REUNIÃO DE CONJUNTURA

11/06/2018

Artigos de Bancos Centrais e BIS

Peter Praet: **Monetary policy in a low interest rate environment**

Speech by Peter Praet, Member of the Executive Board of the ECB, at the Congress of Actuaries, Berlin, 6 June 2018

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A salient feature of the economic environment in advanced economies has been the steady decline of short and long-term interest rates over several decades to the extremely low levels which currently prevail. [1] Since 1980, long-term interest rates have declined by about 860 basis points in the United States, 790 basis points in Germany and more than 1,200 basis points in France.

I am acutely aware that an environment of low interest rates poses considerable challenges for many of the business models operated by actuaries and other professionals. However, the similar behaviour of yields across different economic areas attests to the global nature of the economic and financial developments at work, as well as to the broad similarity of the methods adopted by monetary policymakers in advanced economies to respond to the adverse developments of the last ten years.

In my remarks today, I would like to outline the ECB's monetary policy response to the different phases of the crisis. Our monetary policy response has taken place in a low interest rate environment, which can be attributed to specific global and euro area factors, some of which are secular and some of which are a legacy of the financial crisis. In any case, the secular trends and structural forces – which, prior to the crisis, had pushed down long-term yields over a span of at least 30 years – made central banks' efforts to stabilise their economies when the crisis finally hit even more strenuous than they would have been otherwise, and required more innovative and bolder measures.

Nonetheless, the present environment of low interest rates need not become permanent as public policy can address some of the causes of the very low interest rates. While several of the secular factors are challenging for policy to reverse, others can be alleviated by effective and targeted policies that boost potential growth and, in the case of Europe, complete the euro area's institutional framework.

Monetary policy plays an important role by creating an environment which facilitates the necessary structural adjustments, even if in itself it cannot address structural aspects of the economy. Indeed, by laying the groundwork for a return of inflation to our objective, our monetary policy measures have been supporting economic activity and have alleviated damage to the economy's growth potential.

Our asset purchase programme (APP) has been the pivotal component of our strategy for countering and reversing the crisis. As you know, since the programme's inception in 2015, the Governing Council of the ECB has made net asset purchases under the APP conditional on progress towards a sustained adjustment in the path of inflation to levels below, but close to, 2% over the medium term. We have set forth criteria to measure the headway we have made towards meeting this stated objective since the programme was launched. Next week, the Governing Council will have to assess whether progress so far has been sufficient to warrant a gradual unwinding of our net purchases. In making its assessment, it will consider the underlying strength of the euro area economy and the pass-through to wage and price formations.

Monetary policy response to the crisis

In the years preceding the onset of the global financial crisis in 2008, over-optimistic growth expectations had taken hold in a number of advanced economies. Although productivity growth had been slowing since the mid-1990s, agents overestimated future income growth and borrowed against it, accumulating excessive levels of debt. At the same time, poor risk management, low capital and liquidity, inadequate corporate governance, and weak supervision and regulation encouraged financial leverage, which led to the build-up of vulnerabilities. This was particularly acute in the United States, where there was a rapid expansion in the development of complex financial securities, which later proved to entail substantial risks.

This oversight can to some extent be explained by the fact that, in the decade leading up to the crisis, the overall macroeconomic environment had been very stable, with some observers even concluding that monetary policy had tamed the business cycle once and for all. This was also the period when the perceived benefits of globalisation reached their high-water mark and, for euro area countries, when Monetary Union came into being, potentially paving the way for the macroeconomic and microeconomic benefits of the European Single Market to be fully unleashed.

When the cycle finally turned in 2008, it set in train a turbulent decade of deleveraging and de-risking, consisting of a number of different phases.

The first phase was similar across advanced economies. It was characterised by the financial panic and abrupt liquidity crisis triggered by the collapse of Lehman Brothers in September 2008. Banks became uncertain about the underlying health of other banks, bringing market funding to a sudden stop. Globally, central banks intervened forcefully and in a coordinated manner so as to provide essential liquidity to the banking sector. During this first phase of the crisis, the ECB lowered its main refinancing rate to the then record low of 1% in May 2009, while letting the pivotal overnight money market interest rate drift down to the floor of the interest rate corridor – a level much lower than 1%. To facilitate banks' borrowing of central bank funds, the ECB expanded the range of eligible collateral for refinancing operations and provided liquidity elastically to the banking sector. The easing impact of our liberal liquidity injections was enhanced by increasing the maturity of liquidity provisions. This phase of the crisis deeply affected euro area banks because, unlike in other jurisdictions, no institutional frameworks were available to swiftly address problems.

Banks' needs for fresh resources put a growing strain on the public finances of those countries whose banking sectors had been allowed to grow to outsized proportions relative to the underlying economy. The contagion from banks to their sovereigns – coupled with growing concerns about the sustainability of high-debt countries – paved the way for the second phase of the crisis: the sovereign debt crisis. The debt crisis was fuelled by the vicious loop between banks and sovereigns. While the contingent liabilities associated with the weak state of the national banks had undermined the credit standing of governments, the attendant loss of value of the bonds issued by these governments contributed to undermining the health of the banks even further.

Financial markets then began to fragment along national fault lines, eventually preventing entire banking systems from accessing market funding. Lack of liquidity, coupled with the erosion of capital due to losses on sovereign exposures, precipitated a renewed credit crunch.

A new round of the vicious cycle with negative feedback loops then began. The tightening in domestic credit conditions aggravated the ongoing recession, eroded the quality of banks' loan portfolios and further weakened banks' capital positions, which in turn made the bailing-out of the banking system by the government even more likely and thus pushed up sovereign borrowing costs even higher.

Confronted with these events, many investors started to think that this negative spiral might ultimately lead the affected countries to exit the euro area. As a result, redenomination risk soared and sovereign spreads widened.

This led to a serious disruption of the monetary policy transmission mechanism and prevented our accommodative policy stance from reaching businesses and households. As the affected economies represented a third of euro area GDP, the contagion became an acute threat to price stability in the euro area.

The ECB monetary policy response to these developments was twofold. First, to ensure that banks had access to longer-term funding, two three-year refinancing operations were undertaken at the end of 2011 and the beginning of 2012. Second, in summer 2012, the ECB's announcement of Outright Monetary Transactions served as a powerful circuit breaker of the ongoing downward spiral. Nonetheless, the sovereign debt crisis left a damaging legacy, which led the way for the third phase of the crisis.

As the euro area entered a prolonged slump, banks in many parts of the euro area – particularly in vulnerable countries – embarked on a drawn-out process of deleveraging, which mainly involved reducing lending to the real economy. Towards end-2013, loans to the private sector were falling by more than 2% per year and a credit crunch loomed. Moreover, by mid-2014, the economic recovery was losing momentum and the weakness in aggregate demand was starting to depress inflation expectations. The sharp fall-off in oil prices that began in the late summer of that year exerted further disinflationary pressure.

The Governing Council had to provide additional policy accommodation to restore price stability. But it faced the challenge that interest rates were already at low levels, limiting the room available for further cuts of its policy rates – the ECB deposit facility had already been brought down to zero in July 2012.

But why were interest rates across the whole spectrum of maturities so low in the first place? Why was the buffer for further monetary policy easing so limited? One way to answer this is by taking a longer-term perspective and disentangling nominal long-term interest rates into three constituent parts: (i) expected average inflation [2], (ii) expected average real rate over the lifespan of a bond, (iii) real term premia, representing the compensation investors require for holding onto a long-term asset. Although data limitations make it hard to derive empirical estimates of each element of this decomposition going far back in the past, what transpires from this analysis is that all components had had a decades-long history of consistent decline. [3]

Taking a historical perspective, long-term inflation expectations had declined steadily since the beginning of the 1980s to stabilise at levels around 2% in the late 1990s. The trend decline and subsequent stabilisation reflected the success of central banks' monetary policy in regaining control of inflation and in establishing strong credibility. However, in mid-2014 these benign developments were overshadowed by a decline in long-term inflation expectations, which, from a central bank's perspective, was highly concerning [4]. Turning to the real term premia, available since 2005 when inflation swaps were introduced in the euro area, we observe a significant decline, mainly on account of the imbalance between the reduced supply of, and the increased demand for, safe assets at the global level, which has been exacerbated by the global financial crisis.

The final component is the expected average real rate. Focusing on its value over the longer run, it is found to have steadily declined due to structural forces on the one hand and to cyclical factors on the other. Structural factors include the slowdown in productivity, unfavourable demographic developments and the increase in savings. The intuition is that these factors drive investment, which in turn determines the demand for loanable funds. In the euro area and other major advanced economies, productivity and population growth, which are also the drivers of potential GDP growth, have been declining for decades. The intersection point of the desired demand for "loanable funds" with the level of savings constitutes the interest rate.

In addition to these secular forces, more cyclical factors linked to the financial crisis have been a drag on real interest rates. In particular, the euro area has faced a massive debt overhang in the public and private sector, resulting in a severe "balance sheet recession" and a tightening of credit conditions. This has required a substantial amount of deleveraging, which in turn reduced investment, prolonged the downturn and weighed on the real interest rate.

Overall, the pre-crisis slowdown in potential growth, coupled with the negative effects of the crisis on investment and private sector balance sheets, has resulted in an imbalance between saving and investment, and largely accounts for the decline in the real interest rate to very low levels.

From a monetary policy perspective, this means that the equilibrium real interest rate – defined as the value of the short-term real interest rate consistent with the economy operating at its potential (or sustainable) level and inflation at its objective – has declined.[5] Faced with disinflationary shocks, a central bank wishing to preserve price stability when the equilibrium real rate has declined has to steer interest rates to levels below the equilibrium real rate prevailing in the long run. Yet, while the equilibrium real rate can be very negative, there is a lower bound to the nominal interest rate.

In the context of the disinflationary pressures we faced in 2014 and 2015, this implied that the room for the additional reduction of short-term interest rates was insufficient to generate the necessary stimulus, given the low level of the equilibrium rate.

To address this challenge, the ECB sought to affect the whole range of interest rates that are relevant for private sector financing conditions. This strategy constitutes of three elements.

The first was the launch of a negative interest rate policy, which entailed a decrease in the deposit facility rate to -0.1% in June 2014 and to -0.2% in September 2014. This first wave of cuts into negative territory provided additional stimulus as it extended the scope of conventional monetary policy. The deposit facility rate was subsequently brought to -0.4% in two further rate reductions in December 2015 and March 2016.

The second was the introduction of a credit easing package, which included a third covered bond purchase programme and an asset-backed securities purchase programme. This aimed to improve the pass-through for each euro of liquidity injected into the financial system to private sector borrowing costs and to reinforce the accommodative monetary policy stance. The package also contained targeted longer-term refinancing operations, which were specifically designed to support bank lending to the private sector.

The third element of the strategy was the addition of a public sector purchase programme to the ECB's asset purchase programme (APP). These measures helped to compress the risk premia all along the yield curve. Shortly after the public sector purchase programme was launched, the Governing Council embarked on a second wave of cuts to the deposit facility rate, which empowered the portfolio rebalancing channel of the APP as it incentivised banks to invest central bank reserves in higher yielding assets.

These instruments were complemented by the use of forward guidance, through which we started to communicate our expectations of future policy, along with the conditions that would warrant a change in the policy stance.

The economic impact of monetary policy measures

Our monetary policy strategy has borne fruit, with 2017 marking the euro area's fifth consecutive year of positive growth. Recently, the pace of economic growth has moderated somewhat, which in part relates to temporary factors and possibly some pull-back from last year's strong growth. In addition, concerns about trade protectionism may have dampened business sentiment and expectations. The recent slowdown could also be a sign that supply-side constraints are becoming increasingly binding. Nonetheless, the underlying strength of the euro area economy persists, with growth above potential and sentiment indicators still well above long-term averages for most sectors and countries.

The underlying momentum is evidenced in the labour market, with around 8 million more people employed in the euro area since the trough in mid-2013. This implies that all of the job losses recorded during the crisis have been recovered. Also, the unemployment rate is at its lowest level for nearly nine years, despite an increase in the labour force of more than 2%.

In terms of demand components, private consumption – one of the main drivers of the euro area recovery since 2013 – is being supported by the steady growth in households' disposable income, higher asset valuations and by an accommodative monetary policy that contributed to a lower debt burden for borrowers. There also appears to be scope for further private consumption growth as anticipated improvements in the labour market should keep consumer confidence high.

At the same time, the investment outlook continues to strengthen and is supported by an ongoing need to modernise the capital stock after years of subdued investment, as well as by very favourable financing conditions, an improvement in profitability and solid demand. The European Commission's biannual investment survey, released on 27 April, shows expectations of a strong increase in real industrial investment of 7% in 2018.

An important factor supporting the good domestic demand performance is the favourable financing conditions for firms and households, which are still influenced by the policy measures that have been announced since June 2014. Bank lending rates to euro area non-financial corporations (NFCs) have fallen by around 120 basis points since June 2014 and to households by around 110 basis points. At the same time, the heterogeneity of lending rates across countries has also fallen sharply, with the pass-through of our measures becoming more even. Loans to NFCs have continued to grow and reached an annual growth rate of 3.3% in April 2017.

The key question for monetary policy is: will growth remain sufficiently strong for the ongoing pressure on resource utilisation to continue to nudge inflation along a pathway that rises fast enough towards our objective?

The main intersection between growth and inflation formation is the labour market. A look at the sectoral make-up of the most recent developments in the job market is encouraging. PMI survey indicators signal continued employment creation ahead across sectors as well as across major countries in the euro area. Measures of labour market tightness, such as the vacancies-to-unemployment ratio or survey indicators of labour shortages, show an upward trend for the euro area that has steepened over the past year. Measures of slack, such as the U6 measure of unemployment, also show improvement. [6]

At the same time, there is growing evidence that labour market tightness is translating into a stronger pick-up in wage growth. Annual growth in negotiated wages in the euro area increased to 1.9% in the first quarter of 2018, from 1.6% in the fourth quarter of 2017. The upsurge was primarily due to Germany, where negotiated wages increased by 2.3% in first quarter of 2018 up from 1.9% in the fourth quarter of 2017, driven by major wage agreements in the German metal and engineering industry, the public sector and the construction sector.

Rising wage pressures are gradually starting to be reflected in aggregate measures of compensation per employee. These, in turn, feed into producer prices for domestic sales of non-food consumer goods.

The Governing Council has three criteria for assessing whether there is a sustained adjustment in the path of inflation towards levels below, but close to, 2% over the medium term: first, the convergence of the projected headline inflation to our medium-term aim; second, confidence in the realisation of this convergence path; and third, the resilience of inflation convergence even after the end of our net asset purchases.

Signals showing the convergence of inflation towards our aim have been improving, and both the underlying strength in the euro area economy and the fact that such strength is increasingly affecting wage formation supports our confidence that inflation will reach a level of below, but close to, 2% over the medium term. As for our third criterion, resilience, waning market expectations of sizeable further expansions of our programme have been accompanied by inflation expectations that are increasingly consistent with our aim.

At the end, any decision concerning the termination or further extension of our net purchases will hinge on the ultimate judgement of the Governing Council. Once the Governing Council judges that the three criteria have been met, net asset purchases will expire, in line with our guidance. From that point in time, inflation developments will remain conditional on reinvestments continuing for an extended period of time and on policy rates remaining at their present levels well past the end of our net asset purchases. Our forward guidance on policy rates will then have to be further specified and calibrated as appropriate for inflation to remain on the sustained adjustment path to levels below, but close to, 2% over the medium term. The stock of long-duration assets held in our portfolio will continue to put downward pressure on longer-term interest rates well beyond the end of our net purchases.

Conclusion

Low interest rates fundamentally reflect the consequences of unfavourable secular trends, combined with the fall-out from the global financial crisis and euro area sovereign debt crisis. As a result, the equilibrium real interest rate has declined to very low levels, although the precise level is very uncertain.

Confronted with a declining equilibrium interest rate and the effective lower bound on policy rates, we had to resort to unconventional monetary policy measures in order to provide the necessary accommodation to support domestic demand, thwart the deflationary risks which were emerging in 2014 and prepare the way for inflation to return to our objective.

However, monetary policy cannot increase the long-term real interest rate. This requires policies that address the factors depressing the real interest rate: increasing potential growth and completing the euro area’s institutional set-up. Such measures would support investment and rebalance saving and investment, which in turn would increase the equilibrium real interest rate and support the normalisation of interest rates.

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[1] I would like to thank John Hutchinson for his support in preparing this speech.

[2] Expected inflation can be further decomposed into “risk neutral” inflation expectations and inflation risk premia.

[3] For the United States such analysis can be undertaken from the late 1990s when Treasury Inflation-Protected Securities became available, while inflation swaps started being traded quite a bit later. See, for example, Abrahams, M., Adrian, T., Crump, R. K., Moench, E. and Yu, R., (2016), “Decomposing real and nominal yield curves”, Journal of Monetary Economics, Volume 84, December, pp. 182-200. In the euro area, these decompositions can also be undertaken using model-based analysis, albeit only over a shorter time period due to the later availability of suitable inflation-linked instruments.

[4] Whereas the inflation risk premia and the real term premia, taken together, display a trend decline over recent decades, the analysis of their individual dynamics is subject to data limitations as estimates are based on inflation-linked bonds or swaps which have only recently become more widespread. But it is likely that the inflation risk premia declined significantly in the 1980s and 1990s alongside the decline in inflation expectations, with investors accepting lower compensation for bearing inflation risk. The decline in inflation risk premia from mid-2014, by contrast, pointed to the increased prominence that market participants assigned to lower than expected inflation outcomes around that time.

[5] More than a century ago Knut Wicksell (1898) described the natural rate as: “There is a certain rate of interest on loans which is neutral in respect to commodity prices, and tends neither to raise or to lower them. This is necessarily the same as the rate of interest which would be determined by supply and demand if no use were made of money and all lending were effected in the form of capital goods”.

[6] The “U6 measure” captures unemployment, underemployment (i.e. workers who would like to work more hours) and marginal attachment, which refers to those members of the workforce who are not seeking employment very actively, because, for example, they are not available to start a new job at short notice or have been discouraged by a fruitless search for work.

Fonte: PRAET, Peter. Monetary policy in a low interest rate environment. Disponível em: < https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180606.en.html> Acesso em: 07 de junho de 2018

Jens Weidmann: Reforms for a stable monetary union

Speech delivered by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the annual reception of the Minister President of the German state of Hesse, Brussels, 05 june 2018

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1 Introductory remarks

Minister President Bouffier
Thank you for your kind words.

I am delighted to see such a large number of guests and would like to greet the representatives of the diplomatic corps, the members of Parliament, the representatives of the European Commission, the Council and other EU institutions, the members of the state government of Hesse, and all the other members of our audience today.

I have lived and worked in Hesse for many years now – in the beautiful Rheingau region and in the buzzing metropolis of Frankfurt, to be precise – and have long since come to feel at home there. Hesse is not only in the middle of Germany, it is also at the heart of Europe.

The political cabaret artist Matthias Beltz once said: “The people of Hesse are surrounded by masses of Germans. They have no access to the sea, the Alps or foreign countries, so they have no direct contact with freedom.” But luckily, freedom comes to us. Hesse, and especially the area around Frankfurt, has an international character, and the region’s cosmopolitan atmosphere makes it an easy and enjoyable place to live.

At the same time, Hesse is home to several EU institutions. One of these is the European Central Bank (ECB), which turned twenty a few days ago. It commenced its tasks on 1 June 1998 in Frankfurt, a few months before the start of the third stage of Economic and Monetary Union.

2 20 years of the euro

In the two decades since it was introduced, the euro has proven a success. The original promise of a stable currency has been kept – the euro is stable both internally and externally. At 1.7 % on average over the last 20 years, the rate of inflation is lower than many people expected.

It is therefore no surprise that support for the euro among the general public is high. According to the latest Eurobarometer survey, three-quarters (74 %) of respondents in the euro area are in favour of the single currency, while only one in five (21 %) is against (the idea of) the euro. In some countries, Germany included, the approval rating is higher than 80 %, even.

However, these positive survey results should not obscure the fact that the euro's second decade was rife with crises and problems: a financial crisis, an economic crisis, a European debt crisis, a banking crisis, a double recession and high levels of unemployment. Several countries experienced a prolonged period of economic weakness and the necessary adjustment measures brought with them social hardship.

Figuratively speaking, you could say that the euro had an easy childhood but a difficult adolescence.

Over the last few years, the Eurosystem's central banks have faced unfamiliar challenges, and not just in their core area of responsibility, which is that of ensuring price stability. During the crisis, they were to some extent forced to act as crisis response units, taking them to the outer edge of their mandate for a while.

In an interview last week, Otmar Issing warned: "Politicians have it easy. They rely on the ECB to sort everything out. But that isn't going to work in the long term."

The dialogue between member states has also taken on a harsher tone at times. But monetary union was actually a project intended to encourage European integration and ultimately even bring about deeper international friendship.

All the same, I would like to stress that, in many ways, the euro area is in better shape today than it was before the crisis. This is thanks to measures taken by its member states as well as changes to the structure of the monetary union, both of which I will now focus on briefly.

3 Reforms in the euro area

3.1 Adjustment progress in the member states

The crisis brought home to all of us what being part of a monetary union means and involves. And the way the countries that were hit the hardest by the crisis have tackled the roots of the problems and have regained their competitiveness, for example, is truly remarkable and receives too little recognition.

In Greece, Portugal, Ireland, Spain and Cyprus, for instance, average unit labour cost growth was above the euro-area average in the pre-crisis period (1999–2007). This was a contributing factor to these countries' loss of competitiveness.

Since the crisis, unit labour costs in all five of these countries have grown more slowly than the euro area average. This has made their economies more competitive.

The structural reforms already undertaken are also beginning to bear fruit and have contributed to the upturn. Take structural unemployment, for instance, which has gone down by just over one percentage point in the euro area, by slightly more in Spain, and by as much as 5 and 7 percentage points respectively in Portugal and Ireland, thus showing that there is more at work here than just the upbeat state of the economy.

Current account deficits, some of which were very high, have also been balanced or even turned into surpluses.

It would be tragic if, given all this, reforms were to be rolled back or consolidation gains squandered. Instead, we should build on the successes that have been achieved.

Incidentally, this also goes for countries such as Germany, which weathered the crisis fairly well.

3.2 Changes to the governance framework to date

But it's not just in the member states that much has happened as a result of the crisis. In the euro area, much has changed for the better in institutional terms as well.

One positive development is the ESM – a permanent euro rescue facility that can grant conditional financial aid to member states in the event of a crisis and can thus prevent a national crisis from jeopardising the stability of the entire euro area financial system.

The creation of the banking union is also a welcome development. Thus far, the banking union encompasses a single supervisory mechanism, a single resolution mechanism, and harmonised national deposit guarantee schemes.

These reforms remedied weaknesses in the structure of the monetary union that were either ignored or overlooked when the euro was founded.

The most experienced among you may remember that the idea of a joint financial supervisory system was actually discussed by the Delors Committee back at the end of the 1980s, but was ultimately dismissed.

The crisis set in motion a learning process in this field, too, in which old beliefs were called into question, and not only in the member states. This, by the way, also applies to the Bundesbank, which, for example, had long been sceptical of a common financial supervision.

The ESM and the banking union, together with stricter financial regulation, have doubtless made the monetary union more stable. If there were new upheavals in the financial system or in individual member states, we would be considerably better prepared to deal with them today than we were in 2010, when the Greek debt crisis caught the euro area off guard.

4 Further reforms

4.1 Guidelines

Much has been achieved in the member states and at the European level. But this still isn't enough to crisis-proof the euro area once and for all. The financial market turbulence last week with regard to Italy is a case in point.

The consensus is that the previous reforms have been insufficient to put the euro area on as sound a footing as we would all like. Meanwhile, the economic environment at the moment is still exceptionally favourable overall, and we should be taking advantage of this.

So I am concerned by the fact that enthusiasm for consolidation in the euro area appears to have waned. Whilst almost all euro area countries reduced their structural deficit by half a percent of GDP or more in 2012, not a single one is set to improve its structural budget balance in 2018. It seems that the reformed fiscal rules are having just as weak an impact as the old rules.

Furthermore, the ECB Governing Council has emphasised again and again that the implementation of structural reforms in the euro area needs to be significantly intensified now in particular, in view of the current favourable economic environment, in order for economies to become more resilient and structural unemployment to fall further should they face stronger headwinds – and by structural unemployment I mean the unemployment that remains even when the economy is doing well. This also needs to be the case if we want productivity and potential growth in the euro area to rise.

At around 1½ %, potential growth in the euro area has recovered since the crisis, but it is still considerably lower than its pre-crisis level of about 2 %.

In this context, there is currently passionate debate about national sovereignty in some member states. In fact, it is national economic policymakers who are responsible for improving the conditions required for growth, employment and social cohesion – through a good education system, efficient public administration, growth-friendly and fair taxation, and an appropriate infrastructure, to name but a few examples.

This is in the countries' own national interests and, at the same time, is the best way in which each individual country can contribute to the stability of Europe. Europe needs to take responsibility as a community – only then will we truly be able to make progress with the European project and also show the citizens of Europe that it creates prosperity.

So while there are many pressing issues to be discussed and decided upon at the national level, an intensive reform discussion is also taking place with regard to the future structure of the monetary union and the EU. This topic, as you all know, is also on the agenda of the EU summit at the end of this month here in Brussels.

The ideas voiced by the French president Emmanuel Macron, which have been greeted with a mix of goodwill and scepticism in Germany, have provided important impetus for the European debate. Furthermore – and this is, I believe, a great achievement – he has created a convincing, lively narrative for the joint European project that citizens can buy into and even be enthusiastic about.

It seems clear to me that there will only be progress in this debate if Germany and France work in concert and move in the same direction.

The Bundesbank has also been providing proposals of its own in this debate for a long time now, and it is within this debate that the agenda for the stability of the single currency is being set.

From my perspective, three guidelines form the basis of these proposals.

1. The European Union should focus more of its attention and spending on tasks that create added value for the citizens of Europe.
2. The institutional and economic conditions of the monetary union need to be set up in such a way that the Eurosystem can properly fulfil its mandate and does not have to intervene on a regular basis as a crisis response unit.
3. A stable monetary union requires both solidarity and solidity, and it is essential that the alignment of actions and liability be maintained.

Allow me, if you will, to delve slightly deeper into this last point in particular.

The alignment of actions and liability means that the authority to make decisions needs to be linked to the responsibility for the consequences of such decisions. Or, in other words, only he who has the power to influence decisions is also prepared to bear the risks that these decisions entail.

When it was decided in Maastricht to create an economic and monetary union, the member states agreed to pool their sovereignty in monetary matters at the European level. However, under the existing regulatory framework, responsibility for fiscal policy – as for general economic policy – lies with the individual member states, as I have already mentioned.

From the outset, there have been measures in place designed to prevent unsound public finances from jeopardising the stability of the single currency. Rules on debt have been laid down in the Stability and Growth Pact; it is prohibited to simply print more money as a way of financing the public sector; and countries cannot take on each other's liabilities – the famous no bail-out clause.

In principle, though, the member states remain sovereign in fiscal matters. And indeed, this sovereignty is something that they have always confidently championed and defended. In this vein, I recall Matteo Renzi, the former Italian Prime Minister once asserting that "It's up to us to decide what taxes we cut, not some Eurocrat sitting in Brussels".

If monetary union reforms were to include a far greater degree of fiscal risk-sharing, actions and liability would only remain aligned if certain sovereignty rights were to be transferred to the European level. Otherwise we would end up with imbalances and dubious incentives.

But ceding a significant portion of their sovereignty to Brussels is precisely what the euro area member states are not prepared to do – to give a European finance minister the right to intervene in national budgetary planning if they fail to comply with the fiscal rules, for instance.

It seems to me that it's already hard enough at times to ensure that the Commission's existing powers are enforced and respected. And that's why I'm convinced that any reform steps need to fit within the existing Maastricht framework.

4.2 Risk sharing and provisioning

But complying with the Maastricht framework doesn't necessarily rule out an expansion of mutual liability. If actions are properly aligned with liability, risk sharing can make a lot of sense.

In principle, there are justifiable arguments in favour of having the collective resources of the ESM function as a fiscal safety net for the European Single Resolution Fund, as per the Commission's suggestion. After all, we already have banking supervision at the European level, meaning that we share the responsibility for supervisory decisions.

For similar reasons, the Bundesbank isn't opposed to a common European deposit insurance scheme per se. Quite the contrary. Such a scheme would, without doubt, contribute to a more stable financial system, as it would reduce the risk of bank runs. And shared supervisory responsibility makes a good case for joint liability here, too.

But to protect the link between actions and liability, risks that have arisen under national responsibility must be reduced before a common deposit insurance scheme is created. What's more, the impact of national policy decisions on the quality of bank balance sheets must be limited.

The stocks of non-performing loans on countries' bank balance sheets – some of which are very high – are an example of this kind of legacy risk. The average non-performing loan ratio has fallen by around one-third in Europe since 2014. But in some countries it remains very high and well above pre-crisis levels.

The large holdings of government bonds on bank balance sheets are also problematic. Owing to a regulatory loophole, government bonds are backed by little to no capital. And – unlike with private borrowers – there is no cap on individual banks' exposures to sovereign debtors.

Before a deposit insurance scheme can be created, these sovereign default risks on banks' balance sheets would need to be reduced in the long term, as would stocks of non-performing loans. Otherwise the insurance scheme would find itself assuming liability for them.

My colleague on the ECB Governing Council, Benoît Cœuré, rightly pointed out the other day that "A deposit insurance scheme should be seen as an insurance against economic risks, just as you take out liability insurance to protect yourself against the risk of an accident." But as you all know, ladies and gentlemen, you can only take out a liability insurance policy to cover future accidents, and not if the damage has already been done.

Following the logic of an insurance scheme, and given that member states will still have a bearing on the health of their banks in future, the concept of a permanent national risk retention requirement also seems worth considering. Think, for example, of insolvency law and how it is legally enforced.

If we look further afield, beyond the banking union, a rainy day fund modelled on the type in place in several US states is certainly worthy of consideration. Many states put aside budget surpluses for hard times. But new scope for borrowing and fund transfers between states are incompatible with this approach.

However, it is reasonable to question whether countries with solid public finances even need such a fund. After all, European fiscal rules are less strict when it comes to government debt than the constitutions of the US states, most of which prohibit new borrowing altogether.

But such an instrument would at least offer greater room for manoeuvre in difficult situations without needing to expand fiscal risk sharing or requiring cross-border payments.

4.3 Private risk sharing

Increased risk sharing within the euro area would make member states better able to absorb economic shocks. The same goes, in particular, for private forms of risk sharing.

A recent article by ECB economists shows that, in the euro area, when a particular member state experiences an economic slump, 80 % of that downturn bleeds through to consumption in that country. Now, at first, it might seem plausible to us that it is chiefly the people in the affected country that have to tighten their belts.

But in the US states, 40 % – at most – of a shock to GDP is reflected in a fall in consumption growth. So there's clearly another way. The rest of the impact is absorbed elsewhere. For instance, because the losses sustained by an enterprise in one USstate are distributed across the whole country as shareholders are often domiciled in other states. [1]

The much greater importance of private risk sharing in the United States shows that private risk sharing is capable of enhancing the individual countries' resilience in the euro area, too. Integrated and efficient financial markets are a key prerequisite for this.

Creating a capital markets union, as proposed in 2015 by the Commission, would move Europe a long way towards achieving this aim. Which is why the Bundesbank explicitly endorses the project.

It has the potential to spur economic growth, dismantle barriers to cross-border investment, diversify corporate financing and strengthen private risk sharing. And it would also be a key contribution to making the euro area more stable.

The more successful efforts to strengthen cross-border equity financing are, the greater the sums the capital markets union could be expected to contribute to strengthening private risk sharing. After all, there is one key difference between equity and borrowed funds: equity investors participate directly in economic risk and in gains and losses. Creditors, on the other hand, are not exposed to losses – except in the case of insolvency.

Equity therefore provides better opportunities for sharing risks and opportunities. However, there are incentives for firms to obtain funding through debt rather than equity. In many countries, for instance, debt interest is tax-deductible, but the cost of equity isn't.

To that extent, the efforts being made to create a common assessment basis for corporation tax represent a good opportunity to reduce the preferential tax treatment being given to debt and to make equity financing more attractive.

5 Focusing the EU

Ladies and gentlemen

The euro area can only be strong as part of a strong European Union.

What this requires – and that will be my last item for today – is for the EU to focus more single-mindedly on those tasks in which it has a comparative advantage and the benefits of which it can sell convincingly to the public – that is, tasks that clearly have European added value.

There are tasks that can be performed better at the European level than the national. From an economic standpoint, these might include Europe-wide public goods and therefore policy areas with cross-border externalities, in particular.

As we know, public goods are defined as goods that individuals cannot be excluded from using, the use of which does not reduce the amount available to someone else. Because these traits are an open door to free ridership, these services have to be provided by the government sector. The use of European public goods is scattered far beyond national borders. These tasks should then be relocated to the European level.

French President Emmanuel Macron has listed as such tasks defence, the protection of external borders, migration policy, climate protection and the expansion of digital networks. All of which are fields in which there is visible European added value. And if you read the interview with Chancellor Merkel at the weekend, you will know that she expressed similar views.

That is why it would be appropriate to add the topics of border security and migration to the European agenda without delay. This would also help individual member states to feel less disadvantaged and abandoned on account of their geographical location.

At the same time, however, the principle of subsidiarity enshrined in the EU Treaty needs to be applied more effectively, as there are tasks that are still more at home at the domestic level. And that is why it is a welcome development that Commission President Juncker has convened a task force for subsidiarity and asked it to consider which powers are better exercised nationally or locally than at the European level.

This task force, headed by the First Vice-President Frans Timmermans, has been given until mid-July to submit a report. This report should also present ways of better incorporating regional and local government in EU policy-making – an idea which is surely being followed with great interest here at the Representation of the State of Hesse.

More Europe does not necessarily have to mean more money for Europe. I am thinking, for instance, of the establishment of a single market for services and a common digital market in Europe. These are projects that do not necessarily cost much but which deliver a lot. Studies show that they could achieve growth effects twice the size of those provided by the creation of the single market for goods.

However, it is clear that providing European public goods generally comes with a price tag attached.

Germany – unlike other net contributors – has already declared its willingness to put more towards the EU budget.

Europe first needs to define the tasks that it would make sense to accomplish jointly and that should therefore also be funded jointly instead of starting off by talking about money, and thus putting the cart before the horse. So it should be less about how much each party pays and receives and more about figuring out how to invest the funds wisely.

6 Conclusion

Ladies and gentlemen
As early as five years ago, then-Federal President Joachim Gauck, in my estimation, put his finger on the essence of the debate on European policy reform when he said that “This union involves give and take; it must not be a one-way street for anyone. It is based on the principle of reciprocity, equality and mutual commitment. More Europe must mean: more reliability. Reliability and solidarity will rise and fall together.”

There is virtually nothing to add to that. And I therefore thank you for your attention.

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[1] J Cimadomo et al (2018), Risk sharing in the euro area, ECB Economic Bulletin, Issue 3, pp 98-112.

Fonte: WEIDMANN, Jens. Reforms for a stable monetary union. Disponível em: < https://www.bundesbank.de/Redaktion/EN/Reden/2018/2018_06_05_weidmann.html>
Acesso em: 07 de junho de 2018

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