.

However, the first line of defence in making a bank resolution less likely is the establishment of higher capital requirements for banks. Hence, the G20governments decided during the financial crisis to improve both the quantity and quality of banks' capital and liquidity.

The goal of the Basel III framework, then, is to strengthen the resilience of the financial system. But to achieve that goal, it is important for Basel III to be implemented completely. This is especially the case for the currently debated elements of the Basel III framework, which are scheduled to be finalised by the end of this year.

But a well-functioning banking system is essential for financing the real economy, and it is therefore crucial for an ongoing economic recovery in the euro area. That's why it's important to reiterate that we shouldn't introduce a "Basel IV" framework through the back door. The GHOS are absolutely right to stress that finalising Basel III shouldn't lead to a further significant increase in banks' capital requirements, and – might I add – the outcome should also be regionally balanced.

Finalising Basel III is not an easy task. While I would admit that the distinct differences in how banks' internal risk-based models assess credit, market and operational risks need to be reduced, an approach consisting of excessively high parameter floors that would effectively undermine the risk-weighted approach taken in Basel III would not be an appropriate solution.

Risk-weighted measures were initially introduced by Basel II to encourage banks to enhance their internal risk management and rating models by adapting to the regulators' standards. This general route is still appropriate. However, while the financial crisis revealed that banks still underestimated certain risks, Basel III rightly continues to adhere to the risk-based approach.

A regulatory framework following the non-risk-weighted approach would be fraught with problems of its own. It sets banks problematic incentives to take greater risks. And so it was decided to improve regulatory standards within the Basel III framework. The comparability of parameters between banks' internal models and regulatory models as well as across different financial institutions and jurisdictions has to be adjusted with a sense of proportion.

Nevertheless, the leverage ratio – as a non-risk-weighted instrument – is a useful complement as a backstop. I therefore agree with my colleague Mark Carney from the Bank of England who once said in this context that it is sometimes good to wear a belt and suspenders to prevent your trousers from falling down.

Last but not least, I would like to come back to a point I mentioned earlier on today, which is directly related to financial regulation: Sovereign exposures on banks' balance sheets still represent a channel for the dangerous sovereign-bank nexus which acted as an accelerant in the euro-area crises. It is essential, then, for sovereign debt to be incorporated appropriately into banking regulation.

5. Conclusion

Since I last spoke here in Amsterdam 2½ years ago, a great deal of work has been done in the euro area to overcome the turmoil unleashed by the crisis, and important measures like the SSM and the SRM have been implemented to safeguard the future stability of monetary union. Nevertheless, now is not the time for complacency.

If we are to shore up the resilience of EMU, it is mainly the individual member states that are responsible for strengthening their economies. But additional measures at the European level are needed to foster growth in the euro area. And last but not least, we will need to make further reforms to EMU's institutional framework. These reforms can lay the foundations for restoring the

balance between control and liability.

Thank you for your attention.

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[1] See, for example, Ann Harrison, John McLaren and Margaret McMillan (2011), "Recent Perspectives on Trade and Inequality", Annual Review of Economics Vol. 3, pp 261-289.

[2] See, for example, Daron Acemoglu (2003), "Patterns of Skill Premia", The Review of Economic Studies, Vol. 70, No. 2, pp 199-230; Paolo *Epifani*and Gino *Gancia (2008)*, "The Skill Bias of World Trade", The Economic Journal, Vol. 118, Issue 530, pp 927-960.

[3] OECD (2015), "In it together: why less inequality benefits all", Paris.

[4] Stephen G Cecchetti, Madhusudan Mohanty and Fabrizio Zampolli (2011), "The real effects of debt", BIS Working Papers No. 352.