Axel A Weber: Germany's economic perspectives and European monetary policy

Speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the annual dinner of the German-British Chamber of Industry & Commerce, London, 14 June 2007.

*   *   *

1 Introduction

Dear Lord Mayor, My Lord, Minister, Dear Sir Nigel, Dear Mr Wood, Dear Mr Hoppe, Ladies and Gentlemen.

First of all, I want to thank you for inviting me to your annual dinner. Being in London is always a pleasure for me, not least because I spent some time here as a visiting fellow at Queen Mary college, the University of London – albeit nearly 20 years ago. For me, coming to London therefore means coming back to a city I know well and of which I have happy memories.

Over the next few minutes, I shall be saying some words on both Germany’s economic situation and on European monetary policy.

2 Germany’s economic situation and prospects

At the outset, let me briefly recall how Germany’s economy has been performing over the past few quarters. In a nutshell: in the course of last year, Germany increasingly began to act as the economic engine of the euro area.

In 2006, German real GDP grew by 3.0% in calendar-adjusted terms, which was the highest rate since 2000. This development stood in stark contrast to 2002-2004, when the German economy put in a dismal performance overall.

And, even in 2005, German real GDP grew by only 0.9%, which was not impressive either. But simply looking at the annual growth rate in 2005 would mean overlooking the positive tendency during the course of that year, with quarterly GDP rates accelerating.

Regarding the current stage of Germany’s upswing, one thing in particular is worth mentioning. In comparison with the beginning of the current upswing, the economic expansion in progress is no longer being driven mainly by external demand in the form of strong exports. In fact, business investment has become the main factor fuelling economic growth at present.

Strong corporate investment, in addition to still buoyant export demand, has been driving Germany’s economic expansion over the past few quarters.

What we have observed so far might be called the “classical pattern” of the German “business cycle chain”, which consists of three elements.

- First, an initial demand stimulus in the form of strong exports.
- Second, as a result of this stimulus, a stepping-up of corporate investment.
- Third: an increase (albeit rather slight up to now) in private consumption.

All in all, Germany’s economic development over the past six quarters or so has exceeded most analysts’ forecasts – including my own, which was already higher than those of many market participants.

Against this favourable backdrop, there arises the question of what has actually been the main reason for the German economy rebounding so strongly, especially given its weak performance at the beginning of this decade.

One crucial element in this success story has been wage moderation. Wage moderation can be seen as the result of a learning process that was set in motion by two factors – the competitiveness problems of major industrial sectors, and stubbornly high rates of unemployment. This process was accompanied by enterprises’ restructuring efforts, which have led to a falling level of corporate debt and a marked decline in the corporate sector’s net interest burden.

Both factors have played a major part in the regaining of German industry's price competitiveness, which explains the resurgence of Germany's economy to a large extent.

Looking into the future, will today's upward dynamics be of a lasting nature? Will Germany's economy be maintaining its strong momentum in the quarters to come?

My answer is probably "yes". I think there are several reasons to be rather optimistic. We are currently experiencing an economic upturn with a favourable outlook.

My positive assessment is based mainly on three likely facts. First: The global economy remains on its strong growth path. According to IMF estimates, in 2007, global economic activity is expected to expand above its long-term average for the fifth year in succession.

German enterprises are well placed to participate fully in this positive development of the global economy. In many countries, there is a large demand for high-quality capital goods, a market segment in which German enterprises have traditionally been strongly represented. Seen in this light, exports are likely to continue generating major stimuli for the upswing in Germany.

Second: With regard to the domestic economy, too, the prospects for a continuation of the upswing are promising. What is particularly important is that business investment is likely to remain a major factor underpinning economic activity. The current high level of utilisation of industrial plant capacity and a considerable need for replacement investment suggest that investment is still clearly on the up. In addition, external financing conditions remain favourable. Moreover, firms' underlying sentiment is also very optimistic, which means that not just the recent hard data, but also soft indicators and the "psychological factor" signal stronger future capital formation.

Third: The marked ongoing improvement in the labour market situation should support the strengthening of private consumption. This means that there is the potential for a self-sustaining upswing in Germany.

Overall, German economic growth has not only gained momentum but has also become more broad-based over recent quarters. Hence, the conditions are in place for the upturn to last for a considerable period of time.

Against this backdrop and not surprisingly, Germany is no longer seen as "the sick man of Europe" as was the case at the beginning of this decade. The UK, too, was once stuck with this rather unpleasant label, even though that was roughly 30 years ago.

During the past ten years, however, the UK has been experiencing sustained economic growth while inflation has remained largely under control. Mervyn King, the Governor of the Bank of England, has frequently referred to this development as the "*nice decade",* a pun in which "*nice*" stands for "<u>n</u>on-<u>i</u>nflationary <u>c</u>onsistently <u>e</u>xpansionary".

Given Germany's disappointing economic performance on average since the mid-1990s, we certainly cannot describe our economic development during this time in a similar manner. While inflation has been contained, economic growth in Germany over the past ten years just cannot be portrayed as constantly expansionary. On the contrary: on average, growth in the UK over the past 10 years has been nearly 2.8% per annum, whereas the German economy has grown, on average, by a mere 1% year on year.

However, when comparing the economies of Germany and the UK, there are two things, besides differences in growth performance, which are particularly striking. First, during the past ten years, the share of Germany's total industry in economic value added has remained quite stable at roughly one-quarter. In the UK, by contrast, total industry's share declined from one-quarter in 1997 to roughly 17 per cent last year, while added value, especially of the service sector, showed a marked increase.

Deindustrialisation is a development which reflects a secular trend among most developed countries. Within this process, the development in the UK so far has been much more pronounced than it has been in Germany.

Second, during the past ten years, domestic demand in the UK has been by far the most important driver of economic growth, while external demand in the form of net exports has played a dampening role. In Germany, the picture is somewhat mixed. However, external demand contributed, on average, much more to economic growth between 2001 and 2005 than domestic demand, which began setting the pace in the course of last year.

Evidently, with regard to major structural features as well as growth drivers, there are substantial differences between the UK and Germany. However, the current economic performance of both countries clearly shows that enhancing growth and job creation is not necessarily the result of only one particular economic pattern. In fact, empirical evidence would seem to suggest that both the British and the German developments can yield favourable results.

Regardless of the differences just mentioned, one feature common to both economies has been that both have enjoyed a stability-oriented monetary policy over the past decade. The fact that the "Old Lady of Threadneedle Street" – the Bank of England – was granted independence ten years ago is certainly among the prominent factors explaining the UK's economic performance during the past decade.

Let me continue with a brief look at European monetary policy.

3 European monetary policy

Last week, the ECB's Governing Council decided to raise the key ECB interest rate by 25 basis points to 4%. This decision was taken in view of the prevailing upside risks to price stability over the medium term.

In brief, the underlying reasons for our decision were the following: incoming information has repeatedly indicated that the euro area is continuing to expand at a pace which is significantly faster than was generally expected one year ago. Looking to the medium-term future, the economic outlook remains favourable, too.

Against the backdrop of supportive external and internal economic conditions, the most recent Eurosystem staff macroeconomic projections foresee average annual real GDP growth in the euro area in a range of between 2.3% and 2.9% this year, and between 1.8% and 2.8% in 2008.

The risks surrounding this favourable outlook for growth are broadly balanced over the short term. Over the medium to long term, though, the balance of risks remains slightly tilted to the downside, owing mainly to external factors such as the possibility of further increases in oil prices, the fear of a rise in protectionist pressure, and concerns about possible disorderly developments in the wake of global imbalances.

Regarding price developments, inflation (as measured by the HICP) was 1.9% in May. According to Eurosystem staff projections, average HICP inflation is expected to be around 2%, or more precisely between 1.8% and 2.2%, this year and between 1.4% and 2.6% next year.

The risks to the outlook for price stability are predominantly on the upside, mainly due to increasing capacity utilisation in the euro area and gradually improving labour markets. This implies, for instance, that pricing power in market segments with low competition may increase and that wage developments might be stronger than expected. With respect to oil prices, too, there is still the possibility of further increases.

In addition, the vigorous expansion of money and credit aggregates in an environment of already ample liquidity is clearly amplifying these existing upside risks to price stability.

Against the backdrop of the positive economic environment in the euro area, our monetary policy stance is still on the accommodative side and far from being restrictive. Given that inflation is projected to remain above our stability threshold, we remain committed to countering risks to price stability over the medium term in order to solidly anchor inflation expectations at levels consistent with our definition of price stability.

When the Governing Council began increasing key interest rates in December 2005, there was widespread criticism. The main argument put forward by critics at that time was that the Governing Council was not taking due account of the economic environment, and that the rate hike therefore came too early.

Since then, however, most of the critics have had to admit that this decision, although heavily criticised at the time, was warranted.

This has important implications: in my view, had we not started increasing key interest rates in December 2005, we would have been "fallen behind the curve". In such a case, monetary policy runs the risk of losing control over inflation expectations, which are only firmly anchored at levels consistent with price stability if monetary policy is credibly committed to that price stability target.

Our experience since December 2005 once again underscores that monetary policy has to be conducted in a forward-looking manner and, in turn, must not wait for risks to price stability to materialise. Metaphorically speaking, a stability-oriented monetary policy cannot be conducted by looking through the rear view mirror. Looking through the side window, that is relying primarily on current observations of growth and inflation, is not sufficient either, since today's inflation cannot be influenced by current monetary policy decisions, owing to the long and variable lags of monetary policy transmission.

Thus, the only viable option for monetary policy is acting in a forward-looking manner in order to ensure price stability over the medium term.

Let me sum up: monetary policy in the euro area will do what is necessary to maintain price stability and thus contribute to supporting sustainable economic growth and job creation in the euro area. Germany's economy is back on track and the outlook for Germany and the euro area over the medium-term future remains favourable. Dinner speakers should exhaust their topic, not the audience. Therefore: Thank you for your attention.