Axel A Weber: Challenges and opportunities for the competitiveness of EMU member states. The euro in the financial crisis – the German experience

Presentation by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Copenhagen Business School, Copenhagen, 22 March 2010.

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1 Introduction

Dear President Johann Ross (Copenhagen Business School),
dear Professor Peter Birch Sørensen (Chairman of the Economic Council, Denmark),
dear Gouverneur Christian Noyer and Governor Niels Bernstein,
ladies and gentlemen

The global financial crisis that we have been experiencing since the autumn of 2007 has been a challenge for monetary and fiscal policy in nearly all industrialised countries. In addition, it called our regulatory regimes into question and caused a profound reform process to be initiated at the national, European and global level. With respect to European Monetary Union (EMU) the financial crisis has made clear just how important the euro is as a stabilising factor for the economies of its member states.

Nonetheless, the challenges that lie ahead after the financial crisis and the economic downturn that accompanied it have not diminished. In particular, the financial crisis has led to a renewed debate about perceived imbalances in the euro area. This discussion is not new, as divergencies have been building up steadily since the launch of the euro. However, during the years preceding the financial crisis, the strong global economic expansion and the ongoing economic integration within the euro area partly masked the problems arising from these differential developments. As the financial crisis has called unsustainable business models into question and ruthlessly revealed the structural nature of the disparities, they have now moved centre stage. Taking the specific adjustment processes in a monetary union into account, we have to think about the conditions for sustainable growth in all euro-area economies and about how they can be achieved.

In my following remarks, I will address these two aspects of the recent experiences within the euro area. First, the advantages of monetary union during the financial crisis. Second, the challenges that will have to be overcome in order to resolve the divergencies that have built up within the euro area. The current debate focuses on the differences in price competitiveness between EMU member states. However, in my view losses in competitiveness are not the root of the problem but rather a symptom of underlying unsustainable structural developments in some member states. Accordingly, the marked gains in price competitiveness the German economy has experienced have been a result of necessary structural reforms that were finally addressed in 2003 when domestic problems such as high structural unemployment, rising social security contributions and repeated excessive public deficits became more and more pressing. I will therefore take a closer look at this German experience trying to draw some conclusions for those countries that have lost competitiveness since the launch of the euro.

2 Euro – what have we gained?

My positive assessment of the first ten years of monetary union results mainly from the fact that EMU clearly contributed to a favourable climate for economic growth within the euro area. Throughout the financial crisis, however, the euro proved to be far more than a growth factor for the euro area. In several respects it has stabilised the member economies. As market participants' risk aversion increased, any additional risk would have depressed their propensity to invest. Therefore, the absence of exchange-rate risk within the euro area has represented an additional benefit during the crisis.

More specifically, even though the effective exchange rate of the euro area rose sharply in the financial crisis – before falling again more recently – the euro prevented EMU member states from witnessing a scenario that Europe had experienced in former times, for example during the crisis of the European Monetary System (EMS) in 1992/93. At that time, the EMS had been exposed to a massive flight primarily into the D-Mark, which resulted in significant tensions among EMS currencies. This caused massive adjustment problems for those economies with appreciating currencies and inflationary pressure.

Finally, the fact that banks within the euro area obtain short-term liquidity through the Eurosystem at the same terms and conditions has proved to be a great advantage during the financial crisis. It has significantly mitigated money market tensions and therefore served as a buffer against global financial market shocks. This has protected smaller economies especially. Otherwise some of them would probably have needed to make additional efforts to defend the credibility of their currencies, for example in the form of higher interest rates, interventions on the foreign exchange market or swap agreements with other central banks.

3 Economic divergencies – a challenge for EMU

3.1 Increasing intra-EMU heterogeneity

The search for the causes of the financial crisis has intensified the discussion about global imbalances. What is often overlooked in this discussion is the fact that the euro area as a whole has an almost balanced current account. Consequently, the euro area has not contributed to the build-up of global imbalances. However, the economic divergencies within EMU do need addressing.

One important reason for growing heterogeneity within the euro area is that the benefits of monetary union, in particular lower interest rates and the elimination of exchange rate risk, have not always been used wisely and have tempted some countries to live beyond their means: Too often inflowing capital did not reach the most productive sectors, and in some cases cheaper and easier access to funding led to excessive credit dynamics facilitating a rise in household and corporate debt and ultimately causing the real estate markets to overheat. In addition, fiscal policy often failed to use higher growth and lower interest rates to reduce deficits sufficiently. In economies with rigid or only partly flexible labour markets all these large expansionary stimuli resulted in accelerated wage increases that were well in excess of productivity growth, reducing price competitiveness and exports of domestic firms.

Consequently, price competitiveness has diverged significantly from one euro-area member state to another since the introduction of the euro. Whereas a small group of countries, led by Germany, has achieved gains in price competitiveness, a larger group suffered significant losses, amongst others Greece, Italy, Spain and Portugal. These underlying economic divergencies within the euro area are also reflected in persistent discrepancies in the current account positions of EMU member states. As long as a flourishing world economy and the growth dynamics within the euro area masked the associated problems, those developments were neglected. However, the financial crisis has revealed the unsustainability of this state and therefore increased awareness of the risks it involves. These risks imply depressed future growth prospects, disturbances in capital flows if markets doubt the sustainability of large external borrowing requirements as well as difficulties for monetary policy as a result of the growing heterogeneity of euro-area member states. Hence, correcting the structural problems that are at the root of the economic divergencies is one of the major challenges for the future: For example, domestic firms have to become more competitive by increasing productivity and keeping costs in check, labour market flexibility has to be increased in order to mobilise a larger share of the working age population and to facilitate reallocation of workers to more profitable sectors. And structural deficits have to be brought down to sustainable levels by broadening the tax base or, preferably, cutting expenditure on government consumption and certain transfers.

Taking the current account as one indicator of the extent of these divergencies, one could get the impression that the financial crisis has halted the trend of growing heterogeneity within the monetary union, since current account positions have narrowed significantly in the years 2008 and 2009 (except for Italy and France). However, a closer look at the developments that underlie the changes in current account deficits shows that the reductions are still largely cyclical as they have been driven mainly by sharply falling imports rather than increasing export market shares. Hence, more profound and far-reaching changes have to be undertaken in countries that have lived beyond their means and thereby driven the divergencies within the euro area.

In order to sketch how structural reforms can initiate the necessary adjustments and bring back heterogeneity within the euro area to a natural and sustainable level, I will now turn to the experience of Germany which has just undergone such an adjustment process.

3.2 The German experience

This adjustment process is often perceived and portrayed as a significant improvement in price competitiveness due to ongoing wage moderation and major reforms on labour markets and in the social security system. However, this perception misses the point of what actually occurred in past years.

The price competitiveness of the German economy had indeed declined dramatically in the years 1990 to 1995. During the reunification process, a number of domestic imbalances had built up and became apparent as of the mid-1990s. The most prominent were an oversized construction sector and strong wage and price increases despite a decline in average labour productivity owing to the inclusion of the eastern German economy.

The German corporate sector reacted to this extremely unfavourable position on domestic and international markets by a painful, but eventually successful restructuring process including innovation, outsourcing, wage moderation as well as a balance sheet clean-up. It should be noted that these were market-based adjustments neither initiated nor managed by policy makers.

However, what actually forced the German government to undertake a set of major reforms was a couple of intensifying domestic problems which depressed growth and increasingly constrained policy makers' scope of action. In the economic downturn following the burst of the "New Economy" bubble in the early 2000s, persistently high unemployment peaking at more than 5 million people in 2005 as well as overburdened social security systems led to high fiscal deficits and a protracted period of only meagre GDP growth. Thus, adjustments in the areas of economic and social policy had become inevitable. Finally, in 2003, bold labour market reforms were introduced, which modernised the labour market structure and lowered the high employment threshold of economic growth. They were accompanied by fiscal consolidation and adjustments in the social security systems, in particular the pension system. These structural reforms have paved the way for further necessary market-based corrections, for example in wage setting and intra-plant working-time flexibility, to take place. They have been painful, but the economy was in much better shape afterwards. In my view, this is the core lesson that can be drawn from Germany's experience.

It is true that economic growth in Germany was unusually dependent on foreign trade during the last upswing between mid-2003 and early 2008, but we would be ill-advised to deduce from this experience the need for actively propping-up domestic demand, for example via encouraging higher negotiated wages. Rather, German exports were boosted by strong, but ultimately unsustainable global economic growth, whereas a pick-up in private demand once high unemployment started to decline was repeatedly burdened by exogenous forces. For example, the need to cut excessive public deficits required a more restrictive stance of fiscal policy and the rapid rise in energy prices in 2008 absorbed the sizeable pick-up in nominal disposable income as the upswing was about to broaden to the domestic economy. What is therefore often neglected is that Germany was able to serve as an important buffer for world demand at the height of the financial crisis via its still robust private consumption as well as large fiscal stimulus packages.

Looking ahead and bearing in mind the prospects for global economic growth as well as its regional breakdown, the German economy is unlikely to replicate the growth profile of the most recent upswing. In an external environment characterised by a less steep but hopefully healthier expansion, German enterprises will naturally have to focus more on the domestic market than before. Political coordination of this process which goes beyond the purpose of setting a framework for a market-induced, smooth reallocation of resources is neither necessary nor helpful.

4 Conclusion

Ladies and gentlemen,

the adjustment process the German economy underwent after reunification and during the first years of monetary union has shown that a market-based correction even of severe domestic structural problems is possible if the necessary reforms are addressed. In addition, the effort and inconvenience associated with those adjustments will pay off as they lead to strengthened economic conditions in the individual economies and the euro area as a whole. The EMU urgently needs such market-based adjustments as they are a prerequisite for economic divergencies to come to a halt, for sustainable economic growth within the euro area and thereby for the continuing success of the euro.