

Crises as a catalyst for change – lessons from the past, challenges for the future*



By Jens Weidmann
President of the Deutsche Bundesbank

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1. Introduction

Ladies and gentlemen,

I am delighted to be back here at the European Banking Congress. Of course, I would have preferred to meet you in person at the Alte Oper. But we are all deeply concerned about the latest wave of infections that has spread across Germany.

The Alte Oper has always provided an excellent venue for this event and for cultural life more generally. Another great cultural location in Frankfurt, by the way, is the Städel Museum, where an impressive Rembrandt exhibition is currently on display. One highlight of the exhibition is *The Blinding of Samson*. The painting depicts Samson, a heroic figure from the Old Testament, seized by the Philistines. Rembrandt captured the dramatic story on a single monumental canvas.

Standing up close, you marvel at the many small intricacies, especially Rembrandt's masterful play with light and shadow. At this short distance, though, you lose sight of the big picture (quite literally) – the

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connections and interrelationships escape you. But if you take a couple of steps back, suddenly you understand the whole story.

In a similar way, I would now like to take a few steps back with you and place recent developments in monetary policy in the overall picture. We are overcoming the economic slump caused by the COVID-19 shock. Like other severe crises before, the pandemic will not pass without leaving its mark – including on monetary policy. Therefore, it is worth broadening our view and looking in both directions: backwards and forwards.

2. Past: lessons from the financial and sovereign debt crises

Ten years ago, almost to the day, I gave my first speech at the EBC.¹ Back then, we were dealing with the aftermath of the global financial crisis, and the sovereign debt crisis was shaking the euro area to its very foundations. To prevent the situation from coming to a head, policymakers granted joint assistance loans to financially distressed Member States. The Eurosystem also stepped in, taking on the role of a ‘crisis response unit’ and buying governments and parliaments time for reforms.

Since then, much has been done to shore up the resilience of the financial system. The core idea was to strengthen the liability principle again in order to curb adverse incentives. Stricter financial market regulation has helped achieve this, as have higher capital requirements for banks.

We also learned that, for a stable financial system, it is not enough to monitor the stability of individual institutions. Macroprudential policy was established to take a comprehensive view and use a toolkit of its own.

Much has changed for the better in institutional terms as well. Today, the ESM stands ready to provide financial support to Member States facing severe crises. Another major step forwards was the creation of the European banking union with joint supervision and a single mechanism for restructuring and resolution.

All this has made the monetary union more stable. Nevertheless, by the end of the last decade, there were still some items left on the post-crisis to-do list.²

For example, the sovereign-bank nexus has not been decisively broken. Many banks still hold large portfolios of domestic government bonds. This practice is being encouraged by the preferential treatment afforded to sovereign exposures in terms of capital requirements and the large exposures regime. I am convinced that regulation should not give banks incentives to overinvest in sovereign exposures and to tie their fate to their sovereign’s solvency. Abolishing the preferential treatment would also add to the credibility of the no-bail out rule under the Maastricht Treaty.

Meanwhile, the impression seemed to have grown in public that the central banks were always ready to step into the breach for other policy areas, if push came to shove. In addition, the monetary policy setting had changed: First, inflation in the euro area was stubbornly low – partly as an after-effect of the crisis years. Second, equilibrium real interest rates have fallen, which is likely to have reduced central banks’ room for manoeuvre

¹ Weidmann, J., The world economy in transition – a European perspective, speech delivered at the European Banking Congress on 18 November 2011.

² Weidmann, J., Perspektiven für Europa und den Euroraum, speech delivered at the Centre for European Policy on 20 September 2018.

regarding policy rates. Consequently, monetary policy resorted to unconventional instruments such as quantitative easing to achieve the desired expansionary effect.³

While unconventional monetary policy measures have been supportive for growth and inflation, they have also led us into largely uncharted territory. In particular, large-scale bond purchases transformed the Eurosystem central banks into the biggest creditors of Member States. This caused monetary and fiscal policy to become more closely intertwined, weakening the incentives for sound public finances.

Painted with broad brush strokes, that was the situation we found ourselves in when the pandemic hit.

3. Present: unsound developments laid bare

The previous crises originated in the financial system or the economy. The pandemic, by contrast, is at its core a health crisis. However, like the crises that came before, it is exposing existing problems and laying bare longer-term challenges.

Take fiscal policy, for example. It was right for governments to act swiftly and comprehensively to avert a downward spiral that could have inflicted serious, permanent damage on the economy. Hence, it was appropriate that the requirements of the Stability and Growth Pact were suspended during this phase. Indeed, it was precisely for circumstances like these that the general escape clause was created in the first place. But, before the crisis, the EU fiscal rules lacked teeth. Not only did they grow more and more complex, they were also stretched in practice. Especially countries with high debt ratios didn't do enough to scale back their structural deficits. Thus, during the crisis, debt ratios there rose strongly from an already elevated level.

Monetary policy is another case in point: Last year, the Eurosystem took swift and decisive action. This helped stabilise the economy and laid the foundations for its rapid recovery. However, when the pandemic crisis hit, policy rates were already at a record low – arguably, they weren't all that far away from their effective lower bound. So monetary policy was forced to extend the use of unconventional instruments even further. Indeed, the Eurosystem's holdings of public sector bonds are still growing. Taking all programmes together, these holdings will probably come to roughly one-third of euro area GDP by the end of this year.

The fundamental issue goes beyond the euro area. According to calculations by Stephen Cecchetti and Paul Tucker, in 2007, the central banks in the US, UK, and Japan had total assets ranging from 6% to 20% of nominal GDP. By the end of 2020, the Fed's balance sheet was 34% of GDP, the Bank of England's 40%, and the Bank of Japan's 127%.⁴

Mervyn King, the former Governor of the Bank of England, has recently warned that quantitative easing could become a “dangerous addiction”, saying: “QE tends to be deployed in response to bad news, but isn't reversed when the bad news ends. As a result, the stock of bonds held by central banks ratchets up, expanding their balance sheets into the longer term.”⁵ The path you follow then is like climbing up a mountain. And with every new crisis, you go up a few steps. But the higher you climb, the thinner the air becomes.

³ Weidmann, J., Securing stability – Challenges from the low interest rate environment, speech delivered at the 8th EIOPA Annual Conference on 20 November 2018.

⁴ Cecchetti, S. and P. Tucker, Understanding how central banks use their balance sheets: A critical categorisation, VoxEU.org, 1 June 2021.

⁵ King, M., Quantitative Easing Is a 'Dangerous Addiction', Bloomberg, 20 July 2021.

Looking back, monetary policy has never quite managed to get out of crisis mode. Thus, a return to normality could become more and more elusive.

4. Future: challenges after the COVID-19 crisis

As inflation rates have shot up recently, the issue of monetary policy normalisation has made a forceful return to the public debate.

By coincidence, the Eurosystem adopted a new monetary policy strategy this summer. As part of the strategy review, we reformulated our price stability goal as a symmetric 2% inflation target and confirmed the medium-term orientation of monetary policy. This allows us to “look through” short-term fluctuations in the inflation rate, for example.

Today, the most important question for monetary policymakers is thus: how stubborn will the high price pressures be? The elevated inflation rates will probably take longer than previously projected to recede again. Indeed, supply shortages may wear on for some time, and energy prices have surged further.

Beyond that, the price outlook is exceptionally uncertain. Higher inflation expectations and higher wage growth could strengthen price pressures in the medium term. Thus, the fallout from the pandemic could have a marked impact on the inflation setting. And it could well be that inflation rates will not fall below our target over the medium term, as previously forecast.

We should not ignore the risk of too high inflation and instead remain watchful. Moreover, given the considerable uncertainty about the inflation outlook, monetary policy should not commit to its current very expansionary stance for too long. And to keep inflation expectations well anchored, we need to reiterate over and over again: if required to safeguard price stability, monetary policy as a whole will have to be normalised. This should be crystal clear to everyone – to financial markets as well as to governments, whose funding costs may rise.

But higher funding costs on the primary market will not be the only impact on public finances. Central banks’ extensive bond purchases have made government budgets more dependent on changes in policy rates than before.

On central bank accounts, medium and long-term bonds on the asset side are matched by short-term commercial banks’ deposits on the liability side. Thus, an increasing deposit rate will squeeze central banks’ profits and, through profit distributions, lower government revenues as well.⁶

Against this background, central banks will come increasingly under pressure from governments and financial markets to keep monetary policy expansionary for longer than the rationale of price stability would call for.⁷

⁶ Weidmann, J., Geldpolitik und die Rolle der Notenbanken – ein Ausblick, speech delivered to the Freundeskreis of the Ludwig-Erhard-Stiftung on 1 July 2021.

⁷ Weidmann, J., Too close for comfort? The relationship between monetary and fiscal policy, speech delivered at the OMFIF Virtual Panel on 5 November 2020.

At this point, there's another remark by Mervyn King that might spring to mind: if central banks are obsessed with anything, he said, it is with fiscal policy.⁸ For monetary policy to safeguard price stability in the long term, it relies on solid fiscal policy.

It is therefore vital that all Member States forge a path to sound public finances after the crisis. Hence, the upcoming reform of the EU fiscal rules should draw on the lessons of the past. We need a credible and more binding set of rules. To that end, these rules must become simpler and more transparent.⁹

But there is a temptation to give practically free rein to fiscal policy while expecting monetary policy to fix any solvency problems. Ricardo Reis put it this way: "With its mystical ability to print money and its frequent purchases of government bonds, it is tempting to look at the central bank as a source of solace and respite."¹⁰

In general, the demands placed on central banks have grown from crisis to crisis. One reason might be that central banks have, in emergencies, taken action when politicians were not ready yet. Thanks to the independence of monetary policy, they did not have to compete for political majorities. This has created desires to harness central banks for other goals as well.

We don't have superpowers, unlike Samson, depicted in Rembrandt's masterpiece. He was blessed with superhuman strength. But even great heroes have their weak points: Achilles' weakness was his heel, Superman's was kryptonite, for Samson it was his hair. As soon as his hair was cut off, he lost his power.

Undoubtedly, central banks are powerful institutions. However, if even fictional heroes can stumble, we should certainly not overestimate central banks' capabilities. One of the secrets of success for an independent monetary policy has always been recognising and respecting one's own limitations.

The Eurosystem was granted independence in order to achieve its primary objective of price stability. The more broadly we interpret our mandate, the more we run the risk of becoming entangled with politics and overburdening ourselves with too many tasks.

5. Conclusion

Ladies and gentlemen,

Sometimes pictures are too big. Rembrandt's famous *The Night Watch* was even trimmed on all four sides to fit onto a wall between two doors in Amsterdam's Town Hall.¹¹ The picture I draw in this speech should be spared such a fate. So let me conclude.

For a stability-oriented monetary policy in the long run, three things have to come together: First, a fiscal policy framework within the monetary union that ensures sound public finances; second, central banks that won't become harnessed to fiscal policy or financial markets; and third, a narrow interpretation of our mandate.

⁸ King, M. (1995), Commentary: Monetary Policy Implications of Greater Fiscal Discipline, in Budget deficits and debt: Issues and options (pp. 171–183), Federal Reserve Bank of Kansas City, Jackson Hole Symposium.

⁹ Deutsche Bundesbank, European Stability and Growth Pact: individual reform options, Monthly Report, April 2019, pp. 77-90.

¹⁰ Reis, R. (2016), Can the Central Bank Alleviate Fiscal Burdens?, NBER Working Paper, No 23014.

¹¹ Siegal, N., Rembrandt's Damaged Masterpiece Is Whole Again, With A.I.'s Help, New York Times, 23 June 2021.

Especially in times of high uncertainty, it is important to see as much of the picture as possible, and that means drawing on all the data, different concepts and a broad variety of perspectives. That is what we do on the ECB Governing Council. To my mind, the diversity of opinions and viewpoints on the Council has always been a strength, not a weakness.¹² One aspect that undoubtedly unites the members of the Council is their shared quest for price stability in the euro area.

Like the meetings of the Governing Council, EBC events like this one have always been a forum for exchanging views and engaging in fruitful debate.

Over all these years, I have had the pleasure and the privilege to share in this experience. Oscar Wilde supposedly said: “When bankers get together, they discuss art. When artists get together, they discuss money.” And as you have seen today, the EBC even offers room for both.

Thank you for your attention. ■

About the author

Dr Jens Weidmann (b. 1968) has been President of the Deutsche Bundesbank since May 2011. He is a member of the Governing Council of the European Central Bank (ECB), represents Germany in the International Monetary Fund (IMF) and other international bodies, and has been Chairman of the Board of Directors of the Bank for International Settlements (BIS) since November 2015. After studying economics in Bonn and Aix-en-Provence, Jens Weidmann obtained his doctorate at the University of Bonn. From 1997 to 1999, he worked at the IMF in Washington before becoming Secretary General of the German Council of Economic Experts. In 2003, he joined the Bundesbank as head of the Monetary Policy and Analysis Division. Dr Weidmann headed the Economic and Fiscal Policy Department at the Federal Chancellery from 2006 to 2011, also serving as the Federal Chancellor’s sherpa for the world economic summits of the G8 and G20 countries.

¹² Weidmann, J., In Vielfalt geeint, speech delivered on the occasion of the handover ceremony for the OeNB’s new governor on 1 October 2019.

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SUERF Secretariat
c/o OeNB
Otto-Wagner-Platz 3
A-1090 Vienna, Austria
Phone: +43-1-40420-7206
www.suerf.org • suerf@oenb.at