Ernst Welteke: Germany and Europe - recovery in 2004!

Speech by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the British Chamber of Commerce, IHK Frankfurt, 3 February 2004.

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Ladies and gentlemen

Thank you very much for your warm welcome. I am glad to be here with you tonight. I very much appreciate the opportunity to speak to, and discuss matters with, such a distinguished audience from the business sector.

My remarks today are grouped into three sections. I would like to start with some comments on the economic recovery in Germany and in Europe. To widen the perspective, I shall then outline a number of major shifts in the composition of global growth and world trade flows. Finally, I shall give you my view on structural reforms for a more dynamic economy in order to meet the demographic and competitive challenges that lie ahead.

First of all, however, I would like to tell you that the Executive Board of the Bundesbank has decided to advocate a renewal of the Gold Agreement after the current agreement expires in autumn. The terms and conditions should be similar to those of the current agreement. Sales of around 2,000 tonnes of central banks' gold over a period of five years would translate into annual sales of about 400 tonnes. The Bundesbank envisages a quota of about 120 tonnes a year, which is equivalent to 4% of the total stock.

The gold reserves have been accumulated from external economic activities over a prolonged period. Hence, it is appropriate to manage this asset in a manner which safeguards its underlying value. Future generations should also be able to derive benefit from this asset. I will soon be taking up talks with the Federal Government and the parliamentary parties on the specifics of how to manage this asset.

1. Developing economic recovery

A whole series of indicators is pointing to an ongoing recovery in the world economy. After hitting a trough last March, stock markets -which show some leading indicator properties - have accomplished a powerful turnaround. Business sentiment indicators started to change for the better in summer. For some weeks now, releases of economic data have been providing confirmation that economic activity is picking up. I am confident that autumn saw a change for the better.

1.1 Europe and Germany

In the wake of accelerating growth in the USA and in Asia, world trade is returning to considerably higher growth rates. External demand has been the main factor behind the initial signs of improving economic activity in the euro area.

In the third quarter - the most recent quarter for which detailed data are available - external demand was the only component to make a positive contribution to the GDP growth rate. Consumption essentially stagnated, while stock-building and investment made a negative contribution. The components added up to a 0.4% growth in GDP on the quarter.

Leading indicators point to a strengthening of economic activity during the final quarter of 2003. New industrial orders have come in stronger since the beginning of the final quarter. At the same time, there has been an increase in capacity utilisation — for the first time since October 2002.

National data from Germany have bolstered the latest euro-area indicators. In Germany, new orders and industrial output have been on a remarkable uptrend. The Ifo business climate index showed a ninth successive increase in January. High-flying business expectations are now being underpinned by an improved assessment of the current business situation.

The Bundesbank's estimate of fourth quarter GDP growth is +0.25%. However, the initial estimate of German GDP in 2003 is only -0.1% growth on the year. All in all, most recent data are encouraging, although they do not yet make for a vigorous economic expansion.

For the export-driven recovery to lead to a self-sustaining expansion, domestic demand would need to pick up - both consumption and investment. Consumer confidence in the euro area has stabilised recently at a rather low level. A weak job market and the need for pension provisioning are weighing on private consumption. On the other hand, there seems to be a considerable amount of pent-up demand. German cars that are currently on the road, for example, are fairly old on average. Stable prices underpinned by the euro exchange rate are bolstering incomes in real terms.

In an environment of favourable financial conditions - which have prevailed for quite some time now - firmer expectations of increasing sales should spark investment demand even though capacity utilisation is far below its maximum level. Nominal and real interest rates are low and there is no shortage of liquidity. Loans to the private sector are on an upward trend.

Businesses' export expectations remain generally upbeat despite some concern about a potential loss of price competitiveness following a marked rise in the external value of the euro. Certainly, any currency appreciation tends to imply a loss of price competitiveness unless it is offset by an increase in productivity or by cost-cutting.

It is important not to overestimate the effect the euro appreciation has on overall export demand and, even more so, on the economic recovery. The impact of world trade and world growth dynamics far outweighs the influence of the exchange rate. A strong currency is an asset. The strong Deutschmark served Germany well.

1.2 Risks inherent in the export-led recovery

The economic outlook for the euro area and for Germany are rather good, although some serious risks remain. The US twin deficits are a concern in this respect. In the late 1990s, the US current account deficit had its domestic counterpart in high investment spending. It was financed by foreign private investors seeking an opportunity to invest in the US corporate sector. Today's current account deficit has a domestic flip side in terms of a high budget deficit. It is financed to a large extent by Asian central banks which purchase US treasuries by intervening in the foreign exchange markets.

Exchange rate movements like the dollar depreciation help to unwind imbalances in the world economy, even though they cannot do the trick entirely on their own. The domestic causes of those imbalances need to be addressed. For Europe, the main task in this respect is to boost growth potential by embarking on structural reforms in order to ease existing economic rigidities.

The monetary policy strategy of the euro area does not target the exchange rate. The external value of the euro is one of many factors shaping the prospects for price stability. The ECB Governing Council closely monitors developments in the euro's exchange rate. Currently, the strong euro allows us to keep interest rates at a low level in an environment where demand is picking up and excess liquidity persists.

One of the reasons for the marked improvement in German sentiment indicators is the confidence generated by the evolving reform process. Any perception that reforming zeal is weakening might therefore do harm to the recovering economy. Moreover, reforms are crucial for enhancing competitiveness.

2. Trends in the world economy

I would like to widen my perspective at this point and discuss some rather global topics. Globalisation, deregulation and market orientation have helped to change the shape of the world economy significantly over the past few decades. We have witnessed the integration of more and more countries into the world markets and a sharp rise in global trade.

During the past 30 years, the cross-border exchange of goods and services increased ninefold (in terms of volume) to more than US$ 7,000 billion in 2003. At the same time, substantial changes in the regional composition of trade flows have occurred. While the industrial countries' real share in world exports has gone down from 70% to 60%, that of developing countries has gained ground. The fast-growing economies in East Asia, in particular, have been extremely successful in integrating into the world economy. Their market share of world exports went up from 6% in the 1970s to about one-fifth in 2003. By no later than 2010, East Asia, including Japan, might account for more than one-third of world trade and thus become the world's most important trading area, ahead of the European Union.

The export-oriented development strategy of the Asian economies - in contrast to the more inward-looking approach in Latin America - has brought a considerable measure of success. It has stimulated not only cross-border trade but also economic growth. Developing Asian economies currently account for nearly one-quarter of global production. They have exploited their capacity for fast growth by

- efficiently mobilising their physical and human resources
- adapting foreign technology and
- utilising the opportunities for specialisation resulting from their integration into the world economy.

As a consequence, they have roughly doubled their economic weight over the past 30 years. Real convergence - as suggested by growth theory - seems to work if the right conditions are in place.

At the same time, advanced economies, most notably west and east European countries, have lost significant market shares in world production. Slow population growth, modest gains in productivity and the breakdown of the former Communist planned economies have hampered their economic performance. At present, advanced economies, while representing no more than about one-sixth of world population, account for 55% of global gross domestic product (GDP) based on purchasing power parity (PPP) valuation - about 5 percentage points less than in 1980. The transition countries' share of global GDP has gone down from 12½% to 6½%, although there has been a small increase recently. For the sake of completeness, let me say that the United States' share of global GDP has not changed much over this period.

However, in recent years China has been the most outstanding example in terms of economic performance. Over the past ten years the Chinese economy has grown on average by more than 8% annually in real terms - faster than other Asian countries and very much more than the advanced economies (2½%). Admittedly, China is still a relatively poor country, but the pace at which it is catching up is remarkable. Measured in terms of purchasing power parities, China currently accounts for about 12½% of world production and 5% of world trade.

Bearing these shifts in mind, one is inclined to ask how the world economy might look in 10 years or so. Some experts forecast that the Asian economies (excluding Japan), and especially China, will grow rapidly over this period. As a consequence, they see China and the United States having roughly equal levels of GDP in 2015 (assuming PPP valuation).

Time will tell how realistic those projections are. Some risks are evident in the case of, say, the necessary transformation of loss-making state enterprises and urgent reforms in the financial sector in China - to mention just two economic factors. With respect to the United States, we have recently observed relatively high productivity growth rates, which might contribute to higher-than-expected GDP levels in the US, but the risks arising from the twin deficits in the medium term should not be underrated.

Irrespective of the question of which economy will be in pole position in 2015, unwinding global imbalances and strengthening economic growth pose difficult challenges for the international community.

3. Economic and social reforms

About a year ago, Germany was undergoing a deep crisis of confidence. At the time, only staunch optimists would have thought possible what is now law in Germany. We are being serious about economic reform. Under the heading of "Agenda 2010", the state as we know it is being transformed. A new balance is to be struck between the public and the private sector. This process may well be described as a paradigm shift.

The old ideal of providing social justice through a highly redistributive state is fading away. The ideal has simply failed to live up to expectations. The role of the state is now being redefined as a more subsidiary one. The other side of the equation is that people are being increasingly allowed - and, indeed, expected - to manage their own affairs. Efficient markets and a proper set of incentives are reinforcing this trend. In short, members of the public are being called upon to take responsibility for themselves and to make their own decisions. Only those who are unable to do that can count on the state for support. For a large part of Europe, this approach amounts to a minor revolution.

3.1 *Reforms accomplished*

Early last year, the Bundesbank published a paper entitled "Ways out of the crisis". The paper proposed applying a *coherent* overall strategy for structural reforms in the labour market, the social security systems and fiscal policy. Despite some shortcomings, a major portion of the reforms now being implemented are in line with our proposals.

I would like to stress the enhanced flexibility of the labour market that has now been accomplished. Fixed-term contracts can be used more extensively when setting up a new business. Dismissal-protection rules have been eased for small businesses, thus lowering a major hurdle to new recruitment. Incentives to work in the low-wage sector have been increased by reducing the period of entitlement to transfer payments from 18 to 12 months in most cases. Furthermore, the Crafts Code has been deregulated to enable more people to set up their own business.

Germany has begun to cut back subsidies such as tax breaks for commuters or new home-owners. In the statutory health insurance system, patients now share the costs of any treatment they seek. Over-use of what, up to now, have been regarded as "free" health care services might thus be contained to a certain extent.

3.2 *Unfinished reform business*

There is a lot of unfinished business on the German reform agenda. But, at least, Germany has made a start. Our partner states in Europe and elsewhere are taking note of this. Now is not the time to take a rest, as we still have a long way to go before the German economy has truly regained its former dynamism. We need to build on the newly acquired momentum for reform. There has to be a further improvement in the supply side conditions, red tape has to be cut back, and setting-up a business has to be made easier.

The labour market would clearly benefit if employers and employees were allowed to depart from the terms of centralised wage agreements provided jobs can be secured in that way. A general broadening of the scope for non-centralised wage settlements at the individual company level might also help to improve labour market flexibility.

Non-wage labour costs have reached a level that acts as a major impediment to employment and economic growth. The rapid ageing of the population will put the systems under further pressure unless they are reformed speedily and thoroughly.

In order to contain the cost dynamics in the health care system without compromising quality, higher levels of competition and transparency are needed on the supply side. Insurance contributions have to be made separate from employment contracts. Funding of the pension system must be broadened. As benefits paid out in the pay-as-you-go pension system will have to be cut back for future retirees, private provisioning should be expanded. Furthermore, the younger generations will have to work beyond the present retirement age of 65 years. Postponing reforms in the social security systems will ultimately render them only more costly.

3.3 *Fiscal issues*

Social security systems have contributed significantly to deteriorating public finances. Fiscal consolidation is a priority issue for governments not only in Germany.

There must be no further weakening of the Stability and Growth Pact. Modifying the pact would be as short-sighted an option as non-compliance. In the longer run, there can be no sound money without sound public finances.

Public finances must be consolidated on the expenditure side. This is entirely in line with the objective of a more subsidiary role for the state. Past experience has also shown it to be the most effective road to achieving sound public finances. The economic upswing opens a window of opportunity to get serious about fiscal consolidation.

An overhaul of the income tax that broadens the tax base while lowering tax rates might help to raise the growth potential of the economy. The ideal tax system would be simple, fair and efficient. That ideal is the benchmark for any upcoming tax reform.

Although my remarks on necessary reforms referred to the situation in Germany, the problem areas are - albeit to varying degrees - basically the same in most European countries: social security systems facing ageing populations, high budget deficits and growth-hampering structural rigidities. Especially with regard to such rigidities, the UK's flexible economy is in quite an enviable position.

4. Concluding remark

However large the need for reform, the euro area has a major asset: its currency. The euro has delivered a high degree of macroeconomic stability previously unknown to most of the 300 million people who now use the single currency. I firmly believe that the past five years with their external shocks - terrorist attacks, financial market turmoil, sharp oil price movements - would have been even less pleasant for Europe if not for the stabilising factor of the euro.

Should the UK join the euro area?

Personally, I would appreciate Anglo-Saxon free-market enthusiasm within the Eurosystem. Adopting the single currency would lower transaction costs considerably as the UK and the euro area are already the most important trading partners for each other. It therefore makes sense to integrate financial and product markets further by having a common currency.

I am fully aware of how contentious an issue the euro is in the United Kingdom. Even so, in my humble opinion, the UK joining the euro area would be mutually beneficial. You would be most welcome.