DEUTSCHE BUNDESBANK
EUROSYSTEM

Embargo: 18 July 2014, 12:30 p.m.

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Towards a more stable European Monetary Union

Madrid Stock Exchange
Madrid
18 July 2014

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1 Introduction

Mr Feito

Ladies and gentlemen

Thank you for your invitation and for giving me the opportunity to speak here today.

A few months ago, a Spanish newspaper wrote about my institution: "El Bundesbank, banco central alemán, baluarte del pensamiente neoliberal más dogmatico de la Unión Europea …".

While my understanding of the Spanish language is poor – as is my pronunciation – I assume this was not meant as a compliment, and, moreover, it is not even truthful.

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That’s why I am all the more delighted about the warm welcome you gave me here today.

I would particularly like to thank Juergen Bernardo Donges for his kind introduction. Juergen and I worked closely between 1999 and 2002 when the two of us were with the German Council of Economic Advisors – he was one of what are called the five wise men and I was their secretary-general.

At the time, I remember, Germany was considered to be “the sick man of Europe”. The *Economist* magazine wrote in 1999: “... the biggest economic problem for Europe today is how to revive the German economy”.

Nowadays, Germany is called the economic powerhouse of Europe. This is not least the result of economic reforms that were implemented between 2003 and 2007. Moderate wage policies, greater flexibility in pay policy conditions and shrewd entrepreneurial decisions also helped to restore Germany’s competitiveness.

Germany’s economic success means that it is often seen as a role model for other euro-area countries that have run in trouble. However, reforms in one country cannot be used as a blueprint elsewhere. Each country has to tackle its own structural problems, and it is up to governments, parliaments and their advisors to assess what can be learned from other countries’ experiences.

As far as Germany is concerned, there is no room for complacency; Germany has economic challenges of its own to face. Four of the most important

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are a rapidly diminishing labour force caused by demographic trends; increasing competition on account of globalisation, which is particularly relevant for an economy that succeeds in high technology rather than in the most advanced technology; changes in the energy markets and the politically favoured energy mix; and high levels of public debt.

Looking at the German government's recent economic policy decisions, not all of them adequately address the needs resulting from these challenges nor do they set the kind of example which a large euro-area country like Germany should be setting for the other member states.

However, I do not want to talk about Germany in too much detail today. Rather, I would like to share my views on the future of European Monetary Union.

From an economist's point of view, the question whether a country should abandon its currency and join a monetary union is typically analysed in the framework of what is known as the theory of optimum currency areas.

Without a doubt, the euro area lacks some of the characteristics of an optimal currency area. Labour mobility, for instance, is much lower than in the US; plus the business cycles are not synchronised, nor is there any central fiscal stabiliser.

At the end of the day, the decision to create European Monetary Union was a political one, not an economic one. Nonetheless, in the first 15½ years since the euro was launched, people have enjoyed a stable currency. The

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average euro-area inflation rate has been 2.0%, which is very close to the ECB Governing Council's definition of price stability ("below, but close to, 2%").

However, the crisis exposed shortcomings on a national level and the fragilities of the institutional framework of the monetary union. But I am positive that if we learn from the sovereign debt crisis, the European economy will be stronger than before the crisis and we will be able to maintain our monetary union as a stability union – and it is indeed worth being maintained.

In the next 30 or 40 minutes, I would like to discuss how we can achieve this end. I will start by looking into what still needs to be done at the national level. From there, I will go on to address the weaknesses in EMU's institutional foundation. Moreover, I will touch upon current monetary policy issues.

But before I talk about what needs to be done, let us take a step back and consider what went wrong in the first place.

2 The origins of the crisis

For many euro-area member states, the introduction of the euro ushered in a new era of abundant capital owing to the elimination of exchange rate risks. However, the favourable financing conditions in the euro-area countries which had previously higher interest rates mainly stimulated investment in real estate and public and private consumption.

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Over time, unit labour costs soared, while competitiveness declined. Between 1999 and 2007, on average unit labour costs rose in Spain by 3.0% per year compared to a slight decline in Germany of -0.1%. This led to a decline in Spain's competitiveness of more than 15% over that period.

When the financial crisis broke out in 2007, the vulnerabilities were laid bare: investor sentiment began to shift, and interest rates for the countries in question started to rise sharply, triggering a crisis that is still far from being fully resolved.

In order to understand the onset of the crisis, it is useful to remind ourselves of the euro area's unique institutional set-up.

The euro area teams up one common monetary policy with 18 national fiscal and economic policies. This approach reflects a currency area composed of sovereign member states. It grants member states sufficient leeway to preserve their diversity, that is, to establish their own business models or to tailor institutions and policies to their own national preferences.

Such preferences can differ, for example, with respect to income redistribution or the role of the state in the economy. At the same time, it leaves the consequences of such decisions with the respective member state and consistently rules out the option of mutualising public debt with other euro-area states. But this set-up also creates vulnerabilities.

First, a combination of this kind gives rise to a deficit bias, as it allows the costs of fiscal imprudence to be shifted partially on to others. An unsustaina-

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ble fiscal situation in one country has repercussions for monetary union as a whole.

You can compare this to what economists call the “tragedy of the commons”. Just as overfishing creates negative externalities for other countries, excessive public debt harms the euro area as a whole. Excessive debt in one member state drives up longer-term interest rates for all euro-area countries.

And second, each member state issues debt in a currency it cannot create. Thus, a high level of fiscal discipline is needed to ensure that solvency concerns do not spiral out of control.

Even if there are no explicit fiscal transfers, and irrespective of the approval of national legislatures, central banks’ balance sheets can nonetheless serve as a conduit for shifting risks among national taxpayers if those central banks agree to finance national debt.

This shift is undermining both countries’ individual national responsibility and central banks’ independence. If central bank independence is used for purposes other than price stability, it is only a question of time before central bank independence itself is challenged.

The founding fathers of the euro clearly foresaw the risk of unsustainable public finances for a stability-oriented monetary policy. That was why precautions were put in place to safeguard sound public finances and to protect monetary policy. They took the form of a prohibition of monetary financing of

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government deficits, the no bail-out clause and the Stability and Growth Pact.

Barry Eichengreen and Charles Wyplosz wrote in an article in 1998: “The most compelling rationale for the Stability Pact rests on the need to buttress the no-bailout rule of the Maastricht Treaty”. And, sensing what might happen, the two economists continued: “That need will be most pressing where debt problems place banking systems at risk and where bond market contagion is pervasive.”

At the time, it was assumed that by constraining governments’ ability to fiscally stimulate demand – and by shifting monetary policy to the European level – governments would have no choice but to implement structural reforms, improve their supply side, and strengthen their potential for sustainable growth.

It was also thought that the financial markets would enforce fiscal discipline. As it turned out, things did not exactly work out as expected.

The fiscal rules were breached numerous times, not least by Germany and France. In addition, investors made hardly any distinction between the bonds of individual member states.

From 1999 to 2007 the average difference between EMU government bonds, excluding Germany, and German government bonds, for instance, was a mere 14 basis points which compares to an average spread of 190 basis points over the last five years.

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I will leave it for you to decide whether this was because investors turned a blind eye to the growing differences in economic fundamentals or because they never really bought the idea that the no bail-out clause would hold when the going got tough.

3 Reforms at the national level

The title of the “sick man of Europe” often changes hands. Countries other than Germany are currently the reigning champions in this discipline.

But many countries have made substantial efforts to cut their public deficits. Additionally, structural reforms aimed at removing rigidities in product and labour markets are now underway.

A number of labour market reforms have been introduced to foster employment and reduce adjustment costs during economic downswings. According to the OECD indicators for labour market rigidity, the stressed countries have made noticeable progress in this area. In addition, the retirement age has been raised as well.

Product market rigidities that weaken competition, produce regulatory red tape and inhibit growth are also being addressed. And according to the World Bank’s Doing Business Report, progress has been made in this regard as well: Portugal, Italy, and Spain have climbed up the ranking ladder by 17, 13, and 10 positions respectively over the last four years. Greece has even moved up 37 positions.

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Current accounts in the deficit countries have improved – not only because of shrinking imports, but also because of expanding exports. The latter has been supported by decreasing unit labour costs.

Spain has markedly improved its price competitiveness through lower unit labour costs. Currently, unit labour costs are 6½% below their pre-crisis level, while they have risen by 10% in the euro area as a whole.

In the stressed countries, factors of production are being reallocated to sectors with a strong focus on exports. The construction sector in Ireland accounted for over half of the decrease in aggregate employment; in Spain, Italy and Portugal, it accounted for around two-fifths. In industry, by contrast, either far fewer jobs have been cut or – as in Ireland – new jobs have recently been created.

Thanks to improved competitiveness, Spanish exports have risen by 8% over the past 12 months. Since the cyclical trough in 2009, exports have even risen by more than 50%, with intermediate goods showing particularly strong growth.

Overall, thanks to the reform efforts made so far, the underlying conditions in most of the periphery countries are already significantly better than they were before the crisis. Progress has been uneven, though, and further reforms are needed.

To address the problem of very high unemployment, the IMF recommends more decentralised wage setting and the introduction of greater flexibility at

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the firm level to adapt wages, working hours and employment to the economic situation, which might also be a way forward for Spain.

Overcoming the crisis is still an uphill struggle; if you don't go forwards, you go backwards. With regard to reforms, governments therefore have to keep the pedal to the metal.

However, is it a German central banker's task to call for structural reforms and budget consolidation in other euro-area countries?

Given the important role that sustainable public finances and highly productive member states play in buttressing a stability-oriented monetary policy, and given that the Eurosystem has bought time for national action, I don't think that bringing to mind the pledges that were made to embrace consolidation and structural reforms constitutes meddling in national affairs.

In the euro area, we share a common currency, which means that a lack of reform in one country has implications for the euro area as a whole and for the stability of our monetary union.

While adjustment has to happen primarily in the deficit countries, countries running a current account surplus, such as Germany, face challenges as well as I have outlined before. Last Sunday's victory in the football World Cup should not blind us to reality, either. As Gideon Rachman wrote in a Financial Times comment: "Germany is undoubtedly going through a golden moment – on and off the football-field – but there are reasons for fearing that it will prove all too momentary."

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In any case, deliberately weakening the competitiveness of Germany’s export sector would harm, rather than benefit, the stressed countries’ economies. We should bear in mind that German exports contain imported intermediate inputs from other euro-area countries amounting to 9% of the overall added value.

If Germany were to accept the economic advice to excessively boost its wages in order to stimulate domestic demand, it would harm employment in Germany and, as a consequence, the economic situation in the entire euro area as simulation results show.

Despite this, it is clear that against the background of Germany’s strong cyclical position and the tight labour market, wages will rise faster than in the rest of the euro area. We expect effective wages to rise more than 3% this year and next year.

4 Strengthening EMU’s institutional architecture

However, when it comes to taking action at the European level, the challenges facing Monetary Union are also considerable.

The safeguards originally put in place for the stability of Monetary Union, the Stability and Growth Pact and the no bail-out clause, failed to prevent the crisis. As I have already pointed out, there are additional macroeconomic imbalances which likewise pose a threat to the stability of the euro area: a

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steady loss of competitiveness, persistent current account deficits and high levels of private debt.

Measures to address these deficiencies, such as the strengthened Stability and Growth Pact, the Fiscal Compact and macroeconomic surveillance, have been implemented. I will come back to this in a minute.

Ultimately, the risk of contagion between countries was also underestimated when Monetary Union was established. In response to the crisis, rescue mechanisms such as the EFSF and ESM were put in place, and they did manage to contain the fallout somewhat.

But at the same time, the rescue mechanisms have weakened the principle of individual responsibility, as fiscal responsibility has essentially remained national, while liabilities have been partially mutualised. In other words: the balance between liability and control has become lopsided. Yet I believe that this balance is fundamental to the stability of Europe's Monetary Union.

But how do we restore that balance, and put Monetary Union on a more solid footing? In principle, there are two ways: first, by creating a genuine fiscal union, or second, by making the principle of individual responsibility work.

The first option, a genuine fiscal union, would require the member states to relinquish their fiscal sovereignty and cede it to the European level. In such a setting, the mutualisation of future liabilities would be consistent. This step would necessitate changes to the European treaties and amendments to national constitutions.

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In Germany, such a leap towards more political integration used to be seen as inevitable. Addressing the Bundestag in 1991, Helmut Kohl, for example, remarked that “the idea of sustaining economic and monetary union over time without political union is a fallacy”. But judging by the reluctance of governments and electorates to let Brussels have a say in fiscal matters, this avenue seems to be blocked, at least for the foreseeable future.

This leaves us with the second option, making the principle of individual responsibility work better.

Since public debt in one country has negative spillover effects on other countries in a monetary union, a set of fiscal rules is required, even if the principle of individual responsibility works. Thus, the stiffening of the Stability and Growth Pact and the Fiscal Compact were steps in the right direction. But the mere existence of these rules will not suffice.

The question of how effective these changes will be can best be summed up by the proverb “the proof of the pudding is in the eating” which is often attributed to the Spanish novelist Cervantes because it is cited in a widespread English translation of *Don Quixote*. However, in the Spanish original you read “y si no, al freír de los huevos lo verá”, meaning something like “you will see it when you fry the eggs”.

In other words, it is not yet clear whether the new rules do really bite. Strict and consistent application of the stiffened rules is therefore important. Here, the Commission has a special responsibility.

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Metaphorically speaking, we need to make sure that the Commission does not go beyond its role as a referee and move the goalposts mid-game.

In this regard, some doubts are warranted, as is evident from the recent debate surrounding a flexible interpretation of the Stability and Growth Pact. The Pact, which was reformed less than three years ago, grants a great deal of discretionary scope.

Moreover, there is a risk that recent decisions by the European Council will provide even more of a pretext for lax interpretation. However, an excessively generous interpretation of this leeway would certainly undermine the credibility of the Stability and Growth Pact.

It was only last week when Mario Draghi warned: “To unwind the consolidation that has been achieved, and in doing so to divest the rules of credibility, would be self-defeating for all countries.”

And let us not forget: in the medium term, the Pact stipulates balanced or close to balance budgets. The 3% mark that is frequently used as a yardstick is therefore a ceiling and not intended to be a regular target. This is, incidentally, also true of the 60% debt ratio that almost all euro countries breach.

A look in the rear-view mirror shows how poorly the fiscal rules have worked as a speed limit. Since the introduction of the euro, the economically important member states of France and Italy have exceeded the upper public deficit limit of 3% of GDP in nine out of 15 years. Germany, meanwhile, has

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had seven “entries in the class register”. And as for 2014, we expect six out of 18 countries to exceed the limit.

In the long run, consolidation does not inhibit growth; rather, it is a precondition for sustainable growth. More debt is not a prerequisite for successful structural reform. Quite the opposite is true: sound public finances are a crucial element of a successful reform strategy. Any attempt to trade off reforms against higher structural deficits would pave the way for budgetary arbitrariness, undermining the credibility of the rules. Judging by past experience, it is clear to me that it will take more than simply stiffening the rules to enforce the principle of individual responsibility.

Essentially, this principle requires sovereigns, banks and investors to bear the consequences of their decisions. Juergen Donges wrote in a recent comment: “The principal of individual responsibility includes the possibility of bank and sovereign insolvencies.”

The BRRD and the Single Resolution Mechanism will allow banks to be resolved in a more orderly manner. However, in terms of restructuring sovereign debt, little progress has been made so far.

The principal of individual responsibility requires that it is primarily up to the respective government and its citizens to come up with the revenue required to repay public debt. This holds, in particular, since high levels of public debt often go hand in hand with substantial private assets.

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But it also implies that the risk of non-repayment ultimately lies with investors, since they are the ones who reap the return when things go well. And if the fiscal limit has been reached for real, public debt will need to be restructured without posing a systemic threat to financial stability.

The introduction of collective action clauses in sovereign bonds was a first step in that direction. But more steps are needed. The Bundesbank has put forward a proposal for sovereign bonds to include an automatic maturity extension of three years in case a sovereign needs to make use of the European rescue mechanisms.

This automatic maturity extension would allow the sovereign in question to tackle its fiscal challenges while preventing investors from bolting. Liability and control would be brought better into balance. That would reduce the amount of official financial support, and buy time to figure out whether the problem is one of temporary illiquidity or insolvency.

But ultimately, all these questions boil down to the quip by American economist Allan Meltzer: “Capitalism without failure is like religion without sin. It doesn't work.”

For the above proposals to work, we need to make sure that the restructuring of both banks and sovereign debt is possible without bringing down the financial system as a whole. At the moment, this is perceived as an unpredictable risk.

What do we need to do to make this risk manageable?

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At the core of the problem lies what is now known as the sovereign-bank nexus. In the crisis, this sovereign-bank nexus developed into a vicious circle: Tottering banks and teetering sovereigns lean towards each other for support, but are in fact pushing each other over.

If a large bank or one which is strongly interconnected with other banks runs into difficulties, this can pose a threat to the stability of the entire financial system. The state then often has no other option but to step in if it wants to prevent a meltdown of the real economy. To quote the ESRB's Advisory Scientific Committee: "Banks' liabilities are taxpayers' contingent liabilities."

As a result, necessary rescues can become a huge burden for government finances. This is what happened in Ireland, where the need to prop up the financial system pushed the public debt ratio up by nearly 30 percentage points. Conversely, weak government positions can destabilise banks – directly through their exposure to sovereign bonds, and indirectly through worsening macroeconomic conditions. This was the case in Greece.

How can we break this "doom loop"?

The strengthened Basel III capital rules are a first step in that direction, as they increase capital buffers and thus the capacity of banks to absorb losses. The banking union, with its Single Supervisory Mechanism (SSM), is another such step. Strict and stringent supervision ensures that tough rules are applied equally to all.

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The SSM is important for severing the link between banks and sovereigns. But to make sure that banks cannot pass on the consequences of their actions to the public, more is needed. An effective recovery and resolution mechanism including a bail-in regime that clearly assigns how losses are distributed augments the SSM.

Shareholders and creditors should be first in line to absorb losses. It is therefore to be welcomed that the Directive establishing a framework for the recovery and resolution of failing banks (BRRD) and the regulation creating the Single Resolution Mechanism have been agreed upon.

The sovereign-bank nexus works both ways, however. We also have to make sure that worsening public finances do not infect the financial system.

The banking union still has a sovereign virus, as Daniel Gros from the Centre for European Policy Studies once quipped. To strengthen the banking union's immune system, we need to put an end to the preferential treatment afforded to sovereign debt.

At present, sovereign bonds are treated by European regulators as being risk-free, even though recent history has taught us that the opposite is true: sovereign bonds are not risk-free assets. Hence, sovereign bonds should be adequately risk-weighted, and exposure to individual sovereign debt should be capped, as is already the case for private debt.

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These changes might trigger substantial repercussions, but they would be manageable if they were phased in over a transitional period – which would undoubtedly need to be granted.

Despite these repercussions the changes would be worth because they would make banks more resilient if the fiscal position of the respective sovereign were to deteriorate. And it would bring spreads more into line with the underlying risk, thus sending a disciplining signal to the sovereign.

At the current juncture when it comes to sovereign bonds, banks all too often seem to neglect this principle of risk diversification. In many cases, European banks hold bonds from one sovereign only – their home country. During the crisis, many banks, particularly weak ones, used the low refinancing costs to buy even more sovereign debt; they made a sort of "carry trade".

Between end-November 2011 and end-May 2014, Spanish banks expanded their holdings of Spanish government debt securities by 74%, from €165 billion to €288 billion. 92% of Spanish banks' euro-area sovereign portfolios are domestic.

Only Italian, Greek and Slovakian banks are even more home-biased. However, it is the high level of undiversified sovereign exposures which makes sovereign default a potentially systemic event.

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5 The role of monetary policy

Consistently applying the stiffened rules and putting an end to the preferential treatment afforded to sovereign debt will be instrumental in strengthening the stability of our monetary union. So will the banking union.

Currently, much of the support provided to the whole structure hinges on one pillar alone: monetary policy. But this can only work for so long; monetary policy has already done a lot to absorb the economic consequences of the crisis, but it cannot resolve the crisis.

There is still truth in what Wim Duisenberg, the first President of the ECB, once said: “Don’t ask for monetary policy to perform tricks it cannot deliver.” Therefore, the best contribution the Eurosystem can make to a lasting resolution of the crisis is to fulfil its mandate: that of maintaining price stability.

The Eurosystem’s crisis measures have helped prevent the crisis from escalating. However, some of these measures have, as I have repeatedly pointed out, taken the Eurosystem to the outer edge of its mandate. Meanwhile, the comprehensive measures agreed by the Governing Council of the ECB in June cannot, in my opinion, be compared with the crisis measures taken two or three years ago.

The current measures do not provide for individual countries’ liability risks to be taken onto the Eurosystem's balance sheet. The task now is to prevent an excessively long period of low inflation. Because that could paralyse the euro area’s economy.

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Governor Linde will certainly confirm that the June decision was preceded by much soul-searching as to how best to proceed. These measures are also associated with risks and side-effects, which we would be wrong to play down.

In the long term, the ultra-loose monetary policy poses risks to financial stability. There is a danger of exaggerations on the asset and real estate markets – just think of the hunt for yield.

Low interest rates also ease the pressure on governments to vigorously tackle their countries' problems. There is a danger that the low interest rates will be used not to consolidate budgets, but to finance additional spending.

This is why the Governing Council so insistently calls for sound public finances as a prerequisite for a stability-oriented monetary policy. Or to say it with the words of Mervyn King, the former governor of the Bank of England: "Central banks are often accused of being obsessed with inflation. This is untrue. If they are obsessed with anything, it is with fiscal policy."

So it is particularly important to make it quite clear now that the Eurosystem will not put off a necessary increase in central bank interest rates out of consideration for public finances. Looking at the euro area, I would therefore say that monetary policy has done its bit towards maintaining price stability.

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6 Conclusion

Ladies and gentlemen, let me conclude.

The crisis has laid bare shortcomings at the national level as well as weaknesses in the Monetary Union's institutional architecture.

Repairs at the national level have seen considerable progress, though there is still a long way to go. Like in a marathon, the second half of the course always feels tougher than the first – and one major challenge is to not give in to the growing reform fatigue.

But at this point, the weaknesses in EMU's architecture probably pose a more fundamental challenge. The balance between liability and control has got out of kilter. We need to regain that balance if we are to put EMU on a more solid footing.

Since a genuine fiscal union is not on the cards – and to me, it does not seem to be for the foreseeable future – we need to make the principle of individual responsibility work. But we also need to put an end to the preferential treatment afforded to sovereign debt in order to immunise the financial system against sovereign default.

Finally, monetary policy must not allow itself to be misappropriated for fiscal policy purposes. Otherwise it cannot fulfil its mandate, which is price stability.

And now I am looking forward to hearing your views on this matter.

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Thank you very much.

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