Jens Weidmann: Market economy principles in monetary union

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Wolfram Engels Prize ceremony, Kronberg, 28 March 2014.

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Welcome

Professor Eilfort,

Professor Raffelhüschen,

Doctor Hildmann,

Professor Schweickart,

members of the Kronberger Kreis,

ladies and gentlemen,

Thank you for awarding me the Wolfram Engels Prize, and my special thanks to you, Professor Siegert, for the laudation.

The Wolfram Engels Prize was last awarded in 2007. It is therefore by no means awarded in an inflationary manner – not at all a mistake in the eyes of a central banker. This makes this award, bestowed in honour of a dedicated champion of the market economy, even more special.

I am delighted to accept this prize and see it as supporting not only my work but, above all, that of the Deutsche Bundesbank and its staff, fully aware that the Bank's opinion is not shared in all quarters. The Bank has recently been referred to as the centre of the most dogmatic neo-liberal thinking in Europe. I assume this was not meant as a compliment, and, moreover, it is not even accurate.

The Market Economy Foundation, the foundation awarding this prize, campaigns for regulatory policy and market-oriented thought and is thus making a vital contribution to the economic policy debate. And it is precisely this approach that sits more comfortably with the Bank's own stance.

Together with the Kronberger Kreis, the foundation strives to have market economy principles valued and respected, and to widen the reach of social market economy ideas.

I would like to take this opportunity to speak about market economy principles in the European monetary union and to discuss how to strengthen the principle of liability, as a constitutive principle of monetary union.

Market economy principles and European integration

"Constitutive principles" is of course an allusion to Walter Eucken, whose constitutive principles of competitive order are still the main pillars of our current economic constitution.

Effective competition is key for a market economy and its economic performance. In turn, competition requires free price formation. Competition creates prosperity. However, competition also requires protection.

For competition to have a control function, prices must be stable. Eucken thus stressed the "primacy of monetary policy". He also noted the importance of central rights and obligations for a competitive economy: open markets, rights to private property, freedom of contract and the principle of liability, which I have already mentioned.

He defines liability as an essential regulatory policy institution. In his "Principles of economic policy", he uses the example of an economic order with private property and a centrally

controlled economy to demonstrate what happens when liability and control (steering power) drift apart.

Given the institutional framework of monetary union, this problem is still highly topical, and I shall revisit it later on.

Eucken names "consistency of economic policy" as the final constitutive principle of competitive order. He complains that economic policymakers suffer from a nervous restlessness, often today dispensing with those very rules that were in place yesterday. Little has changed over time. Eucken's words still ring true regarding current economic policy measures in Berlin.

The introduction of a statutory minimum wage of €8.50 to be applied across the board launches a large-scale macroeconomic experiment which, if applied as intended, may endanger the labour market success of recent years. And the pension package will go back on some previous pension reforms and create incentives for early retirement, thwarting the necessary extension of working life given an ageing population.

Such a policy will place an additional burden on future generations but, as Groucho Marx once said, "Why should I do anything for posterity? What has posterity ever done for me?"

While the ordoliberals of the Freiburg School stressed the importance of Ordnungspolitik (translatable as regulatory policy) and mostly rejected intervention in economic processes (such as introducing a minimum wage), the founding fathers of the social market economy saw a need for government economic policy over and beyond this framework.

However, economic policy should be in line with the market mechanism and comply with the principle of subsidiarity. The principle of economic policy in line with the market mechanism and the principle of subsidiarity, borrowed from Catholic social teachings, are thus likewise to be seen as the founding principles of our economic order.

Thus, market economy principles have not just shaped the economic system in Germany, but are also major pillars of European integration.

A constitutive principle of European economic integration was, and still is, non-discrimination against external providers of goods and services. The four fundamental freedoms of the single market are the result of this principle and are summed up succinctly in an expert opinion by the Kronberger Kreis on European integration, to which Wolfram Engels also contributed: "The libertarian message of the Treaty of Rome was an economy with cross-border competition".

The Treaty on the Functioning of the European Union states that the activities of the European Union are to be "conducted in accordance with the principle of an open market economy with free competition". European competition law and rules on state aid have had beneficial effects on member states, often despite resistance from national policymakers – one example being market liberalisation. The Market Economy Foundation rightly awarded the Wolfram Engels Prize to Mario Monti, then a European Commissioner, in 2001 for his commitment to competition law in Europe.

Open markets and free, but protected, competition have increased levels of prosperity in Europe and this economic success played a major role in making European integration attractive, especially to central and eastern European countries. However, accession to the EU has also meant new dependencies and contagion channels requiring member states to toughen their stance on stability.

However, European policy is of course not to be considered sacred. Policies made in Brussels are not always in line with noble principles, such as that of market conformity or subsidiarity. We only need think of the Common Agricultural Policy or the Common Industrial Policy. Policymakers in Brussels and national policymakers act no differently; both are quick to put market economy principles second if this appears warranted in the pursuit of supposedly more important objectives.

Those in favour of a minimum wage, rent price ceiling or the policy switch to non-nuclear energy generation are undoubtedly pursuing honourable and important objectives. However, experience has shown that social and ecological objectives, too, can generally be achieved more successfully if political instruments are in line with, and not opposed to, the principles of market economy.

The Kronberger Kreis' first study back in 1983 was entitled Mehr Mut zum Markt ("More market, more glory"). This is still the motto of the Kronberger Kreis today and is just as pertinent. However, this reaffirmation of the market is otherwise currently not so popular.

The crisis has certainly changed the view of the market economy system and has raised doubts about the efficiency of markets. Business as usual is, of course, not an option.

However, I do not believe that the crisis has called into question the fundamental principles of market economy. Instead, the crisis has shown that the principles embodied by Ordnungspolitik were not sufficiently implemented in some areas. For instance, in the financial sector, these principles and the resultant rules had virtually been reversed in some cases.

Market economy principles in monetary union

Primacy of monetary policy

The European Union is also based on market economy principles; two in particular: first, the principle of liability and, second, that which Eucken called primacy of monetary policy.

Primacy of monetary policy is reflected by the fact that the Eurosystem has chosen price stability as its primary objective. The Eurosystem shall support the general economic policies in the Union but only where this is "[without] prejudice to the objective of price stability" (Article 127 TFEU).

According to the legal opinion of the Federal Constitutional Court, the Eurosystem's monetary policy mandate stops where the Eurosystem begins managing economic policy; in other words, if the Eurosystem, for instance, grants financial aid to member states or takes measures to safeguard the current composition of the euro area.

Prices must be stable for competition to have a control function. In his book Wohlstand für alle ("Prosperity for all"), Ludwig Erhard wrote "the social market economy is unthinkable without a consistent policy of price stability".

In line with his convictions, Erhard campaigned for the Bundesbank's primary task to be safeguarding price stability and for it to remain independent from political interference. The Bundesbank thus became a model of success. However, it was decades before the model of an independent central bank whose primary mandate is pursuing the objective of price stability took hold internationally.

Independence is not an end in itself – the central bank should not become a "state within a state". Instead it should be aware of the fact that independence and price stability are positively correlated. Independent central banks are better able to safeguard price stability than dependent ones. Independence and a Eurosystem mandate strictly limited to price stability are thus two sides of the same coin.

Conversely, this means that the trend currently emerging to confer more and more responsibility on central banks can ultimately challenge their independence. This, in turn, can make it more difficult for central banks to maintain price stability.

Some may contend that the crisis has shown that monetary policy should not just focus on keeping consumer prices stable, but should also safeguard the stability of the financial system. However, I believe that it would be a mistake to define financial stability as an additional objective for monetary policy under a dual mandate.

However, this naturally does not mean that central banks should not assume any responsibility for financial stability. The reigning consensus is that central banks should be given a macroprudential mandate.

At European level we now have the European Systemic Risk Board (ESRB) and, in Germany, the Financial Stability Committee (FSC). Central banks play a major role in both of these institutions. The FSC, which was set up in 2013, comprises the Bundesbank, the Federal Ministry of Finance, BaFin and – in an advisory function – the Federal Agency for Financial Market Stabilisation.

The committee discusses risks to the stability of the financial system based on analyses conducted by the Bundesbank. If the committee fears that unfavourable developments are afoot, it can issue warnings or recommendations. However, it does not have the authority to decide on macroprudential measures.

As macroprudential measures can trigger massive redistribution effects, the decision as to whether they are implemented requires parliamentary control and should therefore not be made by an independent central bank. Such a decision could ultimately endanger a central bank's independence.

There is also no doubt that financial stability policy requires its own set of tools. However, the macroprudential toolkit for financial stability policymakers, including those such as countercyclical capital buffers for banks, is still a "work in progress" and has yet to be put to the test.

It is essential, and the ECB Governing Council is united on this front, that involving central banks in financial stability policy does not alter the primary objective of monetary policy – ensuring price stability. Otherwise the credibility of monetary policy could be endangered. And money is nothing other than trust that has taken on solid form.

However, as monetary policymakers, we should not stand on the sidelines and watch the next crisis brewing. Any looming financial imbalances that pose a threat to price stability should be countered with monetary policy tools.

Incidentally, this has already been built into the ECB Governing Council's two-pillar strategy. The aim of monetary analysis, which is part of the second of these pillars, is to identify the medium to long-term inflation risks resulting from monetary variables.

However, monetary analysis is no crystal ball giving a glimpse into the future. The financial market crisis has also impeded the predictive quality of financial or monetary indicators for future price developments. In this regard, it is also a "work in progress".

3.2 Principle of liability

The second fundamental principle of monetary union is the principle of individual national responsibility.

Much as a market economy can function only if businesspersons assume responsibility for the consequences of their decisions, a monetary union, too, can only function if governments and banks carry the responsibility for their decisions.

In the Maastricht Treaty, monetary union is defined in such a way that monetary and foreign exchange policy are communitised but fiscal and economic policy remain a national responsibility. As a result of this asymmetrical set-up – one monetary policy, 18 fiscal policies – the stability of the single currency is under constant tension.

The already existing propensity to run up debt is even higher for governments in monetary union as the negative repercussion of excessive debt can be passed on in part to other member states. In addition, it was clear when the monetary union was set up that the member states would borrow with money they could not create on their own; doubts about

the solvency of a country could therefore more quickly have serious consequences for the financial stability of the country in question and thus spread to the other member states.

This is one of the reasons why fiscal discipline is so important in a monetary union, which is why precautions to prevent risks to stability were inserted into the Treaty.

First, the member states agreed, in particular, to avoid excessive deficits; the debt rules were fleshed out in the Stability and Growth Pact.

Second, monetary financing of governments was prohibited by banning central banks from lending to member states.

Third, the member states agreed that each country is and remains responsible for its own debt. In addition, the no-bailout rule states that no EU institution and no member state is responsible for the debt of another.

In the 1992 study on unity and plurality in Europe already cited above, the Kronberger Kreis around Wolfram Engels critically examined the issue of fiscal discipline, stating that “There are, however, also factors that give rise to the fear that convergence with fiscal discipline may not be strong enough to prevent undesirable developments”.

The hope prior to monetary union had been that the financial markets would exert a disciplinary effect on fiscal policy. It was expected that the exclusion of mutual liability would cause investors in government securities to demand adequate risk premiums, which would have rendered government borrowing that much more expensive.

This expectation was not fulfilled, however. On the contrary, exceptional interest rate convergence even before monetary union enabled the previously high interest rate countries to borrow on exceptionally favourable terms.

The fact that risk premiums for all countries of the monetary union contracted so heavily, receding in some cases to only a few basis points, is likely, among other things, to be attributable to investors’ apparent doubts about the credibility of the exclusion of liability. In any event, most recent history has shown that the doubts about the no bail-out rule were not irrational.

The fact is that the low interest rates caused a great deal of capital to flow into the euro-area periphery countries, which was not put to use in a very profitable manner. Wage increases which outpace productivity growth put additional strains on the competitiveness of economies. On balance, public and/or private debt grew strongly while current accounts deteriorated.

This was the breeding ground for the euro-area debt crisis, which began in 2010 following the global financial and economic crisis. The substantial increase in risk premiums for bonds of peripheral countries pushed several countries, in particular Greece, to the brink of insolvency.

In this crisis situation, the euro rescue packages and Eurosystem measures prevented the crisis from escalating. However, these crisis measures permanently weakened the principle of individual responsibility.

They caused a redistribution of risk and put elements of mutualised liability in place, disrupting the balance in the relationship between liability and control in the regulatory framework of monetary union: the set of options for controlling the member states’ borrowing did not keep pace.

One might argue that the fiscal rules were, in fact, tightened in the aftermath of the crisis – Stability and Growth Pact, fiscal compact and European semester are concepts which come to mind. Undoubtedly, these were steps in the right direction. But whether these tightened rules will have the desired binding effect remains to be seen. It is, above all, the European Commission that is called upon to be strict in laying down the rules, and certain doubts are unfortunately justified.

As we know, it is not the case that there haven't been any rules in place thus far. However, they have been inadequately implemented. The deficit limit of 3% of GDP has been breached seven times by Germany, eight times by France and a whole of nine times by Italy. According to the Commission's forecast, eight of the 18 member states will breach the deficit ceiling this year.

Allow me to quote one last time from the 1992 Kronberger Kreis study – with a wink: "From the point of view of an individual country, the agreed ceilings for deficits and debt levels represent a certain protection against unsound fiscal policies of other members of the union. At the same time, however, it is also a self-commitment by the governments of the member states towards their citizens. The fact that the European Commission has been tasked with monitoring compliance with the criteria reinforces this self-commitment and does not imply the Commission's conservatorship over national fiscal policy just yet."

22 years later, we must admit that we were probably a bit too optimistic regarding the self-commitment and its reinforcement by the Commission.

The key question now is how to once again reconcile liability and control or, in other words, how the framework of monetary union can be reformed to provide the common currency with a solid foundation.

Essentially, as the Scientific Advisory Board at the Federal Ministry of Finance put it as well, there is the "choice between two diametrically opposing institutional arrangements". Either we proceed towards deeper political integration – a fiscal union, say – or we improve on the existing framework and bolster the individual national responsibility of the individual member states as a constitutive feature of monetary union.

However, a fiscal union must not simply mean extending mutualised liability, because that would merely be a transfer union. A real fiscal union would depend on the member states transferring national sovereignty to the community level, for example by giving the community the necessary right to intervene in the event of unsound public finances.

I believe that there is currently no will, among either the general public or governments, to truly concede sovereignty, which would be a prerequisite for a fiscal union; and this state of affairs is not about to change anytime soon. On the contrary, the member states continue to insist on having the final say.

When the European Commission recommended last year that the deadline for correcting the excessive government deficit be extended for France and other countries, while in return expecting France to implement concrete reforms, the French president reacted indignantly saying that: "The European Commission cannot dictate to us what we have to do."

I think this example illustrates rather clearly the willingness of the member states to allow interference from outside parties.

Therefore, it seems to be that strengthening the Maastricht framework is the only way forward when it comes to establishing a stable regulatory framework. However, this would mean that the liability principle, too, would have to be strengthened or, to quote Otmar Issing: "For a monetary union, in which the countries (…) have transferred their monetary policy to a supranational institution, while insisting in all other areas that they remain sovereign states, the no-bail-out principle is the only solution. Those who insist on self-determination must bear the consequences of their own actions by themselves."

Implications of the liability principle for reforming the EMU framework

But how can the liability principle be strengthened and what does "strengthening the Maastricht framework" mean in concrete terms?

Strengthening the liability principle essentially means that both governments and banks must continue to take responsibility for the consequences of their actions. This implies that citizens

are primarily liable for the public finances of the country in question, and that, secondarily, investors bear the consequences of their investment decisions.

I believe, for example, that a European framework which is based on individual national responsibility must first fall back on the taxpayers of the affected country in an exceptional financial emergency of a member state, given that high public debt levels are often associated with significant private net wealth.

In order for governments with a waning creditworthiness to gain time to find sustainable solutions for their public finances, it is also important to be able to restructure government debt without endangering the stability of the financial system. Introducing collective action clauses for the issuance of sovereign bonds was certainly a step in the right direction. However, the Bundesbank believes that additional steps are required.

The Bundesbank suggested that a clause should be hard-wired into the terms and conditions for the issuance of euro-area government bonds that would automatically extend the maturity of a given country's bonds by three years if that country received loans from the ESM fund. Automatically extending bond maturities in this manner would buy time for crisis countries to resolve their problems without private creditors pulling their capital out. This would allow a better balance to be struck between liability and control.

First, the automatic extension of maturities would cause the volume of financial assistance to decrease significantly. Second, sufficient time would be available to determine whether the problem is one of solvency or liquidity, in other words whether a country is permanently or only temporarily unable to obtain funding in the market.

Strengthening the liability principle ultimately means that, in extremis, it must be possible to declare "governments and systemically important banks insolvent" without jeopardising financial stability in the single currency area. Only the possibility of failure can ensure that financial markets exercise their disciplining function on banks and governments.

Until now, the insolvency of governments and systemically important banks has practically not been permitted because of the probably quite realistic fear that this would threaten the stability of the financial system in the whole euro area. So what ought to be done to ensure that insolvent governments and banks no longer represent a systemic risk in future?

Among other things, the disastrous sovereign-bank nexus would have to be broken. To ensure this, we must do the following.

First, we must further strengthen the financial system's resilience.

Second, we must regulate the financial markets strictly and on the basis of uniform rules.

Third, we must effectively implement a credible resolution regime for banks.

And lastly, we must end preferential regulatory treatment of government bonds.

Progress has already been made with regard to resilience; in particular the implementation of the Basel III capital rules improves banks' ability to absorb loss. Moreover, the Single Supervisory Mechanism, which is due to be launched in November of this year, offers the opportunity to apply a uniform and rigorous supervisory regime.

European banking supervision also requires European banking resolution; otherwise, there would be a disconnect between control and liability. It is therefore right that a Single Resolution Mechanism is now about to be established.

Wolfram Engels once wrote: "Bankruptcy is a part of the market economy." However, it has been virtually impossible to apply this essentially self-evident principle to the banking sector.

In the future, whenever a bank fails, resolution costs must generally be borne first by shareholders and creditors at the top of a liability cascade. After that, a bank-financed resolution fund would come into play, and only as a last resort should public – read, taxpayer – funds be used.

This is what the Council, Parliament and Commission agreed this past week, which is to be welcomed. Despite individual exceptions with regard to details, which are part and parcel of the process of compromise, the agreed resolution mechanism allows a fundamental principle of market economics to be enforced; it should primarily be the owners and creditors of a bank who bear the risks of their investments and not the taxpayer.

To sever the harmful sovereign-bank nexus, the preferential regulatory treatment of government bonds, too, would have to cease. This is an anachronism based on the false assumption that government bonds are risk-free investments. The crisis has vividly demonstrated that investments in government bonds, too, entail risks.

At present, no large exposure limits are in place for government bonds – nor are banks required to back government bonds with capital. Under the current capital rules, a zero risk weight applies to these assets, which means that these government bonds can be fully funded with borrowed money, which gives them an advantage over lending to the private sector.

This preferential treatment has been a factor in banks in several euro-area periphery states, in particular, raising their exposure to domestic government bonds during the crisis; they have thereby tied even more closely their fate to that of their national government. Banks tend to circumvent the liability principle in this way.

If all goes well, banks pocket a decent profit owing to the crisis countries' comparatively high bond yields and the favourable refinancing rates. However, if the government were to become insolvent, the consequences for banks would be negligible as they would ultimately have to be resolved in any case.

For this reason, I have for quite some time now been calling for government bonds to be backed with a level of capital that adequately reflects the risk and for caps to be imposed on such investments, as is commonplace for loans to private debtors. And I am glad that Federal Finance Minister Schäuble has come to share this view. At a Bundesbank conference some weeks ago he said: "This issue must be put on the political agenda."

Meanwhile, he will need to persuade his colleagues in the more highly indebted countries; after all, zero-weighting is a major selling point for government bonds, including those with a lower credit rating.

In conclusion, it can probably be said that a great deal has been set in motion to make the financial system more robust, but a lot remains to be done. What is clear, and I would hereby like to wrap up my comments on the reform of the operational framework of monetary union, is that a stable monetary union cannot exist without a stable financial system.

Conclusion

Ladies and gentlemen, at the end of my speech I would like to once again express my gratitude for being awarded the Wolfram Engels Prize. I would also like to thank the informedia foundation for donating the prize money of €15,000.

With good reason, the Bundesbank's code of conduct prohibits Board members from accepting such sums of money for themselves. Instead, I would like to see this money go to Deutscher Kinderhospizverein. The association helps children who suffer from a life-shortening disease and their families along this difficult path – a commitment I believe deserves the highest recognition and support.

Being awarded the Wolfram Engels Prize encourages me to continue to take clear and sometimes uncomfortable stands. I firmly believe that market economy principles and the rule of law are the main pillars of our economic order, European integration and monetary union.

Those who emphasise principles quickly gain a reputation for being a "stickler for principles". However, a key lesson from the crisis is that the positive influence of markets can only be effective if the implementation of market economy principles of order is ensured.

Before I take up any more of your time, another Erhardt quote comes to mind – not by Ludwig Erhard this time but by Heinz Erhardt who said that "one generally produces many words if one has nothing to say".

On that note, I hope I haven't produced too many words this evening and would like to thank you for your attention.