Andreas Dombret: Statement at the OECD Working Party 3-Meeting

Statement by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the OECD Working Party 3-Meeting, Paris, 14 January 2014.

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Dear colleagues,

Thank you for giving me the opportunity to open the first round of our working group's meeting. Let me begin by wishing you a Happy New Year. In my remarks I will focus on the major OECD economies and address three issues.

- First, the current economic situation, taking into account the major economic developments in 2013. Here, I can be brief thanks to the excellent background papers the secretariat provided.
- Second, possible risks to the recovery stemming from financial market developments.
- And third, policy requirements to keep up the current growth momentum.

In 2013, recovery was underway in the majority of OECD economies – including the euro area as a whole. This positive momentum has been confirmed by the latest OECD leading indicators that were published yesterday. However, growth is still low when compared to the levels achieved before the global financial crisis. In addition, the recovery has been remarkably uneven.

The US comes closest to a self-sustaining expansion. Here, I would like to emphasize the substantial progress in household deleveraging and the successful correction in the housing markets. Both factors will help future growth to be grounded on sound fundamentals. But the Fed's caution shows that considerable economic slack probably remains.

In the euro area, the recovery is still nascent, muted and uneven. However, a number of crisis countries have left their recessions behind. Rebalancing is underway. According to the recent OECD Economic Outlook, all crisis countries are expected to achieve a current account surplus in 2014. This would equal an average improvement of more than 10 percentage points of GDP compared to 2008. Thus, competitiveness-enhancing reforms are beginning to bear fruit and need to be continued.

Germany is part of the rebalancing equation. Since 2007, the intra euro-area German current account surplus has continuously shrunk from 4 ½-% of GDP to 2 ¼-% of GDP. This adjustment has been driven by rising imports. Domestic absorption has become a more important driver of economic growth. As business investment is projected to rebound in 2014 and 2015, the rebalancing should proceed.

Japan is a special case, given its long-lasting deflation. Here also, the end-2012 recession gave way to a remarkable expansion in 2013. Furthermore, against the backdrop of significant monetary easing there are indications that deflation finally may come to an end.

In a nutshell: the advanced economies have entered 2014 in better shape than they were one year ago. But they are far from being in good shape.

The economic improvements were backed by the extraordinary low policy rates and unconventional measures by central banks. Insofar monetary policy can be regarded as successful. But it came at a price. Monetary policy is in uncharted territory. Questions came up whether further monetary easing could have diminishing or even negative returns.

Against this background, sizeable downward risks and vulnerabilities continue to exist. In addition to those mentioned in the background note, I will briefly focus on the fragilities of the recovery in the context of financial market developments.

In 2013 there was only one way for most asset prices to go: upward. The EuroStoxx 50 increased by 18%, the FTSE 100 by 14%, the Dow Jones by 28%, and the Nikkei skyrocketed even by 57%. Funding conditions for troubled sovereigns and banks eased significantly. Market volatility decreased, too.

After years of risk aversion, sentiment switched to a "risk on" mode. 2013 was a very good year for financial investors. However, I look at these developments with some unease.

Indeed, catching-up dynamics after excessive pessimism up to the summer of 2012 can explain some of the asset price increases. Yet abundant global liquidity in addition to abating risks and improving fundamentals has certainly played a role, too. One might even argue that the influence of ultra-loose monetary policies has begun to be stronger on financial asset prices than on real activity.

The contrast between buoyant financial markets, on the one hand, and still limited improvements in economic fundamentals and activity, on the other, is apparent. The low volatility we have observed over the last quarters might even have blurred market participants' risk perception.

Did financial markets enter a new phase of "irrational exuberance"? Such a verdict is certainly debatable. But at least financial markets have anticipated significant further improvements of economic fundamentals and prospects.

This creates vast room for negative confidence shocks. The global financial crisis taught us how detrimental contagion and a negative feedback loop between the financial markets and the real economy can be. Therefore policy makers should be ambitious to deliver. Fighting reform fatigue will be the best insurance against the downside risks.

Building on the progress made in 2013, we will need to lay the groundwork for a sustained recovery in 2014. Economic policies should be geared toward restoring the role of the private sector in the growth process. Policies should foster productivity gains, increased employment and higher investment in the real sector. The public sector must be prepared for leaving the driver's seat of the economic developments.

As regards monetary policy issues, we will discuss them in detail this afternoon. So I will just make one remark. Should the Fed and the BoE exit from their current extraordinary loose monetary policy stance earlier than other major central banks this would constitute a challenge for communication and expectation management. However, in contrast to a widespread view, a timely exit should be primarily seen as a welcome step towards normalization and not as a "risk".

Reducing the role of the public sector also translates into tackling its high debt levels. This remains a key challenge. Consequently, policy makers need to use the current period of relative calm and make progress in bringing down public debt ratios. In the euro area, the trajectory of public debt has not been reversed yet. In Japan, the required adjustment remains particularly challenging, while the US would benefit from long-term financial reforms.

Banking sector policies must ensure that the sector is well-capitalized and that balance sheets are strong. This is especially important for the euro area's bank-based financial system. With the first steps towards a banking union and the recapitalization measures already implemented, a lot has been done. However, with regard to many European banks there are still signs that markets do not believe that banks' non-performing assets have been cleaned up thoroughly. The ECB's upcoming assessment is both a chance to create transparency about banks' asset quality and to establish the basis for adequate capitalization. It will contribute to enabling banks to once again perform their role as financiers of the real economy.

However, in economic policy there is no silver bullet. I caution against the view that a banking union can solve the crisis the euro area is currently facing. If successfully completed, it will be milestone for European financial integration. But it cannot serve as a substitute for further structural reform and fiscal adjustment. Financial and structural reforms need to give incentives for increased private sector investment. In some euro-area economies we will need to reduce the excessive debt burden in the non-financial sector and to improve competitiveness, building on last year's achievements.

In Japan it is crucial to implement the third arrow of "Abenomics" as the IMF emphasized in its latest World Economic Outlook. China, which we will discuss in more detail over lunch, has embarked on a profound reform of the economic and social model in order to create the foundation for private sector-led growth in the future.

So I welcome the emphasis the secretariat's background note places on investment. The economic situation in the major OECD economies may differ significantly. However, with the notable exception of Canada, lackluster investment has been a common feature. More of the same of ultra-loose monetary policy will be no solution to this problem. The agenda of the Australian G20 presidency and ongoing work on the OECD level leave me confident that the work on fostering investment will continue during the year.

Let me conclude by posing three questions:

- First, will private sector investment pick up this year and take over a central role in sustaining growth?
- Second, will monetary policy – where the required conditions are met – manage an orderly exit from its extraordinary measures?
- Third, will fiscal consolidation and structural policies be continued in a challenging political environment?

If we respond with "Yes" to these three questions at our meeting in January 2015, then 2014 will later be considered as a good year – the fourth condition of course being that Germany wins the World Soccer Championship.

Thank you for your attention.

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