Ernst Welteke: The Bundesbank's view on the world economy

Speech by Mr Ernst Welteke, President of the Deutsche Bundesbank, at the Annual Members' Dinner of the Financial Services Industry Association in Dublin, on 4 September 2001.

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I

Ladies and gentlemen!

For a true European Dublin today is a great place to be. Ireland has shown the most spectacular catching-up process in the EU. It is all the more impressive as Ireland lies geographically on the edge of the EU. The favourable starting conditions created by the advent of the common currency framework were helpful in this respect. Economic and political convergence make for an ever-stronger economic entity in Europe.

Great challenges are ahead for us. We are on the eve of the physical introduction of the single European currency. And we are in the process of negotiating the access of new EU members, most of them much less wealthy than the current member states.

The euro area is the second-largest economy in the world. Right now, we find ourselves in an environment of slowing global growth. Increasingly, the global markets have brought the strains in the world economy to our doorstep, faster and with more thrust than at first expected. We do not blame the markets, though. On the contrary, we are glad to see the financial markets in Europe evolving rapidly. In this regard, the euro is important. The single currency both facilitates and accelerates integration. And with the financial markets becoming ever-more complicated, financial supervisors are faced with a challenge. In Ireland, as well as in Germany, a debate on how best to design prudential supervision is taking place.

II

Ladies and gentlemen!

The development of the Irish economy is indeed impressive. Most of the catching-up took place in the second half of the 1990s. Since 1994, Ireland has been the fastest-growing country in the European Union with an average real growth rate of eight percent a year. More than half of the growth occurred due to an increase in capital and labour inputs. Employment growth was the highest in the EU. The unemployment rate has fallen by nearly ten percentage points during this period. With employment conditions being that favourable, Ireland now sees net immigration.

Ireland is the only EU country that has consistently seen double-digit growth in private investment since 1994. Productivity has thus risen faster than in most EU countries. Ireland is now among the most productive countries in the EU. Last year, GDP per worker was 15 percent above the EU average.

Foreign direct investment has been important in financing the Irish boom. Inward direct investment nearly tripled between 1998 and 2000. The major part originated outside the EU; the US alone contributed three-quarters. Ireland is now a favourite location for enterprises trying to gain a foothold in the EU.

These impressive developments have improved living standards considerably, GDP per capita in Ireland is 117 per cent of the EU average. As productivity increases, however, the need for subsidisation should decrease in step. The Irish boom owes much to funds allocated by the European Union. For the period 2000-2006, Ireland will be granted a total of 4.2 billion euros via both the Structural Funds and the Cohesion Fund. Well, I just mentioned this fact to complete the picture.

The flip side of the impressive catching-up process in Europe can be seen in what is recognised as a lack of economic convergence. And, most often in view of the national inflation rate, Ireland is being cited as an example.

Well, then, what exactly is meant by “convergence”? The term is one with many facets. The Treaty of Maastricht set out to measure *nominal* convergence. You remember the fiscal and monetary criteria: inflation rate, capital-market rates, sustainable fiscal policy and exchange-rate stability.

The Maastricht criteria were subject to heated debate in academia, as well as in policy circles. By no means are they mere history. On the contrary, they are very much alive. They are to be applied when further countries join the euro-currency area, be it the pre-ins like the UK or the accession countries.

The Maastricht criteria, however, are in a way both “stability criteria” and “convergence criteria”. They ensure that a country is not pursuing policies that might impinge adversely on the stability of the common currency. In the longer run, such stability must be built on economic integration. An extensive body of theory has evolved on the characteristics of optimum currency areas. Central criteria are flexibility for wages and prices as well as mobility for goods, labour and capital. Most of these criteria call for a high degree of *structural* convergence. Market integration is crucial in this respect.

Under the common currency framework, market integration is deepening. It is already well advanced in trade in goods and services, and in financial markets. The labour market is lagging somewhat behind. In this respect, Ireland looks like being in a somewhat difficult situation. Labour mobility is hampered by being an island on the edge of the common currency area. Furthermore, Ireland’s neighbour and most important trading partner, the UK, has not yet joined the euro.

Apart from structural and nominal convergence, there is *real* convergence - a term I use here in the sense of synchronicity of business cycles. Real convergence is of importance in a currency union, because all the countries in the union are subject to the single monetary policy. The Governing Council of the European Central Bank designs monetary policy to fit the euro area as a whole. A country whose business cycle gets completely out of step might therefore suffer from an individually inadequate monetary policy. However, marching in absolute lock-step is not necessary, as can be seen in the US, where certain regions grow faster than others.

During recent years, Ireland has been growing considerably faster than, for example, Germany. The faster growth is due mainly to catching-up, and to the still incomplete synchronicity of the Anglo-Saxon and the continental business cycles. Irish economic growth derived additional impetus from the start of the European Monetary Union. Interest rates in Ireland were effectively cut by three percentage points on January 1, 1999.

That sort of extra stimulus sent real interest rates to a historic low and boosted demand. Fiscal policy, the instrument to cushion such monetary shocks, was tightened. However, with the fiscal surplus being already large, this tightening did not prevent inflation from starting to rise in late 1999.

Considering the facts that led to this situation, does it really indicate a lack of the necessary convergence? I don't think so. A major part of the excess inflation is accounted for by the catching-up, and by the one-off effect of the start of the common monetary policy. As economic and financial integration is going on, the business cycles will grow ever-closer, that is, real convergence will increase further.

III

Ladies and gentlemen, world output grew by 4.7 per cent last year, the highest rate in a decade. That growth rate could not be kept up. Has the world economy now bottomed out? My answer: “We do not know for sure” should come as no surprise to you.

The US economy is still playing the key role in the global economy. It accounts for 22 per cent of world GDP and for 15 percent of world exports. The heavy dependence of NAFTA and some Asian countries on trade with the US proliferates US weakness.

Signals from the US economy continue to be mixed. No direction is clearly visible from the data. The slowdown started with domestic technology investment. Recently, some spillovers have been observed. Consumer demand, up to now the stablest pillar of demand, is advancing more moderately. Inventory correction that set in quickly is now well advanced. A positive contribution to growth may be expected in the near future.

The slowdown opens a window of opportunity to unwind macroeconomic imbalances - both those domestic to the US and international ones - in an orderly manner. In the US, the personal savings rate has started to increase, slightly but steadily, since the fourth quarter of 2000. Slackening domestic demand should help to contain the large current-account deficit. The tech bubble has been deflated.

The labour market is no longer overly tight. The dollar/euro exchange rate may have seen a turnaround; at least the downward trend is broken.

However, the risks are for real. The overconfidence in technology investment in the US may have given rise to over-investment that can be unwound only slowly. In case of a further fall in equity prices the slump in consumer confidence and demand may be prolonged somewhat.

In spite of these risks, I tend to find the prospect of the start of a modest recovery towards the end of this year plausible and encouraging. The macroeconomic easing should show its effects in the second half of 2001. The Fed has brought interest rates down by 300 basis points in seven rate cuts, and a tax cut of about 55 billion dollars is becoming effective this year. The confidence of both businesses and households has strengthened somewhat, and usually this presages a pick-up in growth.

In Japan, the economic situation is broadly unchanged. The banking crisis still weighs on the economy, a marked revival of economic activity is still not in sight, nor is it being predicted for the near future. Unfortunately, macroeconomic policy has very little leeway left for providing further stimuli. Structural reforms could - as in the euro area - be of considerable help in accelerating potential growth.

In the wake of slower global growth, the euro-area economy has lost some of its previous dynamism. World trade is no longer growing at double-digit rates. Caution in investment, as well as in consumption spending, is being reflected in receding industrial production; the July increase is not yet to be regarded as a firm signal of a turnaround. Furthermore, capacity utilisation is now lower, although still above its long-term average rate. Business confidence has sunk, the previous reduction in unemployment has come to a halt.

The euro-area economy has been hit particularly hard by the oil and food crises. Both led to sharp price increases and put the consumer into a state of uncertainty. The oil price shock caused a negative terms-of-trade effect and major reductions in real disposable income. At this juncture, we see the economy of the euro area having lost momentum, after the vigorous expansion in the year 2000. There are, however, several reasons for feeling confident. The waning food crises will no longer weigh on consumption and this year's tax cuts are to come into effect in some euro-area countries.

The risks are clearly on the investment side. A major part of the reduction in GDP growth during the first quarter - the latest data available - occurred owing to a lower contribution of gross fixed capital formation. Capacity utilisation is still high, and the global outlook does not call for stepping up investment. On the whole, business sentiment, and thus the propensity to invest, hinge on a more optimistic view of the world economy. Financing conditions, however, are favourable in the euro area. Capital markets rates are about the same level as rates in the US.

In an environment of weakening growth the continuation of the consolidation of the public sector's finances is becoming more difficult. In 1997, the European Governments decided to implement the Stability and Growth Pact. They agreed to pursue a policy of eliminating structural deficits. In most euro area countries, this process is well advanced. These countries are in a somewhat favourable position, as they have enough room to manoeuvre to let automatic stabilisers work in full. A minority of countries (Germany, Italy, France and Portugal) - which, however, account for 70 per cent of euro area GDP - still show structural deficits of a considerable extent. Under the present circumstances, therefore, the automatic stabilisers should only be allowed to work fully in those countries whose budget positions are close to balance or in surplus.

Recently, suggestions have been aired to replace targets for the public sector deficit with targets for public expenditure. I am strongly in favour to stick to the tried and tested deficit target. The public sector deficit is the decisive measure for its demands on the financial markets. The deficit is the benchmark for a government's stability-orientation.

Last Thursday, the Governing Council of the ECB decided to lower its key interest rates by 25 basis points. We considered that the available evidence points to an improvement in the outlook for price developments. With regard to the first pillar of the monetary policy strategy, the three-month average of the annual growth rate of M3 was 5.9 per cent. However, this figure needs to be corrected for some holdings which do not necessarily have implications for price stability in the medium term.

Regarding the second pillar, there are clear signs of lower inflationary pressures from the demand side. Lower growth expectations, a strengthening exchange rate, the downward trend of the growth of consumer and producer prices lead to the expectation that price stability will be restored in the not too distant future. Overall, as several indicators are pointing to an abatement of inflationary pressures, the

new level of interest rates is compatible with the maintenance of price stability over the medium term, which, in turn, is essential to create a favourable environment for sustainable economic growth.

IV

The evolution of the slowdown in the US highlights how important and how effective financial markets are. The speed at which the slowdown spread around the world underlines this importance.

Changes in investment and in financing habits have altered the international links between the business cycles. For the first time since the mid-seventies oil crisis, the G-7 countries are slowing in step. Evidence is piling up that this synchronicity is more than sheer chance.

Financial markets seem to more and more replace trade in goods and services as the *major* transmission channel for economic developments. The reasoning runs as follows:

Financial market prices react immediately, once new information becomes available. So financial markets reflect developments in, and expectations for, the real economy very quickly. Modern information and communication technologies are of help. Any investor anywhere in the world can in no time update his view of - let’s say - the correctness of the markets' expectations as to the future path of ECB interest-rate policy. If his opinion differs from the markets’, that is, if he perceives opportunities for arbitrage, he will rearrange his portfolio.

What is new about this process - besides technology? International portfolio diversification is no longer a privilege of institutional investors. Today, nearly everybody’s portfolio is internationally diversified. International portfolio diversification may occur in its direct form, for example, in holding shares in companies located in different countries. It may otherwise come in its indirect form: foreign direct investment. More and more often, companies substitute foreign direct investment for international trade. FDI flows are growing fast.

The financial sphere in Europe has changed tremendously. We now have a common currency in the euro area. Currency risk has been eliminated. Financial markets are integrating faster than ever. They have become, and are still becoming, broader and deeper. Breadth and liquidity of financial markets, however, favour a capital-market-oriented financial system of Anglo-Saxon type. And disintermediation, in turn, fosters the breadth of capital markets. The broader and more liquid financial markets are, the more attractive they are to international investors. Thus, the euro is one of the forces working towards ever-closer financial links between national economies.

Ever closer financial integration has times and again provoked calls to “throw sand in the wheels of the foreign exchange market”. A ”Tobin tax” on short-term currency transactions was proposed to bar excessive currency speculation. Such a tax would clearly lower transaction volume in international currency markets. However, it would come at too high a cost. Foreign trade in goods and services is bound to suffer as well. In the end, the wealth-enhancing international division of labour will be hampered. Furthermore, in times of distress, a Tobin tax is not effective. Expected returns on speculative capital movements during a crisis by far outweigh the costs of any sensible transaction tax. The Tobin tax simply cannot make up for a loss of confidence.

On a worldwide scale, financial links are gaining in importance. Internationally, business cycles are growing closer. That is why Europe was relatively quickly affected by the US downturn, although our starting point was quite different from theirs. Although growth in Europe was vigorous, too, overheating was not an issue with us.

V

The financial services industry is very dynamic not only, but especially, in Ireland. Sophisticated new products, new technologies, new channels of delivery and new forms of cooperation among hitherto separate lines of business pose new risks.

As the financial world evolves, financial supervision faces new challenges. “Basle II” is one instrument for financial supervisors to take these new risks into account. The three pillar approach seeks to bring required minimum capital more into line with economic risk. Second, it brings banks’ risk profiles and their ability for risk management closer into the focus of financial supervisors. And, third, enhanced disclosure will bring about more transparency and even will integrate financial markets into financial supervision.

It is no accident that new models of financial supervision are being put into practice in several countries. Ireland has decided on a new model, and Germany is also in the process of devising a new institutional structure for its supervisory authorities. In both our countries, the role of the central bank in the supervisory task is affected.

In March, the ECB published its views on the role of central banks in prudential supervision. The ECB argued in favour of a strong involvement of central banks. That view is well-founded. In all major industrial countries, the responsibility for the stability of the financial system is assigned to the central bank. Macro- and microprudential analyses, however, are intertwined. If you want to assess the risks to the system, you need to know about the players. If you want to assess individual risks, you need to know about their exposure to systemic risk.

Central banks are required to oversee the smooth functioning of payment systems, another source of systemic risk. During the conduct of monetary policy, central banks collect information which is of use in the supervision of individual financial institutions. Interlinking central bank functions and prudential supervision takes advantage of these synergies.

In Germany, the envisaged reform of financial supervision is linked to the reform of the Bundesbank. In its statement on the planned reform of the Deutsche Bundesbank, the ECB made it clear how valuable the independence of a central bank is - institutional independence, personal independence and financial independence alike. The Maastricht Treaty set out to protect central bank independence in all three regards. Article 108 of the Treaty explicitly protects both the independence of the ECB and the independence of all the national central banks within the ESCB. Any central bank reform at the national level must likewise respect such independence.

VI

Ladies and Gentlemen!

Today, financial integration is one of the distinctive features of the world economy. Ireland has been in a position to exploit this development to its advantage. The catching-up has indeed been impressive, and is encouraging in view of the upcoming eastward enlargement of the European Union.

Recent developments suggest that business cycles are linked more closely in a world of deeper financial integration. For the eurozone, this is particularly good news, as it facilitates the conduct of the single monetary policy. The ESCB has been successful in pursuing a stability-oriented monetary policy. Its strategy and recent monetary policy decisions will contribute to more growth and stability in Europe.

In 118 days the physical introduction of the euro will bring the single European currency to completion. In Ireland you will then use the same notes and coins as will people in Greece. This is globalisation on a European scale. As economic and political integration deepens, Europe can, Europe wishes to and Europe will increasingly assume responsibility on a global scale.