Jens Weidmann: How to address the euro area's economic challenges?

Keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the 25th European Banking Congress, Frankfurt am Main, 20 November 2015.

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1. Introduction

Ladies and gentlemen

It is a great pleasure for me to speak to you. As I stand before you today, it's hard to believe that a whole year has already gone by. I don't think that there is any event I've attended more regularly – with the exception of the Bundesbank's presentation of its annual accounts.

At last year's event, I suggested that contemporary banking and medieval banking have as much in common as a Ferrari and a donkey cart.

What holds true for a subsystem of the economy certainly must hold for the economy at large. In terms of complexity and sophistication, today's economy and its medieval counterpart are worlds apart.

This, however, raises an obvious question. If the euro-area economy really is a sleek sports car, why has its performance been decidedly less than dynamic? Is the engine sputtering? Have the tyres lost pressure? Does the body produce drag?

The answer to these questions is: all of the above. The euro area's growth engine is not firing on all cylinders. The euro area's tyres have lost pressure – that is, Europe's banks have reduced their leverage. And although the lowering in the form of fiscal consolidation has been crucial to prevent the euro area from careening off the road, at the same time, the reduced ground clearance makes it harder to cushion bumps – meaning that it may become more difficult to respond fiscally to negative economic developments in the euro area.

To counter all this, monetary policy in the euro area has put the pedal to the metal. It has lowered interest rates into negative territory, and it has embarked on large-scale asset purchases for most sovereign bonds.

But while monetary policy has certainly provided a boost, growth is generally considered to be only moderate.

So, what is needed to return to cruise speed? Can we overhaul the engine for better performance? Does it make sense to top up the tyres with air? Should we try to eliminate the fiscal downforce? Or should monetary policy try to push the needle even closer towards the rev limiter?

In the next 20 minutes, I will explore these options in turn, starting with the engine overhaul, that is, with structural reforms.

2. EMU's growth engine

The European Commission estimated in 2013[1] that the euro-area medium-term growth prospects – in other words, the growth rate in the next ten years without any additional reforms – is only 1%. These figures would hardly earn you a place in the heart of a young Top Trumps enthusiast.

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[1] European Commission (2013), "The euro area's growth prospects over the coming decade", Quarterly Report on the Euro Area 12(4).

What's more, one might argue that a lot of potential in terms of structural reform has already been unlocked, especially in the countries worst hit by the crisis.

And indeed, much has been done to correct the macroeconomic imbalances that are at the root of the struggle the euro area is facing. The divergence between prices and wages on the one hand and productivity on the other was the driving factor behind the current account deficits. These deficits had to be financed externally and gave rise to the precarious levels of public and private debt.

Prior to the crisis, current account deficits in Spain stood at 9½%, in Portugal at 12% and in Greece at a remarkable 14½%. When markets refused to continue financing the deficits at longer-term bearable interest rates, the gap had to be closed. The financial support provided under the rescue mechanisms and our common monetary policy have smoothed the adjustments – without these measures, the adjustments would have been far more abrupt.

Still, adjustment had to happen, and the reforms undertaken so far have facilitated these adjustments. Wage negotiations, for example, have been decentralised and wage indexation has been abolished or reduced – Spain is a case in point. This makes it possible for wages to take the specific situation of each firm into account and to make firms more flexible in their response to economic shocks. As a consequence, unit labour costs have gone down by 18% in Ireland, 5% in Spain, 4% in Greece, and 1½% in Portugal.

Prices and wages have been brought more into line with productivity. This will allow all crisis countries except Greece and Cyprus to switch external deficits into surpluses in 2015. As a result of the ongoing restoration of competitiveness, the euro area has now been placed on a sounder footing.

But while competitiveness is necessary for growth, it is in itself not enough. Ultimately, growth hinges on productivity. This is where we now have to redouble our efforts. Not doing so would mean "taking the pain but missing out on the gain", as Benoît Cœuré has aptly put it. The structural reforms that are now needed are the ones that unleash innovation and propel productivity.

We also need them now because these are the reforms that can credibly raise expectations of a higher income in the future. And if income is expected to be higher tomorrow, investments will be made today. Reforms that increase supply will thus support demand as well.

The willingness to invest depends on capacity utilisation, which is recovering gradually in the euro area, the level of funding costs, which is low due to the ultra-loose monetary policy, and predominantly on expectations about future growth. Without profitable investment projects, lowering funding cost will not go very far in stimulating the economy.

Hence, the key question is: what actions are required to brighten the euro area's growth prospects? Structural reforms are mostly grouped into product market and labour market reform. In both areas, there are still many gains to be reaped. Progress in these areas would strengthen productivity by making it easier to shift production factors to areas of higher yield. And by the same token, it would improve countries' ability to adjust to unforeseen economic events and structural shifts like digitalisation in the future.

2.1 Product market reform

To paraphrase Tolstoy: when it comes to productivity, every unhappy country is unhappy in its own way. There is therefore no "one size fits all" approach best suited to increase productivity everywhere. Some countries need a greater focus on product market reforms, while others need additional efforts regarding labour market reforms or cleaning up bank balance sheets. And countries like Greece are also in urgent need of administrative reforms.

Nevertheless, I will try to make some suggestions. My list is by no means exhaustive, but perhaps it can serve as food for thought in the discussion to follow.

Let me start with product market reform. A bigger market makes it more attractive for any potential entrant to compete in it. And more intense competition spurs innovation. In the long run, innovation as a result of increased competition is the main reason why market integration raises welfare.[2, 3]

But for newcomers to be able to challenge incumbents, they must not trip over red tape. Unfortunately, bureaucratic barriers to setting up a business are still high in many European countries – not least in Germany, which ranks 107th in the World Bank's Doing Business report in this regard – interestingly, a rank it shares with Antigua and Barbuda. This implies a considerable distance to the frontier of best practice. In New Zealand, for example, establishing an enterprise only takes a single official contact.

How large is the impact of barriers to entry on the overall economy? Research suggests it is quite large indeed. Raising entry costs from very low levels such as those observed in Denmark, for example, to moderate levels like those in Spain might reduce per capita GDP and total factor productivity by up to 10%.[4]

And the small differences in the administrative cost of entry between Europe and the US seem to explain 10 to 20% of Europe's lag vis-à-vis the US with regard to total factor productivity and the capital-output ratio – even though such quantitative estimates always have to be taken with a pinch of salt.[5]

2.2 Labour markets and productivity

Barriers to market entry can exert a powerful drag on productivity. But there are other factors in play as well. On average, bigger firms tend to be more productive and are better placed to compete in export markets. Unfortunately, the growth of small, innovative companies is hindered in some European countries by a plethora of regulations that kick in at a certain size threshold.

In France, for instance, many regulations become binding when a firm reaches a size of 50 employees. This causes some firms which would otherwise expand to stay below that level. Research[6] suggests that this distortion might lead to a loss of 4–5% of French GDP.

Size-contingent regulations exist also in other countries especially in Portugal or Italy. What these regulations all have in common is that they deter firms from expanding. In other words, they are a drag on growth.

By the same token, tearing down the still existing barriers to a common services market and a common digital market in Europe holds the promise of doubling the gains achieved by integrating goods markets.[7, 8]

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[2] Badinger, H (2005), "Growth Effects of Economic Integration: Evidence from the EU Member States", Review of World Economics 141, 50–78.

[3] Boltho, A and Eichengreen, B (2008), "The Economic Impact of European Integration", CEPR Discussion Paper No 6820.

[4] Barseghyan, L (2008), "Entry Costs and Cross-Country Differences in Productivity and Output", Journal of Economic Growth, 13(2):145–167.

[5] Poschke, M (2010), "The Regulation of Entry and Aggregate Productivity", Economic Journal, Royal Economic Society, vol 120(549), pages 1175–1200, December.

[6] Garicano, L, Lelarge C and Van Reenen, J (2013), "Firm Size Distortions and the Productivity Distribution: Evidence from France", CEPR Discussion Paper 9495.De Bruijn, R, Kox, H and Lejour, A (2008), "Economic benefits of an Integrated.

[7] "European Market for Services", Journal of Policy Modeling 30, 301–319.

[8] Copenhagen Economics (2010), The Economic Impact of a European Digital Single Market, Final Report.

In Germany, for example, this could imply an additional 400,000 jobs over the period 2015 to 2020.

But reforms at the European level alone will not suffice to master Germany's looming challenge – its demography. To counter the dampening effects of the demographic development, we have to boost employment by increasing labour force participation, by allowing for labour market-oriented immigration, and by improving the integration of long-term unemployed.

The immigration of refugees can also provide opportunities for growth in Germany over the medium term. To seize these opportunities, however, requires decisive policy action – among other things, mainly efforts to ensure labour market integration. That means language courses, improving school education, and vocational training.

But we should be realistic and not create undue expectations. Experience suggests that integrating refugees into the labour market will take time. In the end, immigration can alleviate our demographic challenge, but it cannot solve it completely.

3. Bank leverage

As we have seen, the euro-area growth engine can still be tweaked in quite a few ways. But what about reducing rolling resistance by reflating the tyres, for example by turning back the clock on regulatory reforms to allow for more leverage?

Regulation is a Goldilocks issue. It appears that there is – like the tyre pressure – such a thing as an optimal degree of regulation. Regulation below that level, as in the pre-crisis era, greatly increases vulnerability, without doing much in terms of sustainable growth. If regulation goes too far, however, viable firms might not get the funding they need.

I would argue that the deleveraging process that has taken place so far in the euro area has largely remained within the safety zone.

Sufficient capital buffers are crucial – and for large international banks they will have to increase further with the recently adopted requirements for bail-in-capital (TLAC) – but so is regulatory certainty, which is why I am in favour of bringing Basel III into full effect next year rather than conveying the impression that regulators are already working on a possible Basel IV.

Equity is costly, which is why exceedingly high capital requirements might unduly curtail bank lending. But equity is costly partly because of the preferential tax treatment of debt, which is why I am in favour of doing away with it.

Furthermore, the recent credit developments do not suggest that the new capital requirements constrict lending on a lasting basis. Since last autumn, lending to non-financial corporations has recovered perceptibly in the euro area. And Bundesbank research[9] suggests that the factors that hamper credit developments for example in Spain and Italy, such as the private sector's attempts to reduce its debt overhang and the high levels of non-performing loans in banks' balance sheets, have abated markedly.

Of course, this recovery is also partly due to monetary policy measures like the TLTROs, which specifically target credit provision.

4. Fiscal policy

If increasing the air pressure of the tyres beyond that optimal level would be a dangerous proposition, what about eschewing fiscal consolidation? Is this a viable option for providing a boost? To anticipate the answer: no, it is not.

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9 Bundesbank Monthly Report, September 2015.

A number of euro-area countries have consolidated their budgets since the outbreak of the sovereign debt crisis. Critics such as Paul Krugman and Joseph Stiglitz have charged that this consolidation has caused more harm than good, as spending cuts and tax increases served to dampen already weakened aggregate demand even further.

Consequently, they are calling for a loosening of the euro-area fiscal stance. But for many countries without fiscal space, that is simply not an option if we do not want to return to the days of 2011 and 2012, when doubts about the sustainability of fiscal policy led to very high interest rates in some euro-area countries. This leaves the countries with fiscal space to raise spending, Germany among them.

However, the periphery's share of German imports is very low, which suggests that spillovers would remain modest – all the more as the import content of public expenditure is especially small.

What is more, incurring additional debt in one member state to stimulate demand in another is a level of fiscal coordination beyond what is provided for in the current institutional framework of the monetary union.

To put it bluntly: this request by some countries would not be consistent with the insistence of the same member states to decide nationally on their budgets – which even goes so far as to reject the mutually agreed obligation stemming from the Stability and Growth Pact.

As debt totals more than €2 trillion and demographic challenges will continue to loom large, Germany should use the opportunity of low interest rates to reduce the debt burden. In that light, pursuing slight budget surpluses makes perfect sense. This holds also because safety margins vis-à-vis deficit ceilings help to buffer unexpected fiscal shocks as we see now, for instance, with the migration inflow.

Germany's future challenges, however, make some changes in fiscal policy advisable. Where Germany's growth potential is concerned, there is consensus that higher public investment does have a role to play.

The size of the investment gap, however, is probably more difficult to gauge. National definitions of public investment differ, which is just one reason why a European average is a flawed benchmark. In the end, it is important that all investment measures are judged on a case-by-case basis, as we have seen in the past that not all public investment measures were money well spent.

And we should focus on shifting priorities in public expenditures. In Germany, for instance, there is no need for a debt-financed fiscal stimulus, as the economy already shows a high level of capacity utilisation. But there is a need for a structural shift of government expenditures from consumption to investment in infrastructure and education. Reforming the financial arrangements among the federal level, the states, and the municipality level could encourage that shift.

5. Monetary policy

Ladies and gentlemen

While monetary policymakers obviously care about real economic developments, the recommended speed they try to maintain is a nominal variable: inflation.

And there's no denying that the clock shows we are currently running below target.

The question is this. How should the Eurosystem act in this situation? Inflation rates in the euro area have been significantly below our definition of price stability for some time now, that is, a level of below but close to 2%. And it is expected that inflation will return only slowly to that level.

An excessively prolonged period of low inflation is clearly not without consequence. It could place a strain on the sustainability of private and public debt in some countries and complicate the economic adjustment process for countries which have lost competitiveness.

And if interest rates are near the lower bound, lower inflation might translate into a tighter monetary policy stance than warranted, in particular if longer-term inflation expectations are affected.

But that is not the end of the story. What also matters is the nature of the inflation shock. At the moment, the sharp fall in energy prices is what is mainly driving the low rates. This drop has pushed down headline inflation by about one percentage point. Correspondingly, the core inflation rate stands at 1% and should gradually increase towards our definition of price stability, which is – let me remind you – a medium-term concept.

Crucially, the decline in oil prices is more of an economic stimulus for the euro area than a harbinger of deflation.

Lower oil prices reduce energy bills for both households and firms. That frees up financial resources which can then be put to use elsewhere – for consumption, investment or for reducing the debt overhang. All of this is good for the economies of the euro-area countries.

At the same time, it seems that the downward risks stemming from international developments have increased somewhat. And uncertainty has risen more generally, as massive migration flows will also leave their mark on the economy. But while the quantitative effects of migration are hard to estimate precisely, it is safe to say that their impact on GDP will be rather stimulative over the projection horizon.

All things combined, I see no reason to talk down the economic outlook and paint a gloomy picture. Rather – and despite all this uncertainty – our forecasts were not far off the mark.

In the end, we should also not forget that the monetary policy measures already taken still need time to fully feed into the economy.

And we need to be aware that the longer we stay in ultra-loose monetary policy mode, the less effective this policy will become and the more the attendant risks and side-effects will come into play – take the exuberance in some financial markets and the problems faced by life insurers as examples. And we should not ignore the risk that fiscal policy could get used to the very low interest rates – leading to a situation in which consolidation efforts peter out and where monetary policy might come under pressure from governments to continue accommodation even if monetary tightening were called for.

6. Conclusion

Ladies and gentlemen, let me conclude.

While growth has recovered somewhat from the fallout of the crisis, it is still less than impressive. But the way to higher growth does not lead through cosmetic changes and quick fixes. We will only get there if we tear down the still existing barriers to product, services, digital, and labour markets and include those who are currently sitting on the economic sidelines. And even then, we might not completely reach the speed of pre-crisis years, as those were driven by unsustainable growth in leverage.

If the euro area is to be converted back into a sleek sports car that turns heads in the street, a lot of engineers still have a lot of work cut out for them.

Thank you for your attention.