

# A stable euro in a strong Europe

Karl Otto Pöhl Lecture to the Frankfurt Society for Trade, Industry and Science

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*Check against delivery.*

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## 1 Introduction

Ladies and gentlemen,

Thank you very much for inviting me. It gives me great pleasure to be here with you today, and I am very honoured to be delivering the Karl Otto Pöhl Lecture.

My congratulations on this series of lectures. Nine years ago, it premiered at the Bundesbank's Regional Office in Hesse at the Taunusanlage in Frankfurt. Since then, various prominent people have presented their views of monetary union. Two of them will come up later on in my talk.

But let's stay for now with the lecture's namesake: Karl Otto Pöhl. On 30 May 1990, he addressed the Frankfurt Society for Trade, Industry and Science as President of the Bundesbank, perhaps even standing right here at this lectern.<sup>[1]</sup>

Times were turbulent back then: German monetary union had just been decided and needed to be implemented within the space of just a few weeks. At the same time, the Delors Report had outlined the transition to a European Economic and Monetary Union. Its first stage entered into force on 1 July 1990. Germany's "Frankfurter Allgemeine Zeitung" newspaper wrote back then that the Bundesbank was facing two unprecedented historical challenges.

As was his nature, Karl Otto Pöhl shied away from neither challenges nor plain speaking. He explained in no uncertain terms where the difficulties and pitfalls of the two monetary unions lay. At the same time, he left no doubt that he would strive tirelessly to ensure that they were a success. He concluded his speech back then with the words: "I am also confident that we will succeed." This combination of plain speaking, drive and optimism were characteristic of Karl Otto Pöhl – and we could do with more of that today as we strive to overcome the current challenges.

Karl Otto Pöhl would have turned 95 this year. We owe him a great deal. His work in the Delors Commission resonates to this day: It was under Mr Pöhl's chairmanship that the Committee of Central Bank Governors drafted the Statute of the European Central Bank. Thus, the European Central Bank was modelled on the Bundesbank and created as an independent central bank that pursues price stability as its primary objective.

However, Mr Pöhl was also well aware that these institutional pillars alone are not sufficient to permanently uphold a stable currency for Europe. A firm foundation is needed for the pillars to stand upon. This foundation consists of sound public finances, integrated markets and public confidence in the central bank. Then as now, it is important to strengthen this foundation so that the euro can withstand even a storm. I would now like to talk about what this means specifically in the here and now.

## **2 Sound public finances in the euro area**

Let's start with public finances – and a question: Why should they matter to us in the first place? The Eurosystem has the task of shaping monetary policy for the euro area. Fiscal policy is the Member States' responsibility. Why then do central bankers talk so often about budget deficits, debt ratios and fiscal rules?[2]

Our mandate provides the answer: Unsound public finances are a threat to price stability. If the debt burden grows steadily in size, people might lose confidence that the government can continue to shoulder this burden without “inflating it away”. Inflation expectations, and therefore inflation itself, could rise. And monetary policy would have to push back more vigorously to keep inflation under control. This, in turn, would come at a greater cost to the economy as a whole.

That is why we must nip in the bud any impression that central banks are under pressure to set key interest rates lower or maintain higher bond holdings than actually warranted by monetary policy out of consideration for public finances. And that is exactly why we are such outspoken advocates of effective fiscal rules. They are intended as guardrails for sound public finances. Then monetary policy can safeguard price stability, and do so with as little cost to the aggregate economy as possible.

Fiscal rules were included in the design of European monetary union from the outset. This was thanks, in part, to Karl Otto Pöhl. Even back in the days of the Delors Commission, he was already advocating binding budgetary rules. Mr Pöhl is also said to have been the first to introduce the idea of a 3% deficit rule.

Since then, the rules have been amended on several occasions. The latest reform entered into force in April 2024. On paper, the earlier rules were not bad at all. In practice, however, they didn’t have the desired effect. One reason was that numerous exceptions and discretionary powers were used to excuse the many instances in which targets were missed. As a result, the majority of euro area countries have debt exceeding the reference value of 60% of GDP (gross domestic product), with a few even well above the 100% mark.

Against this background, the rules were redrawn. In the reform, a great deal of emphasis was placed on national ownership, the intention being to make Member States feel more bound to the thresholds. If this overhaul does indeed lead to the rules having more binding force, that would be very welcome.

At the same time, however, the commitments must also be ambitious enough to significantly bring down high deficit and debt ratios. Given a number of vulnerabilities in the new framework, this is not a matter of course. For example, the country-specific limits are based on many assumptions, some of which extend far into the future. The spending limits are ultimately a matter of negotiation. And in practice, response times to undesirable developments will be very long.

The first acid test is imminent. Spending limits for the first planning period are currently being agreed upon. The plans should stake out a path for high deficit and debt ratios to come down reliably. Responsibility for agreeing such plans lies with the Commission and the Council. In my opinion, Germany should act as a role model in this process. That means leading by example and committing to a path on which the rules are applied rigorously.

Given high levels of debt in the euro area, it is important that the reformed rules work better than the old ones. As I said earlier, sound Member State finances are part of the foundation of a stable economic and monetary union.

### **3 Integrated capital markets in Europe**

But they alone are not enough. In his speech back then to the Frankfurt Society for Trade, Industry and Science, Karl Otto Pöhl explained that the emerging economic and monetary union meant, first, an integration of the markets. That was the most important thing of all, he said.<sup>[3]</sup> In particular, he pointed to the increasing integration of money and capital markets following the lifting of many restrictions on the free movement of capital.

There were, and still are, a number of reasons why it is important that European financial markets should be as integrated as possible. First, this helps ensure that monetary policy impulses have equal effect throughout the euro area. Second, in the event of an economic shock in one Member State, it makes sure that downstream costs are cushioned across the currency area. This contributes to the stability of the economy as a whole and the financial system. And third, in a deep, liquid capital market with a broad range of products, it is easier for enterprises to find the financing that suits them best. This is particularly true of start-ups and growth companies. They need access to a developed venture capital market. More private capital is also important to boost investment in the green and digital transformation of the European economy. This investment is urgently needed to strengthen the EU (European Union)'s productivity and competitiveness.

So you see, everything points to the benefits of a genuine pan-European capital market. And the EU (European Union) set itself the goal of creating a capital markets union a decade ago. Unfortunately, the reality is still very different.

Overall, progress on financial integration in the euro area is disappointing. This was the conclusion recently reached in a report by the European Central Bank. It states that “[b]oth price-based and quantity-based financial integration indicators have declined substantially over the past two years, with no sizeable increase since the inception of Economic and Monetary Union. Despite significant legislative efforts over the last decade, cross-border financial market activities and risk sharing have not grown ...”.<sup>[4]</sup>

This finding demonstrates just how big the task is. But there is also good news: We know fairly exactly where the pain points lie and can start there. Areas for action include, for example, a more vibrant securitisation market, integrated structures in financial supervision, harmonised securities legislation, and better-coordinated national insolvency and accounting rules.

The new Commission now needs to place the pursuit of a European capital market at the very top of its list of priorities. We must make more rapid progress on this issue than we have done so far. Policymakers have mostly been united behind the abstract objectives. However, they have then too rarely found the strength to agree on concrete measures. A whole host of measures is needed to achieve the objectives. In some cases, they encroach deeply on national law. If real progress is to be made, all parties will have to pull together, i.e. the Commission, the Parliament and the Member States.

Happily, the topic has gained fresh momentum this year. Be it the statements by the Eurogroup and the ECB (European Central Bank) Governing Council or the reports by Enrico Letta and Mario Draghi – they are all providing tailwinds. Now is the time to use them!

The Eurosystem itself is also contributing to success in this area, particularly in terms of financial market infrastructure. For example, we are advocating for new technologies to make it easier to issue, trade and settle financial instruments. In my view, digitalisation opens up fresh opportunities to strengthen the efficiency of European financial markets, while also breaking down boundaries between national financial markets. We have far from exhausted the potential here!

## 4 Public confidence in the central bank

A Europe with integrated markets and sound public finances is a stronger Europe. It is a Europe with stronger resilience in the face of crises, even during turbulent times; a Europe that allows us to shape our future with self-assurance and on the back of our own efforts. Achieving this goes beyond the monetary policy foundation; it also involves the basis of citizens' trust in the EU (European Union).

The general public should be able to have as much confidence in the EU (European Union) in future as they do now.[5] We, as the Eurosystem central banks, are also particularly dependent on the confidence and support of the general public.

We act independently of politics. This independence has been deliberately granted to us for monetary policy so that we can fulfil our mandate free from political influence. We cannot simply take the public's trust as a given. Only if the people have confidence in us will they accept the independence granted to us. This trust must be earned time and time again – by acting in accordance with our mandate and communicating transparently and comprehensibly with the public. In short: Our deeds and our words should go hand in hand.

If people have confidence in central banks and their promise of stability, this also helps to anchor inflation expectations.[6] Well-anchored inflation expectations make it easier for the central bank to actually achieve its target. And meeting the inflation target, in turn, reinforces people's confidence in the central bank. In this way, a virtuous circle is created – a cycle of positive events.

The Eurosystem has repeatedly demonstrated that its promise of stability was not merely empty words. Perhaps you remember when the then ECB (European Central Bank) chief economist, Peter Praet, gave his Karl Otto Pöhl Lecture in 2017. At that time, the Eurosystem was struggling with an inflation rate that remained stubbornly below target. Mr Praet explained what the Governing Council had done to counter deflation risks that had emerged since 2014.

Alternatively, think back to the economic environment back when Christine Lagarde spoke with you two years ago. In autumn 2022, euro area inflation had peaked, even reaching double digits for a time. Against this backdrop, the ECB (European Central Bank) President underscored the Governing Council's determination to push inflation down to its 2% target.

Here, too, words and deeds were aligned: by September 2023, we had raised key interest rates by a total of 450 basis points in ten steps – a move that bore fruit. The inflation rate has since fallen significantly. In September of this year, it was below 2% in the euro area – and that for the first time in over three years. Tomorrow we will get the first estimate for October. Inflation is also likely to have risen slightly again due to base effects in energy.

Looking beyond the monthly ups and downs, it can be seen that price stability is no longer far off, but the last mile of the journey still needs to be traversed. In particular, services inflation, which has been relatively sluggish in past experience, remains high, standing at 3.9% at last count.

The ECB (European Central Bank) Governing Council lowered key interest rates in October for the third time since June. This was appropriate in view of the somewhat more favourable inflation outlook shown by the data. Our data-dependent approach has proven its worth, particularly in view of the prevailing uncertainty. A new forecast will be available to the Governing Council in December, and that will show us whether we are still on track in terms of inflation developments. I advise you to remain cautious and not to rush into anything.

Monetary policy needs to ensure that the inflation rate stabilises at 2% over the medium term. Adhering to our promise of stability is absolutely crucial if we are to maintain the confidence that the general public have in us, particularly in light of their inflation experiences in recent years. Accessible communication helps with this.[7]

Karl Otto Pöhl had already come to this realisation, back in a time when central banks were, in some cases, famous (and infamous) for their secrecy. In an interview in 1988, he said: “I am thoroughly convinced that one of my main tasks is to clarify, to explain.”[8]

Studies also suggest that people with a good financial education tend to trust central banks.[9] We therefore have a strong vested interest in improving the public’s understanding of money, currency and central banks. This is where the Bundesbank’s educational resources, such as lectures at schools, training courses for teachers, teaching materials, explanatory films and the Money Museum, come into play.

The effects of financial education could extend even further: researchers from the European Central Bank have investigated how people with differing degrees of financial knowledge responded to the interest rate reversal in 2022 and 2023.[10] People with basic and advanced financial knowledge were surveyed over several months. It transpired that both groups expected significantly higher interest rates. However, there were differences between whether the surveyed groups deemed it better to take out loans or to make savings: those with higher financial literacy adjusted their assessments more quickly and to a considerably greater degree. The impact of the course of monetary policy on people's behaviour therefore also depends on their financial knowledge. As a result, then, greater emphasis on financial literacy could help monetary policy measures to be translated into action on the part of the individual.

A good general understanding of economics and finance has yet more advantages. For instance, such knowledge enables people to make better decisions about how to spend, save and invest their money. Studies show that financial knowledge has a positive impact on households' return on investment.[11] Furthermore, it is more likely to prevent them from making expensive mistakes or falling victim to fraud.

Financial education also affords opportunities for social advancement. It is therefore important to promote the acquisition of such knowledge in society at large. If knowledge about planning for retirement and wealth accumulation is only gleaned from one's parental home, it is primarily those who are already in positions of privilege who will benefit. This can entrench and even exacerbate societal inequalities.[12]

It is all the more worrying that, according to a survey carried out within the EU (European Union), an average of just over one in two individuals possesses basic financial knowledge.[13] Although Germany's performance is above average, we still have plenty of room for improvement. The German government's initiative aimed at strengthening financial education therefore comes as a welcome development. One component of this initiative, a national strategy for financial literacy, is currently under development. The OECD (Organisation for Economic Co-operation and Development) has provided valuable analyses and recommendations that create a sound basis for policy.[14]



In any case, there is no lack of interest, especially among young people. According to an OECD (Organisation for Economic Co-operation and Development) study, 81% of 14 to 24-year-olds would like to learn more in school about options for retirement provision, 87% about how to handle their money and 73% about investment opportunities. [15] In addition, 78% of young people in Germany want economics to play a greater role in school. [16] A stronger focus on economic and financial topics in the school curriculum would fall on fertile ground, then.

## 5 Conclusion

The Eurosystem is well equipped to maintain stable prices in the euro area through independence and a clear mandate. But in stormy times especially, we need to be firmly anchored upon a strong foundation, comprising elements such as sound public finances, integrated markets and confidence in the central bank. This foundation must be maintained, and, where necessary, re-laid.

First and foremost, we are, of course, required to say what we are doing and to do what we are saying. Central bankers would be well advised to adhere to this guiding principle. However, what is also clear is that we cannot guarantee the strength of the euro as a currency by acting alone; rather, politicians and society as a whole have their own parts to play. Pöhl's contemporary Helmut Schlesinger, who recently turned 100 years old, coined the term "stability culture". [17]

I would like to close by citing a quote of Karl Otto Pöhl's that holds as true today as it originally did over 40 years ago: "There is no law of nature stating that we are entitled to live on an "island of stability". Such a privilege has to be earned through applying a durable stability policy." [18] Indeed, this is what we in the Eurosystem are working towards on a day-to-day basis, and I am confident that we will succeed.

## Footnotes

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