Jürgen Stark: Economic perspectives in the euro area and Germany

Lecture by Dr Jürgen Stark, Vice President of the Deutsche Bundesbank, at the dinner with The Money Marketeers, New York, 25 February 2004.

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I

It is an honour and a pleasure to have the privilege of addressing you here today on the economic perspectives for Germany and the euro area as a whole.

As a central banker, I prefer not to focus on the change in the latest monthly sentiment indicators and on quarterly growth figures, but rather on longer-term issues which are essential for a stability-oriented monetary policy, for potential growth and for an economy's resilience to shocks. I shall also be highlighting some differences and similarities between economic fundamentals in Europe and the United States.

European economic and monetary union (EMU) is now in its sixth year with the euro as its single currency. These years have been fairly demanding but despite a number of sizeable adverse shocks, the Eurosystem, which consists of the European Central Bank and the euro area national central banks, has managed to deliver a credible monetary policy stance.

In the run-up to EMU and at its outset, many sceptics queried the feasibility of an "one-size-fits-all" monetary policy with a decentralised but closely coordinated economic and budgetary policy. The area was seen as too heterogeneous for such a demanding regime.

Such criticism has become less vociferous recently due to the monetary policy track record, which proves that the credibility test has been passed so far. Average inflation has been close to 2% and long-term inflation expectations have been well contained, being close to and mostly below our ESCB definition of price stability of below 2%.

The growth performance of Germany and the euro area as a whole has been less encouraging. However, after three years of sluggish growth, the region is finally showing increasing signs of a moderate cyclical economic recovery.

The underlying conditions for strengthened economic growth remain favourable. Financing conditions are generally supportive, with low nominal and real interest rates. The restructuring of corporate balance sheets, particularly in Germany, has made considerable progress. Robust growth in our major trading partners is also aiding the economic recovery process.

The favourable impact of world trade and world growth dynamics are more important for our exports than the recent decline in price competitiveness caused by the appreciation of the euro. The debate on the potential adverse effects of a stronger euro should not distract us from the real underlying obstacles to growth in Europe.

I would not be sketching a full picture of the economic outlook if I failed to mention the risks to the broadening global recovery. Four factors, in particular, have to be watched carefully.

Firstly, global imbalances, especially the persistent US current account deficit. According to the OECD, it is likely to surpass US$600 billion in 2005, which is equivalent to more than 5% of GDP. The deficit is growing both in dollar terms and relative to the size of the economy. What does that mean? Why was it not an issue years ago and why is it an issue now?

Basically, the answer to those questions is that the source and the financing of the deficit have shifted from the private to the public sector. From an US perspective that is not a problem as long as foreigners are willing to continue supplying their savings. But the composition of external financing is becoming unbalanced and, to a growing extent, it is relying on foreign central bank purchases of US Treasuries. The willingness of overseas investors to hold an ever-growing dollar-denominated portfolio is obviously something which cannot go on for ever.

Secondly, protectionist pressure. When Alan Greenspan spoke about globalisation last month at the Bundesbank Lecture 2004 in Berlin, he reminded us of the virtue of open markets. He stated: "it is

imperative that creeping protectionism be thwarted and reversed".[1] This insight comes as no surprise to an economist, but it is a message which is easily forgotten. Unfortunately, that is something which holds true on both sides of the Atlantic. Withstanding archaic reflex responses of emerging protectionism is sometimes a quixotic experience. But we should never forget that open markets and free trade in a multilateral world are key to prosperity - on both sides of the Atlantic.

Thirdly, large fiscal deficits in all major economic regions and increasing debt-to-GDP ratios. It cannot be ruled out that this worldwide deterioration of fiscal positions will sooner or later lead to market reactions. An appreciable rise in interest rates has to be expected when investors begin to doubt the longer-term sustainability of public finances.

Finally, ample liquidity. That is to say the gap on a global scale between real money growth and real GDP growth. This excess liquidity nurtures the risk appetite of investors. The search for yield has led to a considerable narrowing of corporate bond and emerging market sovereign spreads. If excess liquidity is not mopped up at some point in time, it will find its way through in terms of pushing up inflation or in feeding new asset price bubbles which could be costly to unwind.

II

The global economic recovery is at present mainly driven by two centres of gravity: the US economy and emerging Asia. The euro area is lagging behind. Why has growth performance in the euro area and Germany been so sluggish during the past few years?

Growth differentials between the United States and the euro area are for the most part a non-cyclical phenomenon. For instance, the estimates of overall production potential differ significantly.

The US experience might hold important policy lessons in this regard and we have had quite a lively debate in Europe about the need to become more like the United States. In a nutshell: this is about the contest between the pros and cons of the Anglo-American free market model and the European model of social cohesion. I shall try to remedy certain misunderstandings or misperceptions that arise when country-specific factors are compared.

The latest growth figures for the United States are impressive. However, when thinking in terms of prosperity developments, it is necessary to apply a per capita assessment. A country with a fast-growing population needs to generate a greater increase in real income than a country with a less rapidly expanding population if it wishes to maintain or even increase the prosperity of its citizens.

The euro area's annual population growth between 1996 and 2003 was about ¼% (in Germany about 0.1%), whereas the US population grew by an average of about 1% owing to its higher birth rate and a sizeable influx of immigrants. Thus, the annual real GDP change of 2.0% in the euro area (1.2% in Germany) and 3.3% in the US in per capita terms was 1.7% in the euro area (1.1% in Germany) and 2.2% in the US. The per capita growth differential is therefore "only" roughly one-third of the overall figure, which could be narrowed down further if methodological differences regarding the measurement of deflation and depreciation were to be incorporated.

The smaller per capita difference by no means justifies complacency. However, it is a better reflection of the improvement that has been achieved in the standard of living. It still shows that the per capita growth gap between the USA and Europe is growing and not converging. And one also has to take into consideration the fact that the United States is already at a considerably higher level. In 2002, GDP per capita on the basis of purchasing power parities was one-third larger in the United States than in the euro area.

What are the main elements behind these developments? Lower GDP per capita means lower national living standards. Economic well-being is largely determined by productivity. Looking at labour productivity, it is striking that the factor labour is not very efficiently incorporated into the production process in Europe.

The labour force participation rate in the euro area - that is the members of the workforce in relation to the population of working age - is about 68% and more than 8 percentage points lower than in the United States.

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[1] Alan Greenspan (2004), Remarks before the Bundesbank Lecture 2004, Berlin.

Labour utilisation in Europe and Germany has declined significantly, mainly due to three factors.

1. The preference for shorter working weeks and longer holidays. Working hours per person employed during the last 25 years have remained virtually unchanged at around 1,800 hours per year in the United States, whereas in Germany, the average number of hours that employees work is now around 1,450 hours, which is 15% lower than 25 years ago.
2. Withdrawals from the labour force, including high participation in early retirement schemes since the early 1980s. The average retirement age at present in Germany and France is about 59 years.
3. The rise in unemployment, since the late 1970s up to 8.8% of the labour force.

An interim conclusion may be drawn from this: the once popular European belief that the distribution of a presumably fixed amount of labour would lead to greater work opportunities has not become a reality. On the contrary, it has led to higher non-wage labour costs and higher taxes, which have become an impediment to economic growth and job creation.

Labour productivity per hour worked is at present about the same in the United States and in Germany. However, since the mid-1990s, increases in hourly productivity have been lower than in the United States. According to an OECD study,[2] the main factors behind this have been a smaller-scale use and slower diffusion of information and communication technologies (ICT) and less intensive research and development. Other factors that play a role are institutional differences such as labour market rigidities and the relatively entangled web of regulations.

Taken together, this has resulted in a hard core of structural unemployment. In particular, Europe has been less successful than the United States in integrating "marginal" or less productive members of the labour force into the economic process. A better inclusion of this part of the labour force might transitionally slow down changes in labour productivity, but would still increase overall welfare.

Of course, the available data have to be interpreted with caution. Statistical sources vary and societies have deep-seated structural and cultural differences which make any comparison difficult. Nevertheless, despite all terminological, conceptual and empirical difficulties, cross-country comparisons still remain important indicators for evaluating policy measures.

Last but not least, lower productivity per employee than in the United States is, in part, a reflection of the democratic choice or the preference of European societies for shorter working time, which is, in economic terms, a substitution of consumption opportunities through leisure. However, this should not be interpreted as economic inefficiency. It could also be argued that US workers have had to work longer hours than their euro area colleagues to maintain similar per capita growth rates.

Occasionally, it is suggested that not only material living standards should be considered but also other indicators of welfare, as Robert J. Gordon has done.[3] According to his analysis, the GDP of the United States is bloated due, for instance, to the huge cost of keeping more then two million residents in prison and jail (700 inmates per 100,000 residents, whereas Germany has about 80 inmates per 100,000 residents), the higher primary energy consumption per capita owing to the more extreme climate (energy consumption in Germany per capita is about half as high) and elevated transportation costs on account of the greater dispersion of the US population.

These factors boost GDP without creating more welfare. I am not willing to make a value judgement on these issues. Nevertheless, those factors should be kept at the back of one's mind when comparing developments in GDP.

III

In Germany, three years of an almost stagnating economy have led to the so called "Rhineland model of capitalism" being subjected to more intense scrutiny. This development has not only raised questions about the economy, but also about German society and its political system.

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[2] OECD (2003), ICT and Economic Growth: Evidence from OECD Countries, Industries and Firms, Paris.

[3] Robert J. Gordon (2002), Two Centuries of Economic Growth: Chasing the American Frontier, Northwestern University.

The late Rudi Dornbusch once described Germany as an economy with two faces.[4] On the one hand, an immensely successful country, prosperous and stable, with among the highest living standards in the world. On the other hand, a country that is plain stuck with mass unemployment, slow growth, with no idea of what to do about it and even less courage to try. I don't believe that the last two criticisms still hold true.

Less than a year ago, the situation had become so serious that the Bundesbank felt impelled to take an unusual step for a central bank in publishing a reform strategy based on a thorough analysis. To overcome the prevailing crisis of confidence, we called for a coherent overall approach to structural reform in the labour market, the social security system and fiscal policy.

The momentum for reform is almost tangible. The government has already started to implement a number of important measures of its Agenda 2010. This is designed to increase, over time, the growth potential of the German economy and includes

- labour market
- pension system and
- health care

reforms. The objective is a more flexible economy and to bring the social security system more in line with economic capacity.

It is imperative that corrective measures be implemented in a timely manner. Unfortunately, experience shows that in the political sphere often more than 20 years pass by between awareness of social and economic challenges and their being addressed. Not to mention the difficulties in gaining popular support for or mere acceptance of structural changes.

However, policy must not be confined to the "art of the possible". Policy is also the art of making possible that which is necessary.

The general public is beginning to realise that the deep-seated German proclivity for consensus does not work in an environment of low growth rates. Much remains to be done and it is crucial that this impetus does not falter.

The structure of Germany's constitution with its different layers of checks and balances makes it difficult to obtain the large parliamentary majorities needed for implementing daunting reforms. This pronounced decentralised system is firmly rooted in German history. It did not hamper the enormous economic upswing in the second half of the last century, but it has encountered difficulties in coping with the changes that have become necessary owing to reunification, European integration, globalisation and demographic challenges.

IV

Structural change is possible in Europe. The most convincing recent example is European economic and monetary union. The creation of a single European currency was the most far-reaching and challenging monetary event to take place since the Bretton Woods conference in 1944 and the changeover to flexible exchange rates in the early 1970s. The true dimensions of this political project are often underestimated. The same is true of the economic benefits that will materialise over time.

A monetary union has to be grounded in shared values. The basis of those shared values is the definition of the member states' economic policies enshrined in the Maastricht Treaty as the principle of an open market economy with free competition.

However, another fundamental policy decision was also necessary for the introduction of a single currency, namely the willingness to transfer national monetary sovereignty to a supranational institution. The concomitant renunciation of sovereignty signified a profound break with the historical and political self-perception of the EU member states.

European economic and monetary union was possible only against a backdrop of shared traditions, a decades-long process of integration and successful convergence in the 1990s. The opportunity to

[4] Rudi Dornbusch (2000), Keys to Prosperity, MIT.

create a single European currency unleashed great energies in the EU member states. In that process of convergence, inflation rates, interest rates and government debts were reduced to the benefit of the participating economies.

Given reliable underlying economic policy conditions, exchange rate relationships on the foreign exchange markets within Europe were able to stabilise. Those countries which used to have weak currencies gained especially from this since their risk premium on capital market rates decreased appreciably.

Overall, economic and financial policy has become more geared to the medium term and more predictable as a result. Essentially, this means that the member states have said goodbye to the stop-and-go policy that often used to be pursued.

Despite differing economic policy standpoints and traditions, it was possible to develop and put in place a joint stability-oriented strategy for economic and monetary union. That would not have been possible without political courage and the will to shape events.

At this juncture, let me introduce another institutional pillar of European monetary union: the Stability and Growth Pact, which aims to limit the risks to price stability which might otherwise arise from national "free rider" fiscal policies.

From a macroeconomic stabilisation perspective, the central budget of the European Union, at roughly 1% of EU GDP, is insignificant in Europe. The crucial stabilising role compared with the US government expenditure of 34% is played by the national budgets of the member countries, whose general government expenditure accounts for 48% of euro area GDP.

That is one reason why EMU needs a counterweight to the politico-economic incentives to borrow without being penalised adequately by financial markets in terms of a higher interest rate premium as compensation for the national inflation and depreciation risk. The Stability and Growth Pact is therefore also an insurance policy for countries which adhere to sound fiscal policies.

This framework for fiscal discipline makes long-run sustainability of public finance and short-term stabilisation compatible. The objective is to achieve a medium-term budgetary position close to balance or in surplus. An additional rationale for the Stability and Growth Pact is the urgent need to take account of the unfavourable demographic trends in Europe. Such a trend exists in the United States as well, but is less pronounced. By 2050 the share of elderly people (≥65 years) in the population will have gone up from 12% to 21% in the United States and from 16% to 28% in the EU.

Within the fiscal framework of the Stability and Growth Pact, the automatic stabilisers are allowed to operate freely as long as the upper ceiling of the 3% deficit is not endangered. The higher general government ratio in Europe and the structure of social transfer payments make the automatic stabilisers twice as effective as in the United States. As a result, discretionary fiscal policy and all its well-known pro-cyclical drawbacks are less of an issue.

However, some governments' degree of commitment to the rules and procedures of the Stability and Growth Pact has not been encouraging recently. The credibility of the framework has been cast into doubt. This development is jeopardising confidence in the sustainability of public finance in the euro area. European and especially German consumers seem to be more Ricardian in nature than American consumers are. That is to say, they have lost confidence in the soundness of public finance and they tend to regard higher deficits today as higher taxes tomorrow, therefore increasing their savings and holding back on consumption.

Occasionally, the monetary policy of the Eurosystem is blamed for the slow growth performance of the euro area. By the same token, it is acknowledged that the ECB is only fulfilling its mandate. Consequently, it is argued that the mandate should be changed and reflect more the goals of the Federal Reserve System. I believe this line of reasoning is rooted in unfamiliarity with fundamentals within the euro area. But let me also raise two important questions.

1. What is the role and focus of monetary policy?
2. What can be achieved through monetary policy?

In answering these questions allow me to make the following points.

Firstly, the primary focus of European monetary policy is on maintaining price stability over the medium term. The clear and straightforward mandate recognises that this is the best contribution that monetary policy can make to an environment conducive to growth and job creation. This mandate is

not in the least outdated. It reflects the limitations of monetary policy and mirrors the latest insights into monetary theory and practical experience.

Secondly, the mandate also reflects historical experience. The hyperinflation that occurred in some European countries, and especially in Germany, in the 1920s left a profound impression on subsequent generations. In the United States, the Great Depression left its mark and is an important factor in explaining why the mandate given by the US Congress to the Federal Reserve consists of the three non-prioritised goals of “maximum employment, stable prices and moderate long-term interest rates”.

Thirdly, the structural differences between continental Europe and the United States, such as the degree of structural flexibility, impact on the transmission mechanisms and the time lags of monetary policy. What I have particularly in mind in this context are differences in the transmission that arise between a more market-based financial system and a more bank-based one, and the fact that changes in short-term interest rates play a far less important role in investment decisions in continental Europe than they do in the United States.

Finally, having said that, we have to bear in mind that monetary policy does not have the appropriate tools to fine-tune the business cycle or to balance deficiencies in other policy areas. At the same time, not too much emphasis should be placed on monetary policy responses to short-term macroeconomic developments or even indicators. Activist policies directed at exploiting short-term trade-offs between prices and economic growth bear the risk of contributing to instability in the medium to longer term.

In the final analysis, all central banks are concerned about price stability. I would not place too much store on statements that inflation may have been eradicated, even if such assertions do come every now and then from well-known economists. Such statements put matters too strongly and are rather heroic in their assumptions. A world in which basic economic relations have ceased to exist is a dangerous promise to make - perhaps comparable to the irrational exuberance surrounding the hype of the “New Economy”.

Low inflation is an experience of recent history. Its track record does not stretch over decades. And - as far as the euro area is concerned - the Eurosystem has responsibility for a region with a more inflation-prone history.

V

Let me summarise the most important lessons.

1. Up to now, monetary policy in the euro area has been successful. Our experience of anchoring inflation expectations reinforces the commitment to the medium-term approach. Greater activism would do more harm than good, especially considering the environment of little structural flexibility.

2. We need to overcome the disappointing weak economic performance in Germany and the euro area as a whole. Let me be clear about this: the economic problems in continental Europe cannot be reduced to monetary policy issues. What is needed is structural reform in member states, including pension reform, health insurance reform and labour market reform. Fortunately, there is a general recognition of the importance of structural flexibility in terms of raising long-term growth potential and increasing resilience to economic shocks. Addressing these issues will rebuild confidence. Even the larger economies are now showing a willingness to tackle structural impediments.

3. Putting fiscal positions back on a sound track and sticking to the fiscal rules of the SGP would help to restore confidence. The credibility of consolidation measures is crucial. Fiscal adjustment should be seen to lead to a permanent increase in future disposable income. Moreover, if appropriately designed, consolidation can raise output and employment in the medium term. Positive results will most likely be produced in the short run if consolidation is combined with structural reforms.

4. The integration of Europe is an ongoing process, which does not always develop as smoothly as might be hoped for. But, eventually, challenges have been met and the groundwork for new challenges such as the enlargement of the EU with ten new member states has been well laid. Nevertheless, all policymakers have to live up to their responsibilities. EMU offers the opportunity for a more dynamic Europe.