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Fiscal and Monetary Policy – Dancing too Close?

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1 Introduction

Ladies and gentlemen

I would like to thank you for inviting me to be here today, which is a real pleasure for me. The HEC is, without doubt, one of the most renowned European Business Schools. Looking at the number of CEOs of Fortune Global 500 companies it provides, HEC ranks as number four in the world, and as number one in Europe.

But HEC's reach is by no means limited to the business world. There are a number of former students who have risen to the highest positions in the public domain. These include François Hollande and WTO Director-General Pascal Lamy.

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Therefore, it is an exceptional honour for me to receive the Diplôme HEC d'Honneur. And the fact that I am already the third German citizen to receive the Diplôme symbolises the close connections between France and Germany.

Just four weeks ago, France and Germany celebrated the 50th anniversary of the "Elysée-Treaty", the treaty of friendship as it is called. And the friendship between France and Germany has come a long way since Charles de Gaulle and Konrad Adenauer met in Paris to sign the treaty.

However, we still cling to our favourite clichés regarding each other's national cultural behaviour. Let us look at a recent poll in which French people were asked to name some typical German traits. According to this poll, Germans are – first and foremost – very "serious" people. Put in the words of the French writer Stendhal: "It seems that in Paris more jokes are made in the course of one evening than in Germany during a whole month".

Well, I am German so I would not dare to tell a joke. But as I am in Paris I might try at least to pass on a little quip I heard the other day. It goes like this: "How many Germans do you need to change a light-bulb? One, he holds the light-bulb and the rest of Europe revolves around him".

I'm afraid this quip reflects the impression some might have of Germany at the moment. But let me add two things: first, the same joke was being told in the 1990s, and back then, the French where the ones holding the light-bulb. Second, the joke did not reflect actual circumstances in the 1990s, nor does it reflect them today.

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In reality, Europe can only work if all of us move in the same direction. Only together can France and Germany act as the driving forces of European integration. And only together can France and Germany help to solve the current crisis.

However, regarding the crisis, there are some issues on which we have different opinions. And here it is important to address these differences openly, listening to each other and trying to understand what each of us thinks. Only when we share our thoughts and ideas can we develop a sensible solution to our problems.

This is why I am happy to be here today. For it gives me the opportunity to share and discuss my ideas with you. And given that we are at one of the most high-ranking business schools worldwide, I look forward to listening to your ideas as well. But let me begin with a few observations on which I think we all agree.

2 Same crisis, different perspectives?

With respect to the current crisis and its origins, we all see more or less the same problems. We see a sovereign debt crisis; we see high public or private debt and a lack of competitiveness in some member states; we see current account imbalances, and we see weaknesses in the framework of monetary union and in its financial system.

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With respect to the future, we all are focused on the same objective: a prosperous European Union and a stable single currency. However, it is the question of “how to get there” where opinions differ. This should be no surprise because it is indeed a tricky question. To paraphrase the American politician Hubert Humphrey: The solution is hammered out on the anvil of discussion, dissent and debate. So, I would like to highlight three issues where I feel that my view and the view of many decision-makers in Germany might differ from that of others.

Some say it would hurt growth if countries consolidated their public finances at great speed. In my view, consolidation is crucial for growth in the long term and not that bad for growth in the short term.

Some say Germany should do more to rebalance current accounts by reducing its competitiveness. In my view, instead of making one country weaker we have to make all countries stronger. Europe as a whole has to become stronger.

Some say monetary policy should do more to solve the crisis. In my view central banks must focus on price stability, must remain independent, and must not become too closely intertwined with fiscal policy.

In the next part of my speech I would like to explain the reasoning behind my positions.

3 Solving the crisis – the national and the European level

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Let us begin at the national level, in those countries that are at the centre of the crisis. There we see several deficiencies, but I would like to point out two things in particular: high public debt and a lack of competitiveness. In countries such as Greece, Portugal, Ireland and Italy public debt stands well above 100% of GDP. And since the euro was introduced, competitiveness has declined by 12% in Greece, by more than 14% in Spain and by more than 8% in Italy.

These are the underlying problems; this is where we have to apply the medicine. And the medicine of choice seems to be straightforward: governments have to consolidate public finances and they have to embark on structural reforms to make their economies more competitive. The ultimate goal, of course, is to strengthen the foundations for sustainable growth and employment.

Allow me a few words on France at this point. France is the second largest economy in the euro area. It is home to many renowned firms, it has a strong domestic market, and it has favourable demographics – in particular when compared to Germany.

However, France also faces structural challenges. The unemployment rate stands at more than 10%, its world market share of exports has declined by 25% since the beginning of EMU and at around 90% of GDP public debt has reached a level that could potentially hurt growth, according to some studies.

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But France has acknowledged the importance of sound public finances and a competitive economy. And with the “National Compact for Growth, Competitiveness and Jobs“ the government has laid the foundation for some very promising reforms. Furthermore, the social partners agreed on labour market reforms at the beginning of this year. This could be an important step toward achieving a better functioning labour market.

However, regarding fiscal consolidation, more challenges lie ahead. One of them is to meet the commitments under the Excessive Deficit Procedure. According to the last projection by the European Commission, France will not meet the deadline to reduce the deficit 2013 to below the reference value of 3% of GDP. This has now posed the question of whether the deadline should be postponed or not.

It is certainly true that it is more difficult to meet deficit targets in the context of weak economic growth. However, in the current situation we need to recognise that we are faced with a crisis of confidence. There has been a partial loss of confidence in our fiscal rules as well as in the will of European countries to consolidate their public finances.

Moreover, there is the criticism that deficit targets may, in fact, become a moving target. In such an environment it is in my view particularly important for the heavy weights in EMU to give clear signals, which boost the credibility of the fiscal rules and agreements in EMU and the credibility of their consolidation strategy.

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But coming back to the countries at the centre of the crisis, both remedies, consolidation and structural reforms, are hotly debated.

3.1 Consolidation vs growth

Regarding consolidation, many people fear that it will hurt growth. Hannes Swoboda, an Austrian member of the European Parliament claimed that: “Austerity measures won’t bring people out of the crisis. It is like giving poison to a man or woman who is sick.”

Personally, I tend to agree more with Christian Noyer. He said: “In the current circumstances facing Europe, I believe these concerns are misplaced”. I, too, believe that these concerns are exaggerated. It is indeed likely that consolidation will have a short term dampening effect on growth.

However, to quote Mario Draghi: ”What’s the alternative?” Putting consolidation off would just shift the problem into the future. It would buy time but in so doing also worsen matters today as there is the risk that trust in public finances would erode even more. Moreover, a wide-spread lack of trust in public finances weighs heavily on growth. A study by Carmen Reinhart and Kenneth Rogoff implies that debt levels above 90% will reduce growth.

I do not advocate a strict Ricardian view here. I do believe, however, that peoples’ concerns about increasing adjustment needs in the future will affect their spending and investment today. Thus, it is important that governments adhere to the consolidation plans they announced. This will inspire confidence, which is an important prerequisite for the economy to grow. As Jean-Claude

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Trichet once said: “When you’ve lost confidence, when households have no trust, when businesses have no trust, when savers have no trust, then the best way to find growth and jobs is to recreate confidence.”

In my view, this is true not just for the countries at the heart of the crisis. A failure to signal the necessary commitment will not contribute to improving the confidence of investors and consumers in the euro area.

Thus, my appeal for consolidation does not stem from a desire to punish past sins. Rather, the goal is to make those countries at the heart of the crisis stronger. And if we adhere to our fiscal rules there is no need to set up the ECB as lender of last resort let alone to call for inflation as a solution for resolving the debt problem.

3.2 Regaining competitiveness

And the same is true with regard to the second problem I mentioned: the lack of competitiveness in some member states. The most visible sign of this lack are current account deficits. Countries such as Spain, Portugal and Greece imported more than they could export and thus ran current account deficits. Other countries such as the Netherlands and Germany have been running persistent current account surpluses.

In part, these imbalances are driven by fundamental characteristics of the respective economies. For instance, countries with an ageing population naturally save more than they invest domestically. Consequently, they run temporary current account surpluses.

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However, to a large degree the imbalances we observe are driven by structural problems and are not temporary but persistent. And a persistent current account deficit might become a risk. The longer a country's current account is in deficit the more foreign liabilities this country piles up. Eventually, these liabilities have to be paid back which might become difficult if the inflowing capital is not invested wisely. Once the willingness or the ability to repay comes into question capital flows might reverse. This is highly disruptive as spending and investment would have to adjust abruptly.

Against this backdrop, current accounts in the euro area have to be rebalanced. Now, the question is: which countries need to take measures? Those with a current account deficit? Those with a surplus? Both?

The typical German answer would be this: the deficit countries must act. They must address their structural weaknesses. They must become more competitive and they must increase their exports. As a result, the deficits and surpluses would automatically adjust. In other words: Current account positions are symmetric as regards economics statistics, but not when it comes to macroeconomic risks. Thus, it is in the interest of deficit countries to adjust.

Naturally, this position has been challenged and a number of renowned economists take a different view. Christine Lagarde of the IMF for example said: "Those with surpluses could do a little something. It takes two to tango". Her suggestion implies that the adjustment of current accounts should be shared between deficit countries and surplus countries. Those with a surplus

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would become a little less competitive, while those with a deficit would become a bit more competitive, and eventually they would meet in the middle.

Well, the question we have to ask ourselves at this point is: “Where would that take us?” For two reasons I believe it would not take us very far. One reason relates to what would happen inside the euro area, the other relates to the outside world.

Let us first consider the euro area. Imagine that wages in Germany were pushed up, causing the economy to become less competitive. For the sake of argument, let us assume a wage increase of two percentage points. That is, two percentage points on top of what unions and employers would otherwise agree on.

This is the policy shift we fed into our economic models to calculate its effect on the current accounts of deficit countries and on the German economy. According to our economic models, GDP in Germany would decline by ¾% and employment would decline by 1% while the effect on the deficit countries would be close to zero. This sobering result is mainly due to the structure of trade flows between Germany and Southern Europe.

After all, 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. If Europe wants to succeed in this world it has to strive for global competitiveness. The attempt to shield one European

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country from competition by lowering the competitiveness of another makes all of us weaker.

Europe as a whole has to become more dynamic, more inventive and more productive. This is not a new concept; it was already at the heart of the Lisbon strategy. And one thing we have learned from the failure of this strategy is that commitments should always be binding. Against this backdrop, the new Macroeconomic Imbalance Procedure is a step in the right direction.

Nevertheless, in the end, competitiveness is always a relative concept. As the current accounts of deficit countries begin to adjust, the current accounts of countries with surpluses will automatically follow. This process is already well under way. Since its peak in 2007, Germany's current account surplus vis-à-vis the rest of the euro area has about halved. And looking ahead, we expect the surplus to decline further, provided confidence is restored. This expectation is in line with what the IMF says in its latest World Economic Outlook.

So, yes, it takes two to tango and countries with surpluses are already on the dance floor. However, it is the countries with deficits that will have to lead in this particular dance.

4 Solving the crisis – the role of monetary policy

Now that we have mentally entered the dance floor, let us see who else is dancing. Well, monetary policy certainly is and there are many who would like to see it dance even more. European politicians, in particular, have conveyed

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the impression that the ECB is the "last man standing". Spanish foreign minister José Garcia-Margallo, for instance, claimed that "only the central bank could put out the fire".

In my view, this is a misguided perception. The ECB is certainly not able to solve the crisis in a sustainable manner. Earlier on, I talked about the fundamental problems within some member states: high public debt and a lack of competitiveness. Add to that the weaknesses in monetary union's institutional framework, and it becomes clear that monetary policy, or for that matter, exchange rate policy cannot be the solution. These are structural problems that require structural solutions.

The illness is more than the pain it inflicts and monetary policy is just a pain reliever at best. Once the effect wears off, a higher dose becomes necessary – as we have seen throughout the crisis.

Besides, monetary policy has already done a lot to contain the crisis. The ECB Governing Council reduced interest rates to a mere 75 basis points, decided to provide banks with quasi unlimited liquidity, and to intervene in bond markets. With all these measures the central banks of the Eurosystem took on considerable risks, and they became involved in political issues far beyond the traditional role of central banks.

As Stephen King wrote in the Financial Times: "Monetary policy is doing more to redistribute income and wealth than to trigger a rebound in economic activity. Central bankers are making decisions that are more political than

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economic”. Indeed, the measures of the Eurosystem have contributed to a redistribution among tax payers in different countries.

“Well”, you might say, “this is a necessary act of solidarity and a healthy act of pragmatic monetary policy”. Don’t get me wrong: I do not question the case for solidarity. My argument is rather about the question of who decides about solidarity and what it means for the stability of the single currency.

In my view, it has to be democratically elected parliaments who decide about redistributing wealth or risks. Besides, we could run the risk of suffering from the tragedy of the commons in which monetary policy would become a shared resource that would be overused. And this is not just a theoretical consideration. It is something of practical relevance when it sets the stage for a discussion about the independence of central banks.

And such a discussion has begun. Joseph Stiglitz recently claimed that: “The notion of the desirability of an independent central bank was predicated on the belief that monetary policy was a technocratic matter, with no distributional consequences.” From this he concludes that: “The crisis has called into question the notion of independence”. Japan provides a real-life example of a central bank that has come under political pressure.

I must admit that these developments worry me. They worry me because theoretical considerations as well as historical experience contain one central message: Independence and a focus on price stability are crucial for successful monetary policy.

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Central banks should not find themselves dancing too closely with fiscal policy. To paraphrase one of my predecessors: If you dance too close with fiscal policy she will marry you. And the offspring are usually higher inflation and reduced fiscal discipline.

And here, I am not even referring to the German experience of the 1920s. We just have to look back to the 1970s. In these years, inflation rates in countries with independent central banks were comparatively low. While average inflation in Germany stood at 5%, it reached as much as 14% in Italy and 15% in Spain.

Or think of the French experience of the late 1980s. In 1993 the Banque de France became independent and Jean-Claude Trichet introduced his policy of the “Franc fort”. Only then did inflation rates decrease from an average of nearly 4% to less than 2%.

So, if we care about stable prices and if we care about purchasing power then we should be worried. We should be worried because on the European dance floor monetary and fiscal policy are moving toward each other. Think of Greece: while governments hesitated to disburse the next tranche of loans, monetary policy stepped into the breach. Nevertheless, we should not overburden monetary policy with the task of solving a crisis that it cannot solve anyway. The price would be too high.

5 Conclusion

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Ladies and gentlemen, I began my speech with a joke about how to change light-bulbs in Europe. As you might know, traditional light-bulbs are increasingly being phased out in the European Union. This is a sign of the changing times we are living in.

But not everything has to change. Proven concepts such as central bank independence should be preserved. Nevertheless, the most important point of my speech is that we all share the same objective: a prosperous European Union and a stable single currency. This is what unites us and keeps us going.

And as I said in the beginning: Only together can France and Germany solve the current crisis. And as the largest economies in Europe they already contribute significantly through the rescue mechanisms. Stabilizing monetary union requires that both countries are economically and politically strong.

But it also requires a common approach. A common approach that is suited to tackling the underlying causes of the crisis. At the national level, this should include consolidation of public finances and structural reforms. But that is certainly not enough.

We also have to improve the framework of monetary union. This includes reestablishing market mechanisms and the liability of investors for their decisions at all levels: We need mechanisms that allow banks to fail without triggering a systemic crisis – a well-designed banking union would be a step in the right direction. We also need mechanisms that allow states not to be bailed out without triggering a systemic crisis – this includes, for instance, the

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introduction of capital requirements for government bonds and caps on banks' exposure vis-à-vis single countries.

Thus, there are many challenges we have to master and many problems we have to solve. This makes it necessary for us to share our ideas and discuss those issues where we have different opinions. In my speech I have tried to shed some light on my ideas, now I'm looking forward to discussing them with you.

Thank you for your attention.

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