Andreas Dombret: The euro area – where do we stand?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at Money Marketeers, New York City, 4 March 2015.

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1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak at a Money Marketeers event today. I would like to give you a brief overview of the current situation in Germany and the euro area. I am particularly looking forward to discussing these issues with you and hearing your perspective.

Mutual exchange is essential in a globalised world where countries are no longer isolated islands but part of a closely interconnected community. The global financial crisis has highlighted how close these connections are and how quickly a problem in one corner of the world can spread around the globe.

This truth applies all the more to countries sharing a common currency such as the member states of the euro area. Back in 1999, 11 European countries adopted the euro as their common currency. Today, the single currency is shared by 19 countries and more than 300 million people, which in my eyes makes it a success story.

That being said, it has not always been plain sailing. In the wake of the global financial crisis of 2008, the euro area slid into a financial crisis of its own. This was compounded in 2010 when Greece entered into a sovereign debt crisis, triggering a sudden loss of confidence in other member states which eventually brought the euro area to the brink of collapse. Extensive rescue packages by the governments along with non-standard measures taken by the ECB helped to calm the markets and prevented the crisis from escalating.

To some commentators, the situation in the last weeks was not much different. Greece has again captured the headlines. With the decision by the Eurogroup to prolong the existing rescue package for Greece for four months some kind of temporary calm was bought.

Unrelated to Greece, the ECB gave the green light to non-standard measures as a means of addressing the risks associated with too prolonged a period of low inflation.

To obtain a clearer picture, let us take a tour of the euro area to see where we stand at present and where we are headed in the future. Unsurprisingly, I will begin by focussing on the growth prospects of the German economy, not only because this is my home country but also because it is the largest economy in the euro area.

2. The German economy – in good shape but challenges ahead

At the beginning of 2015, the German economy remains in good shape. This is due to a number of factors. First, enterprises have brought their costs under control, their debt level is not unreasonably high, and they have an attractive range of products to offer on global markets. Correspondingly, exports have been rising quite strongly. Second, the German economy is being supported by domestic consumption, and – at least in the last quarter – by investment. In addition, unemployment is low, households are not burdened by excessive debt and real wages are rising on account of low inflation.

The German economy grew by 1.6% in real terms in 2014. However, the relative strength of the German economy at present should not obscure the fact that major challenges lie ahead and that this favourable position is not assured in the long run. In particular, unfavourable demographic trends will have an impact on future growth. The Bundesbank estimates that potential output is currently growing at a rate of 1% per year and will continue to do so until the end of the decade. Compared to the 1990s and 2000s this is a truly underwhelming figure.

Looking ahead to the distant future, Germany will be near the bottom of the league table for growth by international standards. Studies conducted by the OECD show that, by 2060, Germany will have grown at the slowest rate of all 42 countries surveyed, primarily as a result of the demographics-driven decline in the number of hours worked.

With an annual trend growth rate of just over 1% by 2060, the OECD predicts that Germany will grow only half as quickly as the United States. As measured per capita, however, Germany and the US are expected to grow at a similar pace, by 1.5% per year by 2060.

So, what can Germany do to improve its growth prospects in the long run? One frequently voiced proposal these days is that Germany should step up its investment as a lever for increasing its own growth potential as well as that of the euro area as a whole.

Indeed, the total real investment ratio in Germany was markedly lower in the 2000s than in the 1990s. And it was also lower than in the rest of the euro area.

Nevertheless, weaker investment in the last decade was largely the result of the construction boom in the late 1990s which followed German reunification. If construction is excluded from the investment ratio, Germany's situation is no longer any different from the rest of the euro area.

In addition, the construction boom witnessed in other euro-area countries also came to an abrupt end during the crisis, with the result that the ratio for the euro area excluding Germany has now returned to levels close to the German ratio. This effectively disproves claims that the German private sector is investing too little, be it by historical or international standards.

In any case, it is not possible to increase private investment by decree. When it comes to private investment decisions, expectations pertaining to growth and income are of pivotal importance.

Against this backdrop, many commentators point to public investment, which can be directly influenced by the government. With regard to public investment, Germany lags well behind the rest of the euro area. However, this fact alone does not justify assertions that the state should invest more.

Even so, public net investment has been negative for some time now, and there indeed seems to be room for improvement. Infrastructure weaknesses can inhibit growth considerably and there are certainly regional shortcomings in Germany. While a good public infrastructure is important, it does not require higher debt.

Nevertheless, Germany has a good infrastructure on the whole. According to the Global Competiveness Ranking of the World Economic Forum, only six countries have a better infrastructure (the US is ranked 12th).

The medium-term growth prospects of the German economy also depend, of course, on an improved economic outlook in the other euro-area countries. This brings me to the second part of my speech: the future of the monetary union.

3. The euro area – structural reforms needed

When the euro-area crisis began five years ago, many people referred to it as the "euro crisis". However, it was not a currency crisis but a cocktail consisting of a debt crisis, a banking crisis and a balance of payments crisis. While the underlying problems differ slightly between individual countries, the key to overcoming the crisis lies with the affected countries themselves.

In the years following the introduction of the euro, fiscal and economic policies in some member states failed to meet the requirements of a monetary union. These countries experienced strong capital inflows. Unfortunately, the lion's share of this capital flowed into private or public consumption or into an oversized housing sector.

On the back of heavily exaggerated growth expectations, a decrease in competitiveness owing to generous wage settlements and insufficient financial regulation, sizable imbalances accumulated which then contributed to the crisis.

Hence, to resolve the crisis it is the countries themselves that need to adjust. And it has been clear from the outset that the necessary reforms and adjustment measures require patience. In the meantime, major progress has been made as most of the crisis countries have managed to improve their public finances and to solve their structural problems.

Current account deficits have largely been reduced and some countries are now running a surplus. Price competitiveness in the crisis countries has also improved significantly. Measured in terms of the deflators of total sales, competitiveness has improved by 6% in Portugal, 9% in Spain and 14% in Greece. To some extent, these figures can be attributed to the depreciation of the euro. Nevertheless, the figures for the countries I have just mentioned are also positive when measured in terms of the euro area.

Needless to say, the job has not been finished yet. Structural reforms have been implemented, but more needs to be done. Monetary policy measures cannot substitute structural reforms. The Eurosystem has done a lot to prevent the crisis from escalating but it cannot address the underlying problems of the crisis.

Structural reforms are the best way to generate sustainable economic growth and create employment. It is becoming increasingly clear that the efforts are bearing fruit: unemployment rates seem to have peaked, and the economies are growing again.

This makes it all the more important for the achievements not to be compromised. It therefore worries me that Greece might go backwards in terms of its reform agenda.

Greece's newly elected government objected to complying with the financial assistance agreements and intended to withdraw some of the reforms that had already been adopted. There were even brief calls for further debt relief. However, after intense negotiations among the finance ministers of the euro area, the Greek government settled for requesting an extension of the current programme. After the Greek government had also committed to pushing ahead with economic and fiscal reforms, the finance ministers of the euro area approved a four-month extension of the programme. The details of a new financial assistance programme need to be worked out by summer.

Greece certainly needs further assistance from the rest of the euro area. However, further assistance can only be granted if Greece continues with its efforts to restore sound public finances and competitive economic structures. To regain investors' trust, sustainability and competitiveness are necessary requirements.

Suffice to say, it is not enough to correct misalignments solely at the national level, either in Greece or elsewhere in the euro area. We also need structural reforms at the European level. And here, a lot has been done since the crisis broke out.

First, the rules of the Stability and Growth Pact were tightened and a fiscal compact was adopted in order to restore confidence in public finances. Second, a procedure for identifying macroeconomic imbalances at an early stage was established. And third, a crisis mechanism was set up to serve as a "firewall", safeguarding the stability of the financial system in the euro area.

In addition to these measures, the euro area took a major step toward deeper financial integration. On 4 November 2014, the first pillar of a European banking union was put in place. On that day, the ECB assumed responsibility for supervising the 123 largest banks in the euro area. Together, the banks concerned account for more than 85% of the aggregate balance sheet of the euro area's banking sector, making the ECB one of the biggest banking supervisors in the world.

Taking banking supervision from the national level to the European level has three concrete benefits.

First, European banking supervision allows banks in the entire euro area to be supervised in a uniform manner according to the same high standards. These harmonised standards will emerge from the cross-border sharing of experience, noting the best aspects of each national approach to banking supervision and adopting these for use at the European level.

Second, European banking supervision makes it possible to effectively identify and manage cross-border problems. This is essential because large banks are usually active in more than one country.

Third, taking banking supervision from the national to the European level will add a degree of separation between supervisors and the banks they supervise. This will prevent supervisors from handling their banks with kid-gloves out of national interest.

As you can see, we have come to expect a lot from European banking supervision. And in 2016, the Single Supervisory Mechanism will be supplemented by a European resolution mechanism for banks. This will be the final step on the road to banking union and a major step forward in designing a better framework for the European monetary union.

However, to make monetary union more stable, the EMU framework needs further reform, too. The primary objective should be to increase the incentives to make sound and responsible decisions within the euro area. To this end, it is important to rebalance liability and control.

Either we establish centralised rights to intervene in national fiscal policies or we strengthen the principle of individual national liability.

As I do not see enough support for the great leap forward – either in the political sphere or among electorates – I do not expect it to occur in the foreseeable future. Therefore, the principle of national liability needs to be underscored. Otherwise, the deficit bias of member states of the euro area will be strengthened, which is harmful to the stability of the currency union.

Relying on fiscal rules alone will not suffice to overcome the euro area's vulnerability to crises once and for all. On the contrary, additional steps are needed to strengthen the disciplining effect of capital markets on fiscal policy. In that sense, the principle of individual national responsibility ultimately means that governments, too, must be allowed to fail financially.

4. Conclusion

Ladies and gentlemen

Recent events could create the impression of the euro area being stuck in a time loop – it is a bit like "Groundhog Day", but less funny. Nevertheless, it should be stressed that, in the past six years, we have made considerable headway in resolving the crisis and in putting the euro area back on a solid footing. We have achieved a great deal but much still remains to be done – both at the national and at the European level.

If we are to overcome the multiple challenges that lay ahead, all the member states of the euro area will need to work together in a spirit of cooperation and demonstrate a firm commitment to the common currency. On that basis, I am confident that the euro area will remain a stable and prosperous economy.

Thank you for your attention.