Joachim Wuermeling: Prospects for European monetary union

Speech by Prof Joachim Wuermeling, Member of the Executive Board of the Deutsche Bundesbank, as part of the "Finanzwelt Europa"; series of talks hosted by the Landesbank Hessen-Thüringen and the Representation of the State of Hessen to the EU, Brussels, 11 October 2017.

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1. Introduction

Ladies and gentlemen

This is the second time I have had the pleasure of visiting the Representation of the State of Hessen in Brussels this year. In June, I spoke about current developments in the euro area at a lunchtime event dedicated to financial market policy. Since then, a number of occurrences have affected all of us as European citizens, in our economic and political roles, and also at the Bundesbank.

The fact that the Landesbank Hessen-Thüringen and the Representation of the State of Hessen to the EU are coming together to discuss Europe as a financial community in its “Finanzwelt Europa” series of lectures highlights the important role that Hesse plays in Europe’s financial framework. I would therefore like to thank the organisers for giving me this opportunity to talk to you.

The Bundesbank operates in a policy field that is already communitised in the euro area: monetary policy. Our Bundesbank logo consists of yellow stars on a blue background, which shows how strongly the Bundesbank considers itself part of the Eurosystem. The Eurosystem can only pursue sound monetary policy in a stable currency union. This is why the Bundesbank is taking part in the current reform debate.

The title of my speech contains a key term: “prospects". I believe it is almost more important now than ever to talk about the prospects of the EU and the Economic and Monetary Union. The word “prospects” has several layers of meaning. First, it can imply guidance – a compass or a roadmap. What should the EU look like in one, five or ten years’ time? Second, it generates clarity, hope – and ideally even enthusiasm. If the debate surrounding European policy is outlook-based instead of being limited to questions that are certainly important, but rather technical; if the citizens of Europe can see which direction we are heading, then it becomes clear what Europe stands for and why it is worth standing up for Europe. And third, prospects always point to the future. Those who are forward-looking must be innovative and implement reform.

Direction, enthusiasm and reform: these are the kind of prospects that can drive the EU and the euro area forward. That is why it is important for us to meet here to discuss them.

And not a moment too soon. After all, we have been through some turbulent times. Think of Brexit – a “wake-up call” to European policymakers; a shock to all of us who believe that supranational cooperation creates added value for policy, the economy and society. Euro-sceptic feeling prevailed here. Afterwards, something like a countermovement took place, with pro-European forces retaining the upper hand – for instance in the elections in France, the Netherlands and most recently in Germany.

There is currently momentum to undertake reforms, particularly since the French elections. We should harness this momentum, and we are all involved in doing so in our various roles. The Bundesbank is playing its part in this debate by putting forward technical proposals for the euro area.

I would very much like to see this window of opportunity used to make reforms to the euro area that directly address the core problems brought to light by the crises. This is in monetary policymakers' interests, too.

Let me now take a closer look at three issues. First, the monetary policy challenges we are facing. How did the ECB Governing Council act during the financial and sovereign debt crisis and what decisions still need to be made? Second, the reform proposals for the Economic and Monetary Union. How can we do our utmost to prevent future crises from happening? And third, the position of the EU following Brexit – involving a kind of "European digital financial centre".

2. Monetary policy challenges

For the EU, and particularly for the euro area, crises have almost become par for the course over the last few years. The crises have also posed new challenges to the Eurosystem's core business area – monetary policy. As a Bundesbanker, I would like to say a few words about monetary policy during the crises and the decisions that are about to be made.

The ECB Governing Council took a number of non-standard monetary policy measures as a targeted response to the global financial crisis and the euro area sovereign debt crisis. Later on, monetary policy was loosened further because the majority of the ECB Governing Council saw a risk of deflation – a dangerous downward spiral of sinking prices and wages.

The non-standard monetary policy measures include a zero – and even a negative – interest rate policy, a fixed-rate full allotment procedure to cover banks' liquidity needs (provided they have sufficient eligible collateral), targeted longer-term refinancing operations with a maturity of up to four years, various asset purchase programmes and forward guidance, through which the ECB Governing Council indicates the likely future path of monetary policy given the current situation.

Some of the crisis symptoms have now subsided and the threat of deflation has evaporated. The euro area economy is experiencing a sustained and broad-based recovery – but with regional variation.

The ECB's staff projection puts real economic growth at 2.2% in 2017 and at almost 2% in 2018. However, inflationary pressure is increasing only gradually. Although an accommodative monetary policy stance is therefore basically still justified to bolster the economic recovery and thus inflationary pressures in the euro area, at the same time, the current circumstances are opening up the possibility of a return to normal monetary policy.

Even if the net purchases under the asset purchase programme are ultimately discontinued, euro-area monetary policy would remain accommodative. After all, the deciding factor is not so much the amount of monthly purchases but, above all, the total volume of bonds purchased by the Eurosystem. The reinvestment policy means that maturing bonds are replaced by purchases of new securities. So the monetary policy stimulus created by the asset purchases remains strong – it is just not being made stronger still.

We call the gradual scaling back of the asset purchases "tapering". For the Bundesbank, it is important that government bond purchases be phased out quickly due to their serious side effects. The problem with government bond purchases is that they have turned central banks into their countries' largest creditors. The line between monetary policy and fiscal policy is becoming increasingly blurred. Governments' financing conditions depend much more heavily on the actions of central banks than in the past. This creates a proximity between governments and central banks that may threaten the central banks' independence.

In the autumn, the ECB Governing Council will make decisions about the future monetary policy stance. It goes without saying that you will keep a close eye on these decisions and their effects.

3. Reforms of the Economic and Monetary Union

The ECB Governing Council has responded to the crises of the past few years by adopting non-standard measures. The objective of these measures must be to restructure the monetary union in a way that prevents such crisis situations from reoccurring in future, thereby making it unnecessary to again resort to non-standard monetary policy measures.

To achieve this, we need reforms. A clear analysis needs to be carried out before these reforms can begin: What triggered these crises? What reforms are necessary to prevent such crises from reoccurring? What form should these reforms take?

A deepening of European integration is a project that is decided on at the political level. We are currently holding a broad debate on this issue. Recently, French President Emmanuel Macron presented his reform plans in which he called for the euro area to be given its own budget and its own finance minister. He also put forward a number of other proposals, which included the creation of a parliament for the euro area, an EU unemployment insurance scheme, a European Monetary Fund and a common European deposit insurance scheme.

But what reforms would resolve the actual problems in the Economic and Monetary Union? We have to beware of falling into the trap of taking action for action's sake, but focus on solving the actual core problems.

The sovereign debt crisis has taught us that in a monetary union, state sovereignty in fiscal and economic policy decisions becomes problematic if the member countries do not abide by the commonly agreed rules of the game. Two weaknesses became particularly apparent during the crises: first, the excessive debt levels of countries in the euro area; second, the heterogeneous economic developments in the individual member states of the monetary union.

3.1 Sound public finances

We must therefore begin by ensuring sound public finances. "Those who act must also bear the consequences of their actions" – this has to be the basic principle behind the reforms of the European Economic and Monetary Union. In some cases, the relationship between actions and liability was knocked-off balance during the crises when a number of elements of mutual liability were introduced, whilst, at the same time, keeping the sovereign powers of the member states largely unchanged. Responsible decisions can, however, only be made if decision-makers are also held liable for the consequences of their actions.

The Bundesbank has made technical proposals in this regard which follow the basic principle of making those who take risks also responsible for the consequences. The first proposal envisages the possibility of extending the maturities of government bonds whenever member states need European rescue funds. This would ensure that bondholders do not receive funds from European taxpayers whilst a rescue programme is still ongoing, thereby making them responsible for their own actions. If a country is still cut off from the capital markets following a rescue programme, then a bail-in may be carried out, meaning a haircut at the expense of the original creditors. Second, the Bundesbank's proposals seek to end the across-the-board zero weighting of government bonds, giving them an equity capital advantage, in order to reflect the different risk potential of the bonds of various countries on banks' balance sheets. Third, we need an independent fiscal surveillance mechanism, as the Stability and Growth Pact has not had the impact that was originally intended. These proposals by the Bundesbank should lead to sounder public finances and thus to a more stable monetary union on the whole.

3.2 Greater economic growth

Next, it makes sense to strive towards a higher degree of economic growth in a monetary union, and this also strengthens social cohesion.

In a monetary union, the individual member states are no longer able to use the exchange rate as a competitive tool like in the past. On the contrary, reforms of the real economy are necessary in order to enable economic success in every member state. This applies to many areas: the supply of highly-skilled workers, labour costs, an economy's ability to innovate, taxation and much more. It is the responsibility of the individual member states to ensure sufficiently flexible goods and factor markets. Flexible economic structures make it easier to cushion economic shocks. They are also the foundation for dynamic economic growth. This also lightens the burden on monetary policy, which is why the ECBGoverning Council repeatedly calls for the member states to implement structural reforms.

In recent years, the willingness to embrace reforms was greater in some countries than in others. Here, it is not just a question of helping the formerly crisis-ridden countries to get back on their feet. Those countries that were not so severely affected by the crisis, such as Germany and France, must also implement reforms to enable them to meet the challenges of the future.

4. Digital financial centre of Europe

Ladies and gentlemen,

Although the reform efforts in the European Union and in the euro area are not a direct result of Brexit, Brexit has nevertheless acted as a catalyst in many areas. This is particularly true in the case of the financial markets. In a speech held in Florence, UKPrime Minister Theresa May presented her vision of how the British government envisages the negotiations and its future partnership with the EU.

An important part of this partnership will be redefined following the negotiations: the role of London as the most important financial centre in Europe. This role will not, however, dissolve into thin air once the UK leaves the single market, but its role will change. This marks a major turning point with regard to the importance of the financial centres in the European Union.

The question arises as to where key finance-related decisions for countries, enterprises and households in the EU will be made. The assumption that market activity will simply shift towards the euro area or the EU after Brexit is by no means a foregone conclusion.

Competition among financial centres went global long ago. Wall Street or other financial centres could therefore also be among the winners – and Asia, too, for example, which is already undergoing a dynamic catching-up process.

Market positions are not generally set in stone. The market players are continuously reassessing the underlying conditions for new financial centres, yet those which can offer the following features stand a good chance of being successful:

Openness and economic strength

A look back at economic history shows that there is a strong correlation between fewer trade barriers and greater prosperity. And the generated wealth has to be managed and increased. Many successful merchants realised as early as back in the Middle Ages that financial transactions can be riskier, but also more profitable than the pure trade in goods. They consequently began adapting their line of business accordingly. As a result, financial centres sprang up in locations where wealthy businessmen were living. Although things have continued to develop in many ways since then, the fact that strong financial centres tend to emerge in strong economic areas still holds true today.

Political and legal stability

Ultimately, investors not only have an interest in earning a return on their investments, but first and foremost in protecting their assets. More specifically, this means protecting their assets not only against expropriation by the state, but also against losses brought about by inflation, dubious business practices or economically unsound financial institutions. These protective functions are primarily dependent on the institutional framework in place in the respective financial centre. The key ingredients are a stable political system, a reliable legal system, independent courts, independent central banks that are primarily geared towards price stability as well as a regulatory system which focuses on the soundness and credit quality of financial institutions, but which also provides creative potential to expand.

Human capital or, in other words, highly skilled experts

Since time immemorial, highly-qualified workers with specialist skills have been creating new business opportunities using financial products and innovations. Examples of this are in no short supply: in the Early Middle Ages, for instance, business with trade bills in Italy, and then later government bonds underwriting as a specialty in the financial centre of Frankfurt. Around the turn of the millennium, it was financial engineering using securitisation techniques in the Anglo-Saxon world. At the same time, a financial centre has to be attractive enough to lure highly qualified staff. Quality of life is not always clearly measureable, yet it does play an important role when choosing a place to work.

Infrastructure

In the Middle Ages, it was a favourable location along the trade routes that determined where the financial centres would blossom. This was later facilitated by having a good road, rail and air traffic network. Nowadays, the digital infrastructure is playing an increasingly decisive role. Speed in information processing has become a success factor. For financial enterprises which are increasingly focusing on automated trading systems, fast data connections to stock exchanges are essential.

The European Union and the euro area are doing well in embodying many of these features, namely openness and economic strength, political and legal stability and human capital and infrastructure.

We live in strong, diversified economic areas with high living standards and a broad cultural landscape.

We have the euro, whose stability is guarded by the Bundesbank and the other Eurosystem central banks, and which enjoys the confidence of investors around the world.

We do business in a single market with a largely harmonised regulatory framework. People, goods, services and capital can move freely and quickly in the second strongest economic area of the world.

The banking union with its single supervisory mechanism and harmonised regulation has further strengthened trust in the European financial system. And the emerging capital markets union is moving European financial integration further forward.

Competition among financial centres remains lively, however. This prompts me to take a look at one of the features I mentioned earlier and which, in my opinion, merits special attention from politicians and financial market participants alike: digital infrastructure.

Economic history has demonstrated that changes to infrastructure can have a considerable impact. The decline of Venice as a trading and financial centre was sealed when the sea route to India was discovered at the turn of the 15th/16th centuries. The new sea route was much more advantageous than the journey by land, which resulted in oriental spices costing only half the price in northern Europe as in Aleppo, for example. The Syrian commercial city used the old trading routes over land to Asia. And so the port town of Antwerp became the Venice of the 16th century.

The significance of infrastructure becomes clear at this point. Changes have a transformative effect. Alongside the many parallels, there is one difference between the route to India and digitalisation: the sea route was a discovery; digital infrastructure calls for a more targeted implementation and expansion of networks. There is already a highly developed political awareness of this, with France’s President Macron recently defining digital innovation as one of Europe’s core issues. At the Tallinn Digital Summit, the European Union heads of state or government discussed how Europe can make better use of the opportunities available.

Early action is essential for the financial sector: in a first step, cooperation possibilities for a powerful digital networking of EUfinancial centres need to be explored. The mission statement could be that the various locations increasingly function as a kind of “digital financial centre of Europe” or “digital city of Europe".

"Digital financial centre” does not mean that personal contacts and established trust among financial market participants would no longer be necessary. A powerful digital infrastructure would actually make these relationships easier to develop and strengthen, and financial transactions would be facilitated. In this way, development potential which is geographically dispersed over an entire continent would be tapped more efficiently.

Such a project should be market-driven. Policymakers could assume the role of a catalyst, sitting the main players down at one table. Together with market participants, these include market infrastructure operators, who recognised long ago the disruptive potential of blockchain, smart contracts or the like in the issuance, trading, settlement and administration of securities.

IT providers, who can ensure fast and powerful data connections and systems, or legal advisers are also among the key players. As time progresses, they can support policymakers in adapting the legal framework to the new environment in terms of harmonised contractual standards for securities issues across the EU, for example. Start-up centres like Frankfurt TechQuartier are also offering their resources, already providing platforms for cooperation between many FinTechs.

The central banks, that is the Eurosystem with national central banks like the Bundesbank, are certainly not the most important in all this, but they do play a role as market infrastructure operators, for example.

There are numerous challenges to be overcome in this context, one of which being the individual interests of the respective providers. In terms of the individual financial centres, Luxembourg will keep an eye on its position in the funds industry, for example, Amsterdam on its importance for insurers or high frequency traders, and Dublin on its leading role in securitisation. At the end of the day, it is important where jobs and tax revenue are created. But an examination of individual market participants also reveals a varying degree of motivation and different target coordinates.

The merging of existing IT architectures with the least possible friction represents another challenge. A high level of standardisation is required in this instance. Ideally, technical or administrative issues within the EU should not play any role in EUinvestment decisions.

The hurdles for a European digital financial centre are therefore high but not insurmountable. The diversity of the individual financial centres can also represent a strength for a European digital financial centre, especially if the digital networking ensures that the financial market participants can capitalise on the strengths of the decentralised and specialised financial centres.

In general, if we don’t just keep an eye on our own piece of the pie, but join forces, the whole pie can grow in size. In more specific terms, it is worth working together to establish a counterweight to the other major financial centres. A powerful and secure digital network where financial centres offer specialised services and with easy access for global providers and seekers of capital can make a valuable contribution.

5. Conclusion

Ladies and gentlemen, let us use the "window of opportunity" that I outlined at the beginning of my speech. In the coming years, each and every one of you will be confronted with the reforms of European Economic and Monetary Union and with the development of the European financial centre following Brexit. We will all have a role to play. The Bundesbank will be involved in the debate in some areas.

One point that is of particular importance to me is this. Let our action plan be based on an objective analysis. The necessary reforms will certainly involve some unpopular decisions. We must make sure that the debate about the future of the Economic and Monetary Union, the future of the European Union as a whole, is not driven by populist movements. Let us highlight the positive aspects and give the EU what it needs: a compass providing direction, enthusiasm and reform or, in a nutshell, prospects.