Jens Weidmann: Lessons learned from the crisis and economic policy challenges

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 Deutsche Bundesbank's Capital City Reception, Berlin, 17 October 2018.

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1 Welcome

Esteemed ladies and gentlemen,

Colleagues,

Rocks can wander. Straight, curved and zigzag furrows inscribed in the dry loam soil of the Californian Mojave Desert are proof that even heavy boulders really can move out there. Tracks stretching as far as one hundred metres have been discovered.[1]

In the Land of Opportunity, this mysterious place is known as Racetrack Playa. For a long time, it was not known whether this was the work of pranksters or a natural phenomenon. That was until several years ago, when a team of researchers solved the mystery with the help of cameras, GPS technology and weather data.

After it rains at night during the winter months, a thin ice layer forms. When this ice begins to melt in the morning sun, it breaks up and "sails" along the meltwater. Lights winds are then all that is needed to make these panels of ice slowly push rocks across the desert floor. The furrows become visible once they have been dried out by the wind and sun.[2]

But what does this fascinating natural phenomenon have to do with the topics we are addressing today? Heavy objects can be moved given the right combination of forces. The same is true of politics: it's all about the interplay of forces. I would like to use my speech today to talk to you about the way in which political and economic forces work – looking back at the bank bailout during the financial crisis, and looking ahead to the challenges facing monetary policymakers in the euro area and economic policymakers in Germany.

Exactly ten years ago today, the Bundestag and Bundesrat passed the Financial Market Stabilisation Act (*Finanzmarktstabilisierungsgesetz*). One month after the collapse of Lehman Brothers, the then Finance Minister Peer Steinbrück explained that there had not been a financial crisis of such a magnitude in 80 years. To "avert the danger"[3], an extensive rescue package was put together, comprising up to €400 billion in government guarantees for financial institutions.

Ten years on from this Herculean effort, many citizens are quite rightly asking how much it cost to bail out the banks. Federal Finance Minister Olaf Scholz recently put the bill at around €60 billion for central and state government. That equates to just under 2% of German GDP, which isn't exactly a small amount. But such calculations are tricky for a number of reasons. First, it isn't a final invoice: while risk assets can generate income, new losses can also occur. Second, it doesn't factor in the macroeconomic costs of an alternative scenario in which politicians did not act decisively.

It is simply impossible to say with any certainty what would have happened if we had not rescued the banks. Would the crisis have potentially taken an even worse turn? Would many more jobs have been lost? Would taxpayers have had to foot an even larger bill? These risks were real. It was therefore right and important for the Chancellor and Finance Minister, the Bundesrat and Bundestag to intervene decisively.

2 Lessons learned from the crisis

But rescuing the banks was just one of the measures that we, as a united front and working together with international partners, implemented to ward off the crisis. In order to stop the economy from plunging into what might have been a downward spiral, the bailout was accompanied by fiscal stimulus packages and a resolute monetary policy response.

As a result, we managed to avoid a prolonged deflationary economic slump reminiscent of the Great Depression of the early 1930s. This also garnered central banks a great deal of praise on the international stage.

Extraordinary circumstances require extraordinary measures. But their risks and side effects should not be ignored, particularly when looking at the longer term. Research suggests that, for instance, monetary policy accommodation can create incentives for financial market players to take on too much risk, thereby sowing the seeds of new excesses in the financial system.[4] For example, commensurate effects on several US banks were identified by Bundesbank economists in the run-up to the crisis.[5] This is in line with the literature, according to which monetary policymakers are one of the causes of these problems and are hence responsible for mitigating new risks.[6]

The crisis was the product of various factors. With that in mind, the hunt for the perpetrators doesn't play out like a classic detective story with one clear culprit. It is more like Agatha Christie's "Murder on the Orient Express": there were many culprits. Equally varied, then, are the lessons that need to be learned from the crisis – some of which have, in fact, already been taken on board.

Thanks to Basel III, banks are required to hold better-quality capital in far greater amounts. That gives them a buffer to use in case they run into difficulties. And more of their owners' money is at stake because regulators have strengthened the liability principle, which is that whoever reaps the benefits must also bear the liability.

The new resolution regimes are designed to ensure that banks can ultimately exit the market without triggering turmoil in the financial system. Furthermore, banking supervision and regulation were expanded to include macroprudential policy. By taking a system-wide perspective, macroprudential monitoring focuses not least on the interconnectedness of financial players, which could serve as a conduit for contagion effects.

So as you can see, some important lessons were learned from the financial crisis. But in this regard, the acid test for monetary policy is still to come. I believe the answer here is to ensure that monetary policy has a symmetrical effect over the whole of the economic cycle: in a downturn, policymakers must respond vigorously, but in an upswing, they must also be able to tighten the reins again as needed – regardless of the impact this might have on governments' funding costs, for example.

Monetary policy should have a stabilising effect similar to that of a cruise control system that keeps a vehicle moving at a constant speed. When driving uphill, the power of the engine is increased so the vehicle does not slow to a crawl. As the road flattens out, the power must also be reduced. And on a downhill stretch, the car might need slowing down to stop it from going faster and faster.

The euro area hasn't quite finished the uphill climb just yet. Admittedly, the economy as a whole has experienced five years of uninterrupted growth and the latest unemployment rate, at 8.1%, is substantially lower than the pre-crisis average of 8.7%. But domestic price pressures are still subdued, which is why monetary policy remains extremely expansionary. However, in the latest forecast from the ECB, experts anticipate that capacity utilisation in the economy will continue to increase in the next two years on the back of the robust upswing and its driving forces. Core

inflation in the euro area, which strips out energy and food, is therefore likely to rise from 1.1% this year to 1.8% in 2020. And the headline inflation rate will probably persist at a level of 1.7% this year as well as in the next two years.

From my point of view, this is certainly largely compatible with our medium-term notion of price stability. As a result, it is now time to set about exiting the very expansionary monetary policy. The Governing Council of the ECB didn't set the boulder in motion in June, but you could say it got the ball rolling by indicating that it wanted to end the net purchases of government bonds and other securities at the end of the year.

How the rest of the return to normal monetary policy pans out will of course depend on economic developments, especially the path of inflation. But the financial crisis has taught us not to ignore the impact of long-term risks on price stability, either.

Economists at the Bank for International Settlements underline that economic developments are affected not just by business cycles but also by financial cycles, which last for longer and fluctuate more strongly.[7] Financial imbalances can ultimately be associated with deeper recessions and lasting damage to the real economy. Because monetary policy can have an impact on the financial cycle, the BIS researchers suggest extending the time horizon for monetary policy. This would allow longer-term risks to price stability from turbulence in the financial system to be factored into monetary policy decisions to a greater degree. Given this long-term connection, it may be advisable, even for a monetary policy that focuses exclusively on the objective of price stability, to heed developments in financial markets.

3 Economic policy challenges

Ladies and gentlemen,

I fully understand that the current period of low interest rates is a testing time for savers. Although households have for many years been able to offset their low levels of interest income – from savings, for instance – thanks to the good performance of other asset types, the real return on German households' financial assets entered negative territory at the beginning of the year. In part, this was because equity market prices lost some of their earlier dynamism.

But it's fair to say that citizens are not just savers – they are also employees, property owners and taxpayers. And as such, they benefit from the low interest rates.

Of course, interest rates will also gradually pick up as monetary policy returns to normal. But what level they will ultimately reach depends on conditions that monetary policy cannot create. You see, in a long-term equilibrium, the faster the trend growth of an economy, the higher the interest rate.

However, strengthening the forces of growth is a task for economic policymakers. Here, it will be vital to tap into the opportunities presented by digitalisation – through a suitable infrastructure, education, and, not least, market economy conditions such as modern competition law. Economists are now focusing closely on what have been dubbed "superstar" firms – businesses which are becoming hugely powerful market players, mainly as a result of network effects in the digital segment.[8] Bearing this in mind, Federal Minister for Economics Peter Altmaier's initiative to launch the "Competition Law 4.0 Commission" seems especially relevant.

And there is certainly far more scope elsewhere for strengthening economic competition and thus boosting productivity. Take, for example, the rigid fee schedules in the liberal professions, which tend to restrict opportunities for competition. The European Commission has also pointed this out in the past. What's more, isolationist tendencies in the field of foreign investment could be more of a hindrance than a stimulus for economic growth.

Europe is also an important part of the answer to the challenge of increasing productivity. Estimates show that a fully harmonised digital internal market would raise economic output by 4%.[9]

Conversely, demographic change is among the main factors dampening long-term growth. Germany's ageing population means a reduction in the number of potential workers. By the end of the next decade, the ratio of the population of usual working age to older citizens will shrink from 3:1 to roughly 2:1. As a result, by 2060, the OECD expects that Germany's GDP will only increase at a below-average rate compared to the other OECD countries.[10] There is all the more reason, then, to bolster productivity so as to safeguard the growth potential of Germany's economy.

Demographic change will also place substantial burdens on social security systems and public finances. For the time being, there are three main levers which can be used to keep the impact on the statutory pension insurance scheme in check.

One lever is the pension level. The current pension adjustment formula foresees a fall in relation to earnings. By contrast, according to the forecasts, the real pension level would continue to rise.

The second lever is the contribution rate. The rate is set to rise in order to curb the declining level of pensions. Yet, this is driving up labour costs and reining in the competitiveness of the German economy. It is thus essential not to pull this level too far.

I believe that the same applies to a tax-financed increase in the Federal grant. As things are at the moment, the Federal grant will already have to rise more sharply than tax revenue. An additional increase would then either mean putting up taxes or cutting spending elsewhere. There's only so much pressure that the Federal budget can take.

Bundesbank experts, amongst others, have been pointing to the third lever – the statutory retirement age – for some time now. Life expectancy has been rising steadily to date, meaning longer and longer pension-drawing periods but stagnant contribution periods. This all points in favour of raising the retirement age beyond 67. And studies show that higher life expectancy also means better health.[11]

If some individuals do need to retire earlier for health reasons, the system of pensions for people with reduced earning capacity is already in place and has recently been expanded considerably. However, this pension system should not be abused for early retirement in general. The challenge here is to set the eligibility criteria as objectively as possible to avoid undermining the aim of raising the retirement age.

Countries such as Denmark and the Netherlands have already pegged their statutory retirement age to life expectancy. There, the retirement age is set to rise to 68 in 2030 and might even exceed the 70 mark by 2050.

On the back of a long period of economic growth, Germany is currently basking in very favourable public finances. However, burdens stemming from demographic change are looming on the horizon.

Moreover, we cannot kid ourselves that the current period of economic prosperity will last forever. Now is precisely the time for fiscal policymakers to safeguard their capacity for effective intervention. These calls go out, not least, to those countries in Europe where debt levels are still very high and have not come down by much in the past few years. These countries are benefiting, in particular, from the current low interest rates.

But it would be wrong to simply expect things to stay this way. Monetary policy needs to return to normal and interest rates will then rise again. And it is the highly indebted countries that will feel

the strain. The Stability Pact, moreover, requires Member States to have a medium-term objective of a structurally close-to-balance budget.[12]

And it is precisely when the debt pile is big that these efforts must not be neglected. Otherwise the debt ratios will stay put at a high level. In Italy, for instance, the debt-to-GDP ratio has been at more than 130% for years. The rules stipulate that significant consolidation is required in Italy next year. Instead, the Italian government has announced that it will raise the deficit ratio to 2.4%. This would have a significant knock-on effect on the structural balance, and the extremely high level of debt would – at best – slip slightly.

Evidently, such developments are also a worry for many investors: risk premia for Italian government bonds have risen. Ultimately, this again narrows the room for manoeuvre for those fiscal policymakers who appear to be promising higher deficits.

The European Commission has thus issued a very critical comment of Italy's latest budget plans and the breach of the rules outlined therein and rightly so, in my opinion.

4 Conclusion

Ladies and gentlemen,

Together, wind, ice and water can move heavy stones. Ten years ago, many thought that resolving the crisis would be a similar Herculean task. Yet, today, Germany is enjoying remarkably favourable economic times.

The most important thing then is, as Agatha Christie has Hercule Poirot declare in "The Big Four": "Meanwhile we have learnt something, and to know is to be prepared."

Thank you for your attention.

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