LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

DEFENDING THE WOLF
The Useful Contradiction of the Bundesbank

Carlo Bastasin

SEP Policy Brief No. 1 - 2014

The Deutsche Bundesbank, the German central bank, is commonly regarded as the Euroarea's boogeyman. The pressure imparted by the German monetary authority, for instance, rendered the European Central Bank reluctant to follow the footprints of the Federal Reserve and of other central banks, and engage in non-standard monetary policy measures that might rapidly put an end to the crisis that has been plaguing the euro zone. At several stages, during the current crisis, the ECB has been forced to take actions and prevent severe economic and financial dislocations. Given the institutional vacuum at the area-wide level and the lack of political capacity of the other institutions, the European Central Bank had often to move across the borders of its traditional domain. This has given reason to a slew of criticisms repeatedly and loudly voiced by the Bundesbank. Being also the most vocal policy actor evoking the fiscal risks associated with effecting implicit cross-border transfers via the ECB's balance sheet, the Bundesbank has appeared to have a "non-monetary" hidden agenda or even a "national political" mission.

In fact, the Bundesbank has regularly appealed to two fundamental principles of sound economic and monetary policy management that cannot be easily overlooked by anybody concerned that monetary policy may lose its ability to preserve price stability. Should monetary independence be eroded by the increasing tasks devolved to the central banks, wider economic and political consequences might then arise. The first principle is the need to avoid fiscal dominance, not allowing inflation to be determined by the level of fiscal debts; the second is the "principle of responsibility" that sees a contradiction if individual responsibility is blurred by the intervention of joint liability as in the case of a State running unsound fiscal policies and being automatically bailed out by the mutualization of its liabilities.

The Bundesbank considers those principles violated in the recent experience of the Euro area. This leads the German central bank to observe that the current degree of economic integration should be wound down and that a repatriation of responsibilities at the national level should ultimately occur. However, if the two principles – avoiding fiscal dominance and the individual responsibility - need to be applied together, then the paradoxical conclusion is that, contrary to what the Bundesbank maintains, the stability of the euro area cannot be granted by domestic measures enacted by single countries. In fact, to avoid fiscal dominance the euro-area countries must remain exposed to the possibility of a debt default. But default produces a wide array of contagion effects and consequently disrupts the principle by which responsibility should be borne exclusively by the country source of liability. The two principles fall into a grave contradiction.

Ultimately, the problems of coordination between economic policy and monetary policy, emerged with the European crisis, may require a new institutional framework that allows the cooperation between countries

Carlo Bastasin is Senior Fellow at Sep and Nonresident Senior Fellow at Brookings Institution. The paper expands on a presentation first discussed at the LUISS School of European Political Economy in Rome on January 8, 2014.

SEP Policy Briefs are dedicated to the debate about European policy issues. They address topical issues in the European policy debate, focusing also on the institutions and on the governance of the EU and of the EMU.

Available for free downloading from the SEP website (http://sep.luiss.it) • © SEP2014

and European institutions to occur at a much earlier stage than national policymakers are ready to admit. Namely well before the moment when the risks of default loom. Before default spreads its contagion, policy coordination must intervene and prevent a dangerous development in single countries. The consequence may be that common solutions need to be designed on the basis of more – not less - shared sovereignty

The role of the Bundesbank

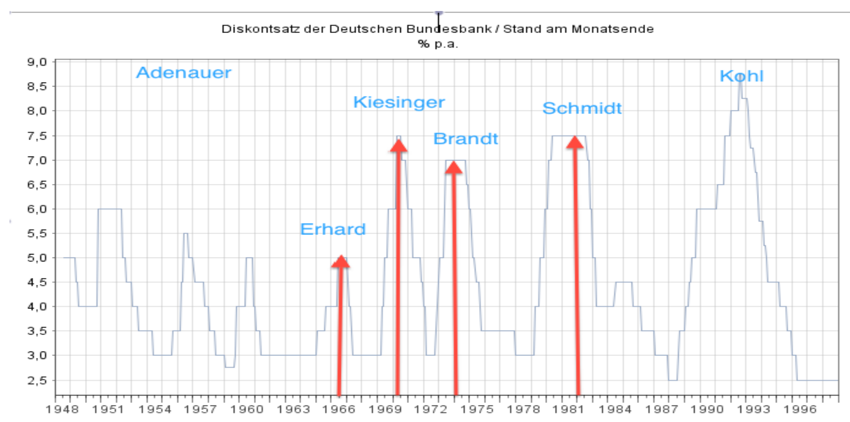
Conventional explanations of price determination assign the central role to monetary policy. Although over the longer term, monetary policy has a neutral impact on economic activity, in the shorter term, monetary policy does influence the real economy, as part of a complex and time-varying transmission of monetary policy actions, via financing costs, spending and saving decisions, into price developments. This framework is normally referred to as a monetary dominance over the price level.

Officially, the Bundesbank embodies the purest orthodoxy of monetary dominance. According to the classification by Debelle-Fischer, the Bundesbank enjoys complete “goal independency” as opposed to “instrument independence”. At least since 1957, the control of inflation is the only goal of the German central bank.

A different interpretation of the historical role of the Bundesbank is that of a guardian of economic stability and policy discipline at large. In this sense the German central bank would not be only a monetary authority, but a political institution interacting with the complex German constitutional system of checks and balances. In this different reading of the Bundesbank's institutional role, the staunch rhetoric on monetary discipline appears as prevalently instrumental to preserving general stability at large. Between 1957 and 1998, for instance, aggressive and preventive monetary action might have been triggered occasionally by risks deriving from income policy decisions or even by the announcements of wage increases that were higher than desirable under the priority of inflation control. Counteractions by the Bundesbank were aggressively enacted when economic policies bore the risk of higher inflation down the road.

An exemplification of the Bundesbank's significant political role can be extracted by the historical interaction of the central bank with post-war German politics. Graph1 shows the regular coincidence between the resignations of German chancellors and the drastic increases in the discount rate by the Bundesbank. The size of the increases and its immediate repeal after the resignations of the chancellors hints at a punitive use of monetary policy instruments, consistent with the strong attitude of political counterbalance – or even a spirit of antagonism - cultivated by the German central bank.

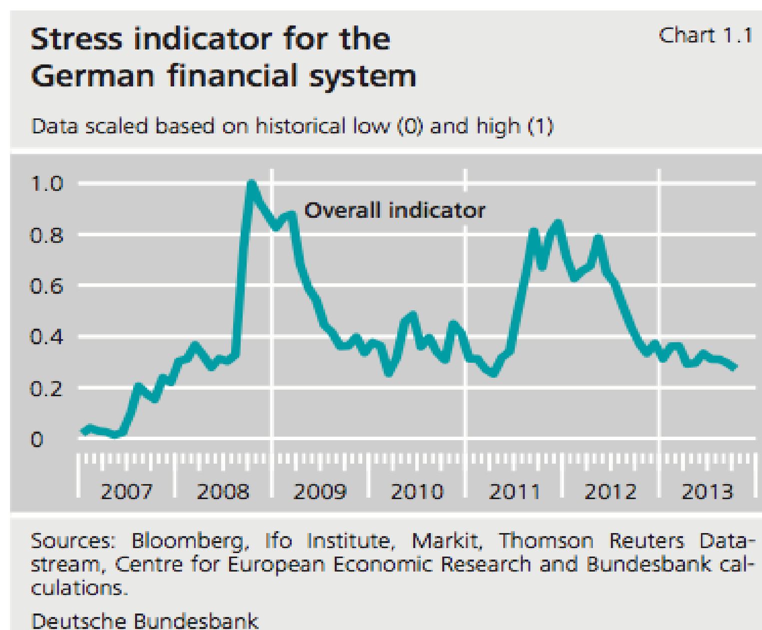
Graph 1: red lines coincide with the resignation of German chancellors



Similarly, the rhetoric of the Bundesbank relative to the European crisis – persistently pointing the finger against fiscal indiscipline as a main cause of instability – seems to have been disingenuously bent to serve the interests of the German central bank, with the aim of influencing the design of solutions and indirectly the developments for the future integration. An indicator of financial stress for the German banks, as reported by the Financial stability report of the Bundesbank published in December 2013 (Graph 2), shows that the major stress during the last years has derived from financial channels, either Lehman or domestic banks predicaments, and not from the sovereign crises affecting the periphery.

Graph 2. Stress Indicator for the German financial system

as reported in the Bundesbank Financial Stability Report of December 2013



Nevertheless according to Bundesbank's president Jens Weidmann there is not much room for doubts: "The imbalances in crisis countries arose because they had been borrowing to live beyond their means".[1] Weidmann himself acknowledges that the crisis also revealed the flaws in the EMU institutional framework.[2] But only in the sense that those institutional arrangements, such as the Stability and Growth Pact and the no bail-out clause, put in place to prevent a build-up of excessive debt by member states, lacked the necessary punch in implementation, not least because they led to a collusive situation in which "potential sinners were passing judgement on fellow sinners",[3] obviously implying that the main cause of financial distress was originated in fiscal profligacy.

According to the Bundesbank the lack of fiscal discipline on the side of some governments was particularly dangerous because the expected disciplining action by financial markets failed to kick in. Investors could not imagine that the other member states would allow one euro-area country to default and one reason, according to Weidmann was that the international capital rules adopted in the early 1990s allowed banks to treat government bonds in their domestic currency as a risk-free investment requiring no capital backing. This regulatory treatment not only encouraged banks to buy government bonds, it also stopped the no bail-out clause from being taken seriously: if government bonds were risk-free, than the eventuality of defaulting on sovereign debt was ruled out. Consequently the no-bailout clause had no way to be enacted.

The principle of responsibility

When the global credit bubble burst, a number of countries were pushed to the brink of insolvency. The bailout funds helped to stabilize the euro area, but did not address the underlying problems. Consequently the bailout funds generated new false incentives and made the Bundesbank insisting that they would be used only as a last resort and at penalizing terms for the recipient government.

[1] Jens Weidmann: "The euro area as a union of stability" Berlin, 2013-10-08, speech to the Conference of Allianz SE and the Market Economy Foundation "Europe: where, how far and with whom?".

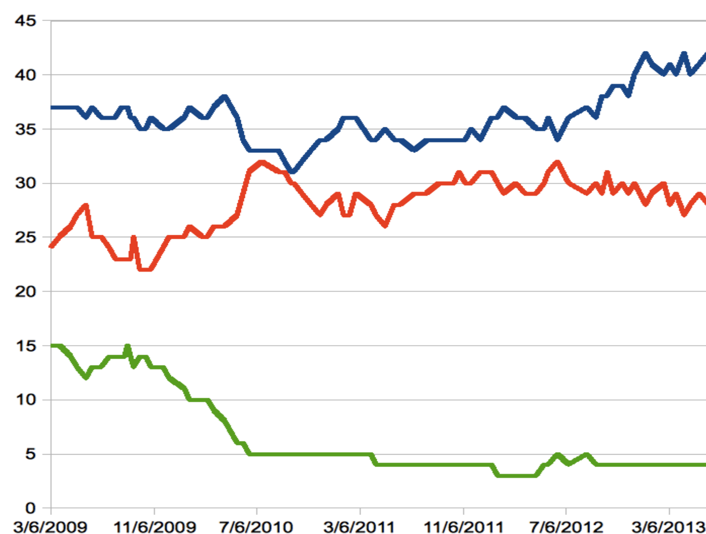
[2] J. Weidmann, ibidem.

[3] J. Weidmann - Darmstadt, 2013-10-30: "The institutional and economic-policy challenges posed by the sovereign debt crisis", speech to the Economic Forum 2013.

Nevertheless some of the ECB's nonstandard measures are inevitably blurring the boundary between monetary and fiscal policy, redistributing risks across countries. The crisis measures increased mutual liability in the euro area without establishing effective control rights. This tilts the balance between liability and control, or what we may call the "principle of responsibility". According to the Bundesbank, if the European governments want monetary union to survive, the balance needs to be restored. This may occur through a realistic threat of default for sovereign debts and through the application of bail-in mechanisms that bite banks' creditors in the flesh, in case banks start becoming too wobbly. A therapy made of defaults and bail-ins may sound like harsh and even hostile to the smooth functioning and the general acceptance of monetary union. In fact, severe enforcement of the criteria of individual responsibility enjoys strong political support in Germany. Defaulting and bailing-in actually entail the political functions favored by the two major political parties in Germany.

Graph 3 shows how after federal election in 2009, the socialdemocratic party, surfing on the wave of popular outrage against bankers' flawed speculations, staged a formidable increase in vote-intentions of about 10% among total voters. That increase mirrored the dramatic losses suffered by the Liberal Party, the political formation more closely associated by the German electorate with banking interests. The rhetoric on the "bail-in", grounded in the principle of punishing the bankers, was seen very favorably by the center-of-the-left electorate. After the Greek crisis, the SPD ceased to recover consensus while the rhetoric shifted away from the bankers' faults and moved towards the faults of peripheral countries living beyond their means. After 2011, when the crisis stroke Spain and Italy and when defaulting became an option that the conservative parties debated publicly, the share of voters who favored the CDU increased dramatically. The position of the Bundesbank – favoring bailing in and defaulting – is de facto completely uncontroversial at home. It is actually backed up by popular consensus and by a very large domestic political front.

Graph 3: The causes of crisis change three different characterizations and impact differently the consensus for the political parties. SPD (red line) benefits largely of the first phase when bankers are blamed for their avidity, while the FDP (green line) collapses. In the intermediate phase the blame is shifted on Greece and this stabilizes the CDU (black line). Finally when Spain and Italy are involved and the risk of mutualization increases, the CDU gains the leadership on the SPD



Repatriation or further Political Integration

However, the German central bank has tried also to build a comprehensive narrative of European integration that could be used as an orientation for political action. According to the Bundesbank there are two different ways for restoring the Liability-Control Equilibrium or, as we use it here, the principle of responsibility. The first way entails advancing on the road of European integration through further mutualization, while the other way implies winding down integration accepting a repatriation of policies and responsibilities.

One option would be to make greater mutual liability conditional on greater mutual control entailing a decisive step towards political union. Member States would ultimately have to relinquish national sovereign rights and combine monetary union with a fiscal union. However, such a transfer of national sovereignty requires the backing of both policy makers and the public. In a historically controversial assessment, the Bundesbank observes that there was no such support even when the European Monetary Union was created and little has changed since, neither in Germany nor elsewhere.

This drastic write-off of any kind of political will behind further integration probably derives from the changes of sentiments by the German central bank itself about European integration. When monetary union was a distant project, the rhetoric at the Bundesbank was open to political integration. As Otmar Emminger had done beforehand, in 1962 Karl Blessing expressed the Bundesbank standpoint very clearly in 1963: “As a European I'd be ready to subscribe to the ideal of a EMU. As a responsible central banker and realist I must underscore that a common currency is possible only once you have a Federal state and one Parliament ”.[4]

Once monetary union, somewhat unexpectedly, came indeed into sight, Karl-Otto Poehl, Helmut Schlesinger and Hans Tietmeyer all highlighted the excessive rapidity of the events and pointed out that in their views political union should have come before, not after EMU. All also had serious concerns for their country as Tietmeyer expressed it: “Re-united Germany can be the big loser. It would lose one of the best and most successful monetary constitutions in the world”. Nevertheless Tietmeyer played a constructive role that also led the whole architecture to respond to the German desired requisites. Now that the Eurozone crisis has raised the opportunity of further political integration, the Bundesbank has not only disputed that this has any popular support, and democratic legitimation, but has already hinted to a continuation of its antagonism even after a confrontation with a hypothetic European government. This has emerged for instance from Weidmann's criticism of Abenomics: “the Bank of Japan has fired the monetary arrow but the government is slow to fire the other two”. Whatever the destiny of political union, the Bundesbank is thus likely to remain sceptic and shows no inclination for any degree of coordination between monetary policy and the rest of the political economy.

If political integration is not inspiring, than the only option remaining is repatriating policies and responsibilities according to a scheme that the Bundesbank calls Maastricht mark two. [5] It is based on the idea that the only answer to the crisis is to strengthen the Maastricht framework. Consequently, more needs to be done to make the fiscal rules more binding. In this sense, the new agreements, such as the revised Stability and Growth Pact and the Fiscal Compact, are steps in the right direction. However, it is vital that the new rules are applied consistently and this may require years of strict surveillance.

However, the essence of a strengthened Maastricht framework is that member states be held responsible for the consequences of their financial policy decisions. In this connection, it must also be possible – as a last resort – to declare governments insolvent without endangering the stability of the European financial system as a whole. Consequently, “Maastricht mark two”, the only viable and realistic option as seen from the Bundesbank, requires that the option of States defaulting on their debt remains at hand.

Fiscal Dominance

One may wonder where the Bundesbank's obsession for fiscal discipline comes from. In order to give theoretical foundations to the Bundesbank's attitude one can resort to the category of fiscal dominance. Basically fiscal policy and inflation are related through monetary policy’s power to accommodate high levels of public debt. In a state of fiscal dominance, monetary policy ensures the solvency of the government and stabilizes real government debt. Taken to the extreme consequences, this “cooperation” between central banks and fiscal policy, leads to inflation being determined by the level of fiscal debt. In the conventional Sargent and Wallace's view: “the monetary authority finances with seigniorage any discrepancy between the

[4] David Marsh: “Die Bundesbasnk”.
[5] J. Weidmann, ibidem.

revenue demanded by the fiscal authority and the amounts of bonds that can be sold to the public".[6] In the Sargent and Wallace setup, fiscal policy runs a chronic primary deficit which leads to a corresponding increase in the money supply. As a simple money-demand holds in the model, price level adjusts to establish equilibrium in the money market. Eventually the central bank finances deficits printing money.

This legitimate fears of fiscal dominance has been clear from the beginning of the works on the architecture of the European monetary union. In fact a number of legal pillars were erected to counter the risk of a loss of independence by monetary authority. Art. 123 of TfEU prohibits fiscal dominance, barring agreements between a government and a central bank similar to the one in place between the Federal Reserve and the US Treasury, which set the Fed's goal of maintaining "relatively stable prices and yields for government securities". Moreover, like the Bundesbankgesetz (the law on the Bundesbank), the Maastricht Treaty only envisages supporting the general economic policy of member states provided this does not prejudice the objective of price stability. Finally the ECB does not have a strong financial-stability mandate to prevent turmoil on the bond market. Its mandate is only to "contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system" (Art. 127-5). Even the Securities Market Program was not motivated with the preservation of financial stability, but rather the containment of disruptions to the transmission of monetary policy decisions.

However, according to the Bundesbank, the legal framework does not provide for the necessary guaranties since fiscal policy may affect inflation even if a central bank does not monetize public debt, but just through the pressure on the central bank to reduce the real value of debt. In asserting this eventuality, the Bundesbank resorts to the controversial "Fiscal theory of the price level". This theoretical setup, which is based on the definition of government bonds mainly as claims to nominal payoffs, maintains that if governments issue bonds for additional expenditure, the value of real debt is higher than the present value of future tax payments. Households feel richer and thus consume more, causing output and inflation to increase. Monetary policy thus has to stabilize the real debt in order to avoid an inflation spiral, with the result that it responds at a rate of less than 1 to 1 to inflation, thereby violating the Taylor principle. Finally higher inflation reduces the public debt and the debt service in real terms. Inflation may easily slip out of control if we consider the eventuality of rational and forward-looking agents. In that case higher inflation could manifest itself before the economy enters the regime of fiscal dominance. This happens because agents know that governments risk hitting a fiscal limit – be it for economic (Laffer) or political reasons - a point at which revenues can no longer be increased. Once the government hits the limit, either an adjustment of fiscal spending or an adjustment of monetary policy needs to occur. Thus, even if fiscal policy has not yet reached its limit, the economic mechanisms attached to the fiscal theory of the price level might already swing into action and stabilize real government debt through higher inflation. So if agents have reasons to believe that fiscal discipline is not strictly enforced, then expectations on weak fiscal consolidation can trigger inflation.

According to Weidmann "Policymakers should not assume that they are on safe ground just because inflation expectations are firmly anchored. Only if agents expect deviations from a "virtuous regime" of monetary dominance to be short-lived – say, because policymakers still enjoy high credibility – will inflation expectations remain well anchored. However, if agents learn that the deviation is going to last for longer than initially expected, their inflation expectations will change. And this might happen very suddenly".[7]

Countering a change in expectations requires strong credibility and this is why the Bundesbank is inclined to reject suggestions – even empirically grounded – that fiscal consolidation in the weaker economies of the eurozone should be slowed down or back-loaded. This does not fit in the official rhetoric spoused by the Bundesbank according to which the current crisis is, to a large extent, a crisis of confidence in the

[6] T.J. Sargent, N. Wallace: "Some unpleasant monetarist arithmerics" Federal Reserve of Minneapolis, Quarterly Reviews, Fall 1981.

[7] T.J. Sargent, N. Wallace: "Some unpleasant monetarist arithmerics" Federal Reserve of Minneapolis, Quarterly Reviews, Fall 1981

sustainability of public finances. Against this backdrop, front-loading, sustained and credible consolidation, would send a clear signal. This, in turn, would bring down long-term interest rates or ensure that they remain at a low level, which would be beneficial for economic growth. By delaying consolidation, on the other hand, governments would risk an increase in market uncertainty. As a consequence, sovereign bond spreads would remain high or go up even further.

The main non-theoretical objection to this view is based on the observation that multiple equilibria are at play in the eurozone. In fact the Bundesbank holds that the interest rate spreads associated with the threat of default are a normal and even desirable feature of the equilibrium, to the extent that they give euro area governments incentives to keep their houses in order. However an alternative view maintains that spreads that are too wide and persistent can be harmful, and that their presence in the euro area (and in fact nowhere else) derives from the ECB's failure to play its role of "lender of last resort". Spreads reflect a vicious circle in government debt dynamics and market expectations, contributing to a "bad equilibrium" or even deepening further disequilibrium through high spreads leading to exploding debts, which in turn justifies the expectation of defaults.

In terms of political feasibility, high spreads could discourage fiscal adjustment by making the dynamics of debts unsustainable and reducing the probability that fiscal efforts eventually pay off. On the other hand, lowering spreads reduces – but not removes - the risk of default. A positive residual probability of default implies that the monetary authorities might be called to "lend in last resort" to an insolvent government. Debt monetization, thus, is not a purely notional out-of-equilibrium risk, but a real risk. Consequently default should not be ruled out, otherwise monetary dominance would be strong ex ante but weak ex post and cit would lack credibility. If debt monetization becomes a real option the whole architecture of monetary policy would potentially infringe the European primary law.

A simple formalization of the interactions at play is the following:

$rd = b + s(\pi)$

where d is debt; r is the real interest rate; b is the real primary balance and $s(\pi)$ is real seigniorage revenue, which is increasing with the rate of inflation, π.

The ex-ante probability that the government will fail to implement the fiscal adjustment is increasing function of b.

Adopting, for the sake of exemplification, values for b that describe the perspectives of fiscal adjustment for Italy, one might observe that fiscal adjustment succeeds with probability 1 if b is $\leq 3 - s(\pi)$

It succeeds with probability 0 if b is $\geq 8 - s(\pi)$

where 8 is a value consistent with the level of primary budget surplus required if Italy must comply by the debt-brake rules starting from the current level of its public debt (133% of GDP)

Closing in on 8 the choice is between default or fiscal dominance. If preserving monetary dominance is a priority, then – as the Bundesbank prescribes - default must occur once the required budget primary surplus reaches the 8% threshold.

It is consistent with the Maastricht framework that countries facing an unsustainable fiscal position will restructure their obligations rather than monetize them through central bank financing. But recent experience has demonstrated that default entails great dangers for the whole of the euro-area and that contagion and other dynamics can disrupt the equilibrium between liabilities and responsibilities. The default on Greek

government obligations, for instance, reverberated on other countries. Statistical evidence on CDS prices and on spread components highlights the non domestic dynamics in the level of interest rates differentials within the monetary union.

Furthermore, the risks sovereign default poses to financial and macroeconomic stability are rarely measurable. Given the inevitably close link between sovereign and bank balance sheets, sovereign default will precipitate financial dislocations so severe that they make the option of default extremely unlikely. Again, financial dislocations tend to cross borders, disregarding - and ultimately violating - the “principle of responsibility”. Eventually, the fact that central banks support the banks and indirectly avert default, does nothing else than restoring the principle of responsibility extolled by the Bundesbank.

If we deem default as dangerous for the stability of the eurozone and a disruptor of the principle of responsibility, but at the same time we want to avert fiscal dominance, then there is no alternative other than sorting out a method of explicit coordination – instead of implicit brinkmanship – between monetary policy and the governments' fiscal policies. It should consist of a procedure of assessment at the behest of the European Central Bank that could call on the EU Commission to spark the needed economic correction before the unsustainable level of budgetary surplus is getting closer and before the choice between defaulting and debt monetization could jeopardize monetary dominance.

This means that the eurozone as a whole must intervene and design an exit of the ailing country from the danger zone. Eventually the Bundesbank was right warning that, in order to avoid fiscal dominance, political union was needed in the euro area.