# Jens Weidmann: Keynote speech - "Europe into a new era - how to seize the opportunities"

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 Frankfurt European Banking Congress "Europe into a New Era - How to Seize the Opportunities", Frankfurt am Main, 17 November 2017.

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## 1. Introduction

Ladies and gentlemen

Central bank communication can certainly be tricky. That is why Bank of Japan Governor Haruhiko Kuroda said three days ago, during an ECB conference on this very issue, that the message needs to be simple. "It should better be straightforward," he told the audience. "That's the best way."

As was also alluded to at the conference by moderator David Wessel, there might now be a new option that would allow Governor Kuroda to be taken at face value – in the truest sense of the word.

Artificial intelligence researchers claim to have found clues in the facial expressions of the Bank of Japan Governor. Supposedly, Kuroda showed "fleeting signs of 'anger' and 'disgust'" at news conferences that preceded changes in monetary policy in 2016.

This raises important questions: Can we now make monetary policy changes with the blink of an eye? And will botox injections be the only way to uphold the maxim "we never pre-commit?"

On a more serious note: Artificial intelligence is a fascinating subject, with wide-ranging implications not least for economics and finance. But today I will confine myself to more everyday matters for a central banker – matters which definitely also have wide-ranging implications for our monetary union.

"Restoring the European project", the title of the upcoming panel, calls for policymakers to live up to their respective responsibilities. What is required of monetary policy, national governments, and European institutions? In the next 15 minutes, I will try to briefly sketch out some possible answers to this question.

## 2. Monetary policy

Let me start by having a short look at the Eurosystem's monetary policy.

The Eurosystem's expansive monetary policy has contributed significantly to the recovery in the euro area. Growth rates have been positive for more than four years. The unemployment rate has almost been reduced to its pre-crisis average. And economic indicators all point to a continued economic up-swing.

In Germany, indicators now suggest even stronger growth than outlined in our June projection. Over the last four years, capacity utilisation has steadily increased. And since 2016, the economy is even running above capacity. The duration and strength of the current recovery is impressive, especially against the background of high political uncertainty globally.

Inflation, however, has not quite kept pace with the recovery. Price pressures are expected to remain rather subdued.

Multiple factors seem to be at play here. The recovery has certainly been aided by the fact that most of the crisis-hit countries have strengthened their competitiveness and turned their current account deficits into surpluses. But improving price competitiveness through wage restraint is, naturally enough, also dampening domestic price pressures.

This factor is euro area-specific. But price pressures have been subdued in other countries, too, in spite of very low unemployment rates. It seems that global factors are affecting inflation as well. Research at the Bank for International Settlements suggests, for example, that greater labour market contestability as a result of global value chains are putting a lid on wages and thus price pressures.[1]

Given the rather subdued inflationary pressure at present, an accommodative monetary policy stance remains appropriate in the euro area. But we must be attuned to the fact that the economic recovery has progressed further than inflation figures currently suggest, and that domestic price pressures will gradually increase in keeping with a path towards our definition of price stability.

This is why, in my view, a less distinct loosening of monetary policy in the next year and setting a clear end date for net asset purchases would have been justified – also against the backdrop of increasing risks and side-effects, the longer monetary policy remains ultra-loose.

Euro-area monetary policy will remain highly accommodative even after net purchases under the asset purchase programme (APP) have been discontinued.

First, what is crucial for the overall effect of the APP is not so much the amount of monthly additional purchases but, above all, the total outstanding volume of sovereign bonds on our books. And the APP stocks held by the Eurosystem will remain at a very high level even after net purchases have been discontinued, as the Governing Council of the ECB has decided to reinvest the proceeds from the maturing bonds.

Second, the Governing Council has decided not to raise interest rates until well after the net purchases have ended.

Setting a clear end date to net asset purchases would have merely meant refraining from pushing down on the accelerator even further – not putting the brakes on monetary policy.

One thing has to be clear in any case: As Mario Draghi has pointed out: Monetary policy alone cannot bring lasting prosperity for our economies.[2] That is the task of governments and parliaments.

### 3. Economic challenges in Germany

In the wake of the sovereign debt crisis, many member states indeed introduced far-reaching reforms which allowed swifter macroeconomic adjustment. Some of them led to a better labour market performance. And some improved competition, thus providing new impetus for innovation.

But more measures are needed, not least in Germany. The challenges Germany faces might seem more latent than those of other member states. But even if the consequences of an aging society might present themselves less abruptly than a sovereign debt crisis, the challenge is no less real. Without policy action, Germany’s growth potential is expected to fall below 1% within the next decade due to the reduction in labour supply.

It would therefore be sensible to modify provisions that discourage participation in the labour market. To further support the participation especially of women in the workforce, continued investments in childcare remain imperative as well.

However, Germany's growth potential cannot be strengthened simply by limiting the losses in labour supply. Germany's economy also has to become more productive.

Here, digitalisation holds untapped potential. Studies show that removing bottlenecks in broadband connection can raise economic growth, as this increases competition and induces innovative products and processes.[3]

To be able to fully capitalise on the digital dividend, investments in skills and education are key. This would not only boost labour productivity, but also enhance job security. 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, both of which are at the root of our economic prosperity.

By the way, even within the European Union there is not yet a common market for digital products and the single market for services still has to be completed.

## 4. Strengthening the euro area's resilience

Facing economic challenges head-on will not only prove a boon to citizens' prosperity: it will also raise the equilibrium real interest rate. And this will make the job of a central bank substantially easier, as it adds distance to the lower bound of interest rates.

But while raising growth potential in Germany and the other member states will go a long way towards strengthening the euro area, it is not the last word in making our monetary union more resilient.

When it comes to resilience, the question of risk sharing has to be addressed. How can shocks that hit individual member states particularly hard be cushioned?

In the United States and other large currency areas, shocks are spread through the distribution of business profits and losses throughout the currency area, because company owners are often resident in other states. The sharing of losses across state borders in the United States absorbs around 40% of an economic shock.[4]

Saving and lending could represent another channel of private economic risk sharing. Enterprises and households take out loans in different US states during an economic downturn to bridge a slump in earnings. In the United States, this type of risk sharing smoothes something like 25% of a shock. To some extent, this includes a contribution of the Federal Deposit Insurance Corporation to this form of risk sharing. In Europe, however, the conditions for putting in place a similar euro-area-wide deposit insurance mechanism are not yet met. I will come back to this point in a few moments.

By comparison, risk sharing through fiscal policy takes a back seat. Only between 10% and 25% of all risks are shared by a common fiscal policy in federations like the US or Canada.[5]

It is thus clear that much could be achieved in the euro area if cross-border corporate funding were strengthened, particularly in the form of equity capital.

A raft of measures would be needed to tear down the walls in European capital markets. Standardising national insolvency regimes is just one especially important step worth mentioning. After all, investors need to count on having the same level playing field throughout Europe. Not only would that promote private risk sharing; it would also reduce capital flows into less productive businesses and stimulate flows in more productive ones. That, in turn, would boost economic momentum, as a recent OECDresearch paper confirms.[6]

On a general note, the development of equity capital markets, including in Europe, is suffering from the preferential tax treatment given to debt over equity capital.[7]

Interest payments can be deducted from taxable income; equity costs cannot. Eliminating this bias would encourage businesses to make greater use of equity capital as a funding instrument. And that would facilitate greater private risk sharing whilst at the same time reducing the debt bias.

Another way in which risk could potentially be shared in times of crisis might be for enterprises and households to take out cross-border loans. Yet this mechanism hardly worked during the crisis in the euro area. Even worse: Depositors in crisis-hit countries lost confidence in their domestic banking systems and withdrew their deposits. Banks in the euro area also lost confidence in each other and reined in their lending.

The Banking Union was created in part to overcome the financial fragmentation triggered by the sovereign debt crisis. With its Single Supervisory Mechanism and rules on bailing-in creditors in the event of bank failures, the Banking Union bolsters the banking sector’s resilience. This makes a loss of confidence in national banking systems less likely. And less danger of a fragmented financial system stabilises cross-border lending, particularly in turbulent times.

A common European deposit guarantee scheme could, in theory, even heighten this confidence. However, as with any insurance policy, one would have to make sure in this case, too, that the insurance does not encourage imprudent behaviour.

Such risks can arise from carelessly granting credit to the private sector. But they can also result from providing sovereigns with too much credit. Since the onset of the sovereign debt crisis, at the latest, we know that loans to general government are not risk-free either.

Banks in the euro area have a sizable share of sovereign bonds on their books. To insure euro-area bank risks in such a situation would be tantamount to insuring fiscal risks.

Given that the member states themselves still decide freely and independently on the level of government expenditure and taxes, this ultimately sets the wrong incentives: finance ministers would see less of a need to pay adequate attention to the sustainability of public finances.

The precondition for a European deposit insurance scheme, then, is that the size of government bond portfolios that banks hold on their books is limited. Loans to sovereigns should not be treated any differently from loans to enterprises or individuals.

Another precondition concerns the stock of non-performing loans in the European banking system. Insurance usually covers future damage, not damage that already exists. Hence, in order to be eligible for a common deposit insurance, banks in the euro area have to either fully provision for non-performing loans or divest them.

Non-performing loans not only constitute an obstacle to a common deposit insurance scheme. They also weigh on financing conditions and, ultimately, growth prospects in the member states concerned. Banks need to clear up existing non-performing loans. And we need to establish rules that ensure the prudent management of non-performing loans in the future as well. The proposals that were recently made by the ECB in this regard strike me as a sensible way forward.

## 5. Conclusion

Ladies and gentlemen

Let me conclude.

After all, I would not want to evoke the feelings that a doctor once gave to a patient who craved immortality.

The doctor informed the patient that immortality was beyond the reach of medicine, but the patient was insistent: "Is there nothing I can do?" The doctor replied: "Well, there is one thing. You could marry an economist and move to North Dakota." "And that will make me immortal?" "No. But that way, even six months will seem like an eternity."

I thank you for your attention and wish you all a stimulating discussion.

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2 Draghi, M (2015), "Monetary policy and structural reforms in the euro area", Speech from 14 December 2015

3 Czernich et al (2011), Broadband infrastructure and economic growth, Economic Journal Vol 121.

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

5 Allard, C, P K Brooks, J C Bluedorn, F Bornhorst, K Christopherson, F Ohnsorge, T Poghosyan and an IMF staff team (2013), "Towards a Fiscal Union for the Euro Area", IMF Staff Discussion Note, 13/09.

6 Adalet McGowan, M and D Andrews (2016), "Insolvency Regimes and Productivity Growth: A Framework for Analysis", OECD Economics Department Working Papers No 1309.

7 German Council of Economic Experts (2017), "Towards a future-oriented economic policy".