

Jens Weidmann: The future of the European 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 IHK Rhein-Neckar New Year's Reception, Mannheim, 31 January 2019.

* * *

1 Introduction

Mr Schnabel,

Mr von Pentz,

Ladies and gentlemen,

Many thanks for your invitation and your kind welcome.

Tradition has it that speeches at new year's receptions look ahead at the topics we will be facing over the coming twelve months. And the speech I will be delivering here today is no exception. But before I look forward towards what the future might hold, let me reflect briefly on an event which took place almost 50 years ago to the day.

It was on 30 January 1969, to be precise. What I would give to have been strolling down London's Savile Row during my lunch break on what was, like today, a chilly Thursday. Passers-by could hardly believe their ears. Music was blaring from the rooftop of house number 3. But it wasn't just any old music – it was the Beatles, and they were playing live¹.

By this point in their career, the Beatles hadn't given a live concert for more than two years, having decided to concentrate on their work in the studio. Recordings for the Fab Four's latest LP, which would later be released under the title *Let It Be*, were being videotaped, and the highlight of the documentary was to be a live concert at a spectacular location. But the band ended up simply performing a concert on the roof of their headquarters.

What no-one suspected at the time was that it would be the last time the Beatles ever performed live. 50 years ago, then, saw the end of a musical era that we still hold dear today. And that's why the Beatles will pop up at various points during my speech here today.

At first glance, the Fab Four wouldn't immediately appear to have all that much in common with central bank topics. That said, Raghuram Rajan, the former chief economist of the International Monetary Fund, does see some parallels between music and monetary policy. A few years ago, he said: "Central bankers nowadays enjoy the popularity of rock stars."

Now, I'm not aware of any colleagues whose public appearances send the audience as wild as John Lennon or Paul McCartney did back in the day. But Rajan has given expression to the great expectations placed upon central banks since the onset of the financial crisis when it comes to steering the economy, putting out fires, or stepping into the breach for other seemingly incapacitated policy areas. We can sense this pressure in the euro area, too, of course. Indeed, the wish list for central bankers here is particularly long. And to some degree, we have only ourselves to blame.

But I imagine that business people like yourselves mainly want me to tell you what the future holds in store for the economy and the euro area. And that pretty much outlines the three main topics I will be covering in my speech here today. Let me begin by looking at the current state of the economy.

2 Normalising monetary policy

Ladies and gentlemen,

Uncertainty is becoming increasingly prevalent in the public debate about the state of the economy. And there's no denying that reports from the German economy haven't been good over the past few weeks and months. Industrial activity, especially, has been disappointing, particularly among automotive manufacturers. German economic output even contracted in the third quarter of 2018 – primarily due to the difficulties which car makers encountered in connection with the new vehicle emissions test procedures.

The Bundesbank's economic experts assumed in their December forecast that the car industry would quickly get to grips with these issues. Then, moderate growth in export markets and brisk domestic demand would enable the German economy to even outpace capacity growth rates somewhat in 2019 and the two years after that.

However, the outturn is far bleaker than this upbeat scenario. Indeed, car production remained very muted into December, and to make matters worse, output in other industrial sectors also sagged in November.

On the demand side, there has been little stimulus of any note from exports since the beginning of 2018. Following an exceptionally good showing in 2017, it was a return to more normal conditions, you could say.

But the measures adopted in the trade dispute between the United States and China are likely to be having an impact as well. A model-based analysis by the Bundesbank indicates that the adopted trade barriers could shrink the two protagonists' respective output levels by 0.5% over the medium term, and world trade would diminish by 1%². Other economies, not least Germany's, would also take a hit, albeit a milder one.

Like exports, German household consumption also remained sluggish in the second half of 2018, despite excellent labour market conditions and rising income levels. Explaining this weakness is altogether more difficult – remember, economists are known for being particularly adept at explaining today why what they predicted yesterday hasn't come to pass.

One possible cause might be the sharp increase in crude oil prices – like me, you've probably been annoyed about the high pump prices for petrol and diesel. This throttled consumer purchasing power during the second half of the year. It was only in December that energy prices fell sharply.

The relevant sentiment barometers are now pointing to a considerable deterioration in the business climate. The businesses surveyed reduced their expectations by far more than their assessment of the current situation, so the stream of bad news from Germany's economy might well continue for some time to come.

And contrary to our December forecast, the dip in growth looks set to continue into the current year. So from today's perspective, the German economy will probably grow at well below the potential rate of 1½% in 2019.

As you can see, I'm not trying to gloss things over. But at the same time, there's no reason for excessive pessimism. To coin a phrase, one protracted dip in growth does not a crash make – in other words: I see neither an abrupt slump nor an extended spell of noticeably receding economic activity.

Despite the current bout of weakness, the economy as a whole is still on an expansion path. Growth in Germany is building off favourable financing terms, rising employment levels and

increasing wages. Fiscal easing this year will add more stimulus still.

For labour market developments in particular, the short-term fluctuations in activity are of secondary importance. What this means is that one of the engines of economic growth is still intact. Gradually, the shortages in the labour market and substantial wage increases will also begin to stimulate domestic price pressures.

All in all, I still believe that the outlook in our December forecast for the next two years is a realistic one. Once the German economy has overcome the weak spell, it looks set to go back to growing at roughly the same pace as its capacity in 2020 and 2021.

That said, uncertainty over the future path of the economy is strong, and the risks for Germany are skewed to the downside. There are two main reasons for this.

The first is that the global trade dispute still hasn't been resolved. So there is a continued risk that protectionism might spread worldwide. This would hit German industry, with its exports-driven business model, particularly hard.

At least a few positive signs emerged from the negotiations between the United States and China. It would be a real step forward if the negotiations brought forth an agreement which sees the market being opened up to foreign businesses and intellectual property getting protection.

The second factor is Brexit.

Jeremy Adler, a British poet and scholar of German literature, said last summer that the United Kingdom is heading for a bona fide Shakespearean drama when it leaves the EU³. And right now, who is to say his assessment is wrong?

As things stand at the moment, the UK will leave the EU on 29 March. If the EU and UK fail to seal a deal, trade will be governed by World Trade Organization (WTO) rules. Compared with the regime in place today, this would take a considerable toll on goods and services trading.

Over the long term, the UK economy would probably suffer painful losses in income. The repercussions for the euro area and Germany, by contrast, would be less severe and arguably manageable.

However, the Bank of England warns of short-term disruptions to trade which could plunge the UK economy into recession. The "Old Lady of Threadneedle Street" simulated a variety of scenarios to reach these conclusions⁴. In the worst case scenario, UK GDP might slump by as much as 8%. That would be a more severe recession than after the financial crisis, and it wouldn't leave us unscathed, either.

Both of these risk factors – the global trade dispute and Brexit – are political by nature, and that's why they both need to be defused by politicians. The Eurosystem has a mandate to preserve price stability. But if the economy takes an unexpected turn for the worse, monetary policymakers don't have much wiggle room at the moment. Unlike the United States, the process of monetary policy normalisation in the euro area is just taking its first baby steps.

The ECB Governing Council decided in December to put an end to the Eurosystem's net asset purchases at the end of 2018. It also reaffirmed its intention to reinvest the principal payments from maturing securities until further notice. This will keep the stock of assets on our books at a constant level. And it is this stock of assets that counts for the programme's economic impact.

Figuratively speaking, then, the ECB Governing Council is keeping its foot on the accelerator, but not pushing it down any further. So the degree of monetary policy accommodation will remain exceptionally high – in fact, roughly as high as it was when the crisis was raging.

In part, this is also due to the persistently low interest rates. The ECB Governing Council has indicated that it continues to expect key ECB interest rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary.

The next steps towards normalising monetary policy will depend on how inflation pans out in the euro area. As things stand today, it is primarily the lower crude oil prices which look set to send the inflation rate this year noticeably lower than the Eurosystem staff had projected in December.

Remember, though, that the ECB Governing Council defines price stability as a medium-term measure, so we would do well to look beyond these fluctuations. I still expect the persistently upbeat labour market conditions and strong wage growth to gradually strengthen the underlying price pressures in the euro area.

Some observers are already calling for a very slow and hesitant normalisation of monetary policy, for fear that higher interest rates might cause corporate sector debt servicing to balloon and thus dangerously curtail investment activity. However, recent Bundesbank research indicates that debt servicing will probably have a moderate impact⁵ on account of the significant deleveraging in a number of sectors and countries in recent years.

Whatever happens, the normalisation process will probably take a number of years, which is all the more reason not to squander any time. You see, monetary policymakers need to regain more leeway to be in a position to respond to an unexpected economic slump.

3 Stoking the engines of economic growth

Ladies and gentlemen,

Amidst all the urgent questions currently being thrown up by Brexit and the trade dispute, there is one thing we mustn't lose sight of: the truly profound challenges facing the euro area are long-term in nature. The European Commission's estimates put its long-term growth potential at just 1.3%⁶.

When it comes to ensuring more growth, some look to the central banks. Yet monetary policy cannot solve structural problems, and when monetary policymakers do attempt to do this, it is to the detriment of their price stability objective.

Monetary policy can do no more than give the economy a slight nudge or slow it down, if this is required to ensure stable prices in the medium term. In doing so, it only influences the cyclical fluctuations around the existing growth trend.

To permanently raise the growth trajectory, the right course has to be set by economic, social and tax policy. In Europe, it is first up to the individual governments to make economic structures in their countries competitive. This is an ongoing task that all countries have to face – even Germany.

On the whole, Germany's standing as a business location isn't bad, but I see three areas we need to work on: education, corporate taxation, and infrastructure.

Germany's good infrastructure is regularly attested to, but it does have specific weaknesses. We do need to catch up on providing high-speed internet access, in particular. The expansion of the fibre optic network is making only slow progress. We definitely need to pick up the pace here.

When deciding where to set up base, enterprises don't just look at the quality of the infrastructure; the tax burden is also an important factor. The reforms in the United States have recently added impetus to the discussion of corporate taxation. Other countries, such as France, have since initiated tax cuts. When it comes to taxes on corporations, Germany is edging its way

to the top of the international league table.

Slightly above average tax rates may be defensible in Germany, but if the difference becomes too great, our attractiveness as a business location will suffer. That's why I believe corporate taxes should also be given due regard.

Companies could be granted targeted relief for research and development, for example. This could set incentives for innovation and bolster competitiveness.

Here in this region, I don't need to explain to you what innovative power is. Mannheim is traditionally considered a city of inventors. Karl Drais built the first bicycle here, Werner von Siemens presented the first electric elevator in Mannheim, and the first automobile built by Carl Benz took its maiden drive on the streets of this city.

At first, Carl Benz only ventured onto the roads at night. And during the day, too, he worked on the vehicle in secret, afraid that someone might preempt him. He only unveiled his invention to the public once he had the patent for it. This shows that technological advances do not simply fall like manna from heaven. They are only made when researchers and developers have an incentive to do such work.

The economist Paul Romer, who won the Nobel Prize in Economic Sciences last year, has also contributed to this understanding. Romer asked, for example, what motivates companies to do research and development. The framework conditions, such as patent protection, are a crucial factor. Government support for research can also play a role. Germany certainly has room for improvement in this area.

Thus, it is gratifying that the Federal Government has addressed this issue and has tax concessions in the works. As the legislative process rolls on, it is vital that the rules are not worded in a way that is too complicated and overly detailed. This would be an important signal that we are serious about creating an innovation-friendly environment.

We should also view the topic of innovation through the lens of the two major challenges facing Germany: digital transformation and demographic change.

The ageing of the German population is slowing long-term growth by reducing the number of potential workers, making it all the more important to permanently strengthen the drivers of growth in the German economy. Digital transformation gives us this chance.

It begins with the government itself. A modern, digital public administration benefits everyone. If, for example, more administrative formalities can be dealt with online, citizens and companies will save a lot of time and money.

There is still room for improvement here, as shown by a current report of the European Commission. For the "digital public services" criterion, Germany came in just 21st out of the 28 EU Member States⁷. The report identifies Germany as one of the EU countries with the lowest level of online interaction between authorities and citizens. Only 39% of the population use electronic public services. By way of comparison, the figure in Estonia is 96%.

Of course, digitalisation still has much greater reach. We are currently experiencing a fundamental change in the world of work. Digital technologies are making ever greater inroads into areas that were long thought to be the reserve of human beings.

As we witness these advances, a witticism attributed to the economist Warren Bennis springs to mind, and I quote: "The factory of the future will have only two employees, a man and a dog. The man will be there to feed the dog. The dog will be there to keep the man from touching the equipment."

Digital transformation is changing many job profiles and, as a result, the requirements on employees. There is an increasing focus on skillsets which a computer cannot replace: social skills and creativity, for instance.

There's barely a single job that won't ultimately be affected by digitalisation. The key to keeping pace with the changes is education. Education puts people in a better position to benefit from the changing environment. Those who deepen, broaden and update their skills will remain equipped for the future of work. I think it's imperative, then, that we establish a culture of lifelong learning.

Let's consider the European level. Here, too, there is still untapped growth potential that we can leverage.

Take the EU Single Market: it has been a success story, but the tale isn't over yet. In the digital world, there are still barriers hindering the free exchange of goods and services.

Copyright law is one example. The national legal systems of the EU countries differ on this point, and only in rare cases are the rules designed to facilitate cross-border use in the digital era. It is therefore time for a modern, European copyright law that creates a fair balance between the interests of creators and users. This would also provide more legal certainty, which enterprises need when they want to invest.

Another of the fundamental freedoms in the EU is free movement of capital. In practice, though, this is not applied enough in SME funding. As before, this is dominated by bank loans, often granted by domestic credit institutions.

A single European capital market would make it easier for companies to tap new sources of funding, even across national borders. This would come with a cross-border stabilising effect in the face of shocks hitting individual countries, and we could spare ourselves the discussion of other, more problematic instruments.

But when it comes to corporate financing, perhaps what some of you fear is new obstacles. Some among you may be thinking of the stricter banking regulation brought about by the Basel III regime. The concern is that banks may pare back their lending as a result. The Financial Stability Board (FSB) of the G20 countries has taken up the issue and is currently examining the role of financial market regulation for the funding of small and medium-sized enterprises.

Previous studies indicate that there are two effects of tighter capital requirements for banks. In the short and medium term, they can lead to a reduced credit supply because banks first shrink their balance sheet⁸. In the longer term, the effect on the supply of credit is actually positive because better capitalised banks can obtain cheaper (re)financing⁹.

As is so often the case when it comes to money, the workings are more complex than they first appear. Anyone wishing to make life a little easier can turn to the Beatles for guidance and comfort. As they once sang, "I don't care too much for money / Money can't buy me love."

4 Reforming monetary union

Ladies and gentlemen,

Not only did the Beatles shape the music of their time in a way that no other group has ever managed, they also showed what makes a good band: it needs to be greater than the sum of its parts. The same is true when musicians come from different musical backgrounds and were previously solo artists.

Which takes us back to the present and to European monetary union. Some 19 countries decided to form a band for the long haul. This band has now been gracing the stage for 20 years,

already twice as long as the Beatles. With that in mind, it's more like the Rolling Stones: there is no end in sight.

And so the euro celebrated its 20th birthday on 1 January. When it was introduced, politicians made the public one promise: the euro would be just as strong as the Deutsche Mark before it. With an inflation rate averaging 1.7% over the past 20 years, inflation is converging towards price stability as defined by the Eurosystem. The original promise of a stable currency has thus been kept.

Of course, we mustn't forget that part of this period was marked by the financial and sovereign debt crisis. It put monetary union to the test on more than one occasion. It could therefore be said that the euro had an easy childhood but a difficult adolescence.

If the crisis did one good thing, then, it was that it opened our eyes to the weaknesses in the institutional framework of the euro area. Paul Romer summed it up perfectly when he said, "A crisis is a terrible thing to waste." [10](#)

It would have been a terrible thing if we had learned nothing from the crisis. In the meantime, a great many problems have been tackled and reforms initiated. If the financial system or individual euro area countries were to once again find themselves in turmoil, we would be better prepared to deal with this today than we were back then.

After 20 years, the euro is all grown up. However, it hasn't yet put all of its growing pains behind it. In other words, monetary union hasn't yet been made crisis-proof once and for all.

In order to be forearmed in the long run, euro area countries first need to be proactive by making their economies competitive. Second, they need to keep their finances on a sound footing, as is also set out in the fiscal rules we have all agreed upon.

Going back to our band analogy, this means that every member of the band can and needs to do their bit in order to make the joint project a success – for instance, by regularly practising their instruments, turning up to rehearsals on time and sharing the group's core values.

However, it is not just the individual euro area countries that are being called upon to take action – there is a lot more work to be done at the Community level, too. The monetary union needs a coherent framework of responsibilities and liability. In this context, striking a balance between national responsibility and European risk sharing is crucial, and the leitmotif should be the alignment of actions and liability.

For entrepreneurs such as yourselves, this goes without saying: decisions will only ever be taken responsibly if those who decide also bear responsibility for the consequences of their actions. This principle of liability needs to apply to governments, too.

The current plans to reform monetary union need to live up to this principle. I would like to take this opportunity to single out two projects for closer examination.

4.1 Strengthening the ESM

A good example of how solidarity and soundness can be aligned is the permanent bailout fund that is the European Stability Mechanism (ESM). It provides member states with financial assistance in severe crises, on the condition that the causes of the crisis must be remedied.

In December, the euro area heads of state and government agreed to strengthen the ESM's role in crisis prevention and crisis management. In principle, I believe this to be a sensible move, as it has already proved itself to be highly adept at combating sovereign debt crises.

However, the ESM needs to be given the requisite powers in order to deliver on its new

responsibilities. One example that springs to my mind is fiscal surveillance under the Stability and Growth Pact.

To date, this task has been handled by the European Commission. However, its dual role as guardian of the treaties and as a political institution is sometimes more of a hindrance than a help when it comes to insisting on sound fiscal policy.

Thus, Friedrich Heinemann, an economist at the Centre for European Economic Research in Mannheim, has been critical of the fact that the interpretation of debt rules is being increasingly steered by political interests. In his view, the European Commission has disqualified itself as a “neutral arbiter”¹¹. Now, while you don’t have to agree with each and every one of his clear statements, it is difficult to deny that the fiscal rules’ credibility has taken a hit and that their binding force urgently needs to be strengthened.

4.2 Completing the banking union

The heads of state and government also agreed that the ESM should backstop the Single Resolution Fund (SRF) in a step towards completing the banking union. If, in the event of a bank resolution, SRF funds proved insufficient, the ESM would then provide a loan to be repaid by the banking sector at a later date.

In principle, this common backstop is appropriate because euro area’s significantly important banks are already subject to joint supervision. But before it comes into force, banks’ balance sheets need to be free of legacy assets. If not, risks that arose under national responsibility would subsequently be communitised.

The same questions arise, and are even more pressing, in connection with a different topic – namely the proposed single deposit guarantee scheme. It could well increase the credibility of depositor protection in Europe and thus reduce the risk of a bank run. However, several conditions need to be met in order to align action and liability and to avoid moral hazard.

First and foremost, the legacy risks lurking on European banks’ balance sheets need to be eliminated. For example, many banks are still sitting on a huge mountain of non-performing loans.

While it is true that the average non-performing loans ratio has fallen considerably in Europe since 2014, the problem largely concerns individual, hard-hit countries. In more than one-third of EU countries, the non-performing loans ratio is still above 5% – in some cases, well above it. Just for comparison purposes, the figure in the United States and Japan is around 1%. What’s more, banks’ risk provisioning to date is nowhere near enough to cover all losses that could result from non-performing loans.

Looking at government bonds, the situation isn’t much better. Many banks hold large stocks of domestic sovereign bonds that are backed by little to no capital, thereby chaining themselves, as it were, to the solvency of their national governments. For instance, holdings of domestic government bonds currently account for around 10% of Italian banks’ total assets, which is actually in excess of their capital levels.

There is a risk of unsound public finances taking their toll on banks, ultimately resulting in the deposit guarantee scheme having to come to the rescue. For that reason, it is not just about cleaning up banks’ balance sheets to get rid of legacy assets in the here and now. We also need to prevent an excessive amount of risk from ever building up again in future – risk that would then be transferred to other countries through a single deposit guarantee scheme.

The sovereign-bank nexus thus needs to be severed once and for all in order to pave the way for a single deposit guarantee scheme. Banking regulation lies at the heart of the problem. Up to

now, government bonds have been given preferential treatment over loans to the private sector and households.

On the grounds of prudence, this special treatment is not warranted and needs to be stopped. After all, the debt crisis clearly refuted the notion that government bonds are risk-free. It would therefore be a mistake to create a single deposit guarantee scheme without first ensuring that all the conditions are met.

When it comes to reforming monetary union, thoroughness should be put before speed. I would prefer to take small steps in the right direction than large strides in the wrong one.

5 Conclusion

Ladies and gentlemen,

The Beatles' impromptu rooftop concert 50 years ago ended after 42 minutes. In my opinion, speeches shouldn't last longer than rock concerts, so I will now bring this to a close.

Thanks to its University of Popular Music, Mannheim, too, has a special connection to modern music. But anyone who wants to give their ears a rest for the time being will find an interesting alternative on offer at the Kunsthalle Mannheim. Until Sunday, it is hosting an exhibition entitled "Constructing the World: Art and Economy 1919–1939 and 2008–2018".

It's actually two exhibitions in one, and sheds light on the era from 1919 to 1939, during which time the Great Depression raged, and the period following the outbreak of the financial crisis in 2008. It asks exciting questions such as how does art respond to change and crisis, and where there are parallels between the two eras.

Whatever answers await you, I can assure you of one thing: the Bundesbank is working hard to ensure there will be no reason to set up a third section of the exhibition so quickly.

Let's take one last look at that rooftop in London's Savile Row. John Lennon ended the concert with a comment highlighting his trademark ironic humour: "I hope we've passed the audition," he said, before leaving the stage.

I, however, will be staying on stage to answer your questions. I look forward to finding out what you would like to know.

But for now I would like to thank you for your attention!

¹ T. Barrell (2017), *The Beatles on the Roof*, Omnibus Press, London.

² See Deutsche Bundesbank, *The potential global economic impact of the USA-China trade dispute*, Monthly Report, November 2018, pp. 11–13.

³ www.deutschlandfunkkultur.de/der-brexit-als-shakespeare-drama-theresa-may-eine-planlose.1008.de.html?dram:article_id=421106

⁴ Bank of England, *EU withdrawal scenarios and monetary and financial stability*, November 2018.

⁵ Deutsche Bundesbank, *The impact of an interest rate normalisation on the private non-financial sector in the euro area from a balance sheet perspective*, Monthly Report, January 2019.

⁶ *The 2018 Ageing Report. Economic and budgetary projections for the EU Member States (2016–2070)*, Institutional Paper 079, May 2018.

⁷ European Commission, *Digital Economy and Society Index Report 2018*.

⁸ Gropp, R., T. Mosk, S. Ongena, and C. Wix (2016), *Bank response to higher capital requirements: Evidence from*

a quasi-natural experiment, SAFE Working Paper Series 156.

⁹ Gambacorta, L. and H. S. Shin (2016), Why bank capital matters for monetary policy, BIS Working Papers No 558, April 2016.

¹⁰ See New York Times Magazine, 31 July 2009, “A terrible thing to waste”, www.nytimes.com/2009/08/02/magazine/02FOB-onlanguage-t.html

¹¹ Süddeutsche Zeitung, 7 January 2019, “Neuer Schiedsrichter gesucht”.