Dr Jens Weidmann
President
of the Deutsche Bundesbank

The crisis as a challenge for the euro area

Speech at the *Verband der Familienunternehmer* (Association of Family Enterprises)
in Cologne
on Tuesday, 13 September 2011

– Check against delivery –

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

Contents

1 Introduction

Ladies and gentlemen

I would like to thank you very much for inviting me to this event in Cologne. As you may know, I spent a number of years studying at the University of Bonn. It was then that I got to know and appreciate the Rhineland region, and I'm always very pleased to have the opportunity to return – even though the subject I'm here to discuss this evening is extremely challenging.

More than three years after the onset of the banking crisis, and more than a year after the sovereign debt crisis first came to a head in the spring of 2010, the financial markets and people across the globe are still scrutinising the situation in the euro area.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

As political efforts are being undertaken to solve the urgent problems associated with the sovereign debt crisis and alleviate its symptoms, there is a danger of many people losing confidence in decision-makers, agreements and institutions. People in Germany – and elsewhere – are worried about their currency. And I take these concerns very seriously.

However, we must not forget that the Eurosystem can boast some remarkable successes in fulfilling its mandate. The euro's record on internal and external value stability is comparable to that of the Deutsche Mark. Along with the single currency's economic and political significance, we must not forget this fact when discussing the current crisis.

As President of the Bundesbank and a member of the ECB's Governing Council, my core task is to safeguard the euro's long-term stability. Credibly fulfilling this mandate not only provides the justification for central bank independence; it also lies at the very heart of public confidence in our single currency.

Maintaining confidence in the euro requires, among other steps, the construction of a sustainable bridge between short-term crisis measures and a credible and stability-oriented framework for monetary union. There needs to be an institutional framework that offers a clear, coherent outlook and provides incentives for the individual parties to act reliably and sustainably. Having this outlook in place will make it easier to allay the short-term difficulties and ease the current tensions. This is the broad framework that we need for European Monetary Union; I would now like to look more closely at the details.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

The sovereign debt crisis has, without question, been the euro's biggest test to date. The financial crisis revealed major fiscal and macroeconomic imbalances in some countries. At the same time, it unearthed weaknesses in the fundamental framework of monetary union and its actual implementation. The fact that almost everyone – including us – underestimated the huge challenges created by the increasing complexity and integration of the financial markets is sure to have played an important role in these developments.

First and foremost, extensive consolidation and reform measures now need to be implemented in the countries that are experiencing difficulties in order to restore confidence in the stability of public finances, re-establish competitiveness and ensure a healthy national financial system. The first steps towards achieving this have already been taken. In some areas, however, there is a long road ahead.

In addition, comprehensive changes must be made to financial market regulation and supervision to make the financial system more resilient. The resolutions expected at the G20 summit in Cannes will be another important step towards this objective.

Moreover – and this is the main focus of my speech here today – the institutional framework for monetary union must be adjusted so as to achieve the right balance between the responsibility of individual countries, liability and monitoring. My greatest concern is the current lack of a coherent outlook in this area. The steps announced, and those already taken, have shifted the balance

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

of the framework in a direction that is not sustainable in the long term. This threatens to substantially harm the public standing of the euro.

In principle, I think that there are two economically sustainable approaches to designing a stability-oriented monetary union for the future. The first would be a return to the founding principles of the system agreed in the treaties, which still essentially applies; this would entail having European rules for national fiscal policy, countries retaining their fundamental fiscal policy independence, applying the no bail-out principle and financial markets disciplining fiscal policy. Despite all the comments to the contrary, I still believe that it is possible to successfully stabilise and consolidate this framework. The other approach would be to embark upon a major shift entailing a fundamental change in the federal structure of the EU. This would involve a transfer of national responsibilities, particularly for borrowing and incurring debt, to the EU.

I believe that political leaders need to take a prompt decision on which of these two routes to take. The middle road of communitising liability whilst retaining independent national fiscal policies threatens to be derailed by its own inconsistency. It would endanger the survival of a stability-oriented monetary union, and thus also the European integration achieved thus far.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

2 Sound public finances as a crucial precondition for a stability-oriented monetary union

The current crisis in Europe was caused in no small part by the imbalances in fiscal and economic policy in some member states, which, in combination with the financial market crisis, triggered the current sovereign debt crisis. The combination of a single monetary policy and decentralised fiscal and economic policies – an issue which had already been central to the debate when monetary union was founded – thus proved to be a flaw in European Monetary Union. The coordinating mechanisms designed to address this weakness were clearly inadequate.

Sound public finances have always been of paramount importance to the internal and external stability of a currency – all the more so in a monetary union where national governments retain sovereignty over fiscal policy. The incentive for individual member states to incur debt is even higher in such a union; if sovereign debt rises in one country, some of the negative repercussions are passed on to the other member states. The risks that this entails were already clearly identified when European Monetary Union was established, and that is why rules for fiscal and monetary policy were laid down in the Maastricht Treaty. These rules aim to shield monetary policy from unsound fiscal policy.

However, one factor was underestimated when monetary union was founded: the risk of contagion means that it is difficult for the other member states to deny assistance to the country at fault and thus force it to bear more of the

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

costs and risks resulting from its misguided fiscal policy. This can therefore lead to a conflict between fully applying the no-bail-out principle and safeguarding financial market stability in the short term. Indeed, the more successful a monetary union, ie the more integrated its real economies and financial markets, the greater the possible contagion effects.

3 The existing legal framework for monetary union

The founders of monetary union were essentially aware of the importance of sound public finances. They therefore imposed a set of rules on the euro area that aimed to prevent these kinds of imbalances from emerging where possible and to correct them where necessary.

Because of the temptation I have already outlined for decision-makers to to misuse monetary policy , it was stipulated that monetary policy would be independent and charged with safeguarding price stability in the euro area as a whole. In the euro area's single monetary policy, financing government deficits in the individual member states was prohibited. As well as the inflation risks arising from the overly expansionary monetary policy that this would entail, there is another important reason for prohibiting such financing in a monetary union where the individual member states retain fiscal policy sovereignty. By supporting individual member states via the central bank balance sheet, monetary policy would redistribute financial burdens between the taxpayers of the different countries. If assistance for individual countries is considered essential for exceptional and overriding reasons, such as a threat to financial

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

stability, it must generally be provided through fiscal policy, which is the responsibility of national governments and parliaments. The most recent ruling by Germany's Federal Constitutional Count was probably based on this reasoning. Monetary policy in a monetary union therefore differs crucially from a purely national monetary policy, such as in the United States or the United Kingdom, where there is no danger of having to shunt risks resulting from unsound public finances between the taxpayers of different countries in order to avoid jeopardising financial stability.

There is still a large degree of national fiscal autonomy within European Monetary Union. The principle of subsidiarity is firmly enshrined in the current legal framework and the national parliaments have the last word in fiscal and budgetary policy decisions. This is true of revenue and expenditure and, in particular, borrowing. The Maastricht Treaty and the Stability and Growth Pact were designed to impose effective limits on government borrowing by restricting sovereign debt to non-critical levels and avoiding lasting deficits. However, the public often have little awareness of these fiscal rules beyond the two threshold figures of 3% for the annual deficit and 60% for the debt level (both in relation to gross domestic product). In fact, the rules are more comprehensive than this – including, for example, the objective of achieving a close-to-balance budget in the medium term.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

4 The run-up to the crisis

Despite the existence of this framework and the substantial successes achieved in consolidating public finances in the convergence phase before the euro was introduced, sovereign debt was not effectively contained in the subsequent phase – quite the opposite, in fact. Looking at the run-up to the crisis reveals, above all, a lack of political will to implement the rules, which were circumvented or even actively bent if there was no other way of avoiding sanctions.

One major back door for getting around the rules was the fact that a majority vote among all member states was required at key points in the excessive deficit procedure in order for it to progress. Otmar Issing described this scenario rather colourfully as “sinners sitting in judgement over fellow sinners”, and it does indeed encourage strategic voting. In many cases, the member states consequently failed to achieve the fundamental budgetary objectives and pre-crisis borrowing was far higher than it would have been had the rules been applied consistently. Another aggravating factor was the weakness of the Commission, as the guardian of the treaties, in its confrontations with the member states.

In some countries, a number of failures – many of which can be summarised as "a loss of competitiveness", "asset price bubbles" and "excessive lending" – played a crucial role in the run-up to the crisis. It would take too long for me to discuss these issues in detail in this speech. However, we should remember that initially neither the national decision-makers, nor the European bodies, nor

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

the financial market participants appear to have recognised the extent of these escalating problems. The preventative mechanisms and risk provisioning were insufficient. When these imbalances were corrected, this placed substantial additional pressure on some countries' government budgets and financial systems. We must draw lessons for the future from these experiences, too.

5 Routes to a sustainable institutional framework for monetary union

As a complement to short-term crisis measures, it is crucial to structure the institutional framework for European Monetary Union so that it is stable, inspires confidence and ultimately lends credibility to short-term crisis management.

I would now like to look at the two possible routes for achieving this in more detail.

5.1 Strengthening the existing legal framework

The current debt crisis in several euro-area countries has revealed the inadequacy of the existing procedures for preventing and resolving such crises. In response, numerous adjustments have since been made to the framework for monetary union. Some of these adjustments have yet to be specified in detail or approved by national parliaments. They do not aim to change the fundamental principles of monetary union. In particular, they expressly reaffirm

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

the no bail-out principle, thus making it clear that individual member states are to bear responsibility for their fiscal policy decisions and investors for their investment decisions.

As a short-term crisis measure, the European Financial Stability Facility (or EFSF) and the European Financial Stability Mechanism (or EFSM) were created in the summer of 2010 after Greece had been granted bilateral assistance loans. Recent decisions specify that the EFSF is to be expanded substantially. Assistance was granted to Ireland and Portugal via the EFSF, and it has recently been signalled that Greece may be granted additional aid.

Another package of reforms aims to prevent future crises by amending the Stability and Growth Pact (or SGP), introducing a procedure for preventing and correcting macroeconomic imbalances and adopting a Euro Plus Pact (or EPP).

Furthermore, for emergency situations in which the preventative mechanisms do not suffice, a permanent crisis resolution mechanism (called the European Stability Mechanism, or ESM) is to be set up to avert dangers to the stability of the euro area as a whole. This mechanism is scheduled to replace the EFSF and the EFSM in mid-2013.

In principle, this was the right decision. It reflects the dimension of increasing financial market integration, which was underestimated by the founders of monetary union and which was facilitated to a considerable degree by having a single currency. Nonetheless, it is crucial to ensure that the specific design of

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

the support mechanisms does not discard key basic principles – such as subsidiarity, independent national responsibility for fiscal policy and the no bail-out principle, and thus also the disciplining function of the capital markets – under the smokescreen of financial stability. This would risk further increasing the euro-area countries' propensity to incur debt and heightening the pressure on the single monetary policy to adopt an accommodative stance.

I am therefore rather critical of some elements of the decisions taken by the euro area's heads of state and government on 21 July. However, I must emphasise that I do not share the all-too common view that the existing framework is unsuitable for a monetary union. I am convinced that its founding principles remain appropriate for a stability-oriented monetary union, too. However, certain adjustments undoubtedly need to be made to this framework to reflect recent experiences. And I certainly do support many of the announced reforms.

Before I discuss the specific points on which I take a critical view, I would like to outline the core elements that a strengthened framework would need. Specifically, I believe that we need to give renewed force to the no bail-out principle, which is still enshrined in the relevant treaties, and to the disciplining of national fiscal policies via the capital markets that this principle entails. There are four key elements in this context:

1. **Prevention:** The planned strengthening of preventative procedures is key to ensuring that crisis prevention is more reliable in the future. However, to ensure that it actually works and avoids the build-up of unsustainable

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

sovereign debt, there needs to be a much greater automatism, particularly in the Stability and Growth Pact, for imposing sanctions when the deficit and debt limits are breached. The procedure for preventing and correcting macroeconomic imbalances and the Euro Plus Pact (EPP) can only act as supplementary tools for avoiding obvious and serious imbalances. In their use, we should nevertheless avoid attempts at macroeconomic fine-tuning.

2. **Financial market stability:** In addition, further suitable measures should be taken in the fields of financial market regulation and supervision to strengthen financial market stability, thus reducing the potential conflict between the objectives of safeguarding financial market stability and ensuring that private creditors remain liable (including in the event of a euro-area country defaulting).

3. **Crisis management mechanism:** There needs to be a crisis management mechanism as a last resort for averting financial crises that threaten the existence of the euro area. It should contain three key elements: attaching strict economic and fiscal policy conditions to assistance, ensuring appropriate interest rate premiums and a credible involvement of private investors in the event of a default.

   Having a strict macroeconomic and fiscal adjustment programme and, above all, significant interest rate premiums over the rates paid by countries with high credit ratings can maintain the incentive for member states to return to the capital market as soon as possible.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

Regarding the disciplining of national fiscal policy through the capital markets, the rules for monetary union should be adjusted so that, when a euro-area country looks likely to experience difficulties, private creditors cannot rapidly shift their liability to the taxpayers of the countries providing assistance. The introduction of collective action clauses (CACs) alone, scheduled to start in 2013 within the framework of the ESM, is highly unlikely to be sufficient to achieve this objective. The approach of adding a trigger clause to the terms and conditions of bonds stipulating that maturities will be automatically extended for a fixed period of time (such as three years) in the event of the ESM granting assistance to the country in question, as proposed by the Bundesbank, should therefore be supported.

I have already stressed that I am critical of key elements of the recent EU decisions concerning the design of the crisis resolution mechanism. In my view, they undermine some of the key basic requirements for an assistance mechanism in the existing legal framework, which is based on countries bearing responsibility for their own finances. One serious cause for concern is the fact that the new, looser credit conditions considerably reduce the incentives for countries receiving assistance to make fiscal and economic reforms to enable as rapid a return as possible to sounder public finances. Adopting these conditions in future assistance programmes (or even in the ESM) would perpetuate such problems and encourage countries to apply for assistance.

The planned secondary market purchases would also further weaken the incentives for countries to conduct an appropriate fiscal policy. If the bonds

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

of countries that are not receiving assistance are purchased on the secondary market, it is unclear how these countries can be strictly obliged to fulfil conditions governing consolidation and reforms. It is also unclear how this can be brought into line with the requirement of granting assistance only as a measure of last resort to avert a risk to the stability of the euro area as a whole.

These decisions mean that member states with an unsound budgetary policy can count on receiving assistance, while countries with sound finances will increasingly be called on to provide funds. In addition, if the impression arises that the conditions attached to the assistance are open to negotiation if targets are missed, there is a danger that the countries receiving assistance will not make sufficient efforts themselves.

This inconsistency can be illustrated through the following example: How can an improved sanction mechanism in the Stability and Growth Pact prevent unsound national fiscal policies if sanctions are threatened but, where rules continue to be breached, protection from the capital market is ultimately granted at extremely favourable conditions – indeed, far better conditions than those for some of the countries providing assistance?

4. **Consistent implementation:** The effectiveness of any set of rules hinges on its implementation – if the principle "pacta sunt servanda" ceases to apply, reliable economic relationships are no longer possible. Ultimately, it is up to the sovereign countries receiving assistance to decide whether or not to fulfil the conditions attached to receiving assistance. To avoid making a

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

mockery of national responsibility, this framework must also clearly establish that no further assistance can be granted if the conditions are not met.

All in all, I believe that strengthening the existing legal framework essentially remains a viable and promising means of stabilising monetary union. However, this framework must ensure that conducting a sound fiscal policy is in the best interests of each individual country – even more so than before the crisis. And, when taking this route, we must not allow the design of the crisis resolution mechanisms to open the door to misguided incentives.

5.2 Core elements of a fiscal union with a substantial transfer of competences from national to EU level

The fundamental alternative to strengthening the existing framework would be to undertake a major shift to a fiscal union, involving a partial transfer of fiscal policy competences to the EU.

Establishing a European fiscal union would not by any means require a complete centralisation of fiscal policy (including policies governing revenue and expenditure). In particular, the principle of subsidiarity implies that wide-ranging competences should remain at national level in order to ensure that the arrangements reflect the preferences of the individual countries' citizens as closely as possible.

In my view, enshrining strict deficit and debt limits for national budgets in EU legislation is pivotal to achieving a stable fiscal union and reliably shielding the

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

Eurosystem's single monetary policy from unsound public finances. These limits would then apply to all levels of national government, including central, state and local government and the social security systems; the EU would need to be granted ultimate powers of intervention to ensure that the limits are effectively implemented in practice. In a fiscal union, these powers of intervention would have to be extensive enough to ensure that national governments lose their sovereignty over fiscal policy when deficit and borrowing limits are breached, if not beforehand. Consequently, the national parliaments would no longer have ultimate decision-making authority over government budgets; their decisions would be subject to approval by a central body.

I must emphasise that, contrary to public opinion, such a fiscal union would not necessarily have to entail joint liability. In principle, this kind of centralised solution could function successfully without joint liability. This would allow room for somewhat greater flexibility in national borrowing. Existing national deficit and debt limits could, in principle, be set and monitored by a democratically legitimised central body, such as the European Parliament. It should then be ensured that decisions exclusively affecting euro-area countries are only taken by representatives of these countries. However, the system for setting deficit and debt limits would need to follow consistent rules; it would have to be rule-based, much stricter than in the existing framework – reflecting recent experience – and should be made difficult to change, for example by requiring large majorities. Within the bounds of this framework, national fiscal policy could then essentially remain autonomous and, if permitted by the rules, could, for example, allow automatic stabilisers for cyclical smoothing to take effect

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

and take out temporary own loans. The EU limits should constitute ceilings; there should, of course, be no obligation to fully exhaust them.

Provided that stringent rules are implemented, this approach could make a crucial contribution to ensuring sound euro-area public finances in the medium term and overcoming the sovereign debt crisis. This kind of framework would shield the Eurosystem’s single monetary policy from unsound fiscal policy.

As I have said: introducing joint new borrowing or communitising existing debt by issuing Eurobonds, which are currently being so widely discussed, would not be at all necessary in this context. However, it would be possible to do so as a second step (but certainly only once fiscal policy sovereignty over deficits and debt had been transferred to the EU) without undermining the consistency of the legal framework, although this framework would have to be tightened even further.

At all events, even in a fiscal union, joint liability would raise the incentives for member states to incur debt. These incentives would therefore have to be restricted, for example through a strict ban on new borrowing at national and EU level. Otherwise, I believe that the fiscal union would be a long way from ensuring an adequate balance between liability and control. A communitisation of debt would be sure to result in a substantial redistribution from sound to unsound countries. In addition, Eurobonds, in and of themselves, would actually be rather counterproductive to solving the fundamental problem that led to the outbreak and spread of the sovereign debt crisis. In short, I believe that the risks associated with Eurobonds far outweigh their potential benefits.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

Alongside reforms to restore competitiveness, such a fiscal union would provide a consistent legal framework. This would be a major step in the process of European integration – a significant move on the part of the EU, or at least the euro area, in the direction of a federal state. However, its implementation would require extensive treaty amendments and probably also amendments to national constitutions – doubtless including the German Constitution, as the German Federal Constitutional Court's ruling has shown. We should be under no illusions: The route to fiscal union would be long and arduous. Without broad support from the people of the euro-area countries, this kind of shift would be almost inconceivable, and it is unclear whether this support actually exists. It is vital not to make the mistake of taking the steps in the wrong order.

6 The increasing misuse of monetary policy

In principle, it is possible for monetary policy to safeguard price stability in either a decentralised or a centralised legal framework for monetary union, provided that the chosen system is adequate. However, substantial problems are likely to arise in future if an inconsistent framework is enshrined in law or – perhaps even worse – an inconsistent framework is not re-enshrined in law but is applied in practice regardless of the legal provisions.

The momentum of the crisis shows a worrying pattern in this respect, particularly from the point of view of a central bank.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

- Insufficient economic and fiscal policy measures in the member states lead to a loss of confidence on the markets, which focus on the new weaknesses.

- Sooner or later the situation escalates, the country in question sees its bond yields rise and has difficulty accessing the capital market. The interest rate rise is all too hastily classified as unsustainable. Crisis meetings are then arranged, at which *ad hoc* measures are adopted and calls are made for monetary policy – which is supposedly the only institution directly able to intervene – to step into the breach to stabilise the situation in the short term. The situation becomes yet more problematic if neither the countries concerned take measures to remedy the situation nor the countries potentially providing assistance wish to take on risks.

- Monetary policy certainly does have tools that can calm the financial markets in the short term. However, taking such measures can blur the boundaries between the responsibilities of monetary and fiscal policy and overstretch the mandate of an independent central bank. In addition, they threaten to perceptibly weaken incentives for fiscal policymakers to take action themselves.

- This in particular can subsequently lead to a delayed or inadequate implementation of fiscal policy measures, bringing us full circle and triggering a downward spiral in which monetary policy is left “holding the baby”.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

It is certainly true that central banks, too, have to learn lessons from the crisis and rethink fundamental positions. I believe that one key lesson is, as I have mentioned already, the primary importance of efficient financial market regulation and supervision for an efficient framework for monetary union and, in particular, for a stability-oriented monetary policy and its interplay with the financial markets.

I am also aware that the real world is not black and white and that rules and actions can be interpreted differently. Nonetheless, following the Bundesbank's tradition, I believe that it is particularly important for monetary policy to remain true to its principles – all the more so in a monetary union. But there is no place for dogmatism. Certain situations not only allow room for a certain degree of flexibility, they also require it.

Financial market stability is, without question, of great importance for monetary policy. Even so, this fact must not lead us to systematically overturn fundamental commitments and responsibilities. This would cast doubt over the legitimacy of an independent monetary policy, jeopardise its primary objective – safeguarding price stability – and compromise the confidence of the general public in monetary policy, which is of vital importance.

Central banks have currently relieved fiscal policy of part of its burden of supporting individual member states or distressed banks. However, this has brought substantial risks onto the Eurosystem's balance sheet. I firmly believe that these risks must now be reduced and on no account increased. It is therefore high time for fiscal policymakers to decide what risks they are willing

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

to take on, both in combating the crisis and going forward. That is not the responsibility of monetary policy.

7 Closing remarks

Ladies and gentlemen, I mentioned at the beginning of this speech that this is a complex and challenging subject. I would like to thank you for giving me the opportunity to discuss this issue in detail here today.

I believe that the current developments are of vital importance for the future of the euro. The democratically elected parliaments must decide on the future fundamental design of European Monetary Union. This could mean maintaining the agreed framework and correcting the incentives so that they are conducive to stability. Alternatively, it could involve undertaking a major shift to a fiscal union, including a fundamental transfer of key areas of responsibility from national parliaments to democratically legitimised European bodies. However, I believe that the middle road embarked upon through some recent decisions is leading us in a direction that is not stable in the long term.

Thank you for your attention.

* * *

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077