Jens Weidmann: Monetary and economic policies on both sides of the Atlantic

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 GIC/SUERF/Deutsche Bundesbank Conference "Monetary and economic policies on both sides of the Atlantic", Frankfurt am Main, 8 February 2018.

* * *

1 Introduction

Ladies and gentlemen

Alfred Nobel once said, “One can state, without exaggeration, that the observation of and the search for similarities and differences are the basis of all human knowledge.”

A conference that discusses “monetary and economic policies on both sides of the Atlantic” naturally takes that perspective of seeking out similarities and differences. This, together with the impressive cast of eminent academics, policymakers and financial market participants assembled today, further strengthens my belief that this conference is a true font of knowledge. It is therefore a great pleasure to have you all here at the Bundesbank’s regional headquarters in Frankfurt.

In my remarks today, I will try to take Nobel’s wisdom to heart as well. What can be learned by discerning the similarities and the differences in monetary policy on either side of the Atlantic? Specifically, what insights does the American experience provide for the European monetary union? And what idiosyncrasies of the euro area might require it to chart its own course?

To me, the comparison might prove instructive with regard to three dimensions in particular.

First, the US is further along in its business cycle, and therefore its monetary policy cycle, than the euro area. But while this is a difference, it may actually allow us to look out for possible similarities – similarities in terms of the appropriate point in time to normalise monetary policy.

Second, the institutional set-ups of the US and European currency areas differ. The Federal Reserve System is the central bank of one country with only one central government. In the European monetary union, a common monetary policy is combined with 19 different national fiscal and economic policies. This institutional difference makes for a difference in the cost-benefit analysis of the policy options.

Third, the euro area economy is more heterogeneous than the US economy. This makes the job of the Eurosystem more complicated. Are there lessons to be learned from the US that would allow for a more even economic development in the euro area? I am confident that the answer is yes – but it might not be the answer that would readily suggest itself.

2 Current monetary policy

But let me start by looking at the current economic developments in the euro area.

The euro area has so far enjoyed four and a half years of continuous economic growth. As Mario Draghi pointed out recently, what started out as a recovery is now a fully-fledged expansion. It is robust and broad-based, with most countries and sectors posting positive growth figures.

As a result, the euro area grew even faster than the US economy last year. After years of challenges, the euro area is now driving global growth, not dragging it down. And indicators show no sign of growth abating anytime soon.

In many respects, the euro area economy might be further along now than the US economy at the time the Fed ended its net asset purchases. The euro area output gap of 0.5 % for 2017, as estimated by the OECD, is considerably smaller than the US output gap of 2.5 % in October 2014. And at that time, the OECD believed the output gap to be even higher, at 3.1 %. This suggests that the euro area economy might utilise its resources more fully now than the US economy did when the Fed ceased its net asset purchases.

Inflation, however, has not kept pace with economic expansion. Domestic price pressure, measured by core inflation (excluding energy and unprocessed food), stands at 1.2 % in the euro area today. By contrast, when the Fed ceased its net asset purchases, US core inflation was 1.8 %.

What is behind the sluggish price developments? Multiple factors seem to be at play here. The euro area recovery has certainly been aided by countries strengthening their competitiveness and turning their current account deficits into surpluses. But improving price competitiveness through wage restraint is, naturally enough, also dampening domestic price pressures.

In parts of the euro area, migration from EU member states not participating in the euro might have played a role as well. In Germany, for example, migration from the non-euro-area member states has eased labour market tensions. This has dampened wage pressures and, in turn, inflation dynamics.

But the euro area is by no means unique in having an inflation rate that is lower than indicators of economic slack suggest. It seems to be a rather widespread phenomenon, characteristic of the current situation in the US, the UK, Japan and Sweden, for example. In the US, unemployment is the lowest it has been since the year 2000, but core inflation stands at 1.8 %, and the Fed's preferred measure of inflation, the index of personal consumption expenditure, stands at 1.5 %.

This suggests that the factors responsible for holding back wage growth are not only idiosyncratic, but international as well. Recent research by the Bank for International Settlements, for example, suggests that the increased contestability of labour markets via the proliferation of global value chains puts a lid on wages and, thus, on prices.[1]

Given the rather subdued inflationary pressure at present, an accommodative monetary policy stance remains appropriate in the euro area. And even after the net purchases have ended, the monetary policy stance will remain loose. However, the favourable economic outlook lends credence to the expectation that wage growth and therefore domestic price pressures will gradually increase in keeping with a path towards the Governing Council's definition of price stability.

The recent pay agreement in the metalworking and electrical engineering industries in Germany is consistent with this picture. Not only is it in keeping with the expectations we based our forecast on: in my opinion, it also demonstrates that the Phillips curve does by all means have informative value where Germany is concerned.

To cut a long story short: If the expansion progresses as currently expected, substantial net purchases beyond the announced amount do not seem to be required.

The recent appreciation of the euro seems unlikely to jeopardise the expansion, by the way. In fact, it is – at least in part – rather a reaction to the brighter growth prospects of the euro area. Besides, recent research suggests that the exchange rate pass-through, which is to say the impact of exchange rate movements on inflation, has declined. But, of course, we will monitor closely any impact foreign exchange rate movements might have on our primary target of price stability.

Nor should we allow ourselves to become unsettled by the decline in equity prices we have just witnessed. US equity prices rose over a prolonged period without any notable corrections, which was unusual given that valuations have been high overall.

Large-scale purchases of sovereign bonds are not the only unconventional monetary policy tool used. Communication in general, and forward guidance in particular, is now a monetary policy tool in itself, geared towards the evolution of long-term rates.

In this regard, BIS Chief Economist Hyun Shin recently recommended central banks that when trying to shape rates through communication, they should avoid reading too much into the development of market rates. Otherwise, "they could find themselves in an echo chamber of their own making, acting on market signals that are echoes of their own pronouncements."

If central banks are to use communication as a policy tool, they must not shy away from necessary guidance for fear of market backlash. Otherwise, communication can become circular. He added: "The more the central bank whispers in order not to upset markets, the more market participants lean in to hear better."

3 Monetary policy and EMU's institutional set-up

Ladies and gentlemen

While communicative independence is important, it is not the only form of independence crucial for monetary policy – especially for a monetary policy combined with 19 different national economic and fiscal policies.

When the ECB presented its OMT programme geared towards eliminating redenomination risk in the euro area, commentators like Paul Krugman applauded the decision, stating that by acting in effect as a lender of last resort to governments, the "ECB is finally doing its job as a central bank". The decision on the PSPP, the Eurosystem's large-scale purchases of sovereign debt, has been met with similar approval as well.

Nevertheless, some in the euro area have also been sceptical of sovereign bond purchases. As you may have heard, I would count myself as one of them.

Are the sceptics exaggerating the risks involved? Are they perhaps victims of what Freud has called the "narcissism of small differences", seeing differences for the sake of being different? Or are the differences indeed substantial with regard to our capability to fulfil our primary target: to maintain price stability?

I would argue that yes, they are substantial. Government bond purchases by central banks involve the fundamental risk of mutualising sovereign liability risks through the central banks' balance sheets.

While this risk can be safely ignored for countries with their own currency, it can be a major problem for a monetary union – especially for one which, like the European monetary union, is not a fiscal union.

At the end of the day, it could introduce common liability through the back door. And in this regard, it's up to elected governments and parliaments to make such far-reaching decisions.

In contrast to the OMT programme, the large-scale sovereign bond purchases currently being conducted take into account some of these concerns.

Only a small part of the programme is subject to risk sharing among the central banks of the Eurosystem. Additionally, the Governing Council decided on limits for the Eurosystem's purchases of individual bond issues and for its overall purchases of debt of any individual country. This is designed to ensure that governments continue to rely on the capital markets for their funding.

These measures make the QE programme less problematic than earlier sovereign bond purchase programmes that aimed to reduce the risk premiums of individual countries.

Nonetheless, one important risk of sovereign bond purchases remains. The national central banks have become the most important creditors to their governments, which might ultimately put the independence of monetary policy at risk.

Exiting its ultra-loose monetary policy would influence governments' financing conditions much more directly than our conventional monetary policy instruments. And the pressure might rise on the Eurosystem to keep funding costs low in order to ensure the sustainability of public finances.

If one adjusts the recent deficit figures for the currently favourable business cycle, one cannot fail but see that consolidation has in effect stalled in the euro area member states. The European Commission expects practically no improvement in the structural balance this year and next. And there is the risk that the current low interest rates might make public finances appear to be in better shape than they actually are. High public debt ratios can become a burden when interest rates begin to rise again.

In the European monetary union, however, fiscal discipline is absolutely essential.The set-up of the monetary union can further compound the tendency of governments to finance their spending through debt, as the consequences of bad policy choices can more easily be externalised to neighbouring countries.

4 Monetary policy and heterogeneity

Ladies and gentlemen

When comparing US and European monetary policy, the institutional set-up is not the only difference that springs to mind. In the euro area, monetary policy is complicated by a higher degree of heterogeneity compared to the US.

Let's take unemployment: in the euro area, the weighted standard deviation of member states' unemployment rates from 2009 to 2017 is 5.7 percentage points. In the US, the weighted standard deviation is only 1.2 percentage points for the same period.

Heterogeneity was higher pre-crisis as well, at 2.2 percentage points from 1999 to 2008, compared to 0.8 percentage point in the US.

A common monetary policy in a currency union means that one size has to fit all – the greater the heterogeneity, the less well it will fit the respective member states. This reduces overall economic welfare. How, then, might heterogeneity be lowered?

Macro-prudential policies are one option. They can be deployed against regional and sectoral pockets of exuberance, in case they are suspected to pose a systemic risk. Possible instruments include higher risk weights for certain asset classes, or loan-to-value ratios that raise equity requirements for a mortgage. Some euro-area countries have indeed taken macro-prudential measures to counter a strong increase in mortgage loans fuelling the ongoing rise in housing prices. And preventing certain sectors or regions from running hot will help to reduce overall economic volatility as well.

First and foremost, however, national economic and fiscal policies need to be tailored adequately to ensure that economic developments do not diverge too much. Countries experiencing a cyclical boom should run a tighter fiscal policy, and countries experiencing a slump should loosen it. But for this to happen, countries need the requisite fiscal space. This is why it's imperative to adhere to the fiscal rules over the cycle.

Structurally, flexible labour markets are another prerequisite of a well-functioning monetary union. The higher the labour mobility within and across member states, the better fit a common monetary policy will be. Robert Mundell was awarded the Nobel Prize for this insight, aptly enough on the occasion of the launch of European monetary union in 1999.

His first theory of optimum currency areas emphasised the necessity of capital and labour mobility. Economists like Peter Kenen later expanded on his work. In particular, they stressed the importance of risk sharing via fiscal and other means for a currency to work smoothly.

And it is here, in my opinion, that the differences between the United States and the euro area are instructive as well.

In the United States, shocks are spread through the distribution of business profits and losses throughout the currency area, because company owners are often residents in other states.

Another channel of private economic risk sharing is through saving and lending. Enterprises and households take out loans in different US states during an economic downturn to bridge a slump in earnings. Risk sharing through fiscal policy takes a back seat by comparison. Only 10 % to 25 % of risks are shared by a common fiscal policy in federations like the US or Canada.[2] It is private means of risk sharing that bring the overall risk-sharing level to about 80 %.

It is important to note that the rainy day funds in place in many US states do not constitute a fiscal risk sharing scheme between the individual states, either. Many US states are strictly forbidden to incur debt. Thus, they set budget surpluses aside in a rainy day fund to be used during an economic downturn. And every state is using only its own fund.

In the euro area, the fiscal rules permit individual member states with sound public finances to take effective fiscal measures against cyclical downturns or crises, without breaching the fiscal rules or having to resort to outside assistance. This makes the potential benefits of a rainy day fund less relevant for us.

Clearly, much could be achieved in the euro area by strengthening cross-border corporate equity funding. To tear down the walls in European capital markets by standardising national insolvency regimes is, in my view, just one particularly important step. Investors need to be able to count on a level playing field existing throughout Europe. Not only would that promote private risk sharing; it would also reduce capital flows to less productive businesses and stimulate flows to more productive ones. That would boost economic momentum, as OECD research confirms.[3]

What is more, the development of equity markets, including in Europe, is suffering from the preferential tax treatment given to debt over equity capital.[4]

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

I mentioned earlier that another way in which risk could potentially be shared might be for enterprises and households to take out cross-border loans in times of crisis. Yet this mechanism hardly worked at all during the crisis in the euro area.

One of the steps taken in Europe to prevent the repetition of a financial crisis was to create the Banking Union. 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 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 cover losses which have already occurred, like bad loans already on banks' books, and that the insurance does not encourage careless behaviour in the future.

Unlike banks in the United States, 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.

One precondition for a European deposit insurance scheme, then, is that the size of government bond portfolios that banks hold on their books is limited.

Doing away with concentration risks of sovereign bonds in banks would be a boon to monetary policy as well. During the crisis, monetary policy transmission was hampered by these large and undiversified sovereign bond portfolios. Potential losses on these portfolios were draining banks' equity buffers. The banks in question were therefore unwilling to lend and to pass on the low policy rates to companies and households.[5][6]

In order to shield an economy from a sovereign in trouble, banks must be restrained in taking on government debt.

5 Conclusion

Ladies and gentlemen

Alfred Nobel never envisioned a Nobel Prize for Economics. On the contrary, he once wrote in a letter that he did not have an economic education, and that he hated it with all his heart. No wonder economics is dubbed the "dismal science".

Obviously, I do not share Nobel's sentiment. On the contrary, I am firmly convinced that a social science that is based on transparent assumptions and is thoroughly steeped in data is of immense benefit to all of us.

But I am equally convinced that a conference like today's, that sets out to discern similarities and differences, would have met with approval, even in the eyes of Alfred Nobel.

Thank you for your attention.

---

[1] Auer R, C Borio and A Filardo (2017), "The globalisation of inflation: the growing importance of global value chains", BIS Working Papers 602, Bank for International Settlements.

[2] Allard, C, P K Brooks, J C Bluedorn, F Bornhorst, K Christopherson, F Ohnsorge, T Poghosyan and an IMF staff team (2013), IMF Staff Discussion Note, 13/09.

[3] Adalet McGowan M and D Andrews (2016), "Insolvency Regimes And Productivity Growth: A Framework For Analysis", OECD Economics Department Working Papers No 1309.

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

[5] Panetta, F. et al. (2009), "The impact of sovereign credit risk on bank funding conditions", CGFS Papers, No. 43, July 2011.

[6] Albertazzi U, T Ropele, G Sene and F M. Signoretti (2012), "The Impact of the sovereign Debt Crisis on the Activity of Italian banks," Bank of Italy Occasional paper, No. 133.