Jens Weidmann: Fresh momentum for Europe

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, upon acceptance of the Grand Decoration of Honour in Gold with Star for Services to the Republic of Austria, Vienna, 26 March 2018.

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1. Welcome and thanks

Ewald

Members of the General Council and the Governing Board of the Oesterreichische Nationalbank

Ladies and gentlemen

I would like to give you my heartfelt thanks for presenting me with the Grand Decoration of Honour in Gold with Star for Services to the Republic of Austria, and to thank you, Ewald, for the very kind words. I truly feel very honoured to receive this medal.

Monetary stability in the euro area, and the prerequisite for this – a monetary union with an enduring focus on stability – are the guiding objectives for our work on the ECB's Governing Council. And I'm delighted that my contribution to this has been recognised here, too. This year, Austria is celebrating not only the 100th anniversary of the Republic's establishment, but also the 40th anniversary of the "Miracle of Córdoba", Austria's legendary 3:2 victory over the West German team at the FIFA World Cup in Argentina. The 21 June 1978 went down in German football history as the "Disgrace of Córdoba", which just goes to show that one and the same event can be viewed very differently through the national lens. Of course, it's perfectly acceptable to take a national view when it comes to football. What is more problematic, though, is when decisions affecting Europe or the euro area are judged solely from the national perspective.

When Ewald Nowotny and I take part in monetary policy discussions on the ECB Governing Council, we each bring to bear our national expertise, our body of experience and our monetary policy stance; not so we can promote national interests, but to create sound monetary policy for the euro area. The other members of the ECB Governing Council equally take this responsibility for the euro area as a whole as their touchstone. That certainly doesn't mean that we always have to agree on all issues. Quite the contrary, in fact. I consider a diversity of opinions to be an advantage. At any rate, it can't be wrong to discuss the correct path, as long as everyone is agreed on the objective.

As a national politician, it is no doubt more difficult to avoid viewing the European discussions from the standpoint of one's home country. By virtue of their office and mandate, their first commitment is to their country's prosperity, and the trick is to synthesise the sometimes divergent national interests into a European whole. These dialectic abilities are particularly needed in the negotiations about a new European financial framework. I would consider it a mistake, however, to reduce the discussions surrounding the EU's financial framework to the issue of net payments to the EU budget. It would make more sense to first clarify which tasks the European Union is to take on in future, which tasks it might be possible to return to the member states, and where savings could be made.

Exactly six months ago, the French President, Emmanuel Macron, gave a speech at the Sorbonne calling for the communitisation of a host of policy fields, such as defence, securing external borders, and climate protection. Joint responsibility in those fields can certainly be justified economically.

A renowned expert in public finances once put it this way: “In keeping with the principle of fiscal equivalence for the creation of public goods, the existence of both positive and negative interregional external effects leads to macroeconomic inefficiency.”[1] What Ewald Nowotny, from whose textbook this sentence is taken, is saying is that when a policy’s impact goes beyond national borders, it can make sense for responsibility to be shared. Clarifying how these joint responsibilities are to be funded should be the second step.

The national perspective and the extent of national responsibility also play an important role in the debate about the institutional reform of monetary union. The special, asymmetrical design of monetary union – a single shared monetary policy paired with national sovereignty over fiscal policy – has proven to be susceptible to unwanted developments and crises. Yet there is still very little willingness to relinquish national sovereignty to the European level. This asymmetry will therefore be retained for the time being, and we will have to find ways of making monetary union even more stable in this configuration, too. Monetary union as a whole and its member states are thus facing challenges of a short, medium and long-term nature. The good news is that, after the end of the crisis and given the robust upswing, the starting conditions are better than they have been for a long time.

One of the challenges that should be overcome relatively quickly is ending the Eurosystem’s net asset purchases, without this causing distortions in the financial markets. In the medium term, monetary policy, like the inflation outlook, has to be normalised, thus winning back scope for monetary policy manoeuvring. The objective of making the regulatory framework of monetary union crisis-proof can only be achieved in the medium to long term, even if important groundwork is laid even earlier. And in the long term, the member states will be tasked with managing demographic change and creating the conditions for more economic growth and participation in that growth.

I’d like to go into a little more detail about the near and distant challenges facing the euro area and begin with the reform of monetary union.

2. Challenges facing the euro area

The debate began some years ago, and compared with 2010, when the euro area was firmly in the grip of the crisis, we are already in a much better position. In particular, the euro area has been made more stable by the creation of the European Stability Mechanism and the establishment of a banking union, but also by the new macroprudential supervision regime. In other words, a similar shock to the Greek crisis would no longer find the euro area in such an unprepared state, nor would it spread as easily to other countries. But the euro area isn’t yet permanently crisis-proof. And that’s why it’s good that President Macron’s proposals, and those of others, have given the debate fresh momentum. The Bundesbank, too, has long been contributing constructive proposals to the debate.

Though they may come in different guises, most of the ideas presented recently boil down to expanded joint liability and risk-sharing. In particular, fiscal risk-sharing is said to be a key instrument to cushion country-specific shocks.[2] Specifically, one proposal is for the creation of a common stabilisation facility which would grant funding to the countries hit by such shocks.

But do we need an additional buffer like this?

National fiscal policy can already absorb shocks via automatic stabilisers and, if necessary, discretionary measures – if public finances are sound, as the mutually agreed Maastricht framework requires and aims to safeguard. In cases of severe distress, the ESM grants financial assistance subject to conditions. And private forms of risk-sharing can also cushion country-specific shocks, quite without additional fiscal facilities. If enterprises increasingly find capital providers or lenders from other euro area countries, the negative effects of country-specific shocks will be distributed more evenly across the currency area. Equity capital, in particular, makes an excellent buffer, as the alternative forms of financing – bonds and loans – have to be serviced in full even in economically difficult times. Because of this, if nothing else, I consider the creation of a European capital markets union to be an enormously important project.

If politicians nonetheless opt for increased fiscal risk-sharing, I believe sovereignty rights would have to be surrendered in exchange. After all, joint liability must come with the option of co-determination. Otherwise, there would be the risk of misguided incentives. I don't need to explain the practical relevance and occasional topicality of this connection to listeners from member states with a federal structure such as Austria and Germany.

It would be a false signal, which would threaten to discredit the proposed European risk-sharing mechanism from the outset, to now mutualise risks that arose under national responsibility. That's why, ahead of any fiscal backstop for the Single Resolution Fund or a common deposit protection scheme, it's important that we first make significant progress in getting rid of legacy risks.

Legacy risks include the outstanding stocks of non-performing loans on banks' balance sheets, especially those not covered by loan loss provisions. On average, it would appear that European banks have done little to significantly increase their coverage ratio for losses arising from non-performing loans over the years. It's also worth taking a closer look at the overall stock of non-performing loans. While the average non-performing loan ratio has fallen by around one-third in Europe since 2014, there are two things to bear in mind. First, we are observing a decline from the very high level recorded in the post-crisis years – compared with pre-crisis levels, we still have some way to go. For instance, the average non-performing loan ratios of six euro area countries remain in double-digit territory. To put that into proportion, the share of non-performing loans in the United States and Japan stood at around 1.5% in 2016.

Second, individual member states are the driving force behind much of the risk reduction achieved so far. For example, Ireland and Spain have been able to significantly shrink their high stocks of non-performing loans. By contrast, other countries' high ratios have remained all but unchanged. In other words, we have yet to find a solution to the fundamental problem of non-performing loans being distributed unevenly, with some countries being much harder hit than others.

Incidentally, reducing risk isn't just about addressing the legacy of non-performing loans – it's also about adopting structural measures to prevent similarly excessive risks from accumulating on European banks' balance sheets in the course of future crises. Measures unveiled by the European Commission and the ECB in mid-March to improve provisioning for non-performing loans could play a role here in future.

But the stocks of government bonds on banks' balance sheets – which, due to a regulatory exemption, are backed by little to no capital and are not subject to caps – are also problematic. This has created a nexus between the solvency of banks and that of their home governments which is much more pronounced now than it was prior to the crisis. The regulatory reforms implemented in the wake of the crisis have been limited to reducing banks-to-sovereign contagion. By contrast, the issue of sovereign-to-banks contagion has not yet been addressed – and this would be a prerequisite for creating a European deposit insurance scheme so as to prevent the scheme from indirectly assuming liability for sovereign default risk.

In short, as long it remains possible for actions at the national level – when drafting provisions in insolvency law, for instance – to have a substantial impact on banks in both prosperity and adversity, there is virtually no scope for savers or taxpayers from other member states to be held jointly liable. It is essential that the unity of actions and liability for their consequences be maintained, for it is only in doing so that a stable regulatory framework can emerge. And a stable regulatory framework is crucial if monetary policymakers are to be freed up to concentrate on their mandate of preserving price stability. After all, it won’t do them any good in the long run to have to intervene constantly as a crisis response unit.

3. Challenges for monetary policy

But rather than looking at these risks in detail, I would like to look a little closer at the current monetary policy situation. What is perhaps most striking is the extent to which the economic situation in the euro area has improved. The upswing now rests on a broad base everywhere, and the growth rates recorded by the member states now lie within a considerably narrower range. At 8.6%, the unemployment rate has fallen to its lowest level since the end of 2008. Sentiment indicators remain at very high levels, which suggests that the favourable economic developments we are seeing are here to stay for the time being. Looking at ECB staff projections, GDP growth rates are expected to come in at 2.4% this year, 1.9% in 2019 and 1.7% in 2020.

Despite the fact that economic conditions picked up, price pressures in the euro area remained sluggish. While higher oil prices and the robust upswing did cause inflation to grow much more briskly in 2017 than it had one year earlier, headline inflation slipped again slightly at the start of 2018. The subdued domestic price pressures reflect the fact that some countries are still trying to boost their price competitiveness by keeping wages down. But domestic price pressures are subdued even in countries that weren’t at the epicentre of the crisis. In Germany, for instance, the immigration of workers from other EU countries over the past few years has resulted in a marked decrease in wage pressures. There is also some evidence to suggest that additional factors, such as the increased significance of global value chains, have eased price pressures, and not just in the euro area.

However, according to ECB staff projections, price pressures will pick up again due to further rises in aggregate capacity utilisation. The ECB’s economists expect the inflation rate to amount to 1.4% in both 2018 and 2019, before rising to 1.7% in 2020 – in other words, to a figure that is broadly in keeping with our definition of price stability over the medium term.

With that in mind, it is no surprise that, for some time now, the expectation on the financial markets has been for net asset purchases to come to an end in 2018 already. But even after net asset purchases have become a thing of the past, the monetary policy stance will remain accommodative. Ultimately, the degree of monetary policy accommodation is determined not so much by the monthly volume of net asset purchases as by the overall volume of purchases. And that volume is huge – the Eurosystem’s asset purchases under the current programme are already worth more than €2.3 trillion and consist largely of government bonds. That stock of assets will remain steady even after the net purchases are stopped, because the ECB Governing Council decided some time ago that the proceeds from maturing assets should continue to be reinvested for an extended period of time.

Furthermore, it announced that its policy rates will remain at their current levels well beyond the end of the net purchases. The markets aren’t expecting the first interest rate rise until around the middle of 2019, which is probably not wholly unrealistic. Savers, who have been bearing the brunt of low deposit interest rates for years, are naturally the ones who would most like interest rates to rise as quickly as possible. But ending the net purchases is just the first step on a multiyear path towards monetary policy normalisation. And that’s precisely why it’s so important to actually get the ball rolling soon.

Normalising monetary policy in this way will give policymakers greater leeway to respond to any economic slumps in the future – because the current upswing won’t last forever. Either way, interest rates aren’t set by the central bank alone. When it comes to interest rates over longer-term investment horizons, which are especially important for life insurers and pension funds, for example, monetary policy is just one in a series of determining factors. I will turn my attention to one of these, namely ageing, in the last part of my speech.

4. Facing the challenge of demographic change – improve growth prospects

One of the main reasons why the term structure – that is to say, the relationship between maturities and interest rates – is so flat in the current environment is that the Eurosystem's unconventional measures are being targeted directly at the longer end of the term structure. However, the low long-term interest rates are also a reflection of diminished growth expectations. After all, if economic growth remains sluggish in the long term, investments will then generate lower yields and, whether they like it or not, investors will have to content themselves with correspondingly lower interest rates. If we compare the average growth rates of advanced economies before and after the turn of the millennium, a significant decline is apparent. The expected real interest rates for German Federal securities with a ten-year residual maturity have been caught in a steady downward spiral for around three decades. In and around 1990, the German real yield still stood at roughly 5%, but if we fast-forward one or two decades, this figure falls to around 3% and just over 1% respectively. While it must be said that it is being influenced by the asset purchase programme, it has now dipped as low as –1%. The situation is similar in Austria.

Persistently higher interest rates thus hinge on higher trend growth. But improving growth prospects is a job for national economic policymakers, not central bankers. As they attempt to accomplish this feat, policymakers find themselves increasingly confronted with the issue of ageing. Germany is especially affected in this regard, as shown by medium and long-term economic growth projections. According to the European Commission's latest Ageing Report,[3] Germany's labour force aged between 20 and 64 will shrink significantly over the coming decades, from around 41 million persons at present to 38½ million in 2030 and just under 37 million in 2040. That's a decline of around 10% compared with 6% in the euro area as a whole. The Bundesbank estimates that, not least on account of demographic change, the potential growth rate of the German economy will decelerate from an average of almost 1¼% between 2011 and 2017 to just over ¾% in the mid-2020s.[4]

The European Commission, which uses a different method to calculate potential, puts the potential growth rate of the German economy at a slightly more favourable 1.1% in the 2020s and 1.0% in the 2030s in the report I referred to a moment ago. But that's also markedly down on the status quo, given that the European Commission estimates current trend growth to be 1.9% – a figure that we deem fairly high.

The situation in Austria (and several other countries) is a little more positive. Of course, Austria's population is also ageing, meaning that old-age dependency ratios, which measure the ratio of elderly people to those of working age, are on the rise.

The social security systems must be prepared for this demographic change in good time. An important variable for dealing with the demographic decline in the labour force potential is the labour force participation rate. The aim is to increase the labour force participation of older workers and women especially. Women's labour force participation in Germany and Austria is slightly above the euro area average. However, the difference between women and men is still more than 9 percentage points in both countries, quite apart from the fact that women (in both countries) are four times more likely to work part-time than men. In terms of older workers' labour force participation rate, by contrast, there are considerable differences between Germany and Austria: in the age group of 55 to 64 year olds, the German participation rate is almost 20 percentage points higher than in Austria, while the rate for women is as much as 23 percentage points higher. Adjusting the retirement age to rising life expectancy is a controversial, but effective measure to increase older workers' labour force participation and thus counteract demographic change.

Immigration can also help to dampen or delay the demographic decline of the workforce. For instance, immigration to Germany contributed an average of around 0.2 percentage point to growth between 2001 and 2017. However, the contribution that immigration can make to cushioning the impact of an ageing population on the labour market hinges on whether immigrants can be integrated into the labour market and what professional qualifications the immigrants bring with them. In any case, a systematic approach for labour-market-oriented immigration would make sense.

All these measures target the number of hours worked as a means of dampening the harmful effects of demographic patterns on growth. A complementary approach would be to increase the productivity of those persons who will generate income in the future and will therefore need to support an increasing number of elderly dependents. Economic policies that promote innovation and competition and lower market entry barriers and obstacles to innovation as well as an efficient public administration can make valuable contributions to higher productivity growth.

The education system also has a key role to play. Much of the groundwork for later academic achievement is laid in the early years of childhood. It therefore makes sense to focus more on early-years and pre-school education. In schools, academic success must become less dependent on social background, for instance by ensuring good all-day school facilities are available for all. That would make it easier to prepare children and young people whose parents have little interest in education for their future working life. And, most importantly, we must establish a culture of lifelong learning. That would help ensure that people experience the changing requirements of the labour market more as an opportunity and that they could look with greater confidence towards a longer working life. Incidentally, lifelong learning reduces the mismatch between existing and needed qualifications, in turn contributing to greater productivity. In any case, the days when employees over 50 were considered as difficult to place on the labour market must be a thing of the past.

Efficient education and training systems are equally indispensable in dealing successfully with a phenomenon which could cause quite significant changes to working life and growth: digitalisation. Digitalisation can help raise productivity growth. However, it is unclear how large this contribution might be. Digitalisation will eliminate some jobs, while creating others. On the one hand, digitalisation automates many activities; on the other hand, it also creates new job profiles and jobs. In the recent past, the digital industry itself has contributed more to productivity growth than other sectors that merely employ digital technologies.

Whether the application of new digital technologies will boost labour productivity going forward is not yet clear. It is therefore of the utmost importance to eliminate any obstacles that could stand in the way of this dynamic. Such obstacles might relate to the physical infrastructure – think of the expansion of the broadband network. Another bottleneck factor could be a lack of suitably qualified staff. Already, companies complain of a growing lack of qualified staff, and this is only likely to get worse with demographic change. In Austria, the percentage of firms reporting difficulties hiring IT specialists is, at 61%, considerably higher than the EU average (41%). In Germany, 52% of enterprises reported such problems.

A lot therefore depends on making employees fit for the digital world.

The measures outlined above as examples of ways to deal with an ageing population demonstrate how structural reform can spur growth. The ECB Governing Council, in the introductory statements to its press conferences following monetary policy meetings, regularly warns that “the implementation of structural reforms in euro area countries needs to be substantially stepped up to (...) boost euro area productivity and growth potential.” And this admonition refers expressly, and quite rightly, not just to the former crisis countries. Countries with a strong economy can and must raise their growth potential, as just described. The European Union, too, may additionally create momentum for sustainable growth, for instance by creating a digital single market, through the capital markets union I mentioned earlier and through its commitment to international free trade.

With everyone currently talking of trade, I would like to make one final comment: no one can be interested in a trade war; at the end of the day everyone is the loser. It is therefore a welcome development that the EU has initially been exempted from the tariffs on steel and aluminium that came into force last Friday. That reduces the risk of the current trade conflict with the United States escalating. At the same time, what counts is maintaining the rules-based multilateral framework as provided by the WTO. It makes commerce easier for all countries, directs trade conflict into orderly channels and helps bring about solutions that are acceptable for all involved. It has, for instance, been key in helping boost world trade and economic integration in recent years and decades, thus raising welfare and growth. The multilateral framework has therefore served the global economy well, and we should strengthen, improve and expand it.

The agreement that has now been reached between the United States and the EU is therefore ambivalent: it avoids an open conflict between the world's two largest economic areas, which account for a large percentage of global trade flows. Nonetheless, this is no victory for international free trade, as punitive tariffs remain in place for other countries which were unable to secure preferential treatment for themselves, and even the EU is, to date, only temporarily exempted. The objective must therefore be not only to prevent new barriers to trade or keep them as low as possible, but also to eliminate existing barriers. I very much hope that recent signals from the United States that it is willing to talk about eliminating barriers do not prove to be a false hope, but that they herald a new outlook.

5. Conclusion

At the beginning of my speech, I mentioned Córdoba. Hans Krankl, who 40 years ago scored the winning goal for Austria, moved to FC Barcelona following the FIFA World Cup, where he went on to become Spain's top scorer. The transfer fee is reputed to have been 10 million schillings, which works out at around €700,000. Measured in terms of the sums which change hands for international top players nowadays, that is a bargain, but at the time it was a record fee for an Austrian player. It is safe to say that prices for football players have risen considerably faster than consumer prices. In fact, in the face of recent developments, some people even go as far as to talk of hyperinflation on the transfer market – an aspect of inflation with which we luckily do not need to concern ourselves.

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[1] E Nowotny (1999), Der öffentliche Sektor: Einführung in die Finanzwissenschaft, 4th edition, Berlin et al, p 160.

[2] See, for example, H Berger, G Dell'Ariccia and M Obstfeld (2018), "Revisiting the economic case for fiscal union in the euro area", International Monetary Fund.

[3] European Commission (2017), The 2018 Ageing Report, Underlying Assumptions and Projection Methodologies.

[4] See Deutsche Bundesbank, Demographic change, immigration and the potential output of the German economy, Monthly Report, April 2017, pp 35–47.