Jens Weidmann: Prospects for Europe and the euro area

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 Centre for European Policy, Freiburg im Breisgau, 20 September 2018.

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1 Welcome

Professor Gerken,
Ladies and gentlemen,

I would like to thank you very much for inviting me to Freiburg.

Two-and-a-half weeks ago I was a guest at the Konzerthaus just a few hundred metres from here. There, I delivered a speech at the annual meeting of the German Economic Association (Verein für Socialpolitik) on the challenges posed by digitalisation. Today I have returned to continue this series of talks on Europe.

Freiburg is an ideal location for this topic. Here, on the doorsteps of France and Switzerland, we find ourselves at the heart of Europe in more than just a geographical sense, as evidenced by the city's history.

Some 650 years ago the city's citizens rid themselves of the unpopular Counts of Freiburg and submitted to the Habsburgs for protection instead. Freiburg thus became part of an empire that, over time, became a European multinational state.

Time and again, parallels are drawn between the Habsburg Monarchy and the EU. For example, historian Harold James wrote, "The EU looks more like the Habsburg Empire, a complex vessel of nationalities where satirists joked that the situation was desperate but not serious.[1] When the empire fell 100 years later, it had lost the support of its people.

Napoleon brought the Habsburgs' rule in Freiburg to an end way back in 1805. But this era has left its mark on parts of the city to this day. Take a look, for instance, at the university or the address of the Centre for European Policy (cep): Kaiser-Joseph-Strasse 266.

With an unquestionably pro-European stance and by employing its governance principles, cep is able to constructively and critically analyse institutions and processes in Europe.

This is an approach that I can identify well with, namely because it's not enough for Europe to be dear to your heart. Only a Europe that also works will appeal to its citizens in the long term. That's why I think it is important for attention to be paid to the core principles of Ordnungsökonomik or the "economics of order", such as the principle of liability and the primacy of foreign exchange policy.

Otmar Issing made it clear in an interview: "Whoever voices concerns about the spread of centralism and interventionism is branded a bad European. But the reverse is true."[2]

Economic prosperity and a stable currency are key to ensuring backing for the European project. And a Europe that can find the answers to the burning questions of the hour – a Europe that can add real value to the lives of its citizens – will also find backing and support.

I would like to go into a little more detail about this outlook with you today. In particular, I will highlight globalisation and technological progress, international trade policy and competition with China as current challenges before moving on to discuss the role of the EU and reform steps for the euro area. But I’d like to start by taking a brief look back.

2 Ten years after the financial crisis

Over the past few days and weeks, a slew of media reports have reminded us of the events of ten years ago, when the financial crisis came to a tumultuous head with the collapse of Lehman Brothers.

Many observers regard this as the climax of the crisis, which was followed by a global recession in 2009. In terms of severity, there was no precedent for such a downturn in post-war history.

In the euro area, the financial crisis later coalesced with the sovereign debt crisis. What’s more, the unemployment rate peaked at 12% in mid-2013. The rate has since fallen to 8.2% – but this is not a value that we can content ourselves with.

The member states hit especially hard by the crisis have made huge strides: they have reduced new government borrowing, cut their current account deficits, improved their competitiveness and implemented structural reforms.

Take Greece, which, in 2008-09, had a vast current account deficit and a gaping hole in its general government budget – both of which reached 15% of GDP. Last year, however, the current account was broadly balanced and a surplus was even recorded in the general government budget.

All in all, five countries received financial support via assistance programmes with conditions attached. A month ago today, Greece was also the last of these five countries to cast off the status of "programme country".

Greece’s exit from the adjustment programme marks an important milestone. But it would be premature to think of the crisis as over and done with. As I recently said in Athens, there is still work to be done.

Continued structural reforms are needed to accelerate growth, create more jobs, and boost both productivity and wages – not just in Greece but in other euro area countries, too. By the way, we in Germany should not be content to merely ride the wave of the successful labour market and social reforms implemented in the 2000s.

The institutional foundations of monetary union require further reform if the euro area is to be made permanently crisis-proof. Because there’s one thing we can probably all agree on: none of us want a repeat of the last ten years of crisis.

The extensive rescue packages put together in recent years have triggered debates in the countries providing assistance on the mutualisation of liability and intergovernmental transfers. In the countries receiving assistance, the conditions attached to the programmes were seen as very severe in some cases and as outside interference in national decision-making.

3 A strong Europe: more important than ever

The crisis in the euro area and the way in which it was resolved have also stirred up animosity and resentment and given a boost to anti-European movements. Decidedly euro-critical and populist parties have enjoyed electoral success in many member states. But this development cannot be put down to rescue measures alone, as populist movements are flourishing outside the euro area, too.

Looking at the economic setting, this discontent may come as a surprise, what with the global economy experiencing a robust upswing. In the United States, the United Kingdom, Germany and elsewhere, unemployment has fallen to its lowest level in decades.

But it would seem that economic effects aren't the only significant factors at play here. Digital change and globalisation, for example, are transforming the way we live and work.

Populist movements play on the fact that people perceive these profound changes as a threat. And I can understand that many people feel uneasy and cheated, and why they fear that they have lost control. "Take back control" – that was the motto of Brexit supporters.

Walter Eucken once remarked, "People's opinions, their mental attitudes, are often more important as regards the direction of economic policy than economic facts themselves."[3]

3.1 Globalisation and technological progress

From an economic perspective, it is clear that technological progress and free trade boost general prosperity in the long term. However, looking at the bigger picture obscures the fact that employment prospects and relative wages are shifting. Change brings with it winners and losers.

Economists are now investigating the distributional effects of globalisation in greater detail. Studies show that China's integration into the global economy played a particular role in subsequent massive manufacturing job losses in the United States.

Now, these job losses may well have been more than offset by job creation in other sectors, but these new jobs were often created in other places. Local labour markets have been seemingly slow to adapt, and the lifetime income of affected workers has been markedly reduced.[4]

Looking at Germany, on the contrary, Wolfgang Dauth and his colleagues found that globalisation has opened up important opportunities to export to eastern europe and China and thus helped preserve manufacturing jobs.[5] But this, too, is an overall view of the situation.

It is the job of politicians to create the conditions needed for new, future-proof jobs. People have to be given the ability to meet today's job requirements so that they, too, can reap the benefits of globalisation and digitalisation.

Education will play a key role here, particularly since this issue affects employment prospects for lower-skilled workers. And wherever social hardship arises, a target-driven tax and transfer system should step in and act as a cushion.

3.2 Protectionism

By contrast, protectionism and isolationism are no way to create "prosperity for all".

We are currently seeing international trade escalate to a new level. More than a year ago, the Bundesbank was already drawing attention to the economic disadvantages and risks associated with a trade dispute in an edition of its Monthly Report.[6]

Simulations exercises conducted as part of a global economic model show that, by introducing new tariffs, the United States runs the risk of damaging not least its own economy. That's because higher prices would largely stifle the purchasing power of American consumers. Retaliatory tariffs introduced by trading partners would probably then make the deterioration in global economic activity and trade worse still. There are only losers in trade wars.

Some politicians believe that higher tariffs will reduce current account deficits. However, the model calculations show that this, too, could turn out to be fantasy. While new import tariffs would indeed reduce imports, foreign demand for exports would probably fall at the same time. And it is precisely a debtor country such as the United States that would probably feel the additional strain of higher interest rates in the wake of upward price pressures.

You'll no doubt know the song by Janis Joplin that goes as follows: "Oh Lord, won't you buy me a Mercedes Benz? My friends all drive Porsches, I must make amends."

The song probably doesn't feature on Donald Trump's playlist. After all, the fact that Americans like to drive German cars while Germans are not so impressed by American ones is a thorn in his side.

But as long as it is an expression of consumer preference, it does not constitute market or competition distortion. At the end of the day, there are also American products and services that are in very high demand in Germany – in the IT and mobile sectors, for instance, or the internet search engine industry, to name just a few.

It is also difficult to pin market distortions on trade or current account balances. All in all, the current account balance reflects the countless saving and investment decisions made within an economy.

In addition to the decisions made by enterprises and households, fiscal policy plays a role here. Simulation exercises conducted by the Bundesbank reveal that the tax cuts passed in the United States will probably push up debt and current account deficit levels considerably.[7] This will do nothing to reduce global imbalances.

Furthermore, given the diversity of economic relationships and level of interconnectedness with third countries, looking at the goods traded between two countries alone is insufficient. Trade expert Gabriel Felbermayr pointed out that, overall, the United States actually has a current account surplus with the EU: income from services and primary income more than compensate for its trade in goods deficit.[8]

Felbermayr also wrote, "The EU is in no way a paradise for advocates of free trade, especially when compared to the United States."[9] For 48% of all products, the EU imposes a higher tariff than the United States, while the reverse is true for 30% of products.

It is a welcome development that the two sides are now discussing how to dismantle trade barriers. Lowering tariffs would boost welfare and benefit consumers, in particular.

For example, a study carried out by the European Commission shows that consumers have saved €60 billion a year since the 1990s as a result of tariff reductions. Nowadays, thanks to the conclusion of a free trade agreement, purchasing a car from Korea with an import value of €13,300 is tariff-free, but a 10% import tariff that was previously in place would have resulted in additional costs amounting to €1,300.[10]

Germany is quite rightly determined in calling for free trade in goods. With that in mind, restrictions on capital flows are something that is difficult to reconcile with this.

3.3 Competition with China

And yet we are currently seeing a debate in Germany over the extent to which takeovers from abroad need to be regulated more tightly. Takeovers by Chinese investors are viewed with particular concern, for fear of a state-orchestrated transfer of expertise and technology to China.

Then again, German foreign direct investment in China is still 16 times higher than in the opposite direction, so that ought to ease some of the fears that a "wave of takeovers" by Chinese investors is washing over Germany. If you ask me, we ought to take a measured approach here and be wary of "investment protectionism".

Dieter Kempf, President of the Federation of German Industries (BDI), has warned that government intervention to prevent investment from abroad will always pose a challenge to our governance principles, which we have to thank for prosperity and a highly innovative and globally competitive national economy.[11]

Rather than adopting special measures to fend off Chinese investors, I think it would be better to work towards developing suitable multilateral rules and a level playing field in matters of market access.

Another important measure would be to press for compliance with the existing rules. Unfair trading practices such as dumping cannot be tolerated. In the steel sector, especially, that appears to be a problem in connection with overcapacities in China.

At a fundamental level, China's economic ascendency is, for some, shaking our firmly held belief that the liberal trinity – democracy, the rule of law, and the market economy – is not just more humane, but also more successful, economically, than any other system. Clemens Fuest has spoken of a "third competition among systems"[12] emerging between the Western democracies and China's authoritarian state capitalism.

In the meantime, the breath-taking pace with which China has made up ground has slowed down significantly. Economic growth there has halved from 14% in 2007 to just under 7% last year. One major reason for this is that the export-oriented growth model has reached its limits. On the demand side, the absorptive capacity of the global market is acting as a constraint.

Ultimately, China's economy is quite simply too big to continue growing at a perceptible pace on the back of exports to the rest of the world.[13]

The country is now experiencing an altogether difficult process of transformation into a more balanced demand-based economy in which private consumption plays a greater role.

The Bundesbank looked in greater detail at this process and the problems it involved in the July 2018 edition of its Monthly Report.[14] Over the past years, China's extremely expansionary monetary policy has fuelled a veritable credit boom. Credit was channelled in particular to state-owned enterprises whose investments have never really been all that productive. Significant overcapacities built up in certain industrial sectors, such as steel manufacturing.

One could argue that the state capitalism characteristic of the Chinese system, especially, is more of a weakness than a strength. That's a point confirmed by Mr von Hayek, who said the following at his inaugural lecture here at the University of Freiburg. The fact that far more knowledge about facts is fed into a market economy system than any one person or even any one organisation can know is the crucial reason why the market economy does more than any other economic system.[15]

That is one reason why I firmly believe that we are still on the right path with our social market economy, our open democracy, and our liberal rule of law.

China has ambitious international plans, not least with its Belt and Road Initiative. At the same time, the United States is forging links between national security interests and international trade policy.

In this difficult situation, what we need here in Europe is a strong EU – not only to stand up for our own interests at the negotiating table, but also to preserve and refine the multilateral rules-based trade order.

Tuesday saw the European Commission present a concept paper for reforming the World Trade Organization (WTO). One point this paper makes is that the WTO should do more to address forced technology transfer and market-distorting government support channelled through state-owned enterprises. And last week Commission President Jean-Claude Juncker used a speech before the European Parliament to say that it was time for Europe to develop what he called Weltpolitikfähigkeit – a term he defined as "the capacity to play a role, as a Union, in shaping global affairs". In his words, "United, as a Union, Europe is a force to be reckoned with."[16]

4 Focus of the European Union

Ladies and gentlemen,

Brexit does indeed represent a step backwards on the European path.

For the EU, the United Kingdom's exit – whether it is a hard or a soft one – will be a painful loss. Germany, especially, shares many of the same beliefs as the UK, such as the merits of market economy incentives and open markets.

But we also need to see Brexit as a wake-up call. For one thing, the public at large need to be given a clearer vision of what benefits European solutions can deliver. For another, there is also the underlying question of the right division of responsibilities between the European and national levels.

Both of these aspects suggest to me that the EU needs to be geared more than ever to reaping the rewards of acting as one. That is why I welcome the European Commission's plans to focus on areas in which the EU can add real value.

There are many tasks that can be performed better at the European level than the national. From an economic vantage point, efforts should concentrate on Europe-wide public goods and policy areas with cross-border externalities.

Nearly a year ago to this day, French President Emmanuel Macron used his speech at the Sorbonne to single out defence, border security, migration policy, climate protection, and the expansion of digital networks as areas where he could clearly see Europe adding value.

A common asylum policy would also help ease the pressure on individual countries which are particularly exposed on account of their locations. Helping people in need is a task that can done better by pulling together, so that the burden does not become too much for any one country.

Note, though, that providing European public goods generally comes with a price tag attached. So once the European to-do list has been drawn up, the question of how the items will be financed needs to be addressed. Germany – unlike other net contributors – has already declared its willingness to put more towards the EU budget.

That said, what counts here is that Europe's general public does not get saddled with even more taxes and public levies than hitherto. And we should continue to steer clear of giving the EU the right to raise debt. With member states already labouring under high levels of general government debt, it would be wrong for the public sector to create even more borrowing opportunities.

Let's not forget that the crisis that engulfed the euro area was a sovereign debt crisis. And that brings me to the final part of my speech here today, in which I will turn my attention to the euro area.

5 Reforming the euro area

To prevent the sovereign debt crisis from escalating, financially distressed member states were granted assistance loans in the shape of the euro rescue package. But the crisis also forced the Eurosystem to adopt stabilising measures that caused monetary policy to test the very limits of its mandate.

You could say the central banks became the crisis response team tackling the blaze. But in the interests of monetary stability, that's something that should not become a habit. Hence the huge importance of forging a crisis-proof regulatory framework in the euro area for the Eurosystem. Then the central bank would be able to credibly focus on its mandate rather than having to put out the fire on behalf of all those that claim that their hands are tied.

Now, there have been a number of improvements at the institutional level since the crisis erupted. The ESM can grant conditional financial aid to member states in the event of a crisis and thus prevent a national crisis from jeopardising the stability of the entire euro area financial system.

Another step forward was the creation of the banking union. Thus far, it is composed of a single supervisory mechanism, a single resolution mechanism, and harmonised national deposit guarantee schemes.

These reforms remedied weaknesses in the architecture of the euro area that had either been ignored or overlooked when the euro was founded.

These measures restored stability in the euro area – there's no doubt about that. But they haven't made it crisis-proof once and for all. And that is why no one doubts that further reform steps are in order. Whatever shape these steps take, the regulatory framework of monetary union needs to be designed in such a way that actions and liability for their consequences are aligned.

Originally, there was a clearly defined allocation of responsibilities, with the Maastricht Treaty stating that fiscal policy was a matter of national ownership. And the no-bail-out clause (which is today Article 125 of the Treaty on the Functioning of the European Union) went as far as to explicitly prevent member states from assuming liability for each other's debts. Action and liability, then, were located at the national level.

As a measure of last resort, the no-bail-out clause states that it must be possible to impose a haircut. That's something that creditors need to be aware of.

I imagine the architects of monetary union will have thought this an unlikely scenario. They did, after all, assume that financial markets and the rules on debt would exert enough of a disciplinary influence.

But the onset of the sovereign debt crisis put paid to that notion. The no-bail-out clause lacks credibility. Even highly indebted member states did not have to pay much in the way of risk premiums in the years leading up to the crisis. And the rules on debt were too tame, not least because Germany, together with France, took the sting out of the Stability Pact early on.

The first step towards a functioning Maastricht framework is to restore the credibility of the no-bail-out rule. It must be possible to reschedule or restructure sovereign debt without crippling the financial system.

Real progress could be made on this front by automatically extending government bond maturities in conjunction with an orderly restructuring regime, and by abolishing the preferential regulatory treatment afforded to government bonds.

The idea of automatically extending bond maturities when assistance is requested under the ESM rescue programme is to keep private investors on the hook when a member state receives assistance loans. Clemens Fuest has stressed that this might prevent private creditors from making a quick getaway at the taxpayer's expense if a crisis strikes.[17]

A more appropriate regulatory regime for sovereign risk would encourage banks to stop holding as much government debt – particularly paper issued by their home countries – and to set aside more capital to cushion losses. That would make a sovereign debt restructuring episode more manageable for the banking system.

Furthermore, two measures need to be taken to make the rules on debt more binding.

First, it would be helpful for the rules of the Stability Pact to be simplified. One expert in public finances, Friedrich Heinemann, has remarked that the official manual illustrating the rules of the pact is more than 200 pages long, and that the various sorts of escape clauses offer a wealth of arguments for justifying high levels of debt.[18]

So the proposals to simplify the fiscal rules, as recently tabled by Germany's Council of Experts and its French counterpart, are a welcome sign. What matters at the end of the day is that these kinds of rules are complied with and that they help swiftly reduce the high debt-to-GDP ratios.

As for the second measure, a more rigorous interpretation of the rules could be achieved by giving responsibility for fiscal surveillance to an independent authority instead of to the Commission. An institution equipped with a clear mandate to guarantee sustainable public finances would not be torn between that mission and the need to achieve other policy goals at the same time.

Ladies and gentlemen,

I must admit that the current reform debate isn't exactly being driven by the idea of strengthening national ownership.

Quite the opposite: there is another idea which is constantly coming to the fore – risk sharing. Be it a European deposit insurance scheme, a facility to cushion asymmetric shocks, or the idea of converting the ESM into a European Monetary Fund, all these proposals are based on the underlying assumption that the euro area would be more stable if its members agreed to share risk.

But the same goes for these proposals, too: they will only deliver stability if actions and liability for their consequences are in alignment. After all, responsible decisions are only likely to be made if the economic consequences are borne by the decision-makers themselves, and by no one else.

Joint liability, then, can only work if decision-making powers are surrendered and legacy assets are scaled back.

Viewed purely in isolation, the existence of a single supervisory mechanism would support the idea of creating a European deposit insurance arrangement. This would help make the financial system more stable since it would reduce the likelihood of bank runs.

On the other hand, the national level is still home to key policy areas which have a bearing on the risks carried on bank balance sheets, such as insolvency regimes. Moreover, bank balance sheets are still riddled with exposures that arose under national ownership. I'm referring here to the very high stocks of non-performing loans in some quarters. But the large holdings of government bonds on bank balance sheets are also problematic.

Risks that arose under national responsibility should not be communitised. After all, as an individual you can't usually take out insurance for damage that has already occurred.

That’s why, before a deposit insurance scheme can be created, sovereign default risks on bank balance sheets would need to be reduced on a lasting basis, as would the stocks of non-performing loans. And looking to the future, it would be important to prevent new risks from building up in the first place. Staying with the insurance analogy I just mentioned, and given that member states will still have a bearing on the health of bank balance sheets in future, the concept of a long-term national risk retention requirement also seems worth considering.

But leaving aside the banking union, there would appear to be no great interest among member states of the euro area to surrender substantial sovereignty rights to Brussels, such as the power to intervene in national fiscal autonomy. That's why this is another area where it would be premature to communitise liability and share risk.

6 Conclusion

Ladies and gentlemen,

A century ago, Oswald Spengler prophesied the "Decline of the West". That decline has failed to materialise, just like the collapse of capitalism that Karl Marx had once predicted, or the "End of History" thesis posited by Francis Fukuyama.

Events these days revolve around China, trade disputes, geopolitical conflicts, the refugee crisis, Brexit, populism, globalisation, digitalisation and demographic change. Some may see the challenges facing Europe and our open society and paint a bleak future that they are powerless to change.

But Karl Popper’s words show us a different path: "The future depends on ourselves, and we do not depend on any historical necessity."[19]

I am certain that we Europeans together have the strength to overcome the challenges of our time. We need to remedy the flaws that have come to light in the euro area and take Brexit as a cue to strengthen and focus the European Union.

Thank you for your attention. I look forward to the discussion.

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2 O. Issing, Saat für zukünftige Konflikte, interview with the Wirtschaftswoche, 16 Februar 2018, p. 23.

3 W. Eucken (1952), Grundsätze der Wirtschaftspolitik, Chapter XII.

4 See D. H. Autor, D. Dorn and G. H. Hanson (2016), The China Shock: Learning from Labour-Market Adjustment to Large Changes in Trade, Annual Review of Economics, Vol. 8, pp. 205–240.

5 See W. Dauth, S. Findeisen and J. Südekum (2017), Trade and Manufacturing Jobs in Germany, American Economic Review: Papers & Proceedings 2017, Vol. 107, pp. 337–342.

6 See Deutsche Bundesbank, The danger posed to the global economy by protectionist tendencies, Monthly Report, July 2017, pp. 77–91.

7 See Deutsche Bundesbank, The potential macroeconomic impact of US tax reform, Monthly Report, February 2018, pp. 14–16.

[8] See G. Felbermayr (2018), Beobachtungen zur US-Leistungsbilanz, ifo Schnelldienst 9/2018.

[9] G. Felbermayr (2018), Zölle im transatlantischen Handel: Worauf, wie viel und wie gerecht?, ifo Schnelldienst 6/2018, p. 8.

[10] See L. Cernat, D. Gerard, O. Guinea and L. Isella (2018), Consumer benefits from EU trade liberalisation: How much did we save since the Uruguay Round?, European Commission, DG Trade, Chief Economist Note, No 1.

[11] Quoted in N. Doll, "Protektionismus und Abschottung haben keine Zukunft", www.welt.de/wirtschaft/article181410812/BDI-kritisiert-Regierung-Protektionismus-und-Abschottung-haben-keine-Zukunft.html, 4 September 2018.

[12] C. Fuest (2018), Der dritte Systemwettbewerb, Frankfurter Allgemeine Zeitung, 27 July 2018, p. 18.

[13] See Deutsche Bundesbank, On the weakness of global trade, Monthly Report, March 2016, pp. 13–35.

[14] See Deutsche Bundesbank, The realignment of the Chinese economy and its global implications, Monthly Report, July 2018, pp. 39–56.

[15] F. A. von Hayek, inaugural lecture on 18 June 1962 at the University of Freiburg.

[16] J.-C. Juncker, State of the Union 2018 – The Hour of European Sovereignty, speech given on 12 September 2018.

[17] C. Fuest, Ein Europäischer Währungsfonds muss die Steuerzahler schützen, Wirtschaftswoche, 15 December 2017, p. 68.

[18] See F. Heinemann (2018), How could the Stability and Growth Pact be simplified?, European Parliament, In-depth Analysis, Euro Area Scrutiny.

[19] K. R. Popper, The Open Society and Its Enemies, Vol. I, Introduction, 1st ed. 1957, Francke Verlag, Berne