Jens Weidmann: Reforms for a stable monetary 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 annual reception of the Minister President of the German state of Hesse, Brussels, 5 June 2018.

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1 Introductory remarks

Minister President Bouffier
Thank you for your kind words.

I am delighted to see such a large number of guests and would like to greet the representatives of the diplomatic corps, the members of Parliament, the representatives of the European Commission, the Council and other EU institutions, the members of the state government of Hesse, and all the other members of our audience today.

I have lived and worked in Hesse for many years now – in the beautiful Rheingau region and in the buzzing metropolis of Frankfurt, to be precise – and have long since come to feel at home there. Hesse is not only in the middle of Germany, it is also at the heart of Europe.

The political cabaret artist Matthias Beltz once said: “The people of Hesse are surrounded by masses of Germans. They have no access to the sea, the Alps or foreign countries, so they have no direct contact with freedom.” But luckily, freedom comes to us. Hesse, and especially the area around Frankfurt, has an international character, and the region’s cosmopolitan atmosphere makes it an easy and enjoyable place to live.

At the same time, Hesse is home to several EU institutions. One of these is the European Central Bank (ECB), which turned twenty a few days ago. It commenced its tasks on 1 June 1998 in Frankfurt, a few months before the start of the third stage of Economic and Monetary Union.

2 20 years of the euro

In the two decades since it was introduced, the euro has proven a success. The original promise of a stable currency has been kept – the euro is stable both internally and externally. At 1.7 % on average over the last 20 years, the rate of inflation is lower than many people expected.

It is therefore no surprise that support for the euro among the general public is high. According to the latest Eurobarometer survey, three-quarters (74 %) of respondents in the euro area are in favour of the single currency, while only one in five (21 %) is against (the idea of) the euro. In some countries, Germany included, the approval rating is higher than 80 %, even.

However, these positive survey results should not obscure the fact that the euro’s second decade was rife with crises and problems: a financial crisis, an economic crisis, a European debt crisis, a banking crisis, a double recession and high levels of unemployment. Several countries experienced a prolonged period of economic weakness and the necessary adjustment measures brought with them social hardship.

Figuratively speaking, you could say that the euro had an easy childhood but a difficult adolescence.

Over the last few years, the Eurosystem’s central banks have faced unfamiliar challenges, and not just in their core area of responsibility, which is that of ensuring price stability. During the crisis, they were to some extent forced to act as crisis response units, taking them to the outer

edge of their mandate for a while.

In an interview last week, Otmar Issing warned: “Politicians have it easy. They rely on the ECB to sort everything out. But that isn’t going to work in the long term.”

The dialogue between member states has also taken on a harsher tone at times. But monetary union was actually a project intended to encourage European integration and ultimately even bring about deeper international friendship.

All the same, I would like to stress that, in many ways, the euro area is in better shape today than it was before the crisis. This is thanks to measures taken by its member states as well as changes to the structure of the monetary union, both of which I will now focus on briefly.

3 Reforms in the euro area

3.1 Adjustment progress in the member states

The crisis brought home to all of us what being part of a monetary union means and involves. And the way the countries that were hit the hardest by the crisis have tackled the roots of the problems and have regained their competitiveness, for example, is truly remarkable and receives too little recognition.

In Greece, Portugal, Ireland, Spain and Cyprus, for instance, average unit labour cost growth was above the euro-area average in the pre-crisis period (1999–2007). This was a contributing factor to these countries’ loss of competitiveness.

Since the crisis, unit labour costs in all five of these countries have grown more slowly than the euro area average. This has made their economies more competitive.

The structural reforms already undertaken are also beginning to bear fruit and have contributed to the upturn. Take structural unemployment, for instance, which has gone down by just over one percentage point in the euro area, by slightly more in Spain, and by as much as 5 and 7 percentage points respectively in Portugal and Ireland, thus showing that there is more at work here than just the upbeat state of the economy.

Current account deficits, some of which were very high, have also been balanced or even turned into surpluses.

It would be tragic if, given all this, reforms were to be rolled back or consolidation gains squandered. Instead, we should build on the successes that have been achieved.

Incidentally, this also goes for countries such as Germany, which weathered the crisis fairly well.

3.2 Changes to the governance framework to date

But it’s not just in the member states that much has happened as a result of the crisis. In the euro area, much has changed for the better in institutional terms as well.

One positive development is the ESM – a permanent euro rescue facility that can grant conditional financial aid to member states in the event of a crisis and can thus prevent a national crisis from jeopardising the stability of the entire euro area financial system.

The creation of the banking union is also a welcome development. Thus far, the banking union encompasses a single supervisory mechanism, a single resolution mechanism, and harmonised national deposit guarantee schemes.

These reforms remedied weaknesses in the structure of the monetary union that were either

ignored or overlooked when the euro was founded.

The most experienced among you may remember that the idea of a joint financial supervisory system was actually discussed by the Delors Committee back at the end of the 1980s, but was ultimately dismissed.

The crisis set in motion a learning process in this field, too, in which old beliefs were called into question, and not only in the member states. This, by the way, also applies to the Bundesbank, which, for example, had long been sceptical of a common financial supervision.

The ESM and the banking union, together with stricter financial regulation, have doubtless made the monetary union more stable. If there were new upheavals in the financial system or in individual member states, we would be considerably better prepared to deal with them today than we were in 2010, when the Greek debt crisis caught the euro area off guard.

4 Further reforms

4.1 Guidelines

Much has been achieved in the member states and at the European level. But this still isn't enough to crisis-proof the euro area once and for all. The financial market turbulence last week with regard to Italy is a case in point.

The consensus is that the previous reforms have been insufficient to put the euro area on as sound a footing as we would all like. Meanwhile, the economic environment at the moment is still exceptionally favourable overall, and we should be taking advantage of this.

So I am concerned by the fact that enthusiasm for consolidation in the euro area appears to have waned. Whilst almost all euro area countries reduced their structural deficit by half a percent of GDP or more in 2012, not a single one is set to improve its structural budget balance in 2018. It seems that the reformed fiscal rules are having just as weak an impact as the old rules.

Furthermore, the ECB Governing Council has emphasised again and again that the implementation of structural reforms in the euro area needs to be significantly intensified now in particular, in view of the current favourable economic environment, in order for economies to become more resilient and structural unemployment to fall further should they face stronger headwinds – and by structural unemployment I mean the unemployment that remains even when the economy is doing well. This also needs to be the case if we want productivity and potential growth in the euro area to rise.

At around 1½ %, potential growth in the euro area has recovered since the crisis, but it is still considerably lower than its pre-crisis level of about 2 %.

In this context, there is currently passionate debate about national sovereignty in some member states. In fact, it is national economic policymakers who are responsible for improving the conditions required for growth, employment and social cohesion – through a good education system, efficient public administration, growth-friendly and fair taxation, and an appropriate infrastructure, to name but a few examples.

This is in the countries' own national interests and, at the same time, is the best way in which each individual country can contribute to the stability of Europe. Europe needs to take responsibility as a community – only then will we truly be able to make progress with the European project and also show the citizens of Europe that it creates prosperity.

So while there are many pressing issues to be discussed and decided upon at the national level, an intensive reform discussion is also taking place with regard to the future structure of the monetary union and the EU. This topic, as you all know, is also on the agenda of the EU summit

at the end of this month here in Brussels.

The ideas voiced by the French president Emmanuel Macron, which have been greeted with a mix of goodwill and scepticism in Germany, have provided important impetus for the European debate. Furthermore – and this is, I believe, a great achievement – he has created a convincing, lively narrative for the joint European project that citizens can buy into and even be enthusiastic about.

It seems clear to me that there will only be progress in this debate if Germany and France work in concert and move in the same direction.

The Bundesbank has also been providing proposals of its own in this debate for a long time now, and it is within this debate that the agenda for the stability of the single currency is being set.

From my perspective, three guidelines form the basis of these proposals.

1. The European Union should focus more of its attention and spending on tasks that create added value for the citizens of Europe.
2. The institutional and economic conditions of the monetary union need to be set up in such a way that the Eurosystem can properly fulfil its mandate and does not have to intervene on a regular basis as a crisis response unit.
3. A stable monetary union requires both solidarity and solidity, and it is essential that the alignment of actions and liability be maintained.

Allow me, if you will, to delve slightly deeper into this last point in particular.

The alignment of actions and liability means that the authority to make decisions needs to be linked to the responsibility for the consequences of such decisions. Or, in other words, only he who has the power to influence decisions is also prepared to bear the risks that these decisions entail.

When it was decided in Maastricht to create an economic and monetary union, the member states agreed to pool their sovereignty in monetary matters at the European level. However, under the existing regulatory framework, responsibility for fiscal policy – as for general economic policy – lies with the individual member states, as I have already mentioned.

From the outset, there have been measures in place designed to prevent unsound public finances from jeopardising the stability of the single currency. Rules on debt have been laid down in the Stability and Growth Pact; it is prohibited to simply print more money as a way of financing the public sector; and countries cannot take on each other's liabilities – the famous no bail-out clause.

In principle, though, the member states remain sovereign in fiscal matters. And indeed, this sovereignty is something that they have always confidently championed and defended. In this vein, I recall Matteo Renzi, the former Italian Prime Minister once asserting that "It's up to us to decide what taxes we cut, not some Eurocrat sitting in Brussels".

If monetary union reforms were to include a far greater degree of fiscal risk-sharing, actions and liability would only remain aligned if certain sovereignty rights were to be transferred to the European level. Otherwise we would end up with imbalances and dubious incentives.

But ceding a significant portion of their sovereignty to Brussels is precisely what the euro area member states are not prepared to do – to give a European finance minister the right to intervene in national budgetary planning if they fail to comply with the fiscal rules, for instance.

It seems to me that it's already hard enough at times to ensure that the Commission's existing

powers are enforced and respected. And that's why I'm convinced that any reform steps need to fit within the existing Maastricht framework.

4.2 Risk sharing and provisioning

But complying with the Maastricht framework doesn't necessarily rule out an expansion of mutual liability. If actions are properly aligned with liability, risk sharing can make a lot of sense.

In principle, there are justifiable arguments in favour of having the collective resources of the ESM function as a fiscal safety net for the European Single Resolution Fund, as per the Commission's suggestion. After all, we already have banking supervision at the European level, meaning that we share the responsibility for supervisory decisions.

For similar reasons, the Bundesbank isn't opposed to a common European deposit insurance scheme per se. Quite the contrary. Such a scheme would, without doubt, contribute to a more stable financial system, as it would reduce the risk of bank runs. And shared supervisory responsibility makes a good case for joint liability here, too.

But to protect the link between actions and liability, risks that have arisen under national responsibility must be reduced before a common deposit insurance scheme is created. What's more, the impact of national policy decisions on the quality of bank balance sheets must be limited.

The stocks of non-performing loans on countries' bank balance sheets – some of which are very high – are an example of this kind of legacy risk. The average non-performing loan ratio has fallen by around one-third in Europe since 2014. But in some countries it remains very high and well above pre-crisis levels.

The large holdings of government bonds on bank balance sheets are also problematic. Owing to a regulatory loophole, government bonds are backed by little to no capital. And – unlike with private borrowers – there is no cap on individual banks' exposures to sovereign debtors.

Before a deposit insurance scheme can be created, these sovereign default risks on banks' balance sheets would need to be reduced in the long term, as would stocks of non-performing loans. Otherwise the insurance scheme would find itself assuming liability for them.

My colleague on the ECB Governing Council, Benoît Cœuré, rightly pointed out the other day that "A deposit insurance scheme should be seen as an insurance against economic risks, just as you take out liability insurance to protect yourself against the risk of an accident." But as you all know, ladies and gentlemen, you can only take out a liability insurance policy to cover future accidents, and not if the damage has already been done.

Following the logic of an insurance scheme, and given that member states will still have a bearing on the health of their banks in future, the concept of a permanent national risk retention requirement also seems worth considering. Think, for example, of insolvency law and how it is legally enforced.

If we look further afield, beyond the banking union, a rainy day fund modelled on the type in place in several US states is certainly worthy of consideration. Many states put aside budget surpluses for hard times. But new scope for borrowing and fund transfers between states are incompatible with this approach.

However, it is reasonable to question whether countries with solid public finances even need such a fund. After all, European fiscal rules are less strict when it comes to government debt than the constitutions of the US states, most of which prohibit new borrowing altogether.

But such an instrument would at least offer greater room for manoeuvre in difficult situations

without needing to expand fiscal risk sharing or requiring cross-border payments.

4.3 Private risk sharing

Increased risk sharing within the euro area would make member states better able to absorb economic shocks. The same goes, in particular, for private forms of risk sharing.

A recent article by ECB economists shows that, in the euro area, when a particular member state experiences an economic slump, 80 % of that downturn bleeds through to consumption in that country. Now, at first, it might seem plausible to us that it is chiefly the people in the affected country that have to tighten their belts.

But in the US states, 40 % – at most – of a shock to GDP is reflected in a fall in consumption growth. So there's clearly another way. The rest of the impact is absorbed elsewhere. For instance, because the losses sustained by an enterprise in one US state are distributed across the whole country as shareholders are often domiciled in other states.[1]

The much greater importance of private risk sharing in the United States shows that private risk sharing is capable of enhancing the individual countries' resilience in the euro area, too. Integrated and efficient financial markets are a key prerequisite for this.

Creating a capital markets union, as proposed in 2015 by the Commission, would move Europe a long way towards achieving this aim. Which is why the Bundesbank explicitly endorses the project.

It has the potential to spur economic growth, dismantle barriers to cross-border investment, diversify corporate financing and strengthen private risk sharing. And it would also be a key contribution to making the euro area more stable.

The more successful efforts to strengthen cross-border equity financing are, the greater the sums the capital markets union could be expected to contribute to strengthening private risk sharing. After all, there is one key difference between equity and borrowed funds: equity investors participate directly in economic risk and in gains and losses. Creditors, on the other hand, are not exposed to losses – except in the case of insolvency.

Equity therefore provides better opportunities for sharing risks and opportunities. However, there are incentives for firms to obtain funding through debt rather than equity. In many countries, for instance, debt interest is tax-deductible, but the cost of equity isn't.

To that extent, the efforts being made to create a common assessment basis for corporation tax represent a good opportunity to reduce the preferential tax treatment being given to debt and to make equity financing more attractive.

5 Focusing the EU

Ladies and gentlemen

The euro area can only be strong as part of a strong European Union.

What this requires – and that will be my last item for today – is for the EU to focus more single-mindedly on those tasks in which it has a comparative advantage and the benefits of which it can sell convincingly to the public – that is, tasks that clearly have European added value.

There are tasks that can be performed better at the European level than the national. From an economic standpoint, these might include Europe-wide public goods and therefore policy areas with cross-border externalities, in particular.

As we know, public goods are defined as goods that individuals cannot be excluded from using, the use of which does not reduce the amount available to someone else. Because these traits are an open door to free ridership, these services have to be provided by the government sector. The use of European public goods is scattered far beyond national borders. These tasks should then be relocated to the European level.

French President Emmanuel Macron has listed as such tasks defence, the protection of external borders, migration policy, climate protection and the expansion of digital networks. All of which are fields in which there is visible European added value. And if you read the interview with Chancellor Merkel at the weekend, you will know that she expressed similar views.

That is why it would be appropriate to add the topics of border security and migration to the European agenda without delay. This would also help individual member states to feel less disadvantaged and abandoned on account of their geographical location.

At the same time, however, the principle of subsidiarity enshrined in the EU Treaty needs to be applied more effectively, as there are tasks that are still more at home at the domestic level. And that is why it is a welcome development that Commission President Juncker has convened a task force for subsidiarity and asked it to consider which powers are better exercised nationally or locally than at the European level.

This task force, headed by the First Vice-President Frans Timmermans, has been given until mid-July to submit a report. This report should also present ways of better incorporating regional and local government in EU policy-making – an idea which is surely being followed with great interest here at the Representation of the State of Hesse.

More Europe does not necessarily have to mean more money for Europe. I am thinking, for instance, of the establishment of a single market for services and a common digital market in Europe. These are projects that do not necessarily cost much but which deliver a lot. Studies show that they could achieve growth effects twice the size of those provided by the creation of the single market for goods.

However, it is clear that providing European public goods generally comes with a price tag attached.

Germany – unlike other net contributors – has already declared its willingness to put more towards the EU budget.

Europe first needs to define the tasks that it would make sense to accomplish jointly and that should therefore also be funded jointly instead of starting off by talking about money, and thus putting the cart before the horse. So it should be less about how much each party pays and receives and more about figuring out how to invest the funds wisely.

6 Conclusion

Ladies and gentlemen

As early as five years ago, then-Federal President Joachim Gauck, in my estimation, put his finger on the essence of the debate on European policy reform when he said that “This union involves give and take; it must not be a one-way street for anyone. It is based on the principle of reciprocity, equality and mutual commitment. More Europe must mean: more reliability. Reliability and solidarity will rise and fall together.”

There is virtually nothing to add to that. And I therefore thank you for your attention.

1. J Cimadomo et al (2018), Risk sharing in the euro area, ECB Economic Bulletin, Issue 3, pp 98-112.