Embargo:
15 April 2003, 1:00 p.m. EST

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A European perspective on the world economy

Address at the 13th Annual Hyman P Minsky conference on the State of the US and World Economies

"Economic Policy for Sustainable Growth"

The Levy Economics Institute of Bard College

in New York City

15 April 2003

- Check against delivery -

Ladies and gentlemen!

At times like these, where transatlantic ties are under strain, I regard it as both an exceptional honour and a welcome opportunity to be able to present my European view of the world economy here at the 13th Annual Hyman P Minsky conference on the State of the US and World Economies. Our transatlantic dialogue must not be interrupted, even when our views differ in important respects.

I am a member of the German-American friendship organisation "Atlantik-Brücke". In February, our organisation ran an ad in the New York Times entitled "A Message from Germany". Its essence reads: "For the overwhelming majority of Germans, the relationship with the United States remains of vital importance. Current differences of opinion between governments over the question of Iraq must not be allowed to sever that bond". I would like to confirm that view today here in midtown Manhattan.

In the following, I will first comment on the present state of the world economy, which is characterised by unusually high uncertainty. Afterwards I would like to give you some facts about the German economy. Finally, I will try to spell out the European view of how the fundamentals must be set for sustainable growth to take place.

1 The present state of the world economy

1.1 Uncertainty abounds

The world economy has not been in exactly very good shape these past few months. The ongoing war in Iraq is weighing on the world economy. Financial markets are fickle; confidence among businesses and consumers remains subdued.

We must, however, not be fooled into regarding the war in Iraq as the sole source of uncertainty or the predominant issue for the world economy. Uncertainty was around before that war was on the horizon, and uncertainty will stay on for a while even after a — hopefully fast — end to the war.

What is more, uncertainty stemming from geopolitical strife seems to be deflecting our focus from some fundamental imbalances. Redressing these imbalances is a precondition for a return to sustainable growth. Overinvestment incurred during the millennium boom is being unwound only slowly. Vast spare capacity forms the backdrop for weak capital spending. The economy is bound to recover, but recovery is not necessarily just around the corner.

The IMF expects the US economy to grow at a rate of 2.2% in 2003. According to this estimate, the euro area can expect GDP growth of 1.1%, while Germany should brace for a third year in a row with significantly sub-par growth of 0.5%.

In 2002, North America and non-Japan Asia were the main contributors to world output growth, with the euro area and Japan lagging behind significantly. Two implications are worth consideration.:

1 First, the world economy is depending far too heavily on the US taking the driver's seat. The euro area and Japan must work on improving their ability to produce self-sustained economic growth.

2 Second, the world economy is even more fragile than this tilted growth performance suggests at first sight, for the growth path of the US economy itself is somewhat unbalanced. Its macroeconomic imbalances deserve careful addressing.

The expectation that the world economy will return to a healthy and stable growth path once the dust of war in the Middle East has settled is unrealistic to begin with. Obviously, the workload for the world economy to return to healthy growth will be high on both sides of the Atlantic.

In the euro area structural weaknesses have been building up for more than a decade. They are well known, as is the adequate therapy. Labour market inflexibility is the core European weakness. In a currency union, market flexibility is all the more crucial as exchange rates can no longer cushion asymmetric shocks. The euro-area countries now need to seize the opportunity to embark on serious reforms during times of crisis, where the reform zeal is more pronounced than at more quiet times.

The key message the present situation of the world economy conveys for Europe is that Europe would be well-advised to improve its ability to grow on its own. A tripolar economic and financial world cannot afford to rely on one pole only. Europe, especially now that European Union enlargement is just a year away, has a responsibility to assume in at least three areas: the political, the financial and the economic field. We are prepared.

We have strengths we can build on. The framework for economic and monetary union is sound and strong. You probably know that a European Convention is working on drafting a European constitution. For over four years we have had a single currency, the euro. First, outsiders said EMU would never happen. It happened. Next they said it would not work. It works. Now they say it will not last. Well, guess what? I think it will last.

The euro area economy can rely on a strong industrial core. European products are highly competitive, even after accounting for the massive appreciation of the euro against the dollar by as much as around one-third since hitting its trough in the fall of 2000. The export performance of the euro area economy speaks for itself.

Weaknesses of the US economy are of a more recent origin. They stem mainly from the late nineties' bubble economy. The balance sheets of businesses and consumers are debt-laden, while the public sector also has returned to dissaving. In the environment of weak capital spending, the current account deficit of 5% of GDP is no longer investment-driven. Therefore, it is more of a concern for me now than it was during the last couple of years. More recently, the equity markets' boom-bust scenario has left pension liabilities underfunded on a grand scale. To catch up on old-age provision is a key task for our age-ing societies; saving needs to be expanded.

Recently, the Severe Acute Respiratory Syndrome (SARS) has begun to add to the un-certainty. With its negative impact on transportation and tourism, it seems capable of inflicting serious economic damage at least in Asia, where up to now most of the cases have been observed. Some forecasters even cut their growth forecasts.

1.2 A thorough look at the German economy

Let me now comment on the situation in Germany. Germany-bashing has become a bit of a fashion recently. Some even suspect that we will become another Japan. I take that sort of criticism seriously, and I do see the parallels that lead to such comparisons. However, I am not the least convinced it is accurate; there are some decisive differences.

My country is strong, and so is its economy. Let me explain. Our modern infrastructure excels. Our economy is highly productive. Our industry therefore is highly competitive, as can be seen from the rising volume of exports we ship — a fact worth mentioning since, first, world trade growth is down sharply and, second, the euro is appreciating.

Yet I would be the last person to deny the structural weaknesses that the sluggish world economy is bringing to light. At the Bundesbank, we tend to regard the current confidence crisis not only as highly serious, but also as a window of opportunity for reform. In March, the Bundesbank's Executive Board took the unprecedented step of publishing a staff paper entitled “Ways out of the crisis”. The paper — which is posted on our website — contains analyses of the key areas of reform: public finances, social security systems and labour market issues. It spells out which reforms need to be enacted.

We stress the need for a consistent overall reform package. The key is to strengthen the willingness among individuals to take risks, to perform and to develop initiative. Only then will the fundamentally strong German economy regain momentum.

We must not forget that German reunification in 1990 was a once-in-a-lifetime opportunity. Reunification is a boon for us. But Germany is still suffering from economic policy mistakes made during the unification process. For example, a considerable portion of the recent weak German growth performance is due to the boom-bust scenario that was triggered in the construction sector. Early in the reunification process, building activity was boosted by overly generous tax incentives; now this sector needs to shrink back to normalcy. For seven years in a row this trend has shaved our growth rate.

Insolvencies have been on the rise, not only in the construction sector. The economy at large is also affected, as overall demand is weak in the low-confidence environment. As companies go bust and loans turn sour, is the German banking sector now in crisis?

German banks are well capitalised, and
German banking supervision is highly efficient. There has been only one single bank collapse in the post-war era (Herstatt) — many other industrialised countries have since seen outright banking crises. In Japan, as you may recall, financial supervision in the early stages of the banking crisis tolerated the banks' procrastination, eroding capital bases and misclassification of bad loans and therefore laying the foundation for deep trouble.

The second important difference between the German and the Japanese banking sector is the real estate bubble that still plagues Japanese banks, but never existed in Germany in the first place. A major portion of Japanese collateral diminished to virtual non-existence and thus accounts for the bulk of bad loans in Japan, but not in Germany.

During the strong financial market stretch in the late nineties, German banks were able to generate returns to match the high costs of maintaining their extensive branch networks. Now that financial market activity is less profitable and loan provisioning is on the rise, German banks have embarked on deep cost-cutting measures. The cost-income ratio has been falling for months.

The German banking sector is in a difficult position, this is true, but there is no lurking systemic risk by any means. The case for Germany turning into another Japan is utterly unconvincing. There is, however, one thing Germany — and not only Germany — can learn from the Japanese example: postponing structural reforms is downright unhelpful.

2 Policy mix for sustainable growth — a European perspective

What are the foundations for sustainable growth? From my European perspective, I would like to mention the following three foundations for sustainable growth:

1 A macroeconomic policy geared towards stability,
2 a structural policy geared towards growth, and
3 a sound financial sector.

2.1 Macroeconomic policy: stability orientation

Let me start with my core business as a central banker: price stability. Price stability is the best way a central bank can contribute to steady growth.

Any market economy relies on prices to signal relative scarcity or abundance to market participants. That way, resources are channelled to their most productive uses. A well-functioning price mechanism therefore is a precondition for efficiency and thus for a high standard of living.

Frequent and large movements in the price level tend to disguise movements in relative prices; they tend to block information. It becomes more difficult for market participants to tell the difference between overall price rises and changes in relative prices. Stability in the general price level is a necessity for a market economy to function properly and for investors to make the right decisions. To sum it up, price level stability is invaluable for growth.

A crisp and clear stability orientation of monetary policy therefore is the No 1 foundation for sustainable growth.

Price stability is a good only central banks can deliver. The Maastricht Treaty, which established European monetary union, reflects this insight in setting up a framework for the European System of Central Banks (ESCB) that prioritises price stability as the single most important goal of monetary policy. The Eurosystem shall support the overall economic policies of the European Union only to the extent that this does not threaten price stability. All EU central banks must be free of – and are free of – political interference.

The Governing Council of the ESCB has defined price stability as an annual increase in the general price level of 2% or less. During the run-up to EMU, countries notorious for their inflationary bias have experienced marked disinflation. No longer do people in those countries tolerate price rises. When some retailers tried to raise prices of some products after euro notes and coins came into circulation (in January 2002), people were in a rage. This is a good indication of how deep the newly-won stability consensus in Europe already runs. Never before has there been so much price stability in Europe as during the last decade.

However, price stability is not unique to Europe. Disinflation occurred on a global scale, as price stability has been recognised as the superior concept of monetary policy. No major economy or economic bloc is willing to go back to inflationary habits. In this respect, the prospects for the world economy are highly favourable.

The European stability consensus aims at underpinning price stability with an equally stability-oriented fiscal policy. EU governments therefore agreed on the European Stability and Growth Pact. The idea of the Pact is to not only to promote stability by preventing the emergence of conflicts between monetary policy and fiscal policies. Sound public finances as envisioned by the Pact contribute to sustainable growth, for they foster confidence.

The pact provides a credible framework designed to automatically stabilise the economy over the business cycle. The budget should be balanced over the course of the cycle, allowing for deficits if necessary, but also calling for surpluses if growth is high. The overall debt level of the public sector must be sustainable.

We regard the Stability and Growth Pact framework as a major improvement compared with discretionary stimulus packages that in the past have all-too-often proved to be ill-timed and debt-propelling. The much-chided euro-area social security systems are the main tools of automatic stabilisation.

Calls to revise the pact to counter its alleged procyclicality lead astray. Counter to conventional wisdom, the pact *is* flexible. It even allows for large macroeconomic stimulus. The only problem with the pact is that some governments wish to apply it asymmetrically: they are willing to run deficits in a weak growth environment, but wish to dodge consolidation in times of budgetary abundance. This deficit bias is the very reason for the 3%-of-GDP deficit limit. The ongoing debate is the best evidence of how important the 3% ceiling deficit is.

I am well aware that in the field of fiscal policy, the US and the euro area have recently started to pursue diverging approaches. One might even be tempted to speak of a “global experiment”. Policies on both sides of the Atlantic aim at rebuilding confidence, though the paths vary. While you in the US trust fiscal stimulus to actively rouse the economy from its current stupor, euro-area governments are basically trying to stick to the planned fiscal consolidation paths in order not to undermine hard-won confidence in their stability-oriented fiscal policies.

2.2 Structural policy: growth orientation

So, if macroeconomic policies need to be geared towards stability, then who is responsible for growth? It’s economic policy makers’ business to design a framework conducive to growth in which enterprises can thrive. Pro-growth policies are multi-faceted, but at the end of the day you must get the incentives right: incentives to invest and incentives to work.

The dissatisfying growth performance of Europe owes much to its inflexible labour markets. Labour market policy in the EU is a responsibility of the national governments. Some countries like the Netherlands have successfully improved the framework for their labour markets and already brought down unemployment.

Other countries like my own are still in the middle of an extensive debate as to how best to address the labour market issue. The Chancellor has recently laid out his ideas, and they seem to be going in the right direction. However, the crucial details for most measures still have to be worked out. So what I can tell you today is a bit tentative, but it is nevertheless encouraging.

In Germany, the combination of high labour costs and generous welfare benefits had, over time, crowded out an entire segment of the labour market: low-wage jobs for the low-skill group. Like in other countries, this is the group with the highest unemployment rate. We are now pondering to adjust the incentive structure on the supply side by revamping the schemes of unemployment benefits and welfare assistance. A new type of “mini-jobs” with lower-than-usual payroll taxes is intended to help reinvigorate that labour market segment. Like other countries in Europe, Germany will need to tolerate a higher degree of wage differentiation.

Wage negotiations, centralised up to now, will in the future become more open to company-specific deals. This increase in differentiation is a crucial feature of pro-growth policies. Labour contracts in general will have to become more diverse. More extensive use of fixed-term contracts will be allowed for expanding small businesses, thus abolishing a major impediment to small business growth.

Another core task in growth-spurring labour market reform will be to bring down non-wage labour costs, which are a major barrier to employment growth. That is equivalent to further reforming the social security systems. We have already added a small but fully-funded pillar to our pay-as-you-go pension system. However, pension reform is still unfinished business. Employees will need to resort to more private provisioning.

In terms of growth orientation, Europe has been a bit of a laggard, although we have sound economic fundamentals. The time for more structural adjustments has undoubtedly come. They should help to both exploit and raise the growth potential. In general, economic policymakers need to provide a viable framework for giving enterprises and households certainty of planning.

Pro-growth policies are not restricted to domestic issues. A coherent approach to pro-growth policies must encompass liberal trade policy. Lowering barriers to trade and granting market access must be part of any credible set of pro-growth policies. There are really few things economists are willing to agree on, but the benefits of free trade are among them. Therefore, the Doha round of international trade negotiations is another great opportunity for the world economy to foster growth.

2.3 A sound financial system

The third factor in policies for sustainable growth is a sound financial system. It is a necessary precondition for the exploitation of the growth potential. There can be no investment without financing, and there can be no proper financing without a sound financial sector.

It is not a question of whether a financial system is a capital market system or relies more on banks for the allocation of funds. By tradition, continental Europe tends to be more bank-centred than the English-speaking countries. This tradition is now under change. Not even the setback for financial markets which followed the bursting of the millennium bubble brought this process to a halt.

Under the new single currency, capital markets in the euro area have begun to play a larger role in financing. Financial integration is — aside from price stability — one of the hopes we had for the euro. It materialised quickly. More liquid and more thoroughly integrated euro-area capital markets are providing businesses with better and more diverse financing options. Ever more companies are going straight to the market, implying a changing role for banks. The euro-area financial system is becoming more balanced. Finance in Europe — which has not been bad before the euro arrived! — achieved a structural improvement. The foundations for economic growth in the euro area have improved in step.

To safeguard the soundness of a financial system is a rather complicated task. Effective financial regulation and financial supervision are key to financial stability. As financial products become ever more complex, financial regulators and supervisors need to keep pace with developments in the capital markets. They have to strike a fine balance. Their core task is to make sure that financial institutions are capitalised commensurate to their respective risk profiles, not least in order to contain systemic risk. On the other hand, they do not want to hinder the development and the use of new instruments and will therefore try to permit as much room as possible so as not to hinder growth.

In the aftermath of the late nineties' financial market boom, new questions arose. The role of market integrity has been highlighted by a series of financial scandals. Cases of insider trading, of investment banks recommending clients' stocks against their better judgement, and even some spectacular cases of outright accounting fraud have shaken financial markets to the core. Trust has been lost on a grand scale. It needs to be rebuilt by improving the framework of the markets. Financial markets must be trustworthy; only then will investors be willing to provide finance.

Let me cite one last aspect of sound financial systems. It is also a matter of trust. The infrastructure of the markets needs to be stable and able to withstand shocks. 9/11 was a shock not least to the world financial system. It put payment systems to the test. With a little help from the central banks — we stood ready to provide liquidity — the international financial system proved resilient. Disruptions in the world financial net might easily have a severe negative impact on the world economy. Hence the robustness of the market infrastructure is a major factor in steady and sustainable growth.

3 Concluding remarks

Ladies and gentlemen,
Uncertainty currently weighs on all debates on economic issues. We cannot abolish uncertainty. It is a feature we will have to live with for some more time, as its causes are many. We can and we should, however, work to improve the resilience of the world economy. World economic growth needs to become better balanced. For this to happen, each of the world's major economic zones has some homework to do.

Let me again point out how happy I am to be able to be here with you this afternoon to discuss some important issues of the world economy. Trans-Atlantic debate has traditionally been intense – and it is a tradition I hold in high esteem. Our countries do have differences on vital political questions. We must not let these differences spoil our long-term relationship. The world needs a strong United States of America and a strong Europe to work together with confidence for the benefit of mankind.

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