Jens Weidmann: External imbalances in the euro area

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the International Business Cycle Conference, Kiel Institute for the World Economy, Kiel, 17 March 2014.

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1 Introduction

Ladies and gentlemen

The International Business Cycle Conference has become a firm fixture within an institution that is itself very much a fixture of the German economics landscape. Truly international in its focus from the start, the Kiel Institute for the World Economy has nevertheless shaped the national economic discourse like few other institutions have done.

Over the last hundred years, its global perspective, research quality and policy relevance have made it one of Germany's leading economic research institutes. And to me, this sounds like a formula for success in the 21st century as well. I am therefore grateful for the invitation and for the opportunity to speak here today.

Analysing international developments and Germany's role in them is the Kiel Institute's core competence. But as the English writer Charles Caleb Colton once pointed out, imitation is the sincerest form of flattery. So let me celebrate the Kiel Institute's centenary by having a go at analysing international developments, and Germany's role in them, myself.

In the next 25 minutes or so, I wish to present my take on the external imbalances in the euro area and Germany's role in this context. In particular, I will be focussing on three points:

- that compared to a fixed exchange rate regime, the adjustment pressure of a deficit country in a currency area is cushioned by the single monetary policy, avoiding excessive adjustment costs, but which also calls for additional rules;
- that stimulating German demand cannot be a substitute for removing rigidities in the deficit countries, but that strengthening Germany's growth potential, for instance by increasing competition in the services sector, will be helpful with regard to the current account as well;
- that due to its demographics and degree of economic development, Germany's role as a capital exporter is unlikely to change, which means that, to a certain extent, German surpluses are here to stay.

Let me start by taking a closer look at the role of external imbalances in a monetary union.

2 Macroeconomic imbalances in a monetary union

In the early stages of European economic and monetary union, interest rates in the member states converged at a low level following the elimination of exchange rate risk. From the perspective of deeper economic and financial market integration, this was desirable in principle.

However, the favourable financing conditions in the euro-area countries with previously higher interest rates stimulated their domestic demand. A procyclical real interest rate effect then ensued. Higher domestic demand led to above-average inflation in the respective countries, while nominal interest rates hardly differed across the euro area, causing real interest rates to fall even further in the countries concerned.

At the same time, higher demand caused wages to rise as well, which pushed the real exchange rate up and reduced price competitiveness. But the dampening effect on exports due to the rise in the real exchange rate did not suffice to moderate wage developments in the countries concerned. In other words, the interest rate effect dominated the exchange rate effect. Consequently, worsening exports did not trigger adjustment, and current account deficits continued. As a result, the deficit countries built up ever-larger external liabilities.

However, large external debts, especially when funded through short-term financing, can exacerbate existing national dysfunctions and vulnerabilities. This is precisely what happened in some peripheral euro-area countries during the current crisis: they could no longer finance their deficits through private capital inflows, requiring macroeconomic rebalancing. And this is precisely what I would call a balance of payments crisis: a sudden stop in the inflow of private capital that requires a correction of unsustainable developments and policies.

The reason for the sudden stop in private capital inflow was a loss in creditors' confidence in countries' solvency. In this context, financial markets appeared to recall one important, and hitherto ignored, institutional aspect of the European monetary union: the no-bail out clause. No euro-area country or a European institution is allowed to finance the debt of another euro-area country.

Prior to the current crisis, the possibility of national balance of payments crises occurring in a monetary union like the European one was largely discarded in economic policy discussions. It was believed that individual countries within a monetary union and as part of a single money and capital market would no longer experience funding shortages after exchange rate risk had been eliminated.

In fact, it was long deemed unnecessary to even analyse national balances of payments, as it was thought that a single currency area would prevent balance of payments crises from occurring in individual member states.

As we know now, this theory proved incorrect. Although the balance of payments is an ex-post accounting record, from an economic perspective it expresses an important budget constraint: deficits need to be financed.

Furthermore, the current crisis has shown that national imbalances can create significant contagion effects in a monetary union. In this regard, financial integration has proved a double-edged sword: while it deepened funding reservoirs in good times, the increased interconnectedness also served to propagate shocks far more strongly than before, creating new vulnerabilities.

In the end, to prevent financial stability risks in the euro area from materialising, public funds were used to substitute the drained private funds to finance the deficits: first, through intergovernmental loans or through the European rescue funds, that is the EFSF and the ESM; and second, through refinancing operations of the Eurosystem with banks in the peripheral countries; a point to which I will return later.

It is a well-known fact that in a fixed exchange rate regime, the national central bank can, at least in the short term, choose between directly intervening by selling foreign currency and raising its key interest rate in order to uphold the exchange rate. This is precisely what we have seen recently in some emerging market countries.

Both of these measures produce a squeeze in the domestic money supply and therefore in credit demand, which ultimately reduces the demand for goods and services in the real economy. In the long run, sustainability is restored through the imposed reduction of relative prices and wages.

In contrast to balance of payments crises under fixed exchange rate regimes, the adjustment process in the euro area is cushioned and protracted by the single monetary policy through harmonised short-term interest rates and liquidity assistance measures of the Eurosystem.

This means that the national stock of money in circulation in an individual deficit country is not generally reduced to the same extent as private net capital outflows. Instead, commercial banks can cover their existing financing needs via greater refinancing from the central bank –

at least if they have sufficient collateral and if the central bank has no limit in place for the stock of refinancing credit.

This is precisely the fixed-rate full allotment policy the Eurosystem introduced in 2008 to safeguard the liquidity of the euro-area banking system after the common European money market had encountered severe strains. As a result, there is no monetary policy pressure to adjust prices and wages.

Indeed, empirical studies carried out by the Bundesbank staff have confirmed that current account adjustments take longer in a monetary union than in fixed exchange rate regimes. One could say that the common monetary policy acts as an anti-lock braking system (ABS). It prevents the funding of external deficits from coming to a screeching halt. But a balance of payments crisis is a bumpy ride on a rough surface, and under these conditions an ABS prolongs rather than shortens the braking distance. That is why rally cars do not have ABS. In other words, economic adjustment risks stalling.

But policy room for manoeuvre might be limited in a crisis and the long-term functioning of the monetary union risks being further undermined by the crisis and by attempts to cope with it – as we saw recently. Some crisis measures tilted further the balance between control and liability and monetary policy came under pressure to ease the impact of the crisis on banks and states.

With regard to short-term crisis management, however, it is essential to keep monetary policy and fiscal policy segregated. In a crisis, central banks play an important role as lenders of last resort to solvent banks. This involves short-term refinancing operations in return for high-quality collateral.

Every support measure for a financial institution that goes clearly beyond this means that the central bank is performing a quasi-fiscal role. Measures like financial aid to insolvent banks or the take-over of banks' balance sheet risks rightly belong in the domain of parliaments and elected governments.

Only parliaments and elected governments have the democratic legitimacy needed to redistribute risks between euro-area countries. If central banks were to perform a quasi-fiscal role, they risk becoming dominated by fiscal policy, which could undermine their ability to maintain price stability.

To avoid such a situation, it is important to prevent the build-up of imbalances. Hence, additional safety systems in the form of pre-emptive rules are essential.

In the first place, excessive public deficits have to be avoided by strict deficit rules. Such rules were introduced by the Stability and Growth Pact even before the euro was introduced. Unfortunately, these rules were not enforced strictly enough; they were violated more than once, not least by Germany and France.

In response to the crisis, the rules were stiffened. But the procedure became overly complex and affords considerable political leeway. And so far, the Commission's interpretation has been rather lenient, undermining the binding effect of the new rules.

Additionally, greater economic policy surveillance is crucial. The macroeconomic surveillance procedure is instrumental in detecting and counteracting unhealthy economic developments.

But while safety systems are important, we also need to strengthen the chassis of the monetary union itself.

The balance of payments results from the interplay of international trade and investment decisions. It's not a case of the capital account passively following the current account: both interact through interest rate and price signals. Distortions can therefore originate from both sides, as indeed happened in the run-up to the current crisis. Capital has not always been put to its most productive use. And structural rigidities have hampered adjustment through a shift from the non-tradable to the tradable sector, and curbed growth potential.

Regarding the removal of rigidities in product and labour markets, reforms are now underway. Unit labour costs of deficit countries have fallen as a result, and current accounts have improved – not only because of shrinking imports, but because of expanding exports as well.

Factors of production are being reallocated to sectors with a strong focus on exports. The construction sector in Ireland accounted for over half the decrease in aggregate employment; in Spain, Italy and Portugal, it accounted for around two-fifths. In industry, by contrast, either far fewer jobs have been cut or – as in Ireland – new jobs have recently been created.

Real value added, in particular, already far exceeded its pre-crisis level in the export-intensive information and communication sector in Spain and Ireland in 2012. In Ireland, other business-related services also showed substantial growth. Compared to its pre-crisis level, real value added in trade and tourism increased in Portugal and remained virtually unchanged in Spain.

These sectoral differences are also reflected in credit reallocation, e.g. in Spain. While loans to the Spanish construction sector fell, the more productive export-oriented industrial sector is able to receive loans. This aspect is often forgotten when discussing credit growth in periphery countries.

Progress has been uneven, though, and further reforms are needed to facilitate this shift from the non-tradable to the tradable sector and, therefore, to strengthen sustainable growth.

What is also important, however, is that the banking systems in some euro-area countries haven't correctly fulfilled their economic function. And the national banking supervisory authorities have intervened too little, and too late.

Providing for a more stable financial system and contributing to a more efficient allocation of capital are the ultimate goals of the banking union, which will consist of a Single Supervisory Mechanism (SSM) and a Single Restructuring and Resolution Mechanism (SRM).

To prevent future financial crises, an effective restructuring and resolution regime is of the essence. A functioning resolution regime with a credible bail-in of shareholders and creditors strengthens incentives for effective credit monitoring and moderates banks' risk appetites. In so doing, it reduces the risk that, in the event of future bank failures, taxpayers are again the first line of defence. This will enhance the allocation of capital and reduce the risk of a bubble emerging.

3 The role of Germany

However, the euro area comprises not only balance of payments deficit countries but surplus countries as well, most prominently Germany. Germany's surplus vis-à-vis the rest of the euro area has fallen as a mirror-image of the improvements in deficit countries. Last year, it was about half of its previous high.

Nevertheless, there have been repeated calls for German competitiveness to be lowered to reduce the imbalances in the euro area. One possible solution that has been suggested is a considerable hike in German wages – in other words, a larger increase than is warranted by conditions on the domestic labour market.

The idea behind this is that competitiveness is relative: one country's loss is another country's gain. In terms of the euro area, however, this would only work if the euro area were an island in the world economy and not competing with the outside world. Correspondingly, estimates we have carried out show that the results of such a policy would disappoint.

In our estimates we assumed an additional wage increase in Germany of 2 percentage points above what would normally be expected as the outcome of wage bargaining. Then we used our economic models to calculate the effect such an increase would have on the exports of peripheral euro-area countries.

Given the nature of the trade flows between Germany and peripheral countries, the effect there would be close to zero. Only Ireland could expect a moderate lift. By contrast, Germany's economy would suffer. Depending on the model, employment would ultimately fall by as much as 1%, and output by ¾%.

And a credit-financed increase in public spending would spur exports of peripheral countries even less. The import share of German public demand is only 9%, less than half of the import share of private demand at 21% and less than a quarter of the import share of German exports at just under 41 ½ %.

Fundamentally, Germany's surplus is not due to distortions, but the result of market processes. As the European Commission pointed out in its recently published In-Depth Review, the surplus is the result of an interplay of various factors and developments in Germany as well as globally and among its euro-area partners which affected savings and investment in the domestic economy.

Germany's post-reunification situation was marked by high unit labour costs and high unemployment. To bring real wages down to a market clearing level, a period of wage moderation ensued. This, combined with the realisation that demographic developments would require greater private savings to ensure a comfortable retirement, has caused the saving rate of households to rise gradually over the last decade.

A similar picture holds for the development of corporate savings. At the turn of the millennium, German companies were highly leveraged. At the same time, regulatory and tax incentives made equity more attractive by comparison. Both developments led companies to scale back investment and bolster their equity positions by retaining earnings – to a point where savings actually exceeded investment, an oddity as far as the corporate sector is concerned.

While both household and corporate savings rose, overall investment remained subdued – Germany went from being a capital importer in the 1990s to a capital exporter, and so from posting a current account deficit to a surplus.

The low level of overall investment is attributable to numerous factors. Residential investment fell markedly in the aftermath of the real estate bubble of the 1990s. Business investment has been muted on average as well. The overall investment ratio was 16.7% in 2013, compared with 22.3% in the year 2000.

Following the sharp downturn induced by the financial crisis, corporate investment rebounded at first, but then fell a second time, as uncertainty due to the crisis in the euro area started to weigh on growth prospects.

Finally, the consolidation of public finances was accompanied by a fall in public investment.

Overall, cyclical factors feature prominently when trying to explain the low levels of investment over the last 10 to 15 years. Looking ahead, some of these effects can be expected to abate.

Residential investment has gone up markedly in recent years, fuelled by pent-up housing demand and low interest rates. Demographic trends suggest, however, that this development should slow down over the medium term.

Corporate investment should follow an upward trajectory as well, as uncertainty surrounding the euro area crisis is slowly subsiding. And almost half of all investment in machinery and equipment is comprised of imports; the moderating effect on the current account is therefore comparatively high.

Finally, the German government has also announced an increase, albeit modest, in public investment.

But cyclical factors do not tell the whole story. When looking at sectoral developments, one fact is striking. For the last 20 years, total factor productivity (TFP) growth in services has markedly lagged TFP growth in manufacturing. In fact, while TFP in manufacturing has grown by more than 30%, TFP growth in services has barely budged.

What is behind this phenomenon? The data point to a higher degree of competition in the manufacturing sector following the launch of the common market: mark-ups, an indicator of the pricing power of firms, have gone down since then. By contrast, mark-ups on services have stayed high in Germany, higher even than in many other European countries.

Opening up closed professions, cutting red tape, and improving financing conditions for nascent digital firms, would serve to improve the functioning of the services sector.

But while there is room for improvement in Germany especially when it comes to the efficiency of its services sector, the fact is that European mark-ups are high in general, compared to the US, for example. It is therefore high time to fully harness the forces of the market for Europe, by making the most of its main catalyst for competition and growth, the European single market.

In his report to the European Commission, former Commissioner Mario Monti estimated the potential growth effects of creating a digital single market, which is largely services-based, to be about 4%, on a par with the gains made since 1993. Further benefits would ensue from a reduction in the vast number of exemptions in the services directive.

Reforms that strengthen competition in the services sector therefore hold the promise of delivering stronger and more balanced growth. And more balanced growth is likely to translate into a moderation of the current account as well.

Still, given its demographics and degree of development, Germany’s role as a capital exporter is unlikely to be completely reversed. This means that, to a certain extent, German surpluses are here to stay – a point that the Commission also emphasised in its recent report.

4 Conclusion

Ladies and gentlemen, let me conclude.

The crisis has shown that a monetary union is not a shield against balance of payments problems in the face of persistent imbalances.

Adjustment pressure in a currency area is cushioned by the single monetary policy, which avoids abrupt adjustment but also necessitates additional rules.

Regarding the euro-area imbalances, significant progress has been made. But further reforms are needed to facilitate the shift from the non-tradable to the tradable sector and, hence, to strengthen sustainable growth.

Stimulating German demand by means of an excessive wage increase or a credit-financed increase in public spending cannot be a substitute for that. And given its demographics and degree of economic development, Germany’s current account is likely to have a positive sign in the future as well.

But by removing rigidities in the services sector, Germany might not only strengthen its growth potential, but could do so in a way that is likely to have a moderating impact on the current account as well.

Reforms like these show that adjusting imbalances in the euro area does not need to be a zero-sum game. If done properly, it will serve the interests of everyone, and this is why, despite the struggle and setbacks, it is a path worth pursuing.

I now look forward to our discussion!