Jens Weidmann: Monetary union – ever a work in progress? The euro area torn between the Maastricht framework and fiscal union

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 21st RWI (Leibniz-Institut für Wirtschaftsforschung) Economic Discussion, Essen, 29 November 2017.

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1. Introduction

Ladies and gentlemen

Many a joker in his time has answered the question "How do I get to the philharmonic hall?" with the punch line "Practice, practice, practice."

As my musical talent would certainly never have got me onto this stage, I am all the more grateful to you, Mr Schmidt, for the opportunity to talk here today about current monetary policy and the architecture of monetary union.

I will be discussing what needs to be done to make monetary union stable, and what role monetary policy plays in this endeavour.

2. Congratulations to Wim Kösters

But first of all, I would like to say a few words about Professor Wim Kösters, who is retiring today. It is a special honour to pay tribute to his long and successful career as an academic, an academic manager and a supporter of young talent.

Mr Kösters, you have been a member of the RWI's Board of Directors since 2003 in your function as an academic manager. It is partly down to you, then, that the RWI ranks among Germany's foremost economic research and policy consulting institutions. The Leibniz Association shared this view in its 2012 evaluation, hailing the work of five out of the RWI's six research areas ratings as "good" to "excellent".

First-rate research and problem-driven policy consulting calls for well-trained and motivated employees who are the brains and soul of any institution. But as we all know, that kind of talent doesn't just spring up like mushrooms. Hence the particular importance of nurturing up-and-coming talent – at the RWI, at the Bundesbank and at the many other enterprises and institutions across Germany.

Bearing that in mind, Mr Kösters, it is greatly to your credit that you have done so much for so many years to foster gifted students and doctorate candidates. You have been a member of the board of the Cusanuswerk scholarship body's gifted education foundation since 2008, as well as its chairman since 2011. Incidentally, there used to be long-standing ties between the Cusanuswerk and the Bundesbank – you took over as chairman back then from Hans Tietmeyer, the former president of the Deutsche Bundesbank. I've had the numbers checked: since you became a member of the foundation's board, more than 3,000 students have been sponsored. And at the RWI, too, you helped to create an environment in which the next generation of academics can reach their full potential. The great many RWI employees who submit their PhD thesis each year attest to your achievements.

And let's not forget the many academics trained personally by you, Mr Kösters, in your chair, among them Professor Ansgar Belke, who will be taking part in the subsequent panel discussion.

That panel discussion will be discussing a topic to which you have devoted yourself as an academic since the 1990s, and one which is close to my own heart: the prerequisites for making monetary union a union of stability.

3. European integration

Ladies and gentlemen, even though today's event is essentially a gathering of economists, there is one point which must not be forgotten when discussing monetary union: namely that the euro was also a political project from the outset. As early as 1949, the French economist Jacques Rueff declared that money would pave the way to European integration. In his own words: "Europe will either be built on money or it won't be built at all."

The unification of Europe after the Second World War was a political vision intended to bring lasting peace and stability to the continent. To put it in the words of Jean Monnet, the great European and winner of the Charlemagne Prize, and whose name your chair, Mr Köster, also bears: "By creating Europe, the Europeans are building a true foundation for peace."

Yet it was the integration of Europe's economies that was a major catalyst for European unification. And this in itself has produced remarkable results. Economic integration – in other words, the elimination of trade barriers and the harmonisation of regulations – boosts prosperity. Free trade enables each of us to specialise in what we're best at. Economies of scale can be harnessed more readily. Plus a bigger market results in greater competition. And this in turn fosters innovative power and productivity.

It is, of course, impossible to say exactly how the economy would have fared in the absence of European unification. The impact of the single market on the prosperity of European states, however, has been considerable. It is estimated that European economic integration has boosted annual economic output by between 5 and 25 per cent.[1] [2] [3] That's a handsome 1,450 to 7,250 euro per capita.

There is no question that economic and monetary union was the boldest step towards deeper economic integration. And at the same time, it was a twin promise: of price stability, and of stronger long-term economic growth.

There is a broad consensus that EMU has so far succeeded in delivering on the first of those promises. I dare say that significantly fewer people would claim that it has done likewise on the second.

For one thing, mounting economic competition across borders has been driving change, just like technological progress has, and many people are afraid of this. If the benefits not just of economic integration but of innovation as well are to be felt by the greatest number of people, the framework conditions also need to be right. Flexible economic structures and a good education system, say, are prerequisites for sustainable growth and for ensuring that many people can share in the opportunities offered by technological progress and international trade, for example.

For another thing, though, the financial and sovereign debt crisis shook the euro area to its core. Taxpayers were forced to step in for billions upon billions of euro in bank losses. Joblessness in some member states rocketed to levels hitherto unseen in the post-war era. To all intents and purposes, European and global institutions became the ancillary government in individual countries. And many saw the rescue packages as the first step on the road towards a transfer union – something which had been categorically ruled out prior to the launch of monetary union.

Many perceived the problems instigated by the crisis to be huge. Some even thought them irresolvable. Indeed, a number of commentators, particularly on the other side of the Atlantic, but elsewhere, too, predicted that the euro would come crashing down.

That didn't happen – and it would have been a disaster if it had. At the same time, let's be honest

– the future might also hold regional or sectoral crises in store which put the euro area to the test. The upbeat economic situation right now shouldn't blind us to the fact that it is one outcome of a very accommodative monetary policy.

The low-interest-rate environment, then, is contributing to an air of deceptive calm which might tempt economic and fiscal policy decision-makers to sit back and do nothing. But if a crisis does materialise, the European house we live in today will need to be sufficiently strong to withstand these headwinds. There is still much to do, if we are to make that a reality.

4. Ensuring the long-term stability of monetary union

One defining characteristic of European monetary union is that, while it has a common monetary policy, it also encompasses 19 largely independent national fiscal and economic policies. This, incidentally, is what makes European monetary union unlike other federal currency areas, such as the United States or Switzerland.

This particular composition does not only make European monetary union unique, it also potentially makes it vulnerable. As the crisis made clear, the euro area as a whole ultimately had no option but to cushion unsound developments in individual member states in order to prevent the stability of the entire monetary union from being jeopardised.

The underlying context is that, if you are not careful, membership in a monetary union undermines the incentive to exercise fiscal prudence. This is because the consequences of excessive debt in one member state can, to an extent, be passed on to the rest of the group.

Mr Kösters, you were not alone in flagging this incentive to run up debt inherent to monetary union early on.[4] When a country in a monetary union takes on debt, the interest rate does not rise quite as sharply as it would have if that country had its own currency. Instead, however, the interest rates in all of the other member states rise slightly.

Economic theory calls this phenomenon the "common pool problem", and overfishing is often used as an example to explain it. A single fisherman who catches too many fish leaves fewer behind for others and ultimately jeopardises the long-term sustainability of fish stocks. Overfishing, then, is detrimental to the fishing community. But, for an individual fisherman, it is highly desirable to net as many fish as possible and not consider the interests of other or future generations of fishermen.

This is arguably one reason why historian and winner of the 2017 Charlemagne Prize Timothy Garton Ash described the story of monetary union so far as a "crisis foretold".

Yet that remark is not really entirely fair to the founding fathers of monetary union, who most certainly did have their eye on the particular incentive to run up debt. Their idea was that a combination of market discipline and fiscal rules would keep budgetary policymaking on a sound basis.

As you know, the Maastricht Treaty contains a no-bailout clause prohibiting member states from assuming each other's debts. The treaty also bans monetary financing of government debt by the Eurosystem. Together, these safeguards aim to ensure that investors themselves – and not other parties such as the taxpayer – bear the risks of investing in government bonds.

In addition, the Stability and Growth Pact includes rules to restrict government debt and budget deficits. These aimed not only to ensure that public finances remain on a sustainable path, but also to create the buffers needed to allow budgets to fluctuate over the economic cycle and to enable member states to take countermeasures during economic crises without being forced to call for external aid to fend off looming overindebtedness.

These rules form the principle of national fiscal responsibility. This is the foundation of the Maastricht framework.

Walter Eucken, a founder of the Freiburg school and pioneer of the social market economy, summed up this liability principle as follows: “Whoever reaps the benefits must also bear the liability."

And what goes for the economy goes for countries as well: decisions will only ever be taken responsibly if those who decide also bear responsibility for the consequences of their actions.

Thus, the Maastricht Treaty largely assigned the power to act and liability in matters of economic and fiscal policy to the member states.

And yet, government debt in some euro area countries has risen significantly. One reason for this is the repeated breaches of the budgetary rules – even by Germany, incidentally, at the very beginning of monetary union. Capital markets, contrary to initial expectations, also did not punish these infractions by imposing higher risk premiums. The no-bailout clause, it seemed, lacked credibility.

But another reason for the ballooning debt levels was undoubtedly the financial crisis, which forced euro area countries to shore up their banking systems. This was another reason why doubts emerged over the sustainability of some member states’ debt in the subsequent sovereign debt crisis. Rescue measures were swiftly rolled out to prevent the crisis from escalating.

This episode showed that it might be wise for the euro area, too, to have a lender of last resort to support countries facing exceptional circumstances in order to limit the negative fallout for the currency area as a whole.

Hence the establishment of a permanent safety net in the form of the European Stability Mechanism (ESM). Its financial assistance allows distressed sovereigns to bridge temporary liquidity bottlenecks and put government finances back on a sustainable footing. This is why countries are required to commit to reforms so that they can put their finances back in order as soon as possible.

However, not even the financial assistance programmes have made monetary union crisis-resistant for good. For all their benefits, they added further elements of mutual liability and softened the principle of independent accountability. At the same time, economic and fiscal policy remained a national matter. The balance between actions and liability for their consequences, then, had got out of kilter.

The euro area will only ever be made crisis-proof once and for all if the balance between action and liability is restored. There are two ways in which this can be achieved. Either through deeper integration, ie a situation in which every member state surrenders decision-making powers in fiscal and economic policy matters to the European level, or by returning to an overhauled Maastricht framework. In the latter case, euro area countries would once again bear greater liability for their own decisions.

The first solution is the road to fiscal union with centralised decision-making powers. Admittedly, fiscal union would not guarantee fiscal prudence, and permanent guide rails would need to be added as a matter of stability policy, though it could curb the aforementioned propensity to run deficits.

This is why it was obvious to many economists, even before monetary union was launched, that, in the long term, monetary union must go hand in hand with political union. One of those economists was you, Mr Kösters. In 1994, you wrote: “It should first of all be clear that in the long run the EMU can only exist if accompanied by a European Political Union."[5] German Chancellor Helmut Kohl held a similar view. Addressing the Bundestag in November 1991, he remarked that "the idea of sustaining economic and monetary union over time without political union is a fallacy".

True political union proved unfeasible back then, however. It seems to me that not much has changed in this regard, not least because the necessary transfer of sovereign rights would require comprehensive changes to the EU Treaty and national constitutions.

That would suggest that option number two currently stands a more realistic chance of restoring the balance between actions and liability. It essentially means bolstering the principle of independent national responsibility. Only when public finances are put on a sound footing and countries stop drifting apart economically will the Eurosystem ultimately be relieved of the pressure to constantly intervene as a firefighter. And only then will the financial markets do their job of taking adequate account of risks in their lending activities.

But what would have to change for monetary union's regulatory framework to function better than it has done in the past?

To paraphrase Johann Wolfgang von Goethe: "Easier said than done." Goethe was not just a poet, but also finance minister for the Duchy of Saxe-Weimar-Eisenach. Whether or not this bon mot summed up his experiences in fiscal policy is unclear, however.

In any case, his remark holds true for the fiscal rules in the euro area: established with the best intentions, but rarely adhered to consistently. The European Union's budgetary and debt rules have been reformed over and over again. But that did not make them any stricter, to put it mildly. I have already mentioned that not even Germany set a shining example in the early days.

The latest reform of the Stability and Growth Pact originally set out to strengthen the binding force of the rules on debt. As it turned out, that reform created considerable discretionary scope, mainly for the European Commission. We also drew attention to this in our June Monthly Report.[6] The Commission has already exploited this leeway on several occasions and invariably interpreted the rules very liberally in doing so.

The Commission's dual role as the guardian of the EU Treaty on the one hand and as a political institution on the other is undoubtedly a factor in the repeated compromises made at the expense of budgetary discipline. After all, as a political institution, the Commission must always strive to strike a balance between the various political interests of the member states. The outcome is that individual euro area countries have breached the budgetary rules ever since the financial crisis erupted.

Austrian comic Werner Schneyder once accurately characterised the situation as follows: Europe, he quipped, is made up of countries that do not want to be told to do what they have decided to do themselves.

4.1 Reinforce the binding effect of fiscal rules

What is needed to reinforce the binding effect of the fiscal rules is a straightforward and transparent design and implementation of the rules. An independent institution taking over responsibility for fiscal surveillance from the Commission would be a key step towards a less political approach. That would be a clear marker where unbiased analysis ends and political concessions begin. That is why one of the Bundesbank's suggestions is to strengthen the role of the ESM in matters of fiscal surveillance.

One thing does seem obvious to me, however. If member states retain fiscal autonomy, the sustainability of public finances cannot be safeguarded by rules alone.

This is why it is not just the binding force of the rules that we need to strengthen; we also need the disciplining effect of the market, just as the founding fathers had envisaged of the monetary union. In other words, interest rate levels have to be aligned more strongly again with the risks in government budgets.

That can only be achieved, however, if the credibility of the no-bail-out clause in the Maastricht Treaty is restored. Investors need to be under no illusion that they risk losing their money if they buy bonds from governments that have unsound public finances.

This is another reason why I take a critical stance of the Eurosystem's government bond purchases, because they weaken the market mechanism which prices sovereign solvency risk. This ends up blurring the boundaries between monetary policy and fiscal policy. And yet a clear division of responsibilities is vital for a stability-oriented monetary policy in the euro area if Eurosystem central banks are not to wind up dancing to the tune of fiscal policymakers. This is why I called for a quick end to government bond purchases at the end of October.

4.2 Automatic ESM maturity extension

And this is also why one of the proposals put forward by the Bundesbank envisages changing the contractual terms for government bonds in the euro area. In future, the maturities of a country's bonds ought to be automatically extended as soon as the country applies for financial assistance.

Under the existing procedure, remember, a large part of the assistance loans go towards paying off legacy creditors. This lets those legacy creditors, such as banks, off the hook – at the expense of taxpayers. Extending maturities, on the other hand, would leave them on the hook, and they could be still held liable if debt is restructured down the line. In an emergency, it can be very difficult to tell for certain whether a debtor is temporarily illiquid or actually insolvent. An automatic extension of maturities, however, would grant the ESM far more time to give careful consideration to the question of debt sustainability – and without releasing legacy creditors from liability during this period.

A maturity extension would have the added advantage of substantially reducing the need for financial aid under an ESM programme. This would also broaden the reach of the existing rescue mechanism. Had we already been able to automatically extend maturities by three years back in 2011, say, Portugal would have only needed around €43 billion by 2014 instead of the total of €76 billion it received in financial assistance.

I am also convinced that when it comes to resolving future crises in the euro area, the IMF will arguably play a far less prominent role and could, at most, be involved in an advisory capacity. So this increased clout would certainly be helpful.

Incidentally, the ESM stands for a substantial form of fiscal solidarity. ESM chief Klaus Regling has said that an ESM loan costs two-thirds less than an IMF loan because the ESM – unlike the IMF – does not charge a risk mark-up for its loans. In the case of Greece, for instance, the saving comes to 5.6% p.a. of its GDP.

This is an major transfer to governments in need of assistance. But they are not permanent transfers and they are tied to strict conditionality in order to eliminate as much moral hazard as possible. Permanent direct transfers are not necessary in a functioning currency area, as the United States demonstrates. Quite the opposite, in fact: dividing agents into transfer providers and transfer recipients risks undermining public acceptance of monetary union in individual member countries.

Ladies and gentlemen, the proposed automatic extension of maturities will only boost the disciplinary role of capital markets if restructuring sovereign debt really is a realistic option. But that will only ever be the case if the financial system really can absorb a haircut, because if a haircut brought the financial system to its knees, the community of states would still have an incentive to bail out private creditors.

Politicians and supervisory authorities in the euro area have, on more than one occasion, faced the following paradoxical situation: a haircut for overindebted countries drags down the banking system with it. But if banks carrying government bonds at risk of default on their books are resolved, the necessary rescue measures will plunge the country into financial distress once and for all.

This reminds me a little of the novel Catch-22 by Joseph Heller, in which a “catch-22” is an intolerable situation where every apparent alternative only draws the protagonists ever closer towards their fate. In Heller’s novel, it’s the contradictory rules that put the American soldiers into an absurd situation.

In the euro area, it was primarily the lack of rules regarding this dilemma that was pivotal: there was no rule which stated that, if the worst comes to the worst, it was mainly up to the investors and creditors to shoulder banks’ losses, and not taxpayers.

This is also precisely what makes the new European regime for bank resolution, and its rigorous application, so very important. Because these are the rules which stipulate that if a bank needs to be wound up, investors and creditors will be first in line to bear the ensuing losses. Only after that does a resolution fund financed by banks step in.

Add to that the close-knit sovereign-bank nexus in the euro area, as evidenced by the huge stocks of government bonds which banks hold on their balance sheets. This is why it is not enough to just focus on bank resolution.

4.3 Abolish preferential treatment of sovereign bonds

It would be enough to curb banks’ appetite for government bonds to force them to treat sovereign exposures on their books in exactly the same way as private ones.

Because, unlike in the case of corporate bonds, banks are not required to back government bonds denominated in domestic currency with capital, nor do they have to comply with any ceilings or caps. This is the case irrespective of the issuing sovereign’s credit rating quality – and even though the euro area debt crisis made it quite plain that government bonds are by no means risk-free.

Only when banks hold sufficient capital against government bonds and limits are placed on the size of individual exposures will banks be able to cushion a restructuring of sovereign debt. And only then will there probably be the political will needed to take this step.

The Bundesbank has put the topic of abolishing the preferential treatment of government bonds on the agendas of international committees. But the talks, particularly on the Basel Committee on Banking Supervision, are not straightforward. That’s why it’s now vital that we give the issue greater prominence on the European committees and make headway there.

Ladies and gentlemen, toughening the fiscal rules, abolishing the preferential treatment afforded to government bonds, and automatically extending the maturity of sovereign debt are three important reforms. They can play a part in putting monetary union on a sound long-term footing.

These proposals put the shine back on the principle of individual fiscal responsibility – which is the key feature of the Maastricht framework.

At the end of the day, any proposals on the future direction of monetary union need to be assessed according to how they impact on the necessary alignment between actions and liability.

In a recent speech which garnered a great deal of attention, French President Emmanuel Macron put forward his vision for advancing the European project, suggesting that more policy areas could be communitised – that is, transferred to Brussels and thus funded jointly.

Such proposals are no substitute for strengthening individual national responsibility in the euro area. Nor, by the same token, do they have to be at odds with the principle of individual responsibility. Indeed, it is quite possible that issues like preventing climate change, securing external borders and developing common communications, energy and transport networks can be handled more efficiently at the European rather than national level.

5. Monetary policy

Ladies and gentlemen

One policy area that we all know has long been dealt with collectively at a euro area level is monetary policy. And, as far as monetary policy is concerned, I can kick off the last part of my speech with some good news. The euro area is experiencing an ever more robust economic upturn which has continued unabated over 17 quarters and spread to all euro area countries.

And this trend looks set to continue for a while yet. In September the ECB’s economists raised their forecasts for 2017 economic growth to 2.2%. And they are anticipating growth rates of around 2% for the next two years as well.

An updated forecast will be released in two weeks’ time, as is customary in December, and that will be based on detailed country projections. At the moment, there is good reason to believe that the economic outlook will be just as upbeat then, if not even better. At the very least, several short-term indicators have made for surprisingly positive reading.

And the economic situation in Germany is looking exceptionally good, too. Employment levels are at their highest since reunification, business and consumer sentiment is splendid, and the Ifo business climate index has even hit a new record high. And, going by the latest economic indicators we have received, the difficulties Germany is experiencing in forming a government are showing no signs of markedly dampening the mood.

The economic recovery we’re seeing in Germany and in the euro area is benefiting in part from the Eurosystem’s exceptionally accommodative monetary policy. This monetary policy stance was the ECB Governing Council’s response to the subdued inflation outlook.

One of the reasons behind the muted rate of price inflation is that some euro area countries are still in the process of remedying the loss of competitiveness which played a role in triggering the euro area crisis. But improving price competitiveness generally also means greater wage moderation.

The ECB Governing Council initially responded to the weak price pressures by cutting its policy rates. Once it had cut its rates to 0%, it then started to roll out a host of non-standard measures in an effort to loosen up monetary policy still further.

Since March 2015, these measures have included the Eurosystem’s large-scale purchases of sovereign and corporate assets, currently at a monthly pace of €60 billion per month. From January this will fall to €30 billion a month – with purchases continuing until September 2018, if not longer. As you know, these purchases have been hotly debated, particularly in Germany. And you are no doubt also aware that I myself view these purchases with scepticism, too.

The Eurosystem has now become the largest creditor of the euro area countries. This means that governments’ financing conditions hinge much more directly on our actions than in times of normal monetary policy. My concern, therefore, is that the ECB Governing Council could end up facing political pressure to keep rates low for longer than is justifiable from a strictly monetary policy perspective.

Ladies and gentlemen, my reading of the ECB's projections, however, is that domestic price pressures in the euro area are gradually building and that the projected path is quite consistent with our definition of price stability.

For if there is one thing that is clear, it's that even after net purchases have been discontinued, euro area monetary policy will remain highly accommodative.

October's monetary policy decisions even mean that our foot is still on the accelerator as far as monetary policy is concerned, just not quite so hard as before. Given the favourable economic outlook and the pick-up in prices, a somewhat less accommodative monetary policy stance would also have been justifiable, in my view.

6. Conclusion

Ladies and gentlemen

I've spoken a lot today about how the euro area is managed – its institutional order – and about monetary policy. On the subject of order, the physicist Georg Christoph Lichtenberg once said that "order leads to all virtues, but what is it that leads to order?" Today, I've endeavoured to make the answer clear in the context of the euro area, with the help of various reference points. In essence, the solution lies in ensuring alignment – though since we are in a philharmonic hall, perhaps I should say harmony – between actions and liability. In debates about the future of monetary union I will make sure that this fundamental harmony is not forgotten.

Ladies and gentlemen, I hope you have a stimulating panel discussion. And to you, Mr Kösters, may I wish you all the very best for your upcoming retirement.

Thank you.

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