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The world economy in transition – a European perspective

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1 Introduction

Ladies and gentlemen

First, I would like to thank you for the invitation. It is a pleasure and an honour for me to speak here at the European Banking Congress before such a distinguished audience. The topic of this year's congress is "the big shift" and, just to make things perfectly clear, this does not exclusively refer to the current crisis. While the crisis dominates centre stage, the "big shift" takes places in the background. It does not go unnoticed but it receives less attention. What I am referring to is the continuous rise of emerging economies. This development is to the crisis as plate tectonics is to a volcanic eruption: it is slower yet its implications might be larger. But before we talk about the implications of the big shift, let us take a look at the facts.

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2 Shifting economic powers

Over the past few years, emerging economies have become ever more important players in the world economy. During the last decade, real GDP in these economies grew by roughly 6% per annum. Over the same period, output in advanced economies rose by a little less than 2% on average. According to estimates by the IMF, emerging economies now account for almost half of global output, measured by purchasing power parities. The rising share in world GDP also implies an increasing role of emerging economies as generators of global growth. Between 2000 and 2010, they contributed on average two thirds to the increase in global output, again measured by purchasing power parities. Thus, they actually helped to stabilise the world economy during the recent crisis.

Looking into the future, it is generally assumed that emerging economies' share of world output will increase further. In this regard, the IMF projects that, by as early as 2016, China might overtake the United States as the largest economy when measured in purchasing power parities. However, when it comes to such predictions, the similarity to the plate tectonics that I mentioned earlier, ends. While plate tectonics involve a rather predictable process, the structural change in the world economy is certainly not predictable. Take the example of Japan. Not too long ago, Japan was perceived in a similar way to how China is perceived now: a country that was on the way to becoming the dominating economic power. However, this perception changed rather quickly after the bubble burst and Japan entered what is now labelled the "lost decade". That is not to say that the two countries are similar. What I mean is

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that we cannot predict precisely what will happen over the next few decades by extrapolating past developments.

This notwithstanding, for the past two decades China and other emerging economies have been influencing the world economy to no small degree and they will continue to do so – also from a central banker's point of view. Their integration into the world economy has dampened inflation worldwide, in particular in advanced economies. The reason for this is quite obvious: a growing share of cheap imports. China, in particular, with its seemingly unlimited supply of labour can produce comparatively cheaply. Nevertheless, the theory of development economics predicts that this supply will eventually be exhausted and a turning point will be reached. Recent data from China indicate that wage growth has begun to accelerate. This might lead to the conclusion that the disinflationary effect of globalisation might be reduced or even reversed. However, I would not go so far as to predict strong inflationary pressures in advanced economies emanating from this effect because other countries such as Vietnam or India might join China as important global workbenches. That said, strong growth in emerging markets has undoubtedly contributed to price increases in commodities over recent years, which has had an impact on inflationary trends in advanced economies, too.

The strong growth of emerging economies and their increasing integration in the world economy is definitely to be welcomed as it offers huge opportunities for advanced economies and emerging economies alike. Ultimately, globalisation and the big shift are more than a zero-sum game where one party loses what the other party gains. Nevertheless, the transition entails structural

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changes and a reallocation of resources. Thus, to benefit from globalisation, advanced economies have to stay competitive. The question is: are they doing so? I would like to discuss this question first from a European and then from a German point of view.

3 The European debt crisis as a challenge and a chance

As early as 1954, Jean Monnet, one of the founding fathers of the European Union, said: “Our countries have become too small for today’s world, when compared to the potential of modern technical means and in relation to the dimension of America and Russia today, China and India tomorrow.” In that sense, European integration and also the introduction of the euro could be interpreted as a response to globalisation – as an attempt to create a strong regional pole in an increasingly multi-polar world. And indeed, Monnet’s vision of a single European market has become reality; goods and services, labour and capital flow more freely than ever before. This integration has brought prosperity to the people of Europe and supported Europe in the global political arena. These benefits should serve as a reminder of how important it is to preserve these achievements along with a stable common currency. Regarding the current situation, however, it seems that Europe is being challenged as the debt crisis is putting a huge strain on the euro area, absorbing political and financial resources that could be put to more efficient use.

According to the autumn economic forecast of the European Commission, recovery in the EU has stalled and the sovereign debt crisis is the most

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important downside risk – for the euro area, but also for the world economy. Thus, effectively combating the crisis is essential not only for financial stability but also with regard to the broader economic outlook. However, the foundation for a long-term solution of the crisis remains to be laid. To work out what has to be done, we have to take a look at the root of the crisis and there we find – among several factors – two key items: first, deficiencies in the institutional framework of monetary union, and second, structural deficiencies in various member states. However, the decisions taken for crisis resolution within the monetary union have so far not addressed these two issues sufficiently.

Regarding the institutional framework, policy makers have to decide which direction monetary union is to take. As I have discussed in more detail in earlier speeches, there are in principle two conceivable options which lead to a consistent and economically sustainable framework for monetary union. The first would be a return to the founding principles, that is, taking the responsibility of individual member states in matters of fiscal and economic policy seriously. For this option, it would be necessary to strengthen the current framework in a manner that really ensures sufficient incentives for sound public finances – therefore, the no-bail-out clause is an integral part of this approach. The second option would imply a major shift entailing a fundamental change in the federal structure of the European Union. It would involve a significant additional transfer of national responsibilities to the European level, particularly in fiscal affairs. In the event that national governments do not comply with strict deficit and debt rules, they would have to delegate their fiscal sovereignty to the European level – at least temporarily. Only a clear decision for either of the two options lays the foundation to preserve monetary union as a stability union

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in the long run and to safeguard its role in the global economy. It is up to governments in Europe to make this decision. Hence, I welcome the German government's attempts to press for greater political integration, including transfers of national responsibilities. Let me be clear: it will be a lengthy and arduous process requiring important legal changes. However, a credible commitment to this process could have beneficial effects right away.

However, so far there is no consensus on this, and so an "in-between approach" is being pursued. National fiscal policies are still decided at the national level while the resulting costs are borne by all member states. This approach lacks credibility because of its inconsistency. The lack of success in containing the crisis does not justify overstretching the mandate of the central bank and making it responsible for solving the crisis. However, a clear commitment to our mandate is an indispensable element of a prosperous future for the euro. It was only for this purpose that the Eurosystem was granted independence and this independence is not only a right but an obligation. I am convinced that the current crisis of confidence can not be overcome if trust in the legal and economic framework is lost. I am also convinced that the economic costs of any form of monetary financing of public debts and deficits outweigh its benefits so clearly that it will not help to stabilise the current situation in any sustainable way.

Apart from the institutional framework of monetary union, the second aspect that has to be addressed is structural deficiencies in a number of member states. These deficiencies include a lack of competitiveness, rigid labour markets and the failure to seize opportunities for growth. Solving the crisis also

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requires addressing these deficiencies: the labour markets in the relevant countries have to be reformed and made more accessible to a larger share of the population; the efficiency of administration has to be increased in many areas; opportunities for new businesses have to be created by facilitating the access to domestic markets for goods and services. Undertaking the necessary reforms is not only indispensible to overcome the sovereign debt crisis, it would also help to benefit from globalisation and the “big shift”.

To sum up: the necessary measures are obvious and uncontested. The only thing that we are short of seems to be their implementation. And as I have just argued, the current approach to crisis management has not helped to remedy this. Against this backdrop, it might be consoling to take a look at the German experience because it illustrates how reforms eventually pay off.

4 The German experience

In the first half of the 1990s, the price competitiveness of the German economy declined dramatically because a number of domestic imbalances had built up during reunification. Among these were an oversized construction sector and strong wage and price increases despite a decline in average labour productivity. On top of this, the Deutsche Mark appreciated strongly. The loss of competitiveness put Germany in an extremely unfavourable position on international markets. Consequently, the corporate sector responded with a painful, but eventually successful, restructuring process which included innovation, outsourcing, wage moderation and a balance sheet clean-up.

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The German government was also forced to act. Just after the turn of the millennium, the burst of the "New Economy" bubble caused an economic downturn and led to a protracted period of meagre GDP growth: unemployment was persistently high while overburdened social security systems led to big fiscal deficits. In 2003, bold labour market reforms were introduced. These reforms were accompanied by fiscal consolidation and adjustments in the social security systems, in particular the pension system.

In any case, the reforms put Germany in a position to cope comparatively well with the crisis. Although it was hit rather hard when the world economy went into recession, the labour market proved to be quite resilient and private consumption remained robust at the height of the financial crisis. Thus, Germany could serve as an anchor of stability for monetary union. For this to remain the case, it would be advisable to now stick to the original plans to consolidate the budget. Consequently, the recently envisaged tax cuts would have to be counter financed, for example by cutbacks in tax expenditure.

Leaving these current events aside, the question that remains is: Can other countries learn something from the German experience? I believe it provides a very simple and straightforward lesson that could be summarised by something the famous German author Erich Kästner once said: "Es gibt nichts Gutes außer man tut es" or in English: "actions speak louder than words". At the last summit of EU leaders, promising reforms were announced by several countries – now they have to be implemented.

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5 Conclusion

Ladies and gentlemen, we are living in difficult times that are marked by a big shift in the structure of the world economy. This shift harbours the potential for further prosperity but countries have to adapt to the new environment. And here it seems that many advanced economies are lagging behind. This is especially true for Europe. Policy makers have to come up with a credible solution to address the sovereign debt crisis and its underlying structural deficiencies. The experience of Germany and a number of emerging economies shows that reforms pay off in the end.

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