Jens Weidmann: United in diversity – on the responsibility of countries and regions in the 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, upon receiving the "Medal for meritorious service to Bavaria in a united Europe", Frankfurt am Main, 5 December 2016.

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1 Introductory remarks

Dear Minster of State Dr Merk

Ladies and gentlemen

Thank you very much for the words of praise, and I am pleased and honoured to be the recipient of the “Medal for meritorious service to Bavaria in a unified Europe".

I was not expecting this at all, quite honestly: that I would be honoured “for meritorious service to Bavaria". But we are, after all, talking about “Bavaria in a unified Europe".

I am therefore taking this distinction as (moral) support for my advocacy of a stable monetary union – a monetary union in which actions and accountability are aligned – a monetary union in which rules are observed and agreements are kept. Keeping promises is crucial to ensuring public acceptance of monetary union.

My stability-oriented stance in monetary policy issues could well have been a factor, and you might be expecting me to sound a note or two of caution regarding current ECB policy.

However, the Governing Council has a fundamentally sensible agreement in place not to make any public pronouncements about current monetary policy in the week leading up to a monetary policy meeting. And since a monetary policy meeting is coming up this week, I shall refrain from making any comment about this subject in my speech. But me say this much about fundamental considerations regarding the role of monetary policy:

The idea that central banks can use cheap money to fight the causes of the financial and sovereign debt crisis, fears about globalisation or the upsurge in populism, is dangerous. The central bank constantly stepping into the breach for elected politicians or even going so far as to attempt to influence democratic processes would lead to a politicisation that could jeopardise its independence.

The fact that accommodative monetary policy buys time for politicians is, at best, a side effect, but it must not become the objective of monetary policy decisions. And how a given monetary policy stance is maintained must depend entirely on what is required to safeguard price stability.

My fellow ECB Governing Council members would probably say much the same thing.

The accommodative monetary policy can make fiscal consolidation, as well as reforms, appear less urgent. I am thinking here of institutional reforms to make the euro area more stable. And this is precisely what I wish to talk briefly about today.

2 Assessment of the Italian referendum

In this context, this must, of course, include an initial, provisional assessment of the implications of the Italian referendum. As you know, a majority of Italian voters rejected constitutional reform in yesterday’s referendum.

There is cause for concern that reforms in Italy will stall once again. And this would be a troubling development, not just for Italy. For years now, Italy has been plagued by anaemic growth, very high government debt and piles of bad debt on banks' balance sheets.

To quote the Italian finance minister, a "No" would not the end of the world; however, it is now all the more important for Italy's political class to send convincing signals that it is willing to tackle the root causes of its economic woes.

3 The institutional architecture of the monetary union and the need for reforms

Minister of State Dr Merk,

You have invited us all to attend the award ceremony here at the Prinz-Carl Palace, which houses the offices of Bavaria's prime minister and is regarded as one of Munich's most beautiful buildings.

It is all the more noteworthy that this building's architect, Karl von Fischer, was all of 21 years old and still a student when he received the commission to design this building. However, the patron, a French clergyman named Pierre de Salabert, found Fischer's blueprint too complex – and possibly too expensive – forcing the architect to scale back his design. What was built was the main section with a representative facade and a shortened wing branching off to the left.

Ladies and gentlemen, why am I telling you this story, which I'm sure you know already?

Well, the reason is that it somehow reminds me of the construction of European economic and monetary union. And I'm not saying that the architects of monetary union were novices. But it does appear that it was impossible to give the builders more comprehensive blueprints, which is why the monetary union was initially built with only one wing: the single currency. The second wing – a single fiscal and economic policy – was intentionally left out.

This has left us with a single monetary policy in the euro area but largely autonomous national fiscal and economic policies.

Now, the architects were very well aware that this edifice has a decisive weakness: The risk of accumulating excessive debt is greater in such a monetary union than in countries that have their own currencies.

One reason is that the member states of a monetary union of this design are not borrowing in their own currency. They therefore cannot meet their payment obligations by simply printing money – a solution which, for stability-oriented central bankers, is generally a non-starter anyway.

Another is that there are greater incentives to borrow in a monetary union because any consequences of relying increasingly on capital market funding can be passed on to the other member states.

And that was why the member states pledged to maintain sound public finances, introduced upper limits for annual budget deficits and public debt levels, and agreed to a "no bail-out clause" that would prevent one member state from assuming liability for the debts of another. They also prohibited central banks from printing money to help cash-strapped euro-area governments

This was designed to ensure that member states are liable for their own debts and cannot pass them on to other members of the Community. At the end of the day, people will behave in a responsible manner only if they take responsibility for their own actions. Or, to put it slightly more bluntly: each member state must "pay its own way".

All this is ultimately intended to protect the single monetary policy from coming under pressure to inflate away excessive levels of government debt through monetisation. The founding fathers of the monetary union were well aware that there would be a loud cry for monetary policy action if the soundness of public finances should be at risk at any time.

The debt crisis in the euro area showed us that the Maastricht framework was unable to prevent sovereign debt crises and had also failed to effectively counteract other unsound economic developments such as a severe loss of international competitiveness and excessive current account deficits.

During the crisis, as you are well aware, we then set up the much-publicised European rescue packages during the crisis and took other measures – including through the Eurosystem – in order to prevent the crisis from escalating. But at the same time, these measures undermined the principle of individual national responsibility.

Although the “no bail-out” rule still applies, in reality, elements of communitised liability have been gaining ground. This upset the balance between actions and accountability because, naturally, the member states were not willing to hand over control.

And there are calls for greater joint liability in the euro area, say, in the form of a European deposit insurance scheme or a European unemployment insurance fund, to name but two examples.

Since member states are evidently still as reluctant to cede sovereignty rights to the European level as they were 25 years ago, I think that increasing the communitisation of liability is the wrong route to take. And that is why I am sceptical about calls to build a second wing, so to speak, on the basis of such initiatives.

In a recent article for the Frankfurter Allgemeine Zeitung newspaper (FAZ), Horst Seehofer, the Bavarian state premier wrote, “Europe is a treaty-based community; you can’t always get what you wish". Looking at the proposals for the future development of the euro area, however, it is sometimes possible to get exactly the impression that you can.

We need to restore the balance between actions and accountability. And, to my mind, the only way we can do this is by strengthening individual national responsibility and the decentralised framework.

"United in diversity” has been Europe’s motto since 2000, highlighting the fact that European integration and regional diversity do not have to be a contradiction in terms. And we must not forget that the principle of subsidiarity, which is likewise enshrined in the treaties, also stipulates that tasks should be transferred to the European level only if they cannot be performed adequately when responsibility lies at the national or regional level.

Strengthening individual national responsibility and the decentralised framework implies restoring the credibility of the “no bail-out” clause. That was exactly what was lacking in the run-up to the crisis. The example of Switzerland shows that a credible no bail-out regime for government debt is fundamentally possible.

Of course, the no bail-out principle can only function if it is possible, in extreme cases, to restructure sovereign debt without jeopardising the stability of the financial system. The European rescue measures were motivated not least by the fact that the consequences of a disorderly sovereign insolvency were unpredictable.

The fear of a further escalation of the financial crisis led to European taxpayers’ money being used as the first line of defence. That wasn’t really fair, as it contravened the principle that it is, first and foremost, shareholders and investors who must bear the consequences of their decisions. And it goes at least some way to explaining the increasingly critical attitude of some members of the public towards our economic and financial system.

This is why, a number of years ago, the Bundesbank proposed the automatic extension of bond maturities where governments are facing funding difficulties.

So far, a large part of the funds available to the European Stability Mechanism (ESM) rescue fund has been used to buy out the holders of expiring government bonds. This means that the original creditors are off the hook and European taxpayers are exposed to risk instead. Our proposal of extending the maturity of existing bonds by three years, say, when a government applies for ESM assistance, would keep the burden of responsibility on the original creditors. They could be made jointly liable if debt restructuring were to take place at a later date.

Incidentally, this would reinforce the disciplining function of the capital markets in response to unsound public finances and would therefore have a preventive effect. The greater the risk of an insolvency, the higher the premium has to be that potential creditors demand as compensation for providing further funding.

But it would be irresponsible to rely solely on the markets to impose fiscal discipline. This is something the founders of monetary union also realised, which is why the Stability and Growth Pact also contains rules on debt. But what use are rules when they are interpreted so freely that almost any excuse is accepted for exceeding the deficit limits?

In response to the European Commission's recent appeal to the member states for a more expansionary fiscal policy, the Eurogroup President Jeroen Dijsselbloem recently stressed that, in the event of a conflict of interest between fiscal expansion and excessive deficits, the Commission has to adhere to the pact.

In a sense, the European Commission's take on the rules brings to mind that famous line from Goethe's Faust: "Two souls, alas! are dwelling in my breast". One soul, as it were, is there to guard the treaties, while the other sees itself as a political institution which repeatedly turns not just one blind eye, but sometimes two.

This conflict of aims can only really be resolved if responsibility for monitoring compliance with the fiscal rules is transferred to an independent agency – a proposal that has the backing of both the Bundesbank and Finance Minister Wolfgang Schäuble.

Ladies and gentlemen

As I said earlier, the only way the no bail-out principle can work at all is if the financial system really is able to cope with debt restructuring. This means ensuring that banks, in particular, have enough equity capital to be able to sustain losses from a potential debt restructuring without jeopardising their own solvency.

In international bodies, therefore, we are arguing for risk-appropriate capital backing of government bonds and a cap on large exposures for lending to public debtors.

Incidentally, sovereign nations are not the only public debtors. Federal states and local authorities also borrow money, and in the case of local authorities it is often municipal banks that provide the money, thereby building up cluster risks.

The premise that actions and accountability must go hand in hand applies equally at local government level. In Germany, too, the federal states are not technically liable for debts incurred by their local authorities; however, they do exert substantial influence through federal supervision and through the municipal revenue-sharing scheme. However, these state-level instruments are not always used in a targeted, stability-oriented way. Nor is there an Insolvency Code for local authorities.

Lenders evidently assume that the respective federal state will cover the debts of an insolvent municipality. This explains why local authorities can apparently finance themselves even in a precarious financial situation in the form of excess balance sheet debt, without incurring large risk premiums.

Overall, there are clearly insufficient incentives for municipalities to avoid excessive debt. This is shown not least by the fact that cash advances are often at high levels and sometimes still increasing. While hardly any cash advances were recorded in the early 1990s, their level has since risen sharply and currently stands at over €50 billion, although I should add that Bavarian municipalities make scarcely any contribution to this.

The steep rise in cash advances has meant that some federal states have had to set up local government debt relief and consolidation programmes.

In my opinion, in order to effectively avert the danger of derailing local authority finances, it would be worth thinking about setting municipal cash advances, as a matter of policy, against the scope of the respective federal state as part of the debt brake, and stipulating that, from now on, cash advances can only be taken from a federal state. We made a recommendation to that effect in our October Monthly Report.[1]

Ladies and gentlemen

Fiscal solidarity is a key prerequisite for a stable currency and a stable monetary union. And this prerequisite is a responsibility that lies with the member states and their regions.

Competitiveness and economic prosperity of the member states are also vital for stability, and again, it is primarily at the national level that the course is set for this. I emphasise this because it presents each member state with its own special challenges. And this applies not only to the countries in crisis, but also to supposed paragons of virtue such as Germany.

At all events, the long-term outlook for growth in Germany is not rosy enough to give us cause for complacency. Germany is facing major challenges. Most notable among these is demographic change, but globalisation, digitalisation, the shift to renewable sources of energy, and the integration of refugees into the labour market should also be mentioned.

This makes it all the more important to set the right economic and socio-political course in order to boost economic momentum and ensure the sustainability of public finances. And let me add that not all the decisions made in the past few years fulfilled this requirement.

4 Conclusion

Ladies and gentlemen

As the Swiss musicologist Peter Benary once said – and this surely applies to speeches as well – “Every ending is comforting; only infinity is comfortless.” I would like, therefore, to conclude my remarks.

In the article for the Frankfurter Allgemeine that I mentioned earlier, Horst Seehofer wrote: “When words of warning come from Bavaria, they are spoken out of loyalty and concern for Europe and not out of hostility.” I would like to adopt this maxim – replacing “Bavaria” with “the Bundesbank", of course.

The Bundesbank is an integral part of the Eurosystem. We are committed to the European idea and see the advantages of a single currency. However, if we want to preserve the monetary union as a union of stability, we must not plot our course in the wrong direction.

In this context, any critical comments about the communitisation of liability risks without a corresponding transfer of rights of sovereignty to the European level are not directed against Europe. Rather, they express the concern that joint liability without joint control could cause long-term harm to the European idea.

With this in mind, I thank you warmly once again for awarding me the Bavarian Europe Medal.

I read, by the way, that during its more than 200-year history, the Prinz-Carl Palace has been redesigned, rededicated and rebuilt a number of times, probably putting the building under some strain.

Like the palace, the monetary union is no longer in its original state. It is currently going through a transition period, except that in this case, the architects do not know exactly what it will look like in the future.

For me, it is not so important whether there will be annexes, structural alterations or even partial demolitions; nor are the aesthetics of primary importance. Rather, it is crucial that the outcome is internally coherent, and that means, above all, that actions and accountability are closely interlinked.

Thank you very much.

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[1] Deutsche Bundesbank (2016), Local government finances: Development and selected aspects, October Monthly Report, pp 13-36.