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Charity Registration Number: 208223

## Transcript

# Rebalancing Europe

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26 March 2012

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**Jens Weidmann:**

Thank you, Mr Popham, for the words of welcome. This is a very special event for me. Chatham House has been held in great respect for almost a hundred years – not only in the UK but also in Germany and across the globe. The privilege I feel is underscored by the distinguished audience that has gathered here today. I feel truly honoured to speak to you in such a famous venue.

About six weeks ago, I came across an article in the Frankfurter Allgemeine Zeitung, a leading German daily. The author of the article, an economist at the London School of Economics, had chosen the title: 'The fanatic central bank – where there is a will, there is always just one way'.

Well, I did come here wearing the hat – or rather the suit – of a central banker, and of a 'Bundesbanker' at that. The ideas that I am going to present might therefore be seen as fairly conservative and principled. But, as I hope to convince you, they are still well short of being fanatic. I did not come here to deliver a lecture. I am, in fact, deeply convinced that sharing and discussing ideas will lead to better solutions. During the next quarter of an hour, I will try merely to outline my line of reasoning in order to leave enough scope for discussion.

But first, a brief look at where we currently stand in these challenging times.

*Europe off balance*

We face a crisis that is no longer confined to individual countries. Throughout Europe, it weighs heavily on people's minds and challenges the viability of monetary union in its current form. It is obvious to all of us that the crisis has to be resolved and future crises must be prevented.

The first step must be to contain the crisis, to prevent it from spreading. To this end, policymakers have surrounded the crisis with a 'Wall of Money', which has meanwhile reached a height of €500 billion. Ring-fencing is certainly a sensible approach, but just like the 'Tower of Babel' the 'Wall of Money' will never reach heaven. If we continue to make it higher and higher, we will, in fact, run into more worldly constraints – both financial and political ones.

And, whether we like it or not, we are also changing the rules of the game in monetary union and might set incentives that lead to new problems in the future.

In any case, we must realise that all the money we put on the table will not buy us a lasting solution to the crisis. As Mervyn King frequently and rightly states: 'all we can buy is time' – time that must be used to address the root causes of the crisis.

I think we all agree that the crisis has two major causes: first, the macroeconomic imbalances that have built up in recent years and, second, public and private debt that has ballooned in some member states. Both problems must eventually be addressed. Europe has to be rebalanced.

But views on how to achieve this goal differ. Given the unprecedented character of the crisis and its complexity, this seems only natural to me. Still, I hope that the fault lines will converge at some point in the future and that a consistent approach will emerge.

Now, what are the specific questions we have to address?

### *Rebalancing Europe*

Frankly, there are about a million questions to be answered. But to simplify matters a bit and to keep my outline reasonably short, I will ignore some of them. Altogether, I will address just two questions today.

The first one relates to the macroeconomic imbalances. Their most prominent symptom are diverging current accounts – countries such as Greece run persistent current account deficits, while countries such as Germany run persistent surpluses. The question is: which countries have to adjust? Those with a current account deficit? Those with a surplus? Both?

The second question looks at the additional problem of public debt. It is obvious that public deficits have to be brought down significantly. But is it sensible to consolidate while simultaneously correcting macroeconomic imbalances by deleveraging and by rebalancing the current account?

### *Rebalancing current accounts*

Let us begin by looking at the first question. Normally, exchange rate movements are an important channel through which unsustainable current account positions are corrected – eventually, deficit countries devalue, while surplus countries revalue their currencies. The reaction this triggers in imports and exports then helps to bring the current account closer to balance.

In a monetary union, however, this is obviously no longer an option. Spain no longer has a peseta to devalue; Germany no longer has a deutsche mark to revalue. Other things must therefore give instead: prices, wages, employment and output.

Which brings me back to my original question: which countries have to adjust?

The typical German position could be described as follows: the deficit countries must adjust. They must address their structural problems. They must reduce domestic demand. They must become more competitive and they must increase their exports.

But this position has not gone uncontested. Indeed, a number of renowned economists take a different view. They fear that it would be too much of a burden for the deficit countries alone to adjust. They consequently suggest that surplus countries should shoulder at least part of the burden.

To avoid confusion, it is important to make a distinction at this point. A distinction between the adjustment as such and the burden it entails. Only the burden can be shared. I think most people would agree that the adjustment itself has to take place in the deficit countries. It is true that surplus countries have benefited through higher exports. But ultimately, it was the deficit countries that operated an unsustainable model defined by a credit-fuelled boom in domestic demand, and this model has to be reformed. Not every deficit country needs the same reforms, of course, but all require some sort of adjustment.

By contrast, it is sometimes suggested that rebalancing should be undertaken by 'meeting in the middle', that is by making surplus countries such as Germany less competitive. This suggestion implies that the adjustment as such would be shared between deficit and surplus countries. But the question we have to ask ourselves is: 'where would that take us?'

The competitive edge some economies enjoy did not come for free. It is the result of often painful adjustments among workers and within firms. Giving part of it up to ease the pressure on deficit countries might make these countries better off in relative terms. But would it not make everyone poorer in absolute terms?

We have to acknowledge that Europe is not an island but part of a globalised world. And at the global level, we are competing with economies such as the United States or China. I ask you: how can we, how can Europe succeed in this world if we willingly give up our hard-won competitiveness? To succeed,

Europe as a whole has to become more dynamic, more inventive and more productive.

To make a more popular comparison: imagine that in the Champions League Barcelona were denied Lionel Messi just so that the other teams, including Bayern Munich, had a better chance of winning. Would that be a sensible way to rebalance the competitiveness of Europe's top teams?

In my view, we will gain nothing if we try to rebalance by actively shifting weights at both ends of the scale.

A second point is this: a large proportion of the current account deficits and surpluses result from trade with countries outside the euro area. Even if surplus countries expanded their imports, this would help their fellow euro-area countries to increase their exports only marginally. The latter must first offer something other euro-area countries would want to buy from them rather than from someone else.

To achieve this, the deficit countries must take measures that unlock their potential to increase productivity and improve competitiveness. This would considerably reduce the cost of adjustment and the time it takes.

The OECD and other organisations have for years been promoting a long list of reforms. These aim at making labour markets more flexible, opening up product markets and making the public sector more efficient. A number of reforms have already been announced and, in some instances, implemented in countries such as Portugal, Spain and Italy. And we are already seeing some promising results, especially in Ireland. But despite these first steps, there is still a long way to go.

Such an adjustment will initially place a huge burden on the people in deficit countries, even taking into account the extraordinary boom in the years prior to the crisis. But will the burden be too heavy to bear? A central fear is that of deflation. Unless productivity growth increases miraculously, it is certainly true that prices and wages will have to fall in many cases. But we must not confuse such a one-time adjustment with full-fledged deflation.

And we must acknowledge that surplus countries are already helping to ease the burden of adjustment. What are the rescue packages other than publicly guaranteed interim loans to facilitate the adjustment?

Another thing we should not forget is this: of course, surplus countries will eventually be affected as deficit countries adjust. Not every country on earth can run a current account surplus – unless we trade with 'space aliens' as Paul Krugman recently suggested.

As the deficit countries import less and become more competitive exporters, surplus countries will run lower surpluses. The key issue is whether this happens as a result of market processes or as a result of efforts to fine-tune aggregate demand in the euro area. I would welcome the former, but I object to the latter.

#### *Consolidating public budgets*

Reforms aimed at promoting growth are an important part of the adjustment process – I think everybody agrees on that. But what about consolidation? A frequently cited argument is that it would be too much of a burden for countries to correct macroeconomic imbalances and consolidate public debt at the same time. The result, it is said, would be a vicious cycle of falling demand and slowing economic growth.

It is true that consolidation might, under normal circumstances, dampen economic growth. But structural reforms and consolidation are often hard to disentangle. For example, a bloated public sector or very generous pension system are both a drag on growth and a burden on the budget. And another question is: are these normal times? It is quite obvious that everybody views public debt as a major threat. The markets do, politicians do and people on the street do.

A wide-spread lack of trust in public finances weighs heavily on growth: there is uncertainty regarding potential future tax increases, while funding costs rise for private and public creditors alike. In such a situation, consolidation might inspire confidence and actually help the economy to grow.

In my view, the risks of consolidation are consequently being exaggerated. In any case, there is little alternative. The Chancellor of the Exchequer George Osborne recently said: 'You can't borrow your way out of debt'. In my opinion, he is absolutely right; the only promising approach is to 'cut' your way out.

#### *A bigger role for the Eurosystem?*

'Stop', some might say at this point, 'it is true that member states will eventually have to reform, and governments will have to tighten their belts. But that still leaves the ECB. Shouldn't the ECB temporarily ease the pressure even more?'

Usually, the boundary between monetary and fiscal policy is clear-cut for good reason. Once a central bank becomes involved in fiscal policy, it eventually loses its independence and its credibility as an inflation-fighter. This is the story told not only by economic theory but also by historical experience.

Just think about the unholy 'marriage' between Banca d'Italia and the Italian treasury in 1975. Banca d'Italia promise of marriage was to act as buyer of last resort for government bonds. Until the 'divorce' in 1981, Italian government debt more than tripled, while average inflation stood at 17%. After Banca d'Italia was granted greater independence, inflation rates began to fall significantly. Or think of the UK: after the new monetary framework was established in 1993 and the Bank of England was granted greater independence, inflation rates also came down.

However, during a crisis the boundary between monetary and fiscal policy can become blurred. To contain the crisis, central banks have to act more flexibly and accept more risks on their balance sheets. I think this is unavoidable, and the Eurosystem has already undertaken tremendous efforts in this direction.

But although there are times when things are not black and white, I do not think clear distinctions are completely irrelevant. This is particularly pertinent in a monetary union where member states retain their autonomy in fiscal and economic policy. In such a setting, governments have an incentive to accumulate debt; this is known as a deficit bias. To counter that incentive, the EU Treaty explicitly prohibits monetising public debt.

If central banks went down this route, they would be redistributing fiscal risks and costs among the taxpayers of the euro area. However, this is the prerogative of national parliaments. If central banks' balance sheets are used to bring about redistribution and if the implied costs become apparent, this could have a highly corrosive effect on the credibility of central banks and on their independence. Credibility and independence are, however, indispensable to maintain price stability and to ensure the acceptance of monetary union as a whole. This would be too high a price to pay, and again we would merely be buying time.

### *Conclusion*

This brings me back to the beginning of my speech: we must not just contain the crisis, we must resolve it. To achieve this goal, we must address two central issues: the problem of excessive public debt and the problem of macroeconomic imbalances.

Countries with current account deficits and excessive public debt must act. They must implement structural reforms and they must consolidate their budgets to get back onto a stable growth path. Of course, adjustment is a huge challenge for the people in these countries but the status quo is clearly unsustainable, and doing nothing will lead to even sharper corrections. By contrast, taking up the challenge will open the doors to a more stable and more prosperous future.

In my speech, I have focused on the member states. This is not to deny that an overhaul of the institutional framework of monetary union is equally pressing. Member states have made it clear that they want to retain their autonomy in fiscal policy. But in that case we need stricter rules to counter the deficit bias that I mentioned before. Some progress has been made on this issue. Now, it is decisive that the rules are applied rigorously.

In addition, placing monetary union on a sounder footing is closely linked to regulatory reforms in the financial system. But I will leave these important issues for the discussion, rather than going into them right now.

Admittedly, the crisis has opened our eyes to structural flaws at many levels. But this sobering experience has also provided the impetus to correct these shortcomings. The time has come to move from containing the crisis to resolving it. If we have the will to make the right choices, we will be able to rebalance Europe and lay the foundation for a stronger, more stable monetary union. As Winston Churchill said: 'Difficulties mastered are opportunities won'.

Ladies and gentlemen, I have presented my ideas to you and I now look forward to discussing them with you.

Thank you for your attention.