Jens Weidmann: The future of the European Monetary Union (EMU) and some comments on the German economy

Keynote 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 Federation of Enterprises in Belgium, Brussels, 19 December 2016.

* * *

1. Introduction

Ms Sioen

Mr Timmermans

Mr Smets

Ladies and gentlemen

It is a special pleasure for me to speak on European issues right here at the heart of Europe. Thank you very much for your kind invitation.

Directly opposite the building we are in today, on the other side of Rue Ravenstein, the "Palais des Beaux-Arts de Bruxelles" is located, also known as "Bozar". As you all know better than me, it was designed by Victor Horta, one of the leading Art Nouveau architects, and was built as a new kind of cultural centre that would embrace all forms of art and be open to the general public.

According to the Bozar website, Horta himself imagined this building as being "immense and yet almost invisible, overlooking the city and yet buried underground, multiple and yet unified, prestigious and yet open to all". While Horta was referring to the "Palais des Beaux-Arts de Bruxelles", the words could equally serve to describe expectations with regard to the European Union: "Immense and yet almost invisible, multiple and yet unified, prestigious and yet open to all".

However, over the last few years a growing number of voices have been saying that reality and ambition have increasingly drifted apart: that the European Union has become too visible, more multiple than unified, and too open to all. Europe, many feel, has become more and more associated with obligation instead of opportunity, with bureaucracy instead of business, with heterogeneity instead of homogeneity.

In the following, however, I will argue that now is not the time to throw in the towel, especially where the euro area is concerned.

2. Economic situation and monetary policy

Ladies and gentlemen

As all of you know, this year has been marked by an unusually large number of political events with the potential to elevate uncertainty about the future outlook – notably the decision by UK voters to leave the European Union, the result of the presidential election in the US and, most recently, the referendum in Italy. These results have also been interpreted as signs of a growing scepticism about open markets and free trade. And indeed, calls for protectionist measures have been heard in many countries lately.

It is a fact that worldwide competition presents challenges for individuals and companies alike. And so it is quite understandable that some might feel that globalisation and technical progress are threatening their economic livelihood. More protectionism, however, would be the wrong answer on how to maintain our welfare. The WTO recently announced that it expects global trade to grow by only 1.7% in 2016 – which is about 1 PP lower than in 2015 and the lowest rate since the crisis year of 2009.[1] While for a long time, trade grew twice as fast as GDP, it has now fallen below the GDP growth rate for the first time in 15 years.

I'm convinced that the introduction of trade barriers or other protectionist measures would intensify a situation where growth in global trade already appears to be weak. Such impairments would therefore have the potential to weaken prosperity and innovation in the countries imposing these measures. If many were to act in this way, it would also pose a crucial risk for global growth.

And all things considered, open markets and free trade of goods and services belong to the foundations of our welfare – not only in Germany but also in Belgium, for instance. And here in Brussels, the importance of trade and business for welfare and growth is illustrated by the Grand-Place, which UNESCO describes as "a rare example of a square without a church or any other place of worship, which emphasizes its mercantile and administrative nature". By allowing specialisation and, therefore, using economies of scale, free trade makes production more efficient. By increasing competition it lowers the prices of goods and facilitates the spread of new ideas and technologies, which leads to more innovation and growth. In this spirit, Germany as the new G20 presidency will strive to re-iterate the G20's commitment to maintain open markets and refrain from additional protectionist measures.

But to benefit from the advantages of global competition and exchange, countries need to enable their citizens to manage the changes in their economic and social life. This would mean enhancing education, but also improving the flexibility of goods and labour markets. These are topics to which I will return later in my speech.

Looking ahead to the next three years, and assuming that far-reaching protectionist measures are not adopted in important parts of the world, a moderate expansion of global economic activity can be expected. That also holds for the euro-area economy, which – given the high political uncertainty and the notable shocks that have hit it this year – appears to be more resilient than in the past.

The reduction of the monthly purchase volume under the APP from €80 billion to €60 billion can be seen as an expression of the Governing Council's increased confidence in the economic recovery in the euro area. Additionally, deflation isn't really an issue any longer. And to be honest, in my view, the risk of deflation has largely been overestimated in the past.

This conjunctural picture is in line with the latest Eurosystem staff economic projection, which shows a rather stable growth rate of 1.6% or 1.7% within the projection horizon. These rates are, in any case, higher than potential output growth and would lead to a gradual closing of the output gap, further increasing employment and higher wages.

The German economy is expected to grow more or less in line with the euro area as a whole within the projection horizon. A further decline in unemployment and above-average capacity utilisation means that the robust growth in Germany will be increasingly driven by domestic demand. This projected economic development shows also that Germany doesn't need a debt-financed fiscal stimulus package, such as some occasionally call for. While the German government has indeed increased spending for public infrastructure, this hasn't led to a fiscal deficit. Given the expected burden on the budget and the social security system due to the looming demographic development in Germany, slight public surpluses are absolutely appropriate in times when interest rates are low and tax revenues are rising.

Last but not least, according to our estimates, spill-over effects from German public spending on other euro-area economies are rather low. So the benefits to the rest of the euro area of such a policy would be dubious, while it would be neither useful nor necessary for Germany, against the background of its benign cyclical position and ageing society.

Inflation in the euro area is expected to rise in line with the robust economic growth. The Eurosystem staff projections indicate that the inflation rate will pick up gradually until the end of the projection horizon to a level broadly in line with Governing Council's definition of price stability. In this context, four-fifths of the increase between 2016 and 2017 can be attributed to the development of energy prices. The dampening effect of the slump in oil prices about a year ago is now going to be washed out statistically. In addition to this base effect, OPEC's decision to reduce their oil production might mark a fundamental change of the organisation's strategy. This could lead to a faster closing of the gap between oil demand and oil supply, stabilising oil prices at an elevated level. However, much depends on how other oil producers react. Up to now, it's not clear if the current level of oil prices will set incentives to resume oil production.

And there is a further reason why inflation is currently so subdued in the euro area. The domestic price pressure is weak because of the adjustment processes in some euro-area member states to overcome the biggest economic shock since World War II.

While it is right that the only gradual increase in inflation justifies an expansionary monetary policy stance in the euro area at the current juncture, reasonable people can disagree about the appropriate degree of monetary accommodation. All the more as monetary policy becomes looser automatically over the coming months, even without central bank action: when inflation rises as forecasted in our projections, the real interest rate declines. The effects are similar to a central bank rate cut.

And it is also no secret that I'm quite sceptical with regard to Eurosystem government bond purchases. Although such purchases aren't prohibited per se and they can loosen the monetary policy stance, they are blurring the boundaries between monetary and fiscal policy. And this is especially problematic in a currency union with a single monetary policy and largely autonomous economic and fiscal policies.

Euro-area central banks are now the largest creditors of their member states. All governments ultimately pay the same interest rate on the debt in central banks' balance sheets, regardless of the country's creditworthiness. Currently, as the Eurosystem's deposit rate is negative, they all receive money for that part of their debt.

What's more: the larger the part of the debt that central banks withdraw from the market, the less markets will exert their disciplining forces sanctioning unhealthy public finances with higher risk-premia. This is all the more worrisome as the low-interest-rate environment offers few incentives for governments to consolidate their budgets. 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 instead is being spent to a significant extent. Germany is no exception here, by the way. Of course, this is not only due to diminished market discipline, but also to a lack of rigour in applying the fiscal rules. I will come back to this later.

This fiscal environment could lead to a situation where monetary policy comes under political pressure to make high levels of debt sustainable through low interest rates. This, however, could put price stability at risk.I fear that the danger of fiscal policy becoming too comfortable with the current low-interest-rate environment increases with the time these favourable financing conditions exist.

Besides these observations, I never tire of emphasising that the current very expansionary monetary policy entails additional costs. It is impairing the profitability of banks and life insurance companies, for example. Although both are not targets of a monetary policy geared solely to preserving price stability, central banks cannot afford to ignore this fact if banks' health problems endanger the monetary transmission mechanism, for instance.

Additionally, low interest rates and unconventional monetary policies could also drive up financial risk-taking in some financial market segments or the real estate market. I currently see no sign of exuberance in the real estate market in the euro area as a whole. Yet there's no denying that some national markets are at risk of overheating, and the competent financial stability authorities of some euro-area countries like Ireland, the Netherlands and, more recently, Finland have introduced macroprudential measures to limit the risk of house price bubbles.

Again, even if macroprudential instruments are better targeted to address specific financial stability issues, monetary policy cannot turn a blind eye if rising financial stability risks could get central banks into trouble with regard to safeguarding price stability in the future. In any case, it is key that concerns over financial market volatility or the sustainability of public finances do not lead to a postponement of an exit from the ultra-loose monetary policy, if that's what it takes to reach our price stability target. Otherwise, monetary policy would be taken hostage by fiscal policy or markets.

Ladies and gentlemen

It is the responsibility of member states to make sure that their public finances are able to cope with an increase in interest rates when it happens one day. And it is also the responsibility of member states to ensure sufficient growth and economic convergence. Contrary to what some believe – or wish – it's not central banks that can put the economy on a higher growth path.

Or to put it metaphorically: it is not enough for a car to have a tank full of "liquidity" if you want to speed up. Someone still has to rev up the engine. It's politicians who hold the key to unlocking economic growth. That's why the Governing Council has been tireless in calling for structural reforms. But while the ambition should be to move into a higher gear with regard to reforms, there are signals that we have already shifted back to a lower gear again. "Going for growth 2016", a recent study by the OECD, shows that since 2013 the speed of reforms has slowed down, especially with regard to measures in the fields of "innovation policy, public sector efficiency or product and labour market regulation".[2]

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. But I am convinced that measures which lead to sound public finances as well as competition-based economic systems with flexible labour and product markets would foster growth.

Making it easier for new firms to enter the market is one type of reform helping to raise competition and innovation. Measures easing the process of setting up a new business and, where necessary, eliminating red tape would boost growth potential, too. As a case in point, let me mention the creation of a common services market and a single digital market in Europe. Studies show that this could yield twice the growth effects unleashed by the creation of the common market for goods.[3], [4]

Lowering the barriers that prevent enterprises from exiting the market will likewise foster growth. It would facilitate what Joseph Schumpeter called "creative destruction". OECD research suggests that policy-induced exit barriers matter for productivity growth, because fewer exits lead to less scope for productivity spillovers and the misallocation of capital, labour and skills. It concludes, for instance, that insolvency regimes should be streamlined.[5]

And investing more in skills and education promises to deliver rich rewards, too. This would not only boost labour productivity, but also reduce the risk of workers losing their jobs. And this, in turn, would in my view be the most effective antidote to the feeling many have of being threatened by globalisation and technological progress.

But companies not only stand to gain from higher labour market flexibility: they would also benefit from an increased flexibility in their financing options. This is where the Capital Markets Union comes in. Because European companies largely rely on bank debt – in relation to GDP, about four times more than in the United States[6] - improving and harmonising regulation could help to make equity markets a better funding source for enterprises. And a deeper and more integrated European capital market would also improve financial stability, because equity flows are less prone to sudden stops. Hence, more equity financing makes companies more shock-resistant, thereby supporting growth and jobs.

Research has found that private risk sharing through integrated capital markets is a much more important shock absorber than public risk sharing. The integrated equity markets in the US cushion around 40% of total cyclical fluctuations between federal states.[7]

If a negative shock hits an industry or a specific region, then this loss is spread widely beyond that region. Creditors, on the other hand, are not exposed to losses – except in the event of insolvency. In other words: equity is a shock absorber, debt is a shock amplifier.

3. Improving the institutional framework of the EMU

Ladies and gentlemen

Implementing economic reforms at the national or European level as a way of strengthening the euro area is 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 and to restore trust, for instance by abiding by the agreed rules. 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 sound policies, in particular a healthy 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. The crisis played a role in this, but also that 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. Economic and fiscal 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. Theoretically, there are two possible ways to restore this balance: 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. 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: recent political developments show that a fiscal union approach is not on the cards: The outcome of the Brexit referendum and maybe at least partly the outcome of the Italian constitutional referendum have laid bare the scepticism about the European project and a tendency to reject further integration steps. Furthermore, surveys reveal that many citizens in the EU doubt whether the existing process of integration is still sustainable. And 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, which is 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 laws, 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 from national decisions 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?

Only five minutes away from here, you can visit the Magritte museum. René Magritte once said: "I saw the Uffizi Gallery in Florence, it's not bad but the postcards are better." Whether or not you would agree with that, it is my impression that the same might be said of the fiscal rules. It is not enough that the fiscal rules of the euro area exist on paper: their principles also have to be applied in reality.

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. In addition, recent statements by the Commission show that her interest in enforcing the rules is further continuing to decline. 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. Of course, the European Council ultimately holds the key to the success of any budgetary control. Its determination to enforce the rules and support the Commission in a strict interpretation is all-important.

"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.[8] 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.

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. As for enterprises, 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. A strong inter-linkage between banks and sovereigns increases the probability of a bail-out by other member states and weakens incentives for risk-oriented pricing. And it is precisely this sovereign-bank nexus that contributed to a mutual intensification of the crisis in the euro area, when banks suffered from declining prices for sovereign bonds in their balance sheets and countries from struggling banks in their territory.

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 similar to banks' lending to the private sector 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 (ESM'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 ESM assistance. 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 was already improved substantially. In the euro area, a common restructuring and resolution regime (the Single Resolution Mechanism) and a bank supervision body under the aegis of the ECB (the Single Supervisory Mechanism, SSM) were established.

The Single Resolution Mechanism and the Bank Recovery and Resolution Directive (BRRD), which assure the harmonised implementation of the rules throughout all member states, substantially strengthen 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 as it was already decided in principle by the Basel Committee on Banking Supervision almost exactly six years ago.

That’s why the timely implementation of Basel III is important. This would also reduce regulatory uncertainty for banks which is in my view a grave burden for them. But I want also reiterate that finalising Basel III - i.e. with regard to the design of banks’ internal risk-based models – shouldn’t lead to an additional significant increase in banks’ capital requirements, and the outcome should also be regionally balanced. The fact that Common Equity Tier 1 (CET1) for the directly supervised SSM banks increased after the financial crisis to 12.8% by mid-2016, and that this level is well above the unchanged aggregated capital demand of the Supervisory Review and Evaluation Process (SREP) for 2017 of around 10%, can be taken as a sign of an improved resilience of the European banking sector.

4. Conclusion

To sum up, I am strongly convinced that taking responsibility for national circumstances and policy decisions away from the member states would help neither the countries nor the people nor the European project. Strengthening individual responsibility appears to be the better approach.

Ladies and gentlemen

To borrow the words of Victor Horta: I hope that the duration of my speech was neither too immense nor my main points invisible to you. Instead, I would be glad if I have given you some food for thought on how the economy and the institutions of the euro area might be strengthened.

Thank you very much.

---

[1] www.wto.org/english/news_e/pres16_e/pr779_e.htm

[2] www.oecd.org/eco/growth/going-for-growth-2016-executive-summary.htm

[3] Roland de Bruijn, Henk Kox, Arjan Lejour (2008), “Economic benefits of an integrated European market for services", Journal of Policy Modeling 30, pp 301–19.

[4] Copenhagen Economics (2010), The economic impact of a European digital single market, Final Report.

[5] Müge Adalet McGowan and Dan Andrews (2016), “Insolvency regimes and productivity growth: a framework for analysis", OECD Working Paper (2016)33.

[6] www.bankofengland.co.uk/financialstability/Documents/fpc/fspapers/fs_paper33.pdf, p 6.

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

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