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President

of the Deutsche Bundesbank

Minutes of the press conference

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Press conference

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- I have been in my new post for nearly 30 days now and, right at the start of my term of office, I had a number of important engagements to fulfil (meetings of the ECB Governing Council and the G-10). After that busy initial period, I am pleased to welcome you to my first press conference today.

At today's press conference, I would like to address the following topics.

1 The implications of recent events/Mr Welteke's resignation
2 The future profile of the Bundesbank
3 Monetary policy and credit development
4 The economy and prices
5 Fiscal policy and the Stability and Growth Pact

1 Implications of recent events/Mr Welteke's resignation

During the past few weeks, the Deutsche Bundesbank has encountered an unprecedented level of **public criticism**. Great pressure, not least political pressure, has been exerted on the Executive Board of the Bundesbank.

With the decisions it has taken, the Executive Board has succeeded during this difficult period in protecting the **Bundesbank's independence** and in limiting the damage to its standing.

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Undoubtedly, however, these events have **harmed** the Bundesbank's **reputation** as an institution. My aim – and that of the entire Executive Board – is for the Bundesbank to be in the public eye again because of the **focused** and **effective** way it performs its tasks: what, more than anything, is vital for the Bundesbank's public standing is confidence in the work it does and in its competence. That will be a key concern for me during my term of office.

In order to repair the harm that has been done to the bank's reputation, it will also be important to be more vigorous and active in **informing the general public** of the **Bundesbank's role and tasks** than has hitherto been the case.

2 The future profile of the Bundesbank

There have been many public calls for a downsizing and reorientation of the Bundesbank during the past few weeks. At times, the impression was created that, following the launch of monetary union, the Bundesbank has not responded to its changed role.

In actual fact, the Bundesbank was already taking a constructive part in preparing the way to monetary union from the early 1990s onwards, was involved in a hands-on role in a large number of bodies and committees of the European Central Bank and, in particular, contributed to the European System of Central Banks having no less of an orientation to stability than the Bundesbank during the D-Mark era. **In terms of its tasks**, the Bundesbank

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has **re-geared** itself – away from being the monetary policy decision-maker for the D-Mark to being an integral part of the ESCB.

Following the creation by parliament of a centralised management structure in May 2002, the new Executive Board immediately started to tackle the **organisational restructuring** of the bank *[At the end of 2002: detailed strategy and decisions on operating units; 2003: cash and branch strategy].*

My aim is the **successful completion** in 2007 of the **structural reform** initiated under President Welteke which is already fully in the process of being implemented. Whether, above and beyond that, additional adjustments will be needed hinges quite crucially on factors beyond our control. Among such factors, I include, in particular, structural changes in the banking industry which cannot be anticipated at present.

By 2007, 60% of the locations which existed at the start of 2003 will have been closed: down from 118 (currently 88) locations to what will then be 47 branches; the number of staff will fall by 30% to 11,100 and, as part of this process, we shall be giving up around 40% of the Bundesbank's management positions. The potential savings in terms of staff and material costs are estimated at roughly EUR280 million annually.

That is a significant process of consolidation. All personnel measures have been taken in consultation with the staff representation council and it is an

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important signal for those who work at the Bundesbank that this consolidation process is being initiated in a socially humane manner and that there will be no compulsory redundancies.

It is not solely a matter of organisational restructuring, however. It is closely linked with a **restructuring of business policy**. I endorse the decisions already taken by the Executive Board which involve the Bundesbank focusing on its core tasks and functions. It is not the job of a central bank to operate in business areas that can also be covered by private sector providers. *[For example, confining ourselves to the role of a cash management wholesaler, free-of-charge standard Eurosystem services, additional services in accordance with the full-cost-recovery principle, partial withdrawal from coin processing].*

The **future profile** of the Bundesbank, I believe, has to be geared to three major objectives.

First, as an independent monetary policy authority in Germany, the Bundesbank has always been the **guardian of stability**. Maintaining the stability of the general price level by means of a stability-oriented monetary policy and stability awareness is at the core of its actions. As before, that is the Bundesbank's primary focus.

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Second, the Bundesbank should assume an **appropriate role** among the national central banks of the **ESCB** – a role that is consistent with Germany's economic importance and our stability culture. My aim is to **give the Bundesbank a more distinct profile within the ESCB** by making expert contributions to the major issues of monetary union and employing our expertise, our experience and our resources to take an active part in shaping monetary union.

Third, as an **independent** and **expert voice**, the Bundesbank should enrich the **economic and fiscal policy debate in Germany**. The Bundesbank is a major participant in the national macroeconomic discussion. In contrast to other advisory institutions, it combines the advantages of political neutrality, business policy neutrality and closeness to the market. In particular, we shall be devoting ourselves more than before to financial market issues in the economic policy debate in Germany.

In order to do justice to these desired objectives, the Bundesbank will continue stepping up its **economic research activities**, which it began to do in the 1990s. Issues concerning the stability of the financial system are gaining increasing importance in this context. A stable and efficient financial system is indispensable for a central bank to be able to fulfil its stability mandate. In future, we shall therefore be further expanding our analytical and research capacities for identifying potential risks to the stability of the financial system.

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Banking supervision is undoubtedly another growth area. The legislature has assigned a strong role to the Bundesbank in the conduct of banking supervision. Ongoing oversight and the continuing development of national and international prudential supervisory legislation are requiring an ever higher level of the expertise and skills for the members of staff working in this field.

After all, the Bundesbank also has to provide **first-class services** in **all the other business fields** of a central bank, such as putting in place payment system infrastructures or a foundation for implementing monetary policy decisions. We want to go on doing that in the future and make it a major part of our work.

After the commotion of the past few weeks, we shall now be devoting our full energy again to the important objective tasks I have mentioned. I am confident that, by doing so, the Bundesbank will soon be seen by the general public in the way I feel the bank deserves – as competent, committed and reliable.

3 Monetary policy and credit development

a Monetary policy assessment

The monetary policy of the Eurosystem is geared to maintaining price stability. Jean-Claude Trichet often describes this as the “magnetic needle” of the Eurosystem’s compass. To that end, the Eurosystem, as part of its **monetary**

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policy strategy, regularly analyses the economic, financial and monetary indicators, which permit an **assessment of the future risks to price stability**.

The two pillars of the Eurosystem's strategy mainly help to **structure the various indicators**. This makes it possible to give a clear account of the monetary policy decisions and therefore strengthens the **strategy**'s role as an **instrument of communication**.

On the basis of this **analysis**, **price level stability**, in the assessment of the Governing Council, is **maintained** in the medium term. For that reason, at its meeting in early May, the Governing Council left the Eurosystem's key interest rates **unchanged** and quite deliberately emphasised its "unchanged assessment".

The **underlying monetary conditions** remain **favourable** and **financing conditions do not present an obstacle** to **economic recovery**.

- **Key interest rates** are decidedly low,
- There is an **abundant supply of liquidity** in the euro area

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German enterprises and households are also benefiting from the **low interest rates**. Both longer-term bank interest rates and capital market rates are quite modest and at an all-time low.

b Real interest rate differentials

Permit me to add something to a debate which I feel has led to some confusion of interpretation in Germany recently: the real interest rate differentials in the euro area.

Real interest rates – like nominal interest rates – are at an all-time low. Owing to the low inflation rate in Germany, real interest rates in this country are higher than in the other euro-area countries. While short-term real interest rates in Germany have recently been at ½ percentage point, they were 0% on a euro-area average in April. Historically, however, both German and other European real interest rates are to be seen as low. Even so, in many cases, it is claimed that the single monetary policy is dampening economic activity in Germany – a line of reasoning that is grossly oversimplified and unsustainable in those terms.

- A **lower rate of price increase** for German products by international standards happens also to **improve** German enterprises' **price competitiveness** in comparison with their competitors abroad. Since the launch of monetary union, their price competitiveness against the other

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euro-area countries has gone up by 6%. That is quite a considerable increase in the price competitiveness of German enterprises. It is true that there has been only a small increase against non-euro-area countries (less than 1% compared with the fourth quarter of 1998) but that has been due mainly to the sharp appreciation of the euro in the past two years.

- Furthermore, it is not only enterprises which are benefiting from favourable financing conditions with low real interest rates. German consumers, too, are benefiting from the low rate of inflation since low inflation is doing more in Germany than in other countries to secure the purchasing power of real incomes.
- To calculate long-term **real interest rates** – which represent the more important variable for the development of the real economy and investment, in particular – the **expected rate of price increase** (**“ex ante real interest rate”**) should be used as a basis anyway rather than the current inflation rate. Although the long-term “ex ante real interest rates” in Germany, at 2¾%, were latterly ½ percentage point higher than the euro-area figure of 2¼%, they were around 1 percentage point lower than their longer-term average.[1] Since inflation expectations in Germany and the euro area – in contrast to the actual dynamics of inflation – have scarcely deviated from each other on an average of the past five years (in other words, since the launch of monetary union), the “ex ante real

[1] Real interest rate based on Federal bonds with ten years’ residual maturity and on Consensus inflation expectations. Average from the end of 1989 around 3¾%; since the launch of monetary union around 3%.

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interest rate differential" was, on average, much smaller than that based on the "ex post real interest rates".[2,3]

- Furthermore, ("ex post") real interest rates can also be computed on the basis of producer prices, which have been markedly more homogeneous in their development in Germany and the euro area than has been the case for consumer prices.[4]

An informed statement on the impact of inflation differentials on economic growth can therefore be made only by taking due account of all the macroeconomic effects. The retarding effects of the marginally higher real interest rates will, at all events, be offset over the longer term to a large extent by the stimulus of the other effects.

c Credit development in Germany

The fact that there has been **very little growth** in **bank loans in Germany** for some time now despite the quite favourable financing conditions is **due mainly** to **weak economic activity**, **low investment in machinery and equipment,**

2 The differential is currently ¾ percentage point.
3 The mean value of the real interest rates based on Consensus inflation expectations for the period from January 1999 to April 2004 for Germany as well the euro area is 2.9%.
4 The ("ex post") real interest rate differential calculated in this way, averaging ¼ percentage point since the launch of monetary union, was much smaller than in the case of the HICP (¾ percentage point).

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and declining construction activity. These are the three factors which explain the low rate of credit extension in Germany.

In such a setting, it is not only the loan demand that is at a low level but also the banks’ willingness to grant credit. The tightening of lending conditions, as has been reported for some time in the surveys among banks, is likely to be predominantly cyclical. Our econometric studies have not been able to identify any indications of a more far-reaching limitation of the supply of credit at present. Incidentally, this is also consistent with the studies undertaken this year and last by the German Council of Economic Experts (*Sachverständigenrat*). There are no signs of a supply-side credit crunch in Germany.

4 Economy and prices

Gratifyingly, the **economy in Germany** picked up somewhat more momentum in the first quarter of this year. At an annualised rate, the current pace of expansion is around 1¾%. Seen in that light, it is likely that, **for the first time in a long while**, there was **no further decline in** the average degree of **overall capacity utilisation**. The continued cyclical recovery largely confirms the general expectations that the German economy can gradually free itself from the persistent course of stagnation. From a cyclical perspective, we are –

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to put it somewhat informally – over the worst but not yet out of the woods. That is because **major attributes** are still **lacking** with regard to the **broadness of the fundamentals** and the intrinsic momentum of growth, which are typical of an upswing in the classical sense. Such aspects of an upswing in the classical sense are a strengthening of investment demand and, in particular, consumer demand. That is where the signals we are getting are still decidedly mixed.

The fact that things are basically back on the right track has a lot to with the strong **external stimuli**. Besides Germany's **price competitiveness**, which can be described as good on the whole, exporting is benefiting primarily from the **global** pick-up in demand for capital goods and generally **very buoyant world trade**. This means that the global upswing – driven by the US economy and East Asia – has continued to become stronger and broader. Whether broken down by region or by sector, world economic growth is expected to be powerful and this dynamism will also have a marked effect on the German economy. Over the past few years, it was primarily the external component which shaped the cyclical pattern in Germany. That, too, is something we shall continue to see this year.

Despite the major geopolitical risks and high commodity prices, there appear to be good prospects at present that the expansionary cyclical forces – not least in the **euro area**, the most important sales market for German products – will

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gain in impact. Here, too, the higher growth rate in the first quarter gives reason for cautious optimism.

What also characterises the current economic situation in **Germany**, however, is **persistently weak consumption**. To a large extent, this is still a reflection of the preceding protracted slowdown. Thus, we are in a period in which consumption has not yet recovered. Nevertheless, there are **indications** of a **change in households' consumption and/or saving behaviour**.

Insofar as this reflects the **accumulation of private assets for maintaining the standard of living in old age**, this represents a major contribution to overcoming the demographic strains and pressures and may therefore be seen as something positive. Especially given the demographic development in Germany, that is certainly an important factor. The **pronounced uncertainty about** the specific **details of the social and labour market reforms**, however, has made it considerably more difficult to assess the future outlook for households' incomes and has led to additional restraint in spending. The sooner and more convincingly the relevant policy measures are put in place for greater **planning certainty** and reliability in terms of the underlying conditions, the sooner the present caution can be overcome.

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It will also be important to promote corporate investment. For this to happen, major and fundamental criteria are in place in terms of the cost and price situation as well as on the financing side. Seen in that light, there has been a **considerable improvement** over the frosty **investment climate** of the past three years. That is also revealed by surveys on corporate investment planning. Investment in machinery and equipment will benefit from this, construction less so. A reversal of the trend in the **growth of the capital stock**, **however**, is to be expected only **when** the **investment ratio** has returned to a **sustainably higher level**.

Under the above conditions, the situation on the **labour market** will initially continue to be **the dark cloud over economic developments**. **We are certainly expecting a reduction in redundancies during the course of the year**, **but still no fundamental turnaround**. The existing productivity reserves, better management of working hours, and the additional working days this year likewise suggest **no more than** a **gradual stabilisation**. It is only by simultaneously achieving the goals of an increase in the intensity of employment and higher growth that we shall get to grips with the basic malady of unemployment.

We shall only succeed if **economic policymakers continue to pursue the path of reform**. Economic policy has to re-commit itself vigorously to these reforms which have already been initiated. **Wage policy** has to take greater

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account of **differing circumstances** and **monetary policy** has to **remain true** to its **stability-oriented responsibility**.

5 Fiscal policy and the Stability and Growth Pact

Since the latest tax estimate, **fiscal policy** has again been **taking centre stage** in the economic policy **debate** in Germany.

As the President of the Deutsche Bundesbank, I have the task of

- first, looking at fiscal policy from the point of view of a **national institution which**, **in its economic analyses,** studies and comments on developments in Germany on an ongoing basis.
- Second, however – because I am a member of the Governing Council of the ECB – I have to see national developments in a **European context**, and that is the second major task I have as president of this institution.

In transferring responsibility for monetary policy to the ECB, there was a consensus that **sound public finances** represent a **major cornerstone** of confidence in a stable currency. The Maastricht Treaty and the European **Stability and Growth Pact** were regarded, not least in Germany, as crucial preconditions for relinquishing monetary policy sovereignty. The **President of**

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the Bundesbank is committed to that fundamental stability policy consensus in a quite particular way.

In this connection, I would like to say something of fundamental importance about international rules in general and the Stability and Growth Pact in particular.

International rules have to be

- **goal-oriented, transparent, unambiguous** and **clearly understandable** for the general public.
- They have to **create confidence** and not be subject to the discretion of those affected.
- The **rules have to be binding** and a **breach** of the rules ultimately has to be **punished**.
- The rules also have to have a **certain degree of flexibility** in order to take account of special situations and developments.

All these criteria are fulfilled by the existing set of rules.

- Having said that, it is not possible to see that changes would represent an improvement or would enhance the soundness of public finances in the member states.

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- Rather, a **rigorous implementation of the existing agreements is called for**.
- In **Germany**, a **budget close to balance** in the medium term, as envisaged in the Stability and Growth Pact, was **not achieved even in the favourable period** of the late 1990s.
- An **adequate safety margin** below the 3% limit **did not exist**.
- Given the period of stagnation in the economy as a whole, the **general government deficits expanded** sharply at all government levels, with marked **tax cuts** having **played a part** in this.
- This means that, this year, the 3% limit is running the risk of being exceeded for the third time in succession. This overshooting is foreseeable and there is a major risk of this happening next year as well.
- In 2002, the **debt ratio** overstepped the 60% limit and, by the **end of 2004**, will have grown to **significantly more than 65%**.

Given that situation, it is **not possible to see** how the **call to fulfil** the **commitments** which have been undertaken (achieving a maximum deficit ratio of 3%) in 2005 reflects an excessively rigid and inflexible framework. That is **all the more the case** given the generally expected **recovery in the economy as a whole.**

In saying that, however, one should not conceal the fact that this represents a **demanding task**.

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- **In the current year**, the **deficit ratio** is likely to be **around last year's level,** in particular, owing to sizeable income tax relief and despite considerable spending cuts by the Federal Government.
- **Next year**, the final stage of the income tax reform will lead to further tax relief. **Overall tax revenue**, however, is likely to show a **marked rise again**, which means that a **clear reduction of the deficits** can be achieved provided **spending is kept in check** and the **adopted reform plans are implemented**.
- As things stand at present, **additional efforts** will be **needed** to bring the deficit below the 3% limit. The **objective** is not out of reach, however, and should **not be abandoned under any circumstances**. On the contrary, we regard additional efforts to achieve the 3% limit as quite appropriate.

All levels of government are **required** not to relax in their efforts at consolidation.

- **Tasks and spending** are to be **scrutinised**, not least to adhere again to the relevant budgetary ceilings for new borrowing.
- **Efficiency reserves in the performance of government tasks** need to be opened up.
- The **accurate targeting of government services** needs to be **enhanced.** Not least, there have to be **larger cuts in subsidies**, including

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tax breaks. In this connection, let me draw your attention to the Koch-Steinbrück strategy, which envisages starting a linear reduction in tax concessions and financial assistance in several stages. In that area, further steps should follow the measures that have been adopted. Furthermore, I feel that a more comprehensive reduction is called for in the case of subsidies.

- Passing the buck and stalling **necessary decisions** cannot be in the **national interest**. I therefore repeat the call I made at my official inauguration for all those who bear responsibility for policy in Germany to be aware of that responsibility and for no further delay in the necessary consolidation.

Altogether, fiscal policymakers are faced with the task

- of improving the **overall economic framework** and therefore enhancing the outlook for growth.
- An **expansionary fiscal policy** would, **at most**, bring about **a short-term upturn**. The effects of such a short-term fiscal policy are very short-lived and small in quantity. These are accompanied by long-term losses of confidence that such a policy implies if it is conducted by departing from consolidation objectives which have been set.
- **Pressing ahead** with the initiated **structural reforms**, on the other hand, could **permanently strengthen growth**. A forceful **path of growth**

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is, after all, a crucial **contribution to consolidation** that the Federal Government could make in the present situation.

Major reforms have already been set in train by decisions affecting the labour market as well as health and pension insurance, and the tax rate cuts are also a welcome development. Even so, there is a **need for further action** to be taken.

- In particular, **tax legislation** should be **made much simpler**.
- The **system of statutory health insurance** should be **made more efficient**. This should also involve a greater de-coupling of funding from wages as well as, with a view to the ageing of the population, the adoption of what is probably an inevitable **raising** of the **statutory retirement age**. There are two points I would like to mention here. The first is that the *de facto* age for retirement is converging with the statutory provision of 65 years. Second, given long-term demographic developments, I believe that a gradual raising of the retirement age from 65 to 67 years is called for.

With a comprehensive **medium and long-term strategy**, **confidence in sustainable public finances** should be strengthened. In fiscal policy terms, I regard that as the absolute prime objective to which fiscal policymakers should devote themselves over the next few years. It is only such confidence that can and, in my view, will overcome the caution of consumers and investors.

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