Jens Weidmann: Bundesbank at 60 – committed to a stable currency

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 reception marking 60 years of the Bundesbank, Hamburg, 8 September 2017.

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1. Welcome

Ladies and gentlemen

May I begin by thanking you, Mr Scholz, for your speech and for your respectful remarks about the Bundesbank. I am also very grateful that you have so graciously allowed us to use Hamburg's delightful and prestigious Town Hall as a venue for looking back at 60 years of the Bundesbank and sharing our thoughts on the challenges that lie ahead.

60 years of the Bundesbank – that means 60 years of dedication to a stable currency. Just like its predecessor, the Bank deutscher Länder, the Bundesbank was committed to preserving the stability of the Deutsche Mark. But more than that, the Deutsche Mark grew to become a key currency in the international area and a symbol of Germany's national identity as an economic powerhouse.

The year 1999 saw Germany join European monetary union, and since then the Bundesbank has been committed to a stable euro with equal vigour.

The Bundesbank first saw the light of the world on 4 July 1957, the day on which Germany's Bundestag adopted the Bundesbank Act – alongside the Antitrust Act. Writing at the time, the Frankfurter Allgemeine Zeitung newspaper remarked that this day had witnessed "the adoption of two crucially important pieces of basic legislation for our entire economic system".

When the Bundesbank Act came into force on 1 August 1957, the Bank deutscher Länder, the Land Central Banks and the Berlin Central Bank were merged to form a single institution, the Deutsche Bundesbank.

This new institution took over the headquarters of the Bank deutscher Länder in Frankfurt am Main. I wonder if you are aware that it almost ended up being based in Hamburg. Back then, the British forces were pushing for the Bank deutscher Länder to make Hamburg its home. But as it turned out, the Americans got their way, and the institution was established in their preferred location of Frankfurt, inside the US occupation zone.

That marked a major turning point for Frankfurt. The city evolved into Germany's financial centre and later also succeeded in attracting the European Central Bank. But I don't think Hamburg lost out in any way – Hamburg is an appealing, vibrant and economically successful location as it is.

One thing I am quite certain about is that the choice of location did not influence the Bundesbank's success, which I think can be put down to three key factors:

- Its narrow mandate to preserve price stability,
- Its independence, which allows it to pursue this objective even against political influence, if need be, and
- An appreciation of the need for stability throughout much of the German population, which gave the Bundesbank the popular backing it needed to pursue its monetary policy objectives.

Ladies and gentlemen, the fundamental problem facing monetary policymakers is that they are caught in a conflict of objectives. In the short run, staving off inflation can sap economic momentum and drag on employment. On the other hand, the central bank can temporarily dampen unemployment if it tolerates a higher rate of inflation. This phenomenon is what economists call the Phillips curve relationship. It is a concept which crops up in a famous remark uttered by Helmut Schmidt in the early 1970s, when he once said that “I would rather have 5% inflation than 5% unemployment".

An inverse relationship exists between inflation and joblessness because an unexpected increase in inflation pushes down real wages, lowers the price of labour, and thus tends to lead to a drop in unemployment.

But that only happens in the short run. Because employees will push for the higher rate of inflation to be offset, thus moving real wages and unemployment back to where they were before. There is a shift in the Phillips curve.

And if the unions, fearing a further increase in the rate of inflation, push through even higher wage increases, unemployment will rise as a result.

Let me use an everyday situation to shed more light on how this principle works. Imagine a person who is habitually late for work. Now, their partner might be able to outsmart them once by moving the hands of the kitchen clock forward by five minutes. But in the long run, that person will get used to the new time, so the clock will have to be put forward even more to prevent that person from leaving the house late in future.

That’s exactly how it is with monetary policy. If you fire up the printing presses to fend off unemployment, you will end up mired in high inflation and high unemployment.

Events in the 1970s provided a vivid illustration of this phenomenon. That was a time when central banks in a number of countries sought to cushion the negative repercussions of the two oil price shocks for the labour market by pursuing an accommodative monetary policy.

But as we now know, that move did not pay off. These countries ended up stuck with stubbornly higher rates of inflation but without the flipside of lower unemployment than in countries like Germany and Switzerland, whose central banks had run a policy that was aligned more closely with the goal of preserving price stability.

A central bank mandate geared to price stability helps to prevent the economy from slipping into such an unfavourable balance of high inflation and high unemployment. And the central bank should do all it can to stifle any doubts that it might not be operating safely within the confines of its mandate, because that is the only way it can succeed in anchoring inflation expectations among businesses and households on a permanent basis.

This is where the second condition I mentioned earlier on – independence – comes into play. A central bank must at all times be in a position to pursue its price stability mandate, free from political interference. After all, politicians can easily be tempted to favour the short-term gains of higher employment over the long-term costs associated with a persistently higher rate of inflation.

Bearing that in mind, it was undoubtedly crucial that the Bundesbank, just like its predecessor, the Bank deutscher Länder, had independence from political control. Because German post-war history also bears witness to a number of situations in which the Bank was forced to head off political demands to loosen monetary policy.

One such situation that springs to mind is the famous “Gürzenich speech” which Konrad Adenauer delivered shortly before the Bundesbank was established. At that time, the Bank deutscher Länder had switched to a tight monetary policy stance because there was a risk that the brisk external demand might cause Germany's economy to overheat. Konrad Adenauer, speaking in 1956 at Cologne's Gürzenich Hall, warned that the tight policy would be "disastrous ... for the man on the street". A year later, the SPIEGEL magazine looked back at these events and wrote: "What is more, the credit constraints later turned out to be absolutely correct; they came just in time to prevent the boom from morphing into an inflationary economic gallop."

Another situation I can think of occurred in the year 1979, when the government drummed up sentiment against an increase in the discount and Lombard rates. Manfred Lahnstein, State Secretary in the Federal Ministry of Finance, presented his critique before the Central Bank Council and then went public with his misgivings. He expressed concerns that the policy rate hikes might endanger the economic upswing. As it turned out, the German economy expanded at a real rate of 4½% in 1979, even though policy rates were increased. The Bundesbank, then, did well to prevent the global inflationary tendencies from spilling over into Germany more strongly than they did.

Because the Bundesbank held its ground in both these cases and refused to be knocked off course, the Die Welt newspaper once dubbed it in retrospect the "bulwark on the Main".

That was praise indeed for the Bundesbank, of course. For it had resisted the political pressure not because it was indifferent to the macroeconomic prospects, but it firmly believed, even back then, that monetary stability is the best contribution a central bank can make in the long run towards high levels of employment and sustained economic growth.

It was Milton Friedman who once wrote that the best thing a central bank can do for the economy is "prevent [...] itself from being a major source of economic disturbance". He continued: "Our economic system will work best when producers and consumers, employers and employees, can proceed with full confidence that the average level of prices [...] will be highly stable."

But I am convinced that the Bundesbank only prevailed in its skirmishes with politicians because it could count on the general public's appreciation of the merits of a stable currency. This brings me to the third of the key factors in the Bank's success which I mentioned earlier on. A policy strictly geared to stability only stands a chance of success if the general public is sufficiently aware of the merits of stability. That's because, in the long run, it is not right for democratic states to have a monetary policy which runs counter to public opinion.

On this topic, Otmar Issing once said that each country gets the inflation it deserves.

Ladies and gentlemen

These three pillars – a narrow price stability-driven mandate, independence, and a stability-conscious general public – helped the Bundesbank over the decades to keep the Deutsche Mark exceptionally stable. Between 1956 and 1998 the average inflation rate in Germany was the lowest of all the G7 countries, without putting a strain on employment.

But truth be told, a central bank can only really be successful in achieving its mandate if it is flanked by other policy areas. So there are still more factors which have a bearing on price stability. The recent financial crisis, for instance, showed how difficult it can be for central banks to preserve price stability when the financial system starts teetering.

And another factor that springs to mind is the importance of fiscal prudence: only if there is sufficient fiscal leeway will the automatic stabilisers be able to function in difficult spells for the economy, or the government might even respond to an economic slump by means of targeted spending increases.

The smaller the room for manoeuvre, the more the central bank will come under political pressure to stabilise economic activity in the short run – even if that does mean compromising on price stability.

Sound public finances, then, act to shield monetary policy. And that was precisely why the Stability and Growth Pact was adopted in Europe, and that is also precisely why the Bundesbank repeatedly highlights why fiscal compliance is so important for making the euro a currency that fulfils its promise of stability once and for all.

A clean dividing line between monetary and fiscal policy is important. The spell of hyperinflation in Germany in the 1920s showed only too clearly what can happen when a central bank funds surging government debt.

But there are also other episodes from history in which the financing of fiscal deficits by the central bank went hand in hand with high rates of inflation. One dates back to the 1970s, when the Banca d'Italia was forced to purchase the government bonds that were left unsold at auctions. It doesn't seem to be a mere coincidence that Italy's inflation rate averaged more than 12% during that decade. That would appear to be a realistic diagnosis, given that the Banca d'Italia only managed to clamp down on inflation and stabilise the lira when it set itself free of fiscal policy in the early 1980s.

In Italy, this parting of the ways is known as the Banca d'Italia's "divorce" from the finance ministry. Mario Draghi used a speech on the 30th anniversary to highlight this important event and note that it was the Banca d'Italia's regained autonomy which had enabled it to rein in price pressures – and in a way which did not damage industry, as some sceptics had forewarned.

2. Bundesbank a model of success – and a template for the ECB

Ladies and gentlemen, I think we can take some pride in the way the Bundesbank's success, notably in the 1970s and 1980s, inspired many countries to also make their central banks independent and give them a clear price stability mandate. This trend culminated in the establishment of the European Central Bank, whose independence and clear price stability mandate took after the Bundesbank.

That was undoubtedly a special tip of the hat to the Bundesbank and its work. However, given the high esteem in which the Deutsche Mark was held and the central role which the Bundesbank played in monetary policy matters in Europe with its credible stability orientation, it was clear that the introduction of the euro was also a watershed for the German central bank.

Because the advent of Stage Three of Economic and Monetary Union saw decision-making powers over monetary policy pass to the ECB's Governing Council.

So where the Bank had once been solely responsible for the Deutsche Mark, it now had a shared responsibility for the euro. The Bundesbank president, just like the governors of the other euro-area central banks, has a seat and one vote in the Governing Council. And this co-responsibility is no less important in a federal system which is constantly striving to gauge the right monetary policy path.

Incidentally, co-responsibility for the euro also means putting monetary policy into practice. When banks and savings banks in Germany need central bank money, they turn to the Bundesbank. Because in the Eurosystem, it is the national central banks which are tasked with implementing monetary policy operations.

Besides operationalising monetary policy, the Bundesbank also performs a number of other important tasks, like managing the cash supply. And 15 billion banknotes were handled by our branch staff last year, checked for fitness and replaced, if necessary.

Cashless payment operations are another one of our key tasks. In tandem with our partner central banks – Banca d'Italia, Banque de France and Banco de España – we are responsible for the backbone of European payment and securities settlement operations: TARGET2 and TARGET2-Securities. Day in, day out, we process payments in TARGET2 that are worth something like 1.7 trillion euro. And together with BaFin, the Federal Financial Supervisory Authority, we supervise around 1,800 German financial institutions and play a role in European banking supervision under the aegis of the ECB.

More tasks have been added to our agenda since the financial crisis. One is the statutory mandate given to the Bank in 2013 to contribute to financial stability within Germany. In other words, it is our job to identify risks to financial stability in Germany, issue warnings, and prepare recommendations for the German Financial Stability Committee on how such risks can be avoided. Because one of the main lessons we learned from the financial crisis was that it is not enough to look only at microprudential stability – it was also important to monitor the functioning and performance of the financial system as a whole at all times. Or, to use Janet Yellen's words: before the crisis, "we looked closely at the trees and not as intently as we should have at the forest".

3. Creating stability

Ladies and gentlemen, though the playing field in which the Bundesbank operates has been in constant flux, the main thrust of its monetary policy stance has remained steadfast: our sights are – and always will be – set on stability. This shapes the views I express in the ECB Governing Council, and it also shapes the views of my Bundesbank colleagues in the different Eurosystem working groups.

It is simply the nature of things that debate in the Eurosystem's committees can become heated on occasion, particularly in times like these, which present us with monetary policy challenges.

But it is at precisely these times that I believe there should be intense debate about the right path for monetary policy. And I am also certain that this debate is enriched by the many different perspectives and experiences the Eurosystem's central banks bring to bear.

But of course, this doesn't mean that every decision results in the outcome I would like. After all, that's not how a federal system works. I think Mr Scholz will back me up on this point.

Feeble inflationary pressure is currently posing a monetary policy challenge for the Governing Council. Since 2013, inflation has been lower than the Governing Council's medium-term inflation rate target of close to, but below, 2%. This is due to a wide variety of factors. In addition to plummeting oil prices, the economy was hit by the most severe recession in post-war history. Weak economic activity in the euro area was compounded by the adjustment measures taken by the crisis-stricken countries to regain competitiveness and reduce debt levels.

The ECB Governing Council found itself forced to continuously ease financing conditions until central bank rates had fallen to zero – and even below. To be able to loosen financing conditions further still, the ECB rolled out an extensive programme of both corporate and government bond purchases.

I have always been sceptical of government bond purchases, as I am sure you are aware. Particularly in the euro area, which has a single monetary policy but where economic policy-making is decentralised and in the hands of the 19 different member states, they threaten to blur the lines between monetary and fiscal policy. Ensuring that these lines remain sufficiently clear safeguards our independence, which, in a democratic system, can really only be justified by a narrow interpretation of our mandate.

In any case, we have successfully argued that, under the current government bond purchase programme, the Bundesbank should only buy German bonds and not those of euro-area countries with poor credit ratings, as was the case between 2010 and 2012 under the Securities Markets Programme (SMP). So unlike then, the balance sheets of Eurosystem central banks are, for the most part, not being used to communitise solvency risk.

On the other hand, we cannot deny that the bond purchases over the last two and a half years have now made the Eurosystem the governments' biggest creditors. This means that governments' financing conditions hinge much more directly on our actions than in times of normal monetary policy.

Meanwhile, practically all governments pay the same low interest rates on the share of their debt held by the central bank. And you don't need a crystal ball to see that in future, this will lead to demands for the Governing Council to stand its ground and normalise monetary policy and raise interest rates again.

For me, then, government bond purchases are nothing more than an emergency tool to be used for staving off a dangerous deflationary downward spiral of declining prices and wages, for instance. However, I considered this risk to be low even at the beginning of the bond purchases, and since then, it has all but disappeared.

Meanwhile, the upswing has actually gained momentum and breadth. Capacity utilisation in the economy is increasing, which will also translate into increasing price pressures. However, yesterday's projections show that inflation is set to climb at no more than a sluggish pace and that the uncertainty surrounding the future path of inflation is fairly substantial. That is why the ECB Governing Council has decided to wait until it can assess the monetary policy situation calmly.

Ladies and gentlemen, Anthony Quinn supposedly once said that even when you're 60 you can still feel like you're 40. Although only for half an hour a day.

Luckily, that doesn't apply to central banks. Not least because 60 isn't actually that old for a central bank. After all, the Bank of England and the Sveriges Riksbank have both been in existence for over 300 years.

So we, too, can be just as committed to safeguarding the stability of our currency at 60 as we were at 40.

Indeed, the euro-area crisis brought it home to all of us that the stability of the euro cannot be taken for granted. And the same applies to the stability of the euro area, in fact. Unfortunately, this vindicates the statement made by my predecessor Hans Tietmeyer 20 years ago: "The monetary union will not experience only sunny days. There will be rain and storms, too".

The extensive crisis measures taken by European policymakers and the Eurosystem may have prevented the crisis from escalating, but they have not made the monetary union permanently stable. Above all, additional elements of mutual liability have been introduced. Economic and fiscal policy, on the other hand, remain primarily under the control of the member states. And as we know, they set great store by their sovereignty.

This has knocked the relationship between actions and liability off balance. But I am convinced that responsible decisions can only be made if decision-makers are also held liable for the consequences of these decisions. This is the liability principle on which our market economy system is based and which Walter Eucken held to be a constitutive principle of the social market economy.

Consequently, I am sceptical of reform proposals that boil down to extending mutual liability without transferring the corresponding powers to intervene to the European level. They could ultimately turn the euro area into a transfer union, which would exacerbate the problems in Europe rather than solve them. Most importantly, a development like this would also undermine the foundations of a stable currency.

Given the lack of willingness to cede extensive fiscal sovereignty rights to Brussels, or even to venture into a political union, the only remaining option is the one anchored in the Maastricht Treaty – to reinforce the member states' individual fiscal responsibility.

It is up to the member states to make far-reaching reforms that enable them to strengthen the growth potential of their economies, open up job opportunities to more people and make public finances sustainable over the long term. This is in their own interests, as well as the interests of the euro area.

To reinforce the principle of national responsibility, the capital markets, too, would have to price in the risk of government bonds more adequately. So far, investors have been able to rely on bail-outs via rescue packages – and thus at the expense of European taxpayers – should a euro-area government run into difficulties. Of course, this has weakened investors' risk awareness. We are therefore proposing that the maturity of bonds issued by a euro-area state should automatically be extended for a certain period if that state applies for an ESM programme. This would keep the original creditors on the hook and would require them to be involved in any debt restructuring arrangements.

Aside from this, the crisis showed how troubled banks and ailing states can throw each other off balance. That is why we need to sever the close economic ties between sovereigns and banks in the euro area.

It was with this in mind that we successfully advocated for the banking regulatory bodies to consider at the international level how to eliminate the existing preferential regulatory treatment of government bonds in banks' balance sheets. In future, risk-appropriate levels of capital will need to be held against government loans on banks' balance sheets, just as they are for loans to any private borrower.

Ladies and gentlemen, the founding fathers of monetary union recognised back in the day that Europe should not rely solely on the capital markets to set sufficient incentives for sound public finances. That is why they flanked the no-bailout principle with the budgetary rules belonging to the Stability and Growth Pact.

But a glance at the government debt of the euro-area countries shows that the binding effect of these budgetary rules was never terribly effective in the past. At least, that's the impression you get when you consider that some countries have now exceeded the budget deficit ceiling for the ninth time in a row.

The Bundesbank has therefore spoken out in favour of simpler and more transparent rules, and has suggested that responsibility for monitoring these rules is transferred from the European Commission to an independent institution. The underlying problem is that the Commission plays a dual role as a political authority and the guardian of the EU treaties. This causes a clash which, in the past, has often resulted in the Commission making compromises at the expense of budgetary discipline. It was for this reason that Wolfgang Schäuble, Germany's Finance Minister, also recently reiterated just how important it is for the European Commission to "strike the right balance between its political function and its role as guardian of the treaties".

Realigning action and liability is not an end in itself. It is about creating the right incentives to encourage member states to do all they can to bring about sustainable growth and employment. Ultimately, this also strengthens identification with the European project, as the German Council of Economic Experts recently pointed out.

4. Conclusion

Ladies and gentlemen, it is important to “focus all efforts on preventing inflation,” as Ludwig Erhard wrote in his book “Wohlstand für alle” in 1957.

It is in line with this principle that the Bundesbank has done its utmost to ensure price stability over the last 60 years. If necessary, it is not afraid to ruffle a few feathers if it sees risks to stability.

This has not damaged our reputation among the general public, as proven not only by surveys, but also by the widespread support for us on occasions such as our recent open day in Frankfurt, for example. On our anniversary, Federal President Frank-Walter Steinmeier, too, attested to the public’s deep-seated confidence in the Bundesbank – and not just in the area of monetary policy, but in our other key tasks as well.

We will continue working to justify this confidence.

Of that you can be sure.