Jens Weidmann: Monetary policy and the architecture of 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 Deutsche Bundesbank's Capital City Reception, Berlin, 29 May 2017.

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1. Welcome

Ladies and gentlemen,

dear colleagues,

It was 131 years ago to the day that the American pharmacist John Pemberton published an advertisement for a new drug in the Atlanta Journal. He had created it to cure himself of a permanent malaise.

During the American War of Secession, morphine was the drug used to numb pain. It was also prescribed to John Pemberton to alleviate the pain from a shoulder injury. And, like many others, he had the problem that once he had starting taking it, he couldn’t stop.

So he decided to develop a pain killer that didn’t contain opiates in an attempt to wean himself off of them. And in 1886 he had done just that. Pemberton sold the new drug in his pharmacy and published the advertisement I mentioned earlier.

The business man Asa Griggs Candler tried it and realised that it could be more than just a drug. He decided to market it as a beverage. And it’s name? Coca-Cola.

Today this drink has the reputation of being a real all-round talent. Not only can it quench your thirst, but it is reputed to be good for removing stains and rust as well as for fertilising your plants.

But Coca-Cola isn’t the only all-rounder: monetary policy is also currently being branded as a cure for assorted ills. As well as its own actual mandate of keeping prices stable, some people seem to be under the impression that it should be used to strengthen growth, lower unemployment, safeguard the financial system and guarantee citizens adequate interest rates.

2. Monetary policy

The apparent similarities between monetary policy and Coca-Cola are not confined to their reputation as a “universal product"; indeed, they are both widely considered to be a shot in the arm. And that stimulating effect is increasingly coming to the fore in the economic data for the euro area.

At 9.5 %, the unemployment rate is the lowest it has been for eight years. The growth rate of 0.5 % in the first quarter means that the economy has been expanding for 15 consecutive quarters. For full-year 2017, the ECB staff projections prepared in early March forecast growth of 1.8 %. And judging by the current indicators, the euro area has a good chance of hitting that forecast.

Furthermore, the inflation rate of 1.9 % is exactly where the ECB Governing Council wants it to be - below, but close to 2 %. Yet the latest surge in inflation can mainly be put down to the sharp upturn in energy prices. That is to say, it is ultimately a baseline effect. And when that baseline effect expires, the rate of inflation will shrivel again in the second half of the year, if not sooner.

Activity in the euro area may be steadily firming, but if we take the traditionally highly volatile energy prices out of the equation, inflation is actually still rather subdued. In recent months, core inflation hovered at around 1 % - that's quite some way off the ECB Governing Council's target rate.

That domestic price pressures are still relatively muted can be attributed to a host of factors - all the more so, given that multiple countries are still feeling the after-effects of the crisis.

And I'm not just talking about the huge piles of non-performing loans that are still saddling banks in a number of euro-area countries. Viewed in isolation, those toxic legacy exposures are cramping the ability of banks to supply credit to precisely those young and dynamic enterprises that are entering the market. You could say it's payback time for the failure to cleanse bank balance sheets sooner and more thoroughly.

No, what I'm also talking about are enterprises and households across much of the euro area which are still busy scaling back what are, in some cases, high levels of debt. The fact that savings are outpacing investment in the euro area at the moment is one clear indication of the deleveraging process that is under way.

Yet some of the crisis-ridden countries have succeeded in stepping up their competitiveness and transforming current account deficits into surpluses. But improving price competitiveness through wage moderation naturally has a dampening impact on domestic price pressures.

Retrenchment efforts by general government can likewise soften the upside pressure on prices. In theory, that is. I say that because those efforts have waned perceptibly since 2013. Or to put it another way – most euro-area countries are currently far removed from a concerted austerity policy.

That's because, all told, the euro-area countries have saved a handsome €1,000 billion or so in interest, based on the 2007 interest rate level. And yet the large member states of France, Italy and Spain were precisely the ones which spent every last bit of what they saved in interest payments, instead of using it to pay off their debts.

Bearing this in mind, it is undoubtedly a welcome sign that the new French president has committed to comply with the fiscal rules and announced his intention to roll out additional economic reforms with a view to boosting French growth. A strong French economy will ultimately be a boon for the euro area as a whole.

Given the subdued price pressures, it is still appropriate, in principle, for monetary policy to be in accommodative mode. But in light of the ongoing economic recovery and a consensus inflation rate forecast of just under 2 % for 2019, it is certainly legitimate to ask when the ECB Governing Council should set its sights on normalising monetary policy.

Equally, there are good grounds to have a diversity of views about the right degree of monetary accommodation – all the more so, given that the highly accommodative monetary policy stance is mainly being achieved through the deployment of non-standard instruments.

As you are no doubt aware, I take a critical view of the large-scale purchases of government bonds in particular. In a currency union, purchase operations of that kind blur the especially important boundaries between monetary and fiscal policy. Eurosystem central banks have now become the euro-area countries' biggest creditors. At the end of the day, this can lead to political pressure being exerted on the Eurosystem to maintain the very accommodative monetary policy for longer than appropriate from a price stability standpoint. After all, in the context of asset purchases, changes in monetary policy impact more directly on governments' funding costs than interest rate moves. And that's naturally also problematical in view of the disciplining effect of the capital markets on government finances.

Hence my view that government bond purchases are an instrument of last resort - one which should mainly be used to fend off deflation. But I've said in the past that the fears of deflation are overblown, and since then they have become even less of an issue.

What is more, looking at the monetary policy stance, there is no disputing that the low interest rates and the non-standard monetary policy can potentially boost the appetite for risk in a number of financial market segments or the real estate market.

But at the current juncture I am seeing no signs of excesses in the euro-area real estate market as a whole. Saying that, a number of national markets do appear to be at risk of overheating. The competent financial stability authorities in those euro-area countries - which include Ireland, the Netherlands and also Finland – have therefore launched what are known as macroprudential policy measures in an effort to curb the risk of price bubbles emerging in their housing markets.

Financial system stability can come under threat in particular whenever higher lending and laxer lending conditions at banks drive up the prices of real estate.

But that's not a phenomenon we are seeing in Germany right now. Quite the opposite, in fact. The results of the Bank Lending Survey indicate that lending standards for loans for house purchase are currently much tighter than the mean level observed in recent years.

Even if we are currently seeing no evidence of a real estate price bubble which could pose a risk to financial stability, it is nonetheless important to have the toolkit which legislators recently adopted. After all, a fire brigade needs to have well-equipped fire engines. But it's equally important, if not more so, to have fire safety regulations in place which stop a fire from breaking out in the first place - and that's what it's all about: incident prevention.

When a large number of homeowners put little or no equity into financing their property, the recently introduced loan-to-value (LTV) ratio might need to be put to use.

Similarly, loan-to-income (LTI) ceilings like the ones which are already available in six euro-area countries, including Ireland, Estonia and Cyprus, would also be effective tools for preventing systemic real estate crises if the worst came to the worst.

Incidentally, that's a view which is also held by the International Monetary Fund. The IMF has also criticised - and rightly so - the continued existence of major data gaps which hinder the effective implementation of these macroprudential instruments, even though the new legal basis has been established.

But one thing is also clear in my view. The next financial crisis won't necessarily originate in the real estate market, like it did the last time. Perhaps it will be triggered instead by one of the many daily cyber attacks – an incident, say, which incapacitates a major bank for a while, sending shockwaves rippling through the financial system.

The events surrounding the WannaCry attack just over two weeks ago show how important it is for the potential risks associated with cybercrime to be monitored even more closely than they are at present. And that is why it was right for us to put the topic of cyber security on the agenda for Germany's presidency of the G20.

3. The architecture of the euro area

Ladies and gentlemen, the robust economic recovery in the euro area should not blind us to the fact that the currency union remains vulnerable.

In the wake of the crises, elements of mutual liability such as the European Stability Mechanism (ESM) were introduced to protect the stability of the financial system. This certainly prevented the crisis from escalating. But in a currency union in which monetary policy is centralised and fiscal policy is decentralised, joint liability can also create false incentives.

More specifically, there is a risk that mutualising liability will further increase euro-area countries' existing incentive to run up debt. If action is taken at the national level but responsibility is taken at the European level, the euro area will never achieve long-term stability. Instead, it could lose its footing because policymakers rely on safeguards at the European level. Nor would investors properly factor the potential risks into the interest rates they demand. The capital markets would thus fail to fully perform their disciplinary function. We experienced something similar in the run-up to the financial crisis. Lenders to large banks relied on the fact that, should the worst happen, these banks would be saved because they were important to the financial system.

Debate about the architecture of the euro area has been opened up again. From a central banker's perspective, this is urgently needed. Current proposals focus mainly on deeper fiscal integration, for example by introducing a dedicated euro-area budget, managed by a euro-area finance minister and under the control of a euro-area parliament.

This would make the euro area more like other federal currency unions such as the United States. However, although the United States has its own budget at the community level, which is also controlled at the federal level, the individual states are financially independent. For instance, during the financial crisis, no federal assistance was given to states experiencing solvency problems – not even when California requested help, for example. Nor has the Federal Reserve purchased any bonds issued by the states.

Deeper integration can only make the euro area stronger if each level assumes responsibility for the debts it incurs. Only this will ease the pressure on the Eurosystem to act as a troubleshooter time and time again, which can, however, create conflicts regarding the limits of its mandate and its independence. And only then will the financial markets perform their task of taking sufficient account of risk in their lending activity.

The all-important question is therefore: how can we retain the support function of the rescue mechanisms without letting private creditors off the hook?

One proposal put forward by the Bundesbank envisages, for example, changing the contractual terms for government bonds in the euro area by introducing an automatic three-year maturity extension for all bonds, which would be activated the moment a government applies for an ESM programme. Ongoing deficits would therefore be financed, but original creditors would not be paid off for maturing bonds.

Not only would this continue to provide incentives for private creditors to lend cautiously, it would also significantly reduce the need for financial aid under an ESM programme. It would also vastly broaden the scope of the rescue mechanism. Had it been possible to automatically extend the maturity of bonds back in 2011, Portugal would only have needed around €43 billion to cover its entire budget deficit until 2014 rather than the €76 billion in total that it received in assistance loans.

This solution would also help address another of the current problems with the ESM - its provisions stipulate that assistance can only be granted to countries experiencing temporary illiquidity, and not to those which are insolvent. In an emergency, it can be very difficult to say for certain whether a debtor is temporarily illiquid or actually insolvent. In this case, an automatic maturity extension buys time because bonds issued by private creditors, too, can still be restructured at a later date, ensuring that it is not only the countries providing the assistance that bear the losses.

Of course, the financial system must also be able to withstand a haircut. Otherwise, precious little would have been gained. Because privileged regulatory treatment allows banks to buy almost unlimited amounts of government bonds, which they are not required to back with capital, a haircut is particularly risky for banks. That has got to change.

Not until banks have begun to hold sufficient capital against government bonds and the size of individual exposures has been limited will banks be able to effectively cope with the process of restructuring sovereign debt. And only then is there likely to be any concrete political will to take such action. Government bonds are far from being risk-free. Banking regulation should at last acknowledge this fact.

The Federal Ministry of Finance has made similar proposals. Incidentally, these also include the possibility of strengthening the role of the ESM in the area of fiscal surveillance. After all, unlike the European Commission, the ESM is not exposed to any conflict of interest arising from the need to act both as a political institution and as the “guardian of the EU treaties".

I believe that these changes are needed to make the euro area more stable, regardless of whether we pursue the idea of greater joint financial obligations at the European level.

The more evenly economic shocks are spread across a currency union as a whole, the less likely it is to drift apart. To a certain extent, a common budget could help cushion shocks that affect individual member states and thus synchronise the economic performance of the individual countries to a larger degree.

But this effect would not be as major as some might hope. Fiscal policy in the United States, for example, only absorbs 10–20 % of economic shocks. Private forms of risk sharing play a much greater role. Integrated capital markets, especially integrated equity markets, smooth cyclical fluctuations between the US states, thus cushioning around 40 % of volatility.

If a business’s shareholder base is spread across many different states, so, too, will potential losses ripple out across several states. This absorbs some of the effects on income in the state affected by the shock. And during upturns, these states can benefit from investment opportunities in others.

Taking these steps to make the euro area more robust is a chance that should not go to waste. This is why we support the European Commission’s efforts to establish a European capital markets union when it comes to harmonising insolvency law in the EU, for example.

4. Concluding remarks

Ladies and gentlemen, John Pemberton developed Coca-Cola to free himself from his morphine addiction. No-one would claim that Coca-Cola carries a greater health risk than opiates.

But, by the same token, few would claim that Coca-Cola is an essential part of a balanced diet.

Ultimately, consuming more caffeine than is compatible with a healthy lifestyle only makes us more vulnerable. And the same is true of using monetary policy as a stimulus. It can be used, just like caffeine, to give the economy a boost. But overindulgence presents risks and side-effects.

A healthy monetary union requires a balance to be struck between action and liability, and economic policy to promote sustainable growth.

A sense of balance is also key in a speech delivered at a stand-up reception, meaning it shouldn’t be too long. On that note, all that remains is for me to wish you a pleasant evening and many an interesting discussion.