Klaas Knot: Germany and the quest for a stable monetary union

Speech by Mr Klaas Knot, President of the Netherlands Bank, at the Duitsland Instituut, Amsterdam, 7 April 2014.

* * *

Introduction

It is sometimes joked that the Netherlands is in fact Germany's 17th Bundesland. The excellent remarks by Jens Weidmann remind me of this joke, because there are so many points I agree with. I will not go into them, to avoid that the rest of this afternoon becomes rather uninspiring. Instead, please allow me to reflect on the future and stability of EMU from my own perspective.

Even those who don't agree with Jens Weidmann should take the views of the Bundesbank seriously, for two reasons. First, Germany is the anchor country of the euro. Europe simply cannot afford to alienate the anchor by moving towards an EMU that would make Germany very uncomfortable. We also need to take the views of German policymakers and voters into account. Second, when it comes to economic stability, Germany has one of the best track records in the world. Most advanced economies made at least three serious policy mistakes in the past decades: excessive inflation in the 1970s, excessive budget deficits in the 1980s and excessive credit and house price growth in recent decades. Quite remarkably, Germany is one of the few countries that succeeded to contain all three problems effectively. Of course even Germany had difficulties at times, for instance after the reunification, when it was even called *"the sick man of Europe".* But the patient recovered after following a tough prescription of wage moderation, fiscal consolidation and structural reforms.

Ants and grasshoppers

The historian Harold James shows that Germany's stability has led to economic tensions within Europe for several times in the past few decades. Germany often developed current account surpluses vis-à-vis other European countries, that led to discussions about the burden of adjustment. Such was for instance the case in the late 1970s, after the collapse of the Bretton- Woods system of fixed exchange rates. And it was the case in the late 1980s, around the time when the Louvre and Plaza-agreements on exchange rates were concluded. It was also the case in the monetary union, where these tensions gradually built up again since the start of EMU. Growing current account surpluses in Germany and countries like the Netherlands matched growing deficits in southern European countries. In retrospect, these current account imbalances were at the heart of the sovereign debt crisis.

It would be unfair to only look at Germany for this situation, as many serious policy mistakes were made in southern countries. First, several countries failed to implement the structural reforms that were needed to function smoothly in a monetary union. Rigidities in product and labor markets contributed to severe losses of price competitiveness. Second, several countries experienced booms in domestic demand on the back of unsustainable growth of credit and house prices. Third, several countries failed to use the windfall of lower interest rates due to EMU- membership for a lasting improvement of public finances. Between the mid-nineties and the financial crisis, interest rate expenditure on public debt in the periphery decreased by 4.5% of GDP on average. Only Spain used this fully to reduce budget deficits. Unfortunately, in the other countries, on average almost half of this percentage did not translate into lower deficits. These policy mistakes suggest that the burden of adjustment mainly lies in southern Europe.

But it would also be unfair to turn the crisis into a moral caricature between the virtuous and the profligate, between ants and grasshoppers. As Jens mentioned in one of his recent speeches, several so-called core countries are not in great shape either. Think of low competitiveness and high public debt in France. Think of low productivity growth in the German service sector. And think of the painful correction of house prices here in the Netherlands. This clearly illustrates that all EMU member states need to carry out reforms to improve their economic growth potential.

Moreover, policymakers in all European countries made misjudgments regarding the functioning of EMU. Most didn't see these flaws when we celebrated 10 years of EMU, only months before the collapse of Lehman Brothers. At the time, we all failed to see how the growing importance of financial factors had fundamentally changed the monetary union. It wasn't recognized that the euro area was experiencing asymmetric financial cycles rather than asymmetric business cycles. This is serious omission as recent research shows that these financial cycles are much larger and longer-lasting than normal business cycles. They created divergences that EMU was not designed to deal with. In addition, we thought that the strong increase of financial integration after the introduction of the euro would enhance risk-sharing. But we didn't realize that it also spurred contagion and pro-cyclical capital flows. For example, the financing of southern credit booms also came from banks in France, Germany and the Netherlands. From this perspective, Europeans are in this together, and can only get out together.

Situation has improved

The good news is that the Eurozone indeed seems to be emerging from the crisis, if slowly. The situation has improved significantly since the height of the crisis in the summer of 2012. At that time, financial fragmentation in the euro area reached alarming levels and several countries were suffering from a strong outflow of capital. Financial markets probably responded too pessimistically at times, fuelled in part by fears of the break-up of the euro area. But less than two years later, markets have calmed down and the crisis entered a new phase. This change is not only due to the ECB's Long-Term Refinancing Operations and its Outright Monetary Transactions program, actions that will always to some extent remain controversial. After all, monetary policy cannot solve the problems of EMU. It can only buy time that should be used effectively. No, the situation also improved because European policymakers took measures that seemed unthinkable until recently. And because they did so in a relatively short time span.

This holds to individual countries in the first place. Many vulnerable member states have reduced their current account deficits and improved their competitiveness. They have also made progress with reducing budget deficits and implementing structural reforms. Countries like Ireland and Spain have therefore successfully ended their financial assistance program. But it also holds for the European level, where governance has been strengthened. European policymakers established common supervisory and resolution mechanisms for banks. This banking union will help to reduce the toxic feedback loops between banks and sovereigns. Many countries have also introduced macro-prudential policies, with the ability to co-ordinate these at European level. These recent measures come on top of the enhanced Stability and Growth Pact and the introduction of the Macroeconomic Imbalances Procedure.

Challenge for the coming years

One crucial challenge is to continue on this course, even now financial markets have calmed down.

Much remains to be done, and the calm will only be sustainable if vulnerabilities decrease further. For individual countries, this means more structural reforms. Countries with a support program implemented reforms, but some of the larger founding fathers are lagging behind. Moreover, reforms mainly focused on labour markets so far, while much less progress is made on product and service markets. The gains of further reforms could be significant. According to the OECD and the Commission, they could raise potential GDP by up to 6% on average. Another priority is a further reduction of public debt, which now stands at 96% of

GDP in the euro area as a whole. Countries should strive to return below the 60% threshold of the Maastricht Treaty. This will probably take many years for most countries, but will significantly improve the stability of EMU. For the European level, many elements needed to repair the design flaws in the monetary union are now in place. But the effectiveness of these new governance measures depends crucially on their application in practice. A strict implementation is absolutely necessary. This not only holds for the Stability and Growth Pact and the Macroeconomic Imbalances Procedure, but also for macro prudential policies and the Asset Quality Review of bank balance sheets. Should any problems in the application arise, European policymakers will need to continue to forcefully tackle them. This enables us to keep the monetary union stable also in the long run.