Andreas Dombret: Germany and the euro area – beware complacency

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a joint seminar of the Central Bank of the Republic of Turkey and the Deutsche Bundesbank, Istanbul, 5 July 2014.

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1. Introduction

Ladies and gentlemen

As I pointed out in my opening remarks yesterday, I am happy to be here in Istanbul to attend this joint seminar of the Central Bank of the Republic of Turkey and the Deutsche Bundesbank. Over the past two days we have shared ideas about macroprudential policy, and we have improved these ideas through discussion.

At this point, I wish to change the perspective and take a closer look at the real economy and the macroeconomic situation in Germany. And as Germany is part of a monetary union, my presentation would be incomplete without discussing the situation of the euro area as well.

2. Germany: no time for complacency

Looking to the past, the German economy has shown a remarkable development. As late as 2004, the Economist magazine dubbed Germany “the sick man of Europe”. Plagued by high unemployment and a lack of competitiveness, Germany undertook structural reforms that were as painful as they were successful. Germany left the sick-bed and took bold steps towards recovery – only to be hit full-force by the fall-out of the financial crisis.

In 2009, amidst a global recession, German GDP dropped by 5.1%. For Germany this was by far the biggest downturn in post-war history. However, the economy recovered quickly and in 2011, German GDP had returned to its pre-crisis level – sooner than in any other country in the euro area.

What is the story behind this V-shaped recovery, the big drop and the quick rebound? From a general point of view, it was the structural reforms I mentioned before that prepared the ground for the strong recovery following the crisis.

Nevertheless, the distinctive pattern of a severe drop and a rapid recovery highlights a specific feature of the German economy: its pronounced export orientation. When the global economy faltered in 2009, Germany was hit far worse than other countries. But when the global economy began to recover in 2010, Germany followed suit. Exports were the major driving force behind the upturn in the German economy.

This strong influence of international trade worried some observers. Many felt that Germany’s reliance on exports was risky, as it exposed Germany to the ups and downs of the global economy. Thus, suggestions have been voiced to adapt the German “business model” and reduce reliance on exports. However, these arguments neglect the fact that Germany is not a company with a business model that management can change at will. In the end, it is the decisions of thousands of individual companies that determine the structure of an economy.

In any case, I have doubts that turning away from global markets would strengthen the German economy. Facing global competition ensures that German companies keep up with technological progress and retain their high productivity. This might come at the price of higher volatility, but to me this seems like a price worth paying.

Having said that, the German economy would certainly profit from strengthening competition in the domestic market as well. Take the services sector as an example. For the last

20 years, total factor productivity growth in services has been markedly lower than in manufacturing. In fact, while total factor productivity in manufacturing has grown by more than 30%, 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.

Thus, there is room to improve the functioning of the services sector by promoting competition: opening up closed professions, cutting red tape, and improving financing conditions for nascent digital firms would be options to achieve this objective.

But still, over the last two years or so, domestic drivers of growth have strengthened in Germany. This is certainly good news, as the basis for growth has become broader.

The good shape of the German economy is also reflected in more recent developments. Last year, the economy regained momentum after a brief dip in late 2012 and early 2013. And in the first quarter of this year, the economy grew by 0.8%, while the euro area as a whole grew by 0.2%. However, the strong growth in the first quarter was boosted by favourable weather conditions. Consequently, we expect growth to be weaker in the second quarter. Overall, the German economy is back within the normal range of capacity utilisation.

Against this backdrop, what can we expect from the future? Well, the internal drivers of growth I mentioned will remain in place while foreign demand is likely to pick up again. As a result, growth will be even more broadly based, and its pace is likely to increase further over the next two years. The Bundesbank expects growth to be 1.7% this year, and to accelerate to 2.0% in 2015.

Yet despite this relatively favourable economic position, there is absolutely no room for complacency. The German economy certainly faces significant challenges. Demographic trends, for instance, will pose a sizable challenge to Germany sooner rather than later. The German potential labour force will start to decline from 2018 onwards. Germany therefore needs to act now.

One path would be to increase labour force participation. And there are indeed labour force reserves, particularly among women and the elderly. Germany needs to go to great lengths to integrate them more closely into the economic process. But there is an additional option to address demographic challenges: immigration. A systematic approach to attract skilled labour from abroad would help cushion the impact of an ageing society on the labour market.

In any case, Germany has to accept that fewer workers might be at its disposal in the future. Thus, it will be all the more important for those workers to be trained as well as possible. This will require an education system that meets high standards which are comparable across Germany. Such a system will give children, youth and young adults the necessary environment and assistance to develop their talents to the fullest.

And there is another aspect of demography one has to consider. The demographic burdens on Germany's public budgets will soon grow sharply. Reducing the debt ratio is therefore a matter of urgency in order to combat this. After all, to quote a German politician, "New debt is tantamount to issuing bills of exchange which my grandchildren will pay off".[1] However, many still tend to agree more with Groucho Marx, who is reputed to have asked himself, "Why should I care about posterity? What has posterity ever done for me?" This is probably not the best approach.

[1] Kurt Biedenkopf in an interview with the Berliner Kurier, 6 July 2003.

To conclude: there are challenges ahead, but the German economy is in good shape and the outlook is quite favourable. I think it is justified to attribute this to the structural reforms undertaken more than a decade ago. Does this make Germany a role model for other countries in the euro area? Certainly not down to every detail. Each country is different, and each country needs a different set of reforms. There is one thing we can learn from Germany's experience, though: reforms do pay off eventually. This is an important point to remember and it is confirmed by the current state of the euro area. Let us take a closer look.

3. The euro area: approaching the end of the crisis

In the euro area, the end of the crisis is getting closer – slowly but steadily. Most importantly, the euro area as a whole has finally emerged from recession. So far, we have seen four consecutive quarters of positive growth, and looking ahead, we expect growth to continue. Latest projections by the ECB suggest that euro-area GDP will grow by 1.0% in 2014 and by 1.7% in 2015.

And this recovery is not only driven by the "core euro-area" countries such as Germany. Some of the crisis-hit countries have also finally embarked on the path to recovery. It seems, then, that the efforts to implement structural reforms are indeed bearing fruit.

Competitiveness has improved in most peripheral countries. Improving competitiveness in turn drives exports higher. All peripheral countries, except Cyprus, are projected to see some export growth this year. These achievements are reflected in current accounts increasingly reverting to positive balances.

And Germany is part of this rebalancing equation. Since 2007, Germany's current account surplus vis-à-vis the euro area has shrunk continuously from 4½% of GDP to 2% of GDP. As business investment in Germany is projected to pick up in 2014 and 2015, this rebalancing should continue.

The progress that these abstract figures reflect is also visible in more concrete events. For example, Ireland, Spain and Portugal have exited their financial support programmes without any friction. All three countries recently returned to the sovereign bond markets at relatively low yields.

At the same time, stock markets in these economies have been rising for some time now. These developments underscore the progress that some peripheral euro-area countries have made in adjusting their economies.

However, despite these favourable developments, there is again no time for complacency. In many countries structural reforms are far from finalised, as a report by the EU Parliament suggests. At the same time, public debt is still very high in many countries and has to come down.

Against this backdrop, the recent debate about loosening the rules of the Stability and Growth Pact worries me. It seems that the experience from the crisis is already fading from collective memory. Given the deceptive tranquillity in the financial markets, we are at risk of forgetting what the crisis has taught us about public finances.

But that would have dire consequences. As I emphasised in my opening remarks yesterday, the markets do anticipate that reforms will be finalised and that public budgets will be consolidated. Thus, any doubts over the sustainability of public finances can send huge shockwaves across the euro area. In addition, mountains of private and public debt block the way towards sustainable economic growth. And on a side note: at this stage of integration in the euro area, euro-bonds would not be the right path to choose as they would weaken the incentives for prudent fiscal policy.

Nevertheless, to me, the recent debate about the Stability and Growth Pact shows something else. It seems that there is an expectation that, in the end, monetary policy will provide the ultimate backstop. This expectation, however, is dangerous and cannot be the guideline for policy action – or rather inaction.

Monetary policy certainly helped prevent the crisis from escalating. Still, there is one thing we should be clear about: monetary policy cannot solve the underlying causes of the crisis. It can only buy time. And it is up to national governments to use that time to dig out the root causes of the crisis. Failing to do so will push us back into dangerous territory. We must not let that happen.

4. Conclusion

Ladies and gentlemen

I have presented what I consider to be good news. The German economy is gaining in strength and the euro area has embarked on the path to recovery. Nevertheless, we should keep in mind, what the Irish horse racing jockey Tony McCoy said: "there is no place for arrogance or complacency in racing because you are up there one minute and on your backside the next". Keeping up economically is certainly a race and we should avoid the risk of landing on our backside. Thus, my warning: beware complacency. As a final point, let me emphasise that I have very much enjoyed attending this seminar. It has certainly helped strengthen the ties between the Central Bank of the Republic of Turkey and the Deutsche Bundesbank. Personally, I am looking forward to more visits next year when Turkey assumes the G20 presidency.

Thank you very much.