Andreas Dombret: The euro area – where do we stand?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the German-Turkish Chamber of Trade and Commerce, Istanbul, 10 February 2015.

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1. Introduction

Ladies and gentlemen

Thank you for inviting me to speak here at the German-Turkish Chamber of Industry and Commerce in Istanbul. Isaac Newton once observed that “we build too many walls and not enough bridges”. Istanbul has for centuries been a bridge between two continents – Asia and Europe. It seems to me that Istanbul is therefore an excellent place to hold this year’s G20 meetings. After all, the purpose of these meetings is to build bridges between nations by fostering dialogue and the mutual exchange of information. And this objective is of course also pursued by the German-Turkish Chamber of Trade and Commerce.

Moreover, mutual exchange is essential in a globalised world where countries are no longer isolated islands but part of a closely interconnected community. The global financial crisis has highlighted how close these connections are and how quickly a problem in one corner of the world can spread around the globe.

This truth applies all the more to countries sharing a common currency such as the member states of the euro area. Back in 1999, eleven European countries adopted the euro as their common currency. Today, the single currency is shared by 19 countries and more than 300 million people, which in my eyes makes it a success story.

That said, it has not always been plain sailing. In the wake of the global financial crisis of 2008, the euro area slid into a financial crisis of its own. This was compounded in 2010 when Greece entered into a sovereign debt crisis, triggering a sudden loss of confidence in other member states which eventually brought the euro area to the brink of collapse. Extensive rescue packages along with non-standard measures taken by the ECB helped to calm the markets and prevented the crisis from escalating.

To some commentators, the present situation is not much different. Greece is again capturing the headlines. Unrelated to Greece, the ECB again gave the green light to non-standard measures as a means of addressing the risks associated with too prolonged a period of low inflation.

To obtain a clearer picture, let us take a tour of the euro area to see where we stand at present and where we are headed in the future. Unsurprisingly, I will begin by focussing on the growth prospects of the German economy, not only because this is my home country but also because it is the largest economy in the euro area.

2. The German economy – in good shape but challenges ahead

At the beginning of 2015, the German economy remains in good shape. This is due to a number of factors. First, enterprises have brought their costs under control, their debt level is not unreasonably high, and they have an attractive range of products to offer on global markets, including Turkey. Second, the German economy is being supported by domestic consumption, while investment remains subdued – I will come back to this issue in a moment. In addition, unemployment is low, households are not burdened by excessive debt and real wages are rising on account of low inflation.

As reported by the Federal Statistical Office, the German economy grew by 1.5% in real terms in 2014. When the Bundesbank published its latest economic projections for Germany, real gross domestic product was expected to rise by 1.0% this year and by 1.6% next year. However, this forecast was prepared in November and since then the price of oil has fallen sharply. If oil prices remain at their current low levels, economic growth could prove to be markedly higher this year and next, since the low price of oil has the effect of a small stimulus package.

However, despite the current strength of the German economy, major challenges lie ahead. In particular, unfavourable demographic trends will have an impact on future growth. The Bundesbank estimates that potential output is currently growing at a rate of 1% per year and will continue to do so until the end of the decade. Compared to the 1990s and 2000s this is a truly underwhelming figure.

So, what can Germany do to improve its growth prospects in the long run? One frequently voiced proposal these days is that Germany should step up its investment as a lever for increasing its own growth potential as well as that of the euro area as a whole.

Indeed, the total real investment ratio in Germany was markedly lower in the 2000s than in the 1990s. And it was also lower than in the rest of the euro area.

Nevertheless, weaker investment in the last decade was largely the result of the construction boom in the late 1990s which followed German reunification. If construction is excluded from the investment ratio, Germany's situation is no longer any different from the rest of the euro area.

In addition, the construction boom witnessed in other euro-area countries also came to an abrupt end during the crisis, with the result that the ratio for the euro area excluding Germany has now returned to levels close to the German ratio. This effectively disproves claims that the German private sector is investing too little, be it by historical or international standards.

In any case, it is not possible to increase private investment by decree. When it comes to private investment decisions, expectations pertaining to growth and income are of pivotal importance. And in Germany, demographic change has tended to exert a dampening influence, the shrinking labour force being a paramount factor hindering economic growth.

Against this backdrop, many commentators point to public investment which can be directly influenced by the government. With regard to public investment, Germany lags well behind the rest of the euro area. However, this fact alone does not justify assertions that the state should invest more.

Even so, public net investment has been negative for some time now, and there indeed seems to be room for improvement. Infrastructure weaknesses can inhibit growth considerably and there are certainly regional shortcomings in Germany. Nonetheless, public funds should only be invested in projects that are economically worthwhile. In this regard, public and private investments should be driven by the same considerations.

At the end of the day, public investment only represents a relatively small share of total investment. And as I already indicated: such investment cannot be steered arbitrarily. Rather, it should reflect demographic trends and productivity gains.

The discussion of lack of investment shows that an economy is a complex system in which many factors interact in a complicated fashion. It is therefore not possible to solve all these problems by a single policy measure. This is true for Germany, and it is equally true for the euro area.

3. The euro area – structural reforms needed

Nevertheless, there are many observers who appear to believe that a single institution holds the fate of the euro area economy in its hands, namely the ECB. Just three weeks ago, the Governing Council of the ECB decided upon large-scale purchases of government bonds in order to address the risks arising from too prolonged a period of low inflation.

As you know, the Bundesbank takes a sceptical view of this government bond purchase programme. In our opinion, monetary policymakers are not under any acute pressure to act, as the low inflation rate is mainly attributable to falling energy prices. For the next two years, we are expecting inflation to pick up gradually; certainly, the risk of deflation is very limited.

What is more, government bond purchases are not simply a monetary policy instrument like any other where the euro area is concerned. They entail risks which we believe are not outweighed by the expected effects. For instance, the low interest rates, coupled with high liquidity, could encourage many investors, in their search for yield, to turn to assets they previously avoided due to the associated risks. This makes the emergence of price bubbles more likely, which could compromise the stability of the financial system.

In any case, and here we are in line with the ECB, monetary policy is not a magic bullet. Monetary policy cannot solve the crisis, nor can it put the euro area back on a solid footing. In order to achieve that we need structural reforms both at the national and at the European level.

Let us take a short look at the national level. When the euro-area crisis began five years ago, many people referred to it as the “euro crisis”. However, it was not a currency crisis but a cocktail consisting of a debt crisis, a banking crisis and a balance of payments crisis. While the underlying problems differ slightly between individual countries, the key to overcoming the crisis lies with the affected countries themselves.

In the years following the introduction of the euro, fiscal and economic policies in some member states failed to meet the requirements of a monetary union. And it was these countries which experienced strong capital inflows. Unfortunately, the lion’s share of this capital flowed into private or public consumption or into an oversized housing sector.

On the back of heavily exaggerated growth expectations, a decrease in competitiveness owing to generous wage settlements and insufficient financial regulation, sizable imbalances accumulated which then contributed to the crisis.

Hence, to resolve the crisis it is the countries themselves that need to adjust. And it has been clear from the outset that the necessary reforms and adjustment measures require patience. In the meantime, major progress has been made as most of the crisis countries have managed to substantially improve their public finances.

In addition, current account deficits have largely been reduced and some countries are now running a surplus. Price competitiveness in the crisis countries has also improved significantly. Measured in terms of the deflators of total sales, competitiveness has improved by 6% in Portugal, 9% in Spain and 14% in Greece.

We have certainly not reached the finishing line yet but there is evidence that the efforts are bearing fruit. It therefore worries me that Greece might go backwards in terms of its reform agenda.

Suffice to say, it is not enough to correct misalignments solely at the national level. We also need structural reforms at the European level. And here, a lot has been done since the crisis broke out.

First, the rules of the Stability and Growth Pact were tightened and a fiscal compact was adopted in order to restore confidence in public finances. Second, a procedure for identifying macroeconomic imbalances at an early stage was established. And third, a crisis mechanism was set up to serve as a “firewall”, safeguarding the stability of the financial system in the euro area.

In addition to these measures, the euro area took a major step toward deeper financial integration. On 4 November 2014, the first pillar of a European banking union was put in place. On that day, the ECB assumed responsibility for supervising the 123 largest banks in the euro area. Together, the banks concerned account for more than 85% of the aggregate balance sheet of the euro area's banking sector, making the ECB one of the biggest banking supervisors in the world.

Taking banking supervision from the national level to the European level has three concrete benefits.

First, European banking supervision allows banks in the entire euro area to be supervised in a uniform manner according to the same high standards. These harmonised standards will emerge from the cross-border sharing of experience, noting the best aspects of each national approach to banking supervision and adopting these for use at the European level.

Second, European banking supervision makes it possible to effectively identify and manage cross-border problems. This is essential because large banks are usually active in more than one country.

Third, taking banking supervision from the national to the European level will add a degree of separation between supervisors and the banks they supervise. This will prevent supervisors from handling their banks with kid-gloves out of national interest.

As you can see, we have come to expect a lot from European banking supervision. And in 2016, the Single Supervisory Mechanism will be supplemented by a European resolution mechanism for banks. This will be the final step on the road to banking union and a major step forward in designing a better framework for the European monetary union.

4. Conclusion

Ladies and gentlemen

Looking at current events, some of you may feel reminded of what happened in 2010 and in 2012. Nevertheless, it should not be forgotten that, in the past five years, we have made considerable headway in resolving the crisis and in putting the euro area back on a solid footing. We have achieved a great deal but much still remains to be done – both at the national and at the European level.

If we are to overcome the multiple challenges that lie ahead, all the member states of the euro area will need to work together in a spirit of cooperation and demonstrate a firm commitment to the common currency. On that basis, I am confident that the euro area will remain a stable and prosperous economy.

Thank you for your attention.