Dr Andreas Dombret
Member of the Executive Board
of the Deutsche Bundesbank

Current developments in Germany and Europe

Welcome address at the reception for

the outgoing Deputy Head of the Representative Office

of the Deutsche Bundesbank

in New York
on Wednesday, 24 August 2011
– Check against delivery –

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

Contents

1 Introduction

Ladies and gentlemen

For more than four years we have been facing an unprecedented crisis, which has sometimes led to high levels of uncertainty. I will start my short speech with some information on the current situation in Germany and Europe before returning to the individuals and their role in transmitting such information. Let me stress in this context that it is a pleasure to be meeting all of you today and to have this opportunity to improve our transatlantic relationships and to exchange views later on.

2 Current situation in Germany and Europe

As I mentioned, we have been living in the face of an extraordinary crisis for more than four years. Having originated from the American housing market, this crisis quickly spread to the global financial markets. It caused a severe recession of the real economy and eventually led to an erosion of confidence in the public finances of various countries. In the wake of debt problems and amidst worries about the state of the global economy, we have seen

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

renewed market turbulences over the past weeks. However, looking at the underlying development of the real economy, the situation in Germany and the euro area is not as dire as these turbulences might suggest. Let us begin by taking a look at the situation in Germany.

GDP as the most general indicator of a nation's economic performance has broadly recovered. During the crisis the German economy shrank considerably; in 2009 alone, GDP contracted by 5.1% – by far the most severe downturn for more than half a century. However, in 2010 and the first quarter of 2011, the German economy recovered strongly and the level of economic activity has almost returned to pre-crisis levels by now. These strong dynamics seem to be contrasted by the first estimate of GDP growth in the second quarter of this year which revealed an increase of just 0.1% compared to the first quarter. Nevertheless, this pronounced drop in the growth rate does not come as a surprise and should be no cause for concern: the strong expansion we saw in the first quarter was in part due to catch-up effects, since the last quarter of 2010 had been adversely affected by an exceptionally cold winter. Hence, a certain backlash in the second quarter was to be expected, and in its recent June forecast the Bundesbank actually predicted a growth rate of 0.1% in the second quarter. This suggests, of course, that the GDP growth figure for the second quarter understates the underlying cyclical momentum. As for the remainder of the year, recent leading indicators suggest a continuation of the upswing, albeit at a more moderate pace than before.

To be sure, despite the relatively benign outlook some risks remain. These include uncertainties regarding the US economy, a potential cyclical slowdown in emerging markets, uncertainties in financial markets and the continuing debt problems in a number of countries. However, in Germany these less favourable external conditions are contrasted by more

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

encouraging internal dynamics. Thus, the recent slowdown is no indication that the German economy has been affected by the increased uncertainty, and according to our forecast the German economy will grow by 3.1% in 2011.

This rather positive impression is confirmed when looking beyond GDP growth at other economic indicators. In particular, the German labour market presents a bright picture. It fared unexpectedly well during the crisis and moreover has recovered rapidly. This year, unemployment has reached its lowest level since the beginning of the 1990s. The current unemployment rate stands at 7.0% and employers' willingness to recruit staff is still very high. Given that the slump in 2008 and 2009 was mostly due to a cyclical shock, the labour market profited significantly from previous bold reforms, which had modernised the labour market structure. These structural reforms paved the way for further necessary market-based corrections, for example in wage setting and intra-plant working-time flexibility. Given these circumstances and the still favourable outlook for economic growth, we expect unemployment to fall to 6.5% in 2012. The strong performance of the labour market is one important reason why we expect domestic demand to contribute significantly more to growth than in the past.

Turning from Germany to the euro area as a whole, we find a mixed picture in various respects. Overall, we still see a positive underlying momentum of economic activity. However, the underlying trend may be overstated, as the strong growth we observed in the first quarter was partly due to extraordinary factors. In line with this observation, GDP growth slowed down in the second quarter: according to Eurostat's first estimate, euro area GDP increased by a mere 0.2%. Regarding the further development, signals are mixed at the moment: while recent polls showed that expectations have dampened, current data reveal that orders in the industrial sector increased significantly. Overall it seems that, in line with

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

previous expectations, the euro area economy will continue to expand over the rest of this year, albeit at a moderate pace.

A glance at the labour market in the euro area also reveals an uneven picture: recovery had already been tentative before and slowed down further in spring. Overall unemployment in the euro area currently stands at nearly 10%, while the individual rates range from 4.0% in Austria to as much as 21% in Spain. Finally, consumer prices have been rising over the past months, and although the increase has slowed down somewhat of late, current inflation stands at 2.5% – clearly above the Eurosystem’s 2% definition of price stability. To prevent second-round effects and to ensure that inflation expectations remain firmly anchored, the Eurosystem has raised interest rates twice this year.

3 Challenges in the euro area

The major risk for the euro area is probably the uncertainty resulting from the debt crisis in Greece and some other member states. However, in mid-July, policymakers agreed on an all-encompassing package to stabilise the situation. First of all, it is important to keep in mind that the situation in Greece is exceptional in various aspects, and for these reasons the measures taken should not be extrapolated to other member countries. Furthermore, from a central banker’s perspective, it is to be welcomed that the European Council announced its intention to ensure sufficient capitalisation of banks and adequate collateral. For the Eurosystem’s refinancing operations, solvent counterparties and sufficient collateral are crucial.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

When I mention *counterparties*, please allow me to briefly address one current point of interest in financial markets on both sides of the Atlantic: US dollar funding of European banks. This is certainly an area that relevant authorities, including the Bundesbank, monitor closely. But let me offer you some assurance about the current situation –in particular, of course, from the German point of view. Without a doubt unsecured US dollar funding markets have tightened somewhat recently. For example, US money market funds, which account for a non-negligible but small part of European banks' short-term liabilities, have become more selective when providing funding to non-domestic banks. But let me emphasize that we are very far away from the situation we witnessed in 2008. First, liquidity needs can be covered by a number of other means including secured funding with repos. Second, if need be, the ECB stands ready to mitigate potential bottlenecks, based on the swap agreement in place with the Fed. Third, the lion share of German and other European banks have used the rather benign market conditions in the first part of this year and have completed an over-proportional part –or even all –of their overall 2011 funding needs in the capital market segment. And let me make a final important point here: European banks, in general, have considerably improved their capital base making them less vulnerable to financial strains. Speaking about German banks, the Tier 1 capital ratio currently reaches 12.6 % on average, having improved by about three percentage points between the end of 2008 and June 2011.

But let me return to the bigger picture. It has to be kept in mind that the sovereign debt crisis and, indeed, challenges we face in parts of the European banking system can ultimately only be resolved by ambitious and credible fiscal policy measures, particularly in the countries whose fiscal soundness is being questioned. Conversely, it is imperative to very clearly separate monetary policy from fiscal policy. Wherever the boundary between the two has become blurred, it must be redrawn as quickly as possible.

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

4 Conclusion

Ladies and gentlemen

Let me conclude by stressing the importance of the work done by our Representative Office in New York. As I see it, there are two main functions that this office serves. First, it gives us an opportunity to further explain policy decisions and economic developments in Germany and the euro area on this side of the Atlantic. Second, and for us even more importantly, our New York office reports back to us, in particular, on monetary policy and financial stability issues as well as financial markets developments. Through the financial crisis, in particular, we have seen the significance of directly exchanging information with our colleagues at the Fed, with representatives of commercial banks, policy makers, think tanks and market participants. It allows us to better understand political and economic developments in the US and we are much more in a position to separate noise from significant market developments. Our team here in New York is doing an excellent job identifying and communicating key developments in the US back to Frankfurt. This, I suspect, would not be possible without the support of everyone present here tonight.

Finally, one great side-effect of having people work at our Representative Office is that they become even more valuable when they return home. As you know, Felix Thierfelder has worked at the office over the past three years, which were marked by the financial crisis. He has gained significant experience during this time. We are glad that he is now returning to our Central Office as a staff member in the Financial Stability department. Mr Thierfelder will be responsible for setting up new market contacts and intensifying our existing ones. With the creation of this new post we hope to be better positioned to identify key risks to financial

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077

stability early on. It also testifies to the importance we attach to exchanging views with market participants.

Feline von Heimburg has also been monitoring the development of the financial crisis when working in the Financial Stability departments of both the Deutsche Bundesbank and the European Central Bank. She will now be able to employ the experience she gained in Europe in the more hands-on environment of the Representative Office.

Let me now thank Felix Thierfelder for his work over the past three years and welcome Feline von Heimburg as his successor. I wish both all the best for the future.

Thank you very much for your attention.

* * *

Deutsche Bundesbank • Communications Department • Wilhelm-Epstein-Strasse 14 • 60431 Frankfurt am Main • Germany
www.bundesbank.de • E-Mail: presse-information@bundesbank.de • Tel: +49 69 9566 3511 • Fax: +49 69 9566 3077