# Andreas Dombret: The sovereign debt crisis in Europe and its impact on the emerging market economies

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, to the German-Brazilian Chamber of Industry and Commerce, São Paulo, 6 December 2012.

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## 1. Introduction

Mr Porto
Consul General von Kummer
Ladies and gentlemen

I am delighted to be speaking here today to the German-Brazilian Chamber of Industry and Commerce and I wish to thank you all for your interest.

São Paulo is the financial and economic centre of Latin America and, for that reason, the Bundesbank has been sending a representative to the German Consulate General here since 2005. Today, a new representative has taken up office. His tasks will include regular reports to the Executive Board of the Bundesbank, keeping it informed of economic and financial developments in Brazil and other countries in Latin America. This is because Brazil's importance for the world economy is growing constantly. In 2011, Brazil overtook the United Kingdom as the sixth-largest economy in the world, and it is probably only a matter of time before it dislodges France from fifth place. And, after that, Brazil will have Germany in its sights.

Generally speaking, the past few years have seen the weights in the world economy shifting significantly in favour of the emerging economies. During the sharp economic slump in 2009, the rapidly growing emerging market economies also fulfilled an important stabilising function for the global economy.

Institutionally, the shift in weights was reflected not least by the G7 becoming less important and by the G20 rising to become the central forum for international fiscal and economic policy cooperation. The large emerging market economies are now closely involved in international cooperation. The emerging economies will have greater influence in the International Monetary Fund, too.

People in Brazil and other major emerging economies are concerned about the ongoing financial and sovereign debt crisis in the euro area. The crisis in the euro area is often regarded as one of the greatest risks to the world economy.

In my short speech, I would like to provide a brief outline of the causes and effects of the crisis and investigate the extent to which the crisis is actually impairing growth in the emerging economies.

## 2. Emergence of the crisis and measures to contain it

The sovereign debt crisis has been going on for about three years now. It began with Greece in May 2010, and Greece remains the most difficult problem case in the euro area. But the crisis spread to other euro-area countries. What were the causes of this crisis?

First of all, the unhealthy developments in the run-up to the crisis differed from country to country. The common denominator was that the countries in crisis failed to fulfil the requirements of a monetary union in full. Countries belonging to the European monetary union no longer have their own national currencies. Consequently, there is a single monetary policy for all the member countries. This means that competitive depreciation; in other words, devaluing the national currency to offset losses of price competitiveness is no longer an option.

For some countries, the introduction of the euro brought significantly lower rates of interest than before monetary union. There followed massive flows of capital into those countries, but, unfortunately, these capital inflows were not always put to productive use. Among the unhealthy developments that prepared the ground for the crisis were credit-financed excesses in the real estate markets, oversized financial systems, high levels of government spending – caused by an overblown machinery of state, for example – and a high level of private consumption. Added to this were wage increases that were higher than growth in productivity, which considerably worsened those countries' price competitiveness.

Still, up to the outbreak of the global financial and economic crisis, such economic imbalances within the euro area remained largely without consequences. With the crisis, however, it suddenly became more difficult to finance the permanent current account deficits and yield spreads on government bonds in the euro area increased sharply as a result of growing doubts about the sustainability of government finances. Capital now fled in the opposite direction, into the core economies of the monetary union – above all, Germany.

In order to combat and contain the escalating crisis, the countries of the euro area as well as the European Union set up extensive rescue shields. Besides Greece, Ireland and Portugal, too, took up financial assistance. A programme is being negotiated for Cyprus at present, and Spain is receiving resources to recapitalise its banking sector. The International Monetary Fund is also contributing financially to what are known as the full programmes. This means that Brazil, too, is helping to stabilise public finances in the euro area, which, especially with regard to Portugal, is a remarkable development given the history of these nations.

The Eurosystem – which comprises the European Central Bank and the national central banks of the euro-area countries – has also assumed a major stabilising function. With key interest rates at an all-time low and an ample supply of central bank liquidity, monetary policy is ensuring that the real economy is not overly affected by the tensions in the financial markets. This strategy has largely been successful so far.

What is important in this context is that we never lose sight of the primary objective of monetary policy, which is to safeguard price stability. For this reason, we are concerned by politicians' growing expectations of the central bank. Central banks must not conduct fiscal policy.

### 3. Impact on Brazil and other emerging market economies

The emerging economies are somewhat concerned about the monetary policy stance not only in Europe, but especially in the United States as well. The Brazilian President, for example, has given a clear warning about the consequences of a generous liquidity policy. She spoke of a "tsunami" of cheap money flooding the world.

Such statements reflect both a fear of competitive devaluation and concerns that the sovereign debt crisis in Europe could impair economic growth in the emerging market economies. Some emerging economies are therefore considering the option of tightening capital controls to guard against unchecked inflows of capital.

In the Bundesbank's view, measures restricting capital flows should be a last resort, however; they should be employed only when facing considerable risks and used purely on a temporary basis, if at all. It is our firm belief that, over the longer term, the best means of preventing unhealthy developments is efficient risk provisioning and supervision of the financial sector in conjunction with a stability-oriented macro policy.

Negative spillovers from the European sovereign debt crisis to the emerging market economies might be generated, above all, by weak economic activity in the euro area. That is, at least, an opinion that I often hear expressed at international conferences. More detailed analyses nevertheless suggest that negative spillovers via the external trade channel are fairly limited. For explaining the recent slower pace of economic growth in Brazil and other emerging markets, other negative factors are, in any event, more significant than weak demand in the euro area.

The necessary processes of adjustment in the euro-area countries in crisis have led to a decline in their domestic demand. Naturally enough, this is also associated with lower imports. For foreign trading partners, this means declining exports to the euro area. The effects of this on global economic activity should not be exaggerated, however.

For one thing, a key part of the adjustment is taking place within the euro area itself – something which is being felt, not least, by German exporters. For another, exports to the euro area are of relatively minor importance for most regions outside Europe. Last year, euro-area countries imported goods worth US$ 2,340 from outside the euro area, which corresponds to just under one-fifth of the euro area's gross domestic product (GDP). In the first half of 2012, imports from non-euro-area countries fell by 4 %.

Looking at the situation the other way round, exports to the euro area account for just 4 % of the rest of the world's GDP. If the emerging and developing countries are combined into a single group, the figure is somewhat higher, at 5 %.

Over the past few years, exports of goods to the euro area have made a positive contribution to economic growth in the emerging and developing countries, but this stimulus is now absent. In nominal terms, the lack of this growth impulse explains only about a tenth of the current slowdown in growth in the emerging market economies and developing countries.

For Brazil, the euro area is of even less importance as a sales market. Exports to the euro area account for no more than 2 % of GDP. With an export share of 10 % of GDP, Brazil is, anyway, a rather closed economy. With regard to the currently quite marked slowdown in growth in Brazil, other factors are therefore of greater relevance.

This significant growth slowdown in the large emerging economies is due mainly to specific, home-grown factors. Here in Brazil, the deceleration was especially pronounced in industry. One major reason for the lull since 2010 is the loss of price competitiveness due to the appreciation of the Brazilian real. Another factor, admittedly, is that real earnings in the manufacturing sector have also gone up sharply over the past few years. You all know that Brazil is not a low-wage country. As a result, domestic goods are increasingly being substituted by imports.

The congested infrastructure ranks as a further structural obstacle to macroeconomic development. The fact that there are said to be roughly as many helicopter taxis in São Paulo as there are helicopters in all of Germany is due, if nothing else, to your city having gained a reputation for being faced with frequent traffic jams. Logistics experts say that deliveries of goods in Brazil take twice as long over the same distance as in China. Whether or not the announced government investment programme to modernise the road and rail networks will lead to substantial improvements is something that you are in a much better position to judge than I.

I only wanted to make clear that the direct effects of the euro-area crisis on economic activity in Brazil are fairly small and that the causes of the current weakness in growth are primarily to be found at home.

## 4. Outlook for the European monetary union

While the direct effects may be limited, there is still no doubt that countries outside the euro area have a legitimate interest in a rapid resolution of the crisis within the monetary union. This is because the crisis can also have negative effects via a confidence channel, say, through sharp fluctuations in the capital and foreign exchange markets. We, too, are aware that the crisis is contributing to an erosion of confidence – confidence in the financial, economic and monetary systems. In essence, the financial and sovereign debt crisis is a crisis of confidence. And that is precisely what makes it so dangerous.

The stabilisation measures I have mentioned will not be enough on their own to strengthen confidence in the future of the monetary union again. The member states will have to remedy the unhealthy developments that took place prior to the crisis, which I described earlier. To achieve that, the member states have to put their public finances in order, stabilise their banks, and implement structural reforms consistently so that their economies become more competitive. We have to make the financial system in Europe more crisis-proof and improve financial market regulation. The creation of Europe-wide banking supervision in the context of a banking union – if done properly – could play a major part in this.

In the end, what is crucial is that European monetary union remains a community of stability. The institutional foundations of the monetary union have to become more stable. We need a sustainable solution. A crisis policy relying solely on measures that have a short-term impact would only sow the seeds of future crises. It is therefore in the emerging economies' own best interests that the problems in the euro area are tackled at their roots.

Allow me to conclude: the euro area has to get to grips with its problems and live up to its responsibility as the second-largest economic area in the world. The impression that the crisis in Europe represents a decisive obstacle to growth for the rest of the world and, in particular, for the emerging and developing countries is misleading, however, and diverts attention from other problems and weaknesses.

Thank you for your attention.