Axel A Weber: Heterogeneities within the euro area – a problem for the single monetary policy?

Speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Society of Business Economists annual dinner, London, 9 March 2011.

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1. Introduction

Ladies and gentlemen

First of all, I would like to thank you for inviting me to give the dinner speech tonight. I would like to use this occasion to talk about heterogeneities within the euro area. Obviously, there are several dimensions of heterogeneity to consider, say, in terms of growth, inflation or market interest rates. With respect to economic growth, which usually receives a particular amount of intention, we are seeing a strong economic recovery in some countries, particularly in Germany. By contrast, some countries at the geographical periphery of the euro area are suffering from persistent structural problems. Whether or not this poses a problem for the ECB Governing Council is something I shall discuss later on. But firstly I would like to take a look at the German economy and the economic conditions in the economies at the periphery of the euro area.

2. Germany: strong economic recovery

Germany was among the countries that suffered most from the economic crisis. In 2009, its economy shrank by 4.7%. This has to be borne in mind when considering last year's growth figure of 3.6%, which was one of the highest both in the euro area and within the group of the major advanced economies. Even so, the strong rebound in 2010 came as a surprise to many observers.

GDP growth went down slightly to 0.4% in the final quarter of 2010, after 0.7% in the third quarter and an exceptional second-quarter figure of 2.2%. Even so, the cyclical upswing is still intact. The most recent figure is biased to some extent by the heavy snowfalls and extremely cold weather in December. In line with this picture of a stronger underlying dynamic, leading indicators suggest a rather favourable outcome for the first quarter of 2011.

Moreover, the upswing has recently gained in breadth. The previous economic upswing was driven mainly by strong external demand, but ended incomplete. Unlike then, external impulses are now exerting a greater impact on domestic activity. Corporate investment has increased significantly. Capacity utilisation is continuing to rise and is now back at its long-term average. As a result, firms are becoming more and more willing to expand their capacities rather than just replace existing equipment. Housing construction is expected to go on benefiting from historically low funding costs, whereas public investment is expected to drop sharply given the phasing-out of stimulus programmes and the considerable need for consolidation.

Even private consumption is providing us with some good news. Having been sluggish in the past upswing and resilient during the crisis, it showed perceptible growth of 0.4% in 2010. The very positive household sentiment indicates that the upward trend will become even stronger both this year and next. What underlies this remarkably positive household sentiment? Quite obviously, it is the improved labour market situation and, hence, higher labour income expectations.

Consumption activity might suffer, however, from the significantly gloomier price climate that will probably continue over the next few months. According to the flash estimate, the annual inflation rate (HICP) rose to 2.2% in February. Even though this is clearly lower than the current UK inflation rates, it is the highest figure since autumn 2008. The price climate has therefore deteriorated, although it should not be forgotten that, up to now, this has been due mostly to exogenous shocks, particularly from energy prices.

We expect the German economy to grow on average in 2011 considerably faster than the 2% we projected in early December: 2½% should be a realistic figure as things stand at present. As a result, the German economy should regain its crisis-related losses in output by about the end of this year.

There will be a further decline in unemployment owing to companies' marked willingness to recruit new staff. The fall in unemployment in Germany is not just cyclical, however. Germany is currently reaping the benefits of the sometimes painful reforms introduced over the past decade. This teaches us the important lesson that reforms pay off. Furthermore, robust employment during the crisis was the dividend of greater flexibility in German wage agreements and was also supported by temporary government measures such as the short-time working, which proved to be an attractive option. This is not to deny that major challenges remain: The reforms have tended to reinforce the segmentation of the labour market, and unemployment among the low-skilled as well as long-term unemployment remain at a high level. Nevertheless, current data are impressive: at a rate of 7.3%, German unemployment is now below its pre-crisis level, and the average number of employed persons was at its highest ever in 2010.

Public finances in Germany are benefiting from the economic upswing, too. Following a reversal from a roughly balanced budget before the crisis to a 3.0% deficit ratio in 2009, the 3.3% deficit ratio in 2010 was considerably lower than originally expected. For the current year, we consider it feasible that there will be a further decline in the deficit ratio in the order of 2%, provided that fiscal policy stays committed to consolidation. This relatively favourable – or, perhaps, this rather less serious – state of public finances allowed Germany to act as an anchor during the crisis. Still, the deficit has exceeded the Maastricht threshold in Germany, too, and, even more importantly, the structural deficit is higher than it was before the crisis. Developments which are better than expected should therefore be used for more ambitious deficit reduction rather than for expenditure increases. The objective of a structurally almost balanced budget, which is mandated by both European and national law, calls for considerable further efforts in consolidation.

To sum up, Germany can serve in various respects as a role model for other euro-area member states, particularly those affected by the current sovereign debt crisis and faced with structural adjustment needs. This leads me from the brighter side of recent developments in the euro area to their gloomier aspects.

3. Euro area periphery: persistent structural problems

The broadly based economic upswing in Germany is also benefiting its EU partner countries. However, rather low cyclical volatility in the peripheral countries' export sectors, such as food or tourism, and – with the exception of Ireland – a rather small degree of economic interdependence with Germany mean that positive spill-over effects are limited. Strong German import demand is therefore insufficient to compensate for the structural problems in the countries concerned, where painful adjustment processes have to take place.

The sovereign debt crisis in some euro-area countries is, at present, *the* major challenge for economic and monetary union. However, I am deliberately not talking of a euro crisis, since the continuity of the single currency is not at risk. Publishing obituaries of the euro − as Anglo-Saxon observers, in particular, have done − was definitely premature. European leaders have demonstrated their firm determination to ensure the financial stability of the euro area.

The euro-area debt crisis has become the third phase of the global financial crisis. It would be wrong, however, to blame the markets or the financial crisis for the debt problems that exist in peripheral countries. Rather, I would say that the financial crisis has revealed unfavourable and, ultimately, unsustainable developments which were already in existence before the crisis and which had been carelessly neglected, not least by the markets − too much public spending, oversized construction and banking sectors, losses in competitiveness, to name just the most important shortcomings.

The financial crisis, however, changed investors' perception of sovereign risk and triggered a loss of confidence in the troubled countries' ability to repay their debt. This loss of confidence led Greece to the brink of illiquidity and put the euro area's financial system under severe strain. Consequently, ensuring financial stability in the euro area justified the fiscal stabilisation measures that were implemented in May 2010. Financial assistance to Ireland was justifiable, too, taking into account the spill-over risks to financial stability in the European Union.

The stabilisation measures have nevertheless shaken the foundations of EMU. It is therefore vital that European leaders take the right decisions during the next few weeks when it comes to overhauling the governance of the European monetary union. The final package should not fall short of what was agreed by policymakers at the end of last year.

In addition, it is imperative that member states continue to consolidate their public budgets and to initiate comprehensive reforms in order to address the structural problems in their economies. I know that the necessary measures are painful, but they are also unavoidable. Financial assistance has bought time for smoothing the adjustment process and for regaining credibility. I firmly believe that the countries in trouble will return to growth if the necessary measures are taken within an appropriate timeframe.

4. Implications for monetary policy

Ongoing recessions or weak growth in peripheral countries and strong growth figures in Germany and some other euro area countries have raised the question of whether such heterogeneity poses a problem for the single monetary policy. I would like to make three comments to put this perceived problem into perspective.

Firstly, current euro-area heterogeneity with regard to growth rates is not significantly greater than in the first years of EMU. The weighted standard deviations of quarterly growth rates are only slightly higher than in the years before. What has changed significantly is the national ranking of GDP growth. While the former "sick man of Europe", Germany, has emerged as one of the fastest-growing economies in the euro area, countries that were growing quickly earlier still haven't emerged from recession. With regard to inflation variance, we see larger standard deviations than in the middle of the past decade but lower values than in the first years of EMU.

Secondly, it has to be stressed that the monetary policy decisions of the ECB Governing Council are focused on the euro area as a whole and not on the specific needs of individual member states, let alone individual banks with funding problems. Consequently, developments in individual member countries are relevant to monetary policy only insofar as they have an impact on price stability in the euro area as a whole; this can occur directly via their impact on aggregate inflation, but also indirectly, say, if the monetary policy transmission process is affected.

Finally, heterogeneity is not a problem *per se*, that is to say it is a problem neither for the single monetary policy nor for the individual member states: Persistent heterogeneity in growth rates might simply reflect differences in potential output growth caused, for example, by differing demographic developments or the catch-up processes in some member states. Rather, what we should be concerned about is heterogeneity in terms of the member states' ability to cope with − and to live up to − the challenges of a common monetary policy. However, in such cases, policies other than monetary policy are required to remove existing deficiencies and to ensure the ability of member states to respond to asymmetric shocks: In particular, I would like to mention fiscal consolidation to restore confidence in public finances, thereby creating fiscal room for manoeuvre; structural reforms to improve the flexibility of product and labour markets; and better financial regulation to enhance the resilience of financial systems.

5. Conclusion

Ladies and gentlemen

There are considerable heterogeneities within the euro area. Nevertheless, it can be argued that disparities are more likely to narrow than widen over the medium term. Some euro-area countries, including Germany, have recovered very dynamically from the economic crisis. Other countries, particularly those at the periphery, are persistently suffering from structural adjustment requirements and are constantly under the scrutiny of financial markets. Nevertheless, the implementation of necessary reforms and adjustment processes is the only viable way of returning to a sustainable growth path. On the other hand, we should not overestimate Germany's economic strength over the medium term. The economic crisis has subdued the potential growth of the German economy. We assume that potential growth will go up again slightly to no more than 1% by 2012.

Heterogeneity in the euro area does not constrain the conduct of a stability-oriented single monetary policy. Nevertheless, its full benefits will materialise only if the member states' economic policies and economic structures are sufficiently flexible and adaptable. A reform of euro-area economic governance that reinforces individual responsibilities, and structural reforms in the member states themselves are key to ensuring this.

Thank you for your attention.