

Jens Weidmann: Germany's role in the global economy

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the American Council on Germany, Washington DC, 26 September 2011.

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1. Introduction

Ladies and gentlemen

I would like to thank the American Council on Germany for giving me the opportunity to speak here today. The American Council on Germany was founded in 1952 in order to encourage reconciliation and understanding between Germany and North America following the two world wars in the first half of the twentieth century. To this day, it has the objective of enhancing transatlantic understanding. This is still very important as we are experiencing fast and significant changes. The headwinds generated by the global financial crisis are still being felt and on both sides of the Atlantic a rethinking of old certainties is underway. In such a situation, it is crucial to exchange ideas, re-examine the perceptions we have of ourselves and of one another and foster mutual understanding. With this in mind, I would like to talk about Germany's role in the global economy, which, of course, is closely connected to its role as a member of European Monetary Union.

One thing that people often associate with Germany is its export strength. And the export sector certainly has traditionally played an important role in the German economy. However, the German economy has not always performed as solidly as it is doing now. The past two decades have seen changing patterns in Germany's economic performance, with a major structural weakness following the boom of reunification and an arduous but ultimately successful process of reform in the years that followed.

As popular as individual German export products are globally, Germany sometimes faces the reproach that its export strength comes at the expense of global stability. Critics either imply that Germany promotes imbalances at a global level or within the euro area or that it should have done more to bolster global demand. As I will outline in more detail during this speech, the difficult but ultimately successful adjustment that Germany has undergone in the past has enabled it to serve as an important buffer for global demand during the crisis and an indispensable anchor of stability within EMU, both throughout the crisis and during the subsequent recovery. In order to clarify these points, I will concentrate on the following three aspects:

- First, I will shed some light on the underlying factors behind persistent divergences in price competitiveness within the euro area, which, together with past fiscal profligacy, are to a large part responsible for the problems we are facing today. In particular, I will illustrate how those member states whose competitiveness has deteriorated substantially since monetary union have not managed to take advantage of it.
- Second, I will describe Germany's economic performance during the crisis and the recovery. In particular, I will show how Germany served as an import buffer during the economic downturn that followed the financial crisis. Now that many countries are struggling with recovery, the more dynamic upswing in Germany is providing an important impetus to the rest of Europe.
- Finally, I will turn to the challenges that the European sovereign debt crisis is posing to Germany. Considering that Germany is providing a large part of the fiscal contributions to euro area countries with refinancing problems, confidence in Germany's solvency is vitally important in the current situation. Germany therefore

has to set an example for implementing sound fiscal policies within the euro area. However, this alone will not be sufficient to resolve the sovereign debt crisis. To secure long-run stability within EMU, significantly stronger incentives for sound public finances are indispensable.

2. Intra-EMU divergences

What critics actually have in mind when they talk about Germany's export strength is the existence of current account surpluses which contrast with current account deficits in other EMU member states or other countries around the world. I would like to emphasise that neither current account surpluses nor current account deficits are a bad thing *per se*. Current account surpluses reflect net foreign lending and current account deficits net foreign borrowing, and depending on the circumstances, both can be appropriate for a given country. For a country with a declining working-age population, for example, it is quite reasonable for residents to save money for the future and to invest a share of it abroad. By compensating for a shrinking income in the future, the money saved today allows consumption to be smoothed over time. Conversely, countries which are undergoing a catch-up process and need financing for the investments might be willing and promising borrowers of foreign funds.

Consequently, for a proper assessment we have to take a closer look at the underlying drivers of current account surpluses in some euro-area countries and of current account deficits in others. One worrying development is that divergences in current account balances have mostly gone hand in hand with divergences in price competitiveness. Whereas Germany, as a surplus country, has been able to improve its price competitiveness significantly since the launch of the euro, the current account deficits in Greece, Spain and Portugal and to a lesser extent in Ireland were accompanied by significant losses in price competitiveness: The lower interest rates brought about by monetary union and inflowing capital had partly fuelled unsustainable developments, such as excessive credit dynamics and real estate bubbles in Spain or excessive fiscal spending in Greece. The resulting domestic boom and existing labour market rigidities led to large wage increases well in excess of productivity growth, triggering a loss in price competitiveness and thereby impairing export performance. Current account deficits were therefore ultimately a symptom of countries living beyond their means. The deficits will only decline if ambitious and often painful adjustments are undertaken that bring these economies back on a sustainable track.

What about Germany? At first sight, Germany's gain in price competitiveness since monetary union seems quite large. However, it is important to bear in mind that this increase followed a period of rather weak economic performance in the 1990s after Germany's reunification boom. The most recent competitiveness gains and the resulting impulse for exports were the consequence of a painful but necessary and ultimately successful adjustment process. An important part of this process was a restructuring in the corporate sector, which significantly enhanced the profitability of firms. In addition, there were major and long overdue policy reforms, namely labour market reforms, fiscal consolidation and adjustments in the social security systems. Consequently, and in contrast to some other surplus countries, Germany's current account surpluses were certainly not caused by policy interventions aimed at boosting exports. Instead, they resulted from market-driven adjustments to external pressure as well as overdue structural reforms. It is true that the restructuring process has fostered the emergence of current account surpluses by putting a strain on domestic consumption. As the restructuring process was temporary, however, German current account surpluses are not expected to reach pre-crisis levels soon again.

In addition, Germany's experience should provide some reassurance to those countries faced with the need to restore their competitiveness: Structural reforms can initiate necessary adjustments and will pay off in the end – thanks to its reforms, the German economy was much stronger in the years preceding the crisis than before.

3. Economic spillovers during the crisis and the recovery

Not least for this reason, Germany was able to serve as an anchor for stability within EMU throughout the crisis as well as in the current recovery. Because of its export strength, the German economy was affected particularly strongly by the global economic downturn that was triggered by the financial crisis. However, as this shock hit the German economy in a phase of structural strength and was only temporary, the negative effects were contained. From today's perspective we know that Germany has weathered the economic crisis comparatively well. The labour market was only weakly affected as firms in the export sector chose to reduce working time over staff layoffs, whereas the domestic economy was less affected and even continued to increase employment. Now unemployment rates are even lower than before the crisis. In addition, Germany profited from its previous consolidation efforts. The almost balanced fiscal budget at the beginning of the crisis allowed scope for implementing sizeable fiscal stimulus programmes. As a consequence, private consumption remained robust throughout the crisis, which explains why Germany was able to serve as an important buffer for world demand at the height of the financial crisis. In fact, the huge downturn in the German economy was largely driven by a decline in exports: about two thirds of the downswing can be attributed to a negative contribution from foreign trade.

Having experienced a disproportionately strong decline during the crisis, exports in Germany have also benefited disproportionately from the revival of global economic activity. So far, Germany has undergone a sound process of recovery. Economic activity has almost returned to its pre-crisis level and the output gap has been closed, indicating that the recovery process is at an advanced stage. The recovery is also broader-based than in past cycles. The positive labour market situation and the improved real wages and income expectations of private households are supporting growth in consumption, which had already been resilient throughout the crisis. And even though spillover effects from growth in Germany to other countries are comparatively low, Germany still serves as an important transmitter of the impulses from global demand to other EU member states.

Most recently, the German economic outlook has been dampened by high overall uncertainty, especially regarding further developments in the European sovereign debt crisis. But we expect economic activity to remain robust in the third quarter, and even though expectations for the winter months are subject to considerable risks, this should prove to be more of a soft patch. Nevertheless, there is a heightened danger that financial market turmoil affects the real economy. Thus, it is crucial to find a prompt and consistent political answer to the sovereign debt crisis in order to reduce downside risks.

4. Fiscal discipline and the European sovereign debt crisis

In addition to its robust economic conditions, Germany is an anchor of stability within EMU through the high level of confidence in the sustainability of its public finances as well as through its financial support to those countries within EMU which currently lack this confidence.

While Germany profited from its public finances being in comparatively good shape at the beginning of the crisis, the economic downturn and necessary rescue measures for banks during the crisis have put a serious strain on the national budget. The debt ratio increased by 19 pp to 84% of GDP between 2007 and 2010, mostly due to the support for the financial sector. Given the experience from the sovereign debt crisis, it is imperative to sustain confidence in public finances. This requires credible consolidation efforts now and not just some kind of commitment to future steps.

The debt brake, which Germany has enshrined in its constitution, is principally a good means of achieving this objective, as it legally binds politicians to obtaining sound public finances. Germany has therefore set an important example within EMU and I welcome the aspirations in France, Spain, Portugal and Italy to follow this example. This is an acknowledgement to

the importance of sound fiscal policy. However, the effectiveness of national debt brakes will depend on their specific design and in the case of Germany on the condition that the debt brake is applied according to its rules.

As important as effective national debt brakes are, they are not sufficient to solve the current sovereign debt crisis within the euro area. To achieve this, we need an effective policy framework that meets the requirements stemming from the unique nature of EMU. EMU is a monetary union between sovereign states, not a federal state with a common budget. This is a fundamental difference compared for example to the United States. It means that euro area countries decide independently about their fiscal policy, but that the high indebtedness of one country affects all of the member states because of its effects on the common monetary policy. This harbours the danger of weakening incentives for sound public finances as the individual countries no longer carry the full burden of high sovereign debt by themselves. Ultimately, this could even translate into pressure on monetary policy to ease the burden of high public debt, for example by a more expansionary monetary policy or by using central banks' balance sheets to shift burdens among member states. In order to correct for these adverse effects, European Monetary Union was founded on a stability-oriented policy framework. This framework includes legal provisions that preclude monetary financing of governments, strict fiscal rules laid down in the Stability and Growth Pact and the "no bail-out" clause, which, by ensuring that each country ultimately has to bear the consequences of its own fiscal policy, is an indispensable prerequisite for sound public finances within the euro area.

The severity of the sovereign debt crisis in some member states and the imminent risks of contagion for other member states, however, have threatened financial stability within the European Monetary Union as a whole. The European Council therefore agreed that financial assistance should be granted to countries with severe refinancing problems, a substantial part of which is provided by Germany. This financial support is intended to buy time for the affected countries to conduct necessary structural reforms and implement consolidation measures in order to regain market participants' confidence in the soundness of their public finances and their competitiveness. The assistance is therefore bound to adjustment programmes, which each recipient country has to fulfil.

However, the reduction of interest payments on the financial aid has weakened the incentives for countries in an adjustment programme to re-establish sound public finances via fiscal and economic reforms and return to the capital market. Furthermore, the conditionality of the support measures has been loosened by the recent decisions of July 21st. This weakens the underlying principle of European Monetary Union that each country has to bear the full consequences of its own fiscal policy. Contrary to what is actually needed in order to overcome the sovereign debt crisis, we risk seeing the propensity for excessive deficits rise even further in the future. Germany's debate about the way forward in the crisis is therefore motivated by a serious concern for the stability of monetary union.

We will not be able to regain stability within EMU without re-establishing the credibility of its framework. A fundamental political decision is therefore needed: either the existing policy framework of EMU has to be changed fundamentally or the incentives for sound fiscal policy have to be strengthened within the existing framework. The first option would imply EMU member states abandoning a substantial part of their national sovereignty over fiscal policy and would therefore require fundamental legal changes on the European and possibly also the national level. The second option requires a return to the fundamental principles of monetary union, with each member state bearing the consequences of its own fiscal policy decisions. Either option would be sustainable from an economic point of view. However, combining elements of both options, ie sharing the risks of unsound fiscal policy and retaining national sovereignty over fiscal policy, is condemned to failure. It would undermine the incentives for sound fiscal and economic policy even further, thus achieving the opposite of stabilising monetary union. Ultimately, this approach would also not be credible to financial markets as its inconsistencies raise doubts about the public and political support.

5. Conclusion

Let me conclude my speech on Germany's role in the global economy with some caveats. In spite of the rather favourable performance during the crisis, Germany faces major challenges, overcoming the euro area's sovereign debt crisis being the most pressing. In addition, the level of public debt has risen substantially throughout the crisis. Consequently, and considering the increasing fiscal burdens caused by an ageing society and a shrinking working-age population, consolidation is a major task for Germany, too. It is indispensable to ensure the long-term sustainability of its public finances.

But unlike some other EMU member states, Germany is still in a relatively favourable position. This combined with the fact that Germany continues to be an important economic player despite global shifts in economic weights is due, not least, to painful but ultimately rather successful structural reforms undertaken in the past. It would be short-sighted to rely solely on these achievements. But they could well serve as an encouragement to reform-minded policymakers in other countries. And the fact that these reforms, including the emphasis on fiscal soundness, contributed to revitalising the German economy and to increasing its resilience should not be a cause for concern or complaint. Instead, it should be seen as good news – for Germany, but also for EMU and the global economy.