Axel A Weber: Germany and the financial crisis – challenges and opportunities

Luncheon speech by Professor Axel A Weber, President of the Deutsche Bundesbank, at the American Council on Germany, New York, 26 April 2010.

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1. Introduction

Ladies and gentlemen,

to this day, the Berlin airlift of the years 1948/49 continues to be an impressive monument of the solidarity between the United States and Germany which started after World War II. For this friendship to prosper, the intellectual and cultural exchange between the two countries has been very important. The American Council on Germany in New York as well as its German counterpart the Atlantik-Brücke have, since their incorporation in 1952, contributed largely to a better understanding between the two countries both in political and in economic affairs. Therefore, I am very honoured by the invitation of the American Council on Germany to give a speech about challenges and opportunities facing the German economy in the aftermath of the financial crisis.

In order to explain the background of the current economic situation in Germany, I would first like to take a brief look back to the past.

How would I have assessed the economic situation in Germany, had I given this speech six years ago? In fact, my assessment would have been quite dire. In spring 2004, the German economy was just about to turn the corner after three years of stagnation. However, the relief about the first signs of economic recovery was clouded by obvious structural problems. Whereas the cyclical upturn was sustained primarily by stimuli to German exports stemming from a buoyant world economy, there were hardly any signs of a broadly based and self-sustaining upswing, not least owing to high structural unemployment and depressed private consumption. In addition, the fiscal deficit was expected to exceed the Maastricht Treaty's deficit ceiling of 3% for the third year in succession, hence limiting the scope for fiscal action. Policymakers were well aware of the seriousness of the situation, and economic and social policy reforms had been already initiated. However, strong headwinds in pushing through those reforms were to be expected.

Three years later, in spring 2007, my take on the situation would have been much more positive. At that time the German economy was on a sound upward path. Although the strongest impulses still came from the export sector, domestic economic conditions had very much improved. In particular, a strong recovery in the labour market, breaking the ratchet effect of ever persistently rising unemployment, and a greater employment intensity pointed to improved longer-term growth fundamentals. In addition, a nearly balanced budget was to be expected for 2007. What had happened? First of all, important structural reforms had been successfully implemented. These were bold labour market reforms, which modernised the labour market structure and lowered the employment threshold of economic growth, as well as adjustments in the social security systems, in particular the pension system. The structural reforms paved the way for further necessary market-based corrections, for example in wage setting and intra-plant working-time flexibility. Secondly, the improved economic situation was used for serious fiscal consolidation.

To sum up: The German economy was quite strong, when the first harbingers of turmoil were witnessed on the US housing market. In the meantime, we have experienced a very severe global financial crisis which caused the deepest global recession since World War II. Therefore, I would like to talk about the following two questions:

1. Where does the German economy currently stand, now that tensions on the global financial markets have eased and the global economy is gradually recovering?
2. What are the economic and fiscal policy challenges to which Germany has to respond in order to enhance the framework for economic growth?

2. Where do we stand?

The German economy is clearly in the process of recovering from the deep downturn it experienced in the winter 2008/09. As in most other industrialised economies the recovery process started in spring 2009, driven mainly by a massive fiscal and monetary stimulus. Still, GDP contracted by 5% compared to 2008 and hence by much more than in the United States. Around the turn of the year, economic activity was dampened as the fiscal stimulus wore off and also owing to the inventory cycle. The relatively cold and snowy winter weather was an additional burden for the recovery process. However, trend recovery remained basically intact and the recovery process is expected to regain momentum in the second quarter of 2010. As a typical mainstay of the German economy, exports will once again play an important role in the recovery. However, unlike earlier economic downturns, the labour market stayed surprisingly robust throughout the crisis. As a consequence, consumption activity is this time comparatively stable, therefore supporting the economic growth process.

Nonetheless, there are obvious footprints of the financial turmoil and economic downturn in Germany. These are most obvious in the banking sector. Total write-downs of German banks have so far accumulated to roughly US$ 98.9 billion during the financial crisis. And further losses, especially in the form of write-downs on loans, are still to be expected. Those losses are mainly straining the financial institutions themselves, necessitating huge consolidation efforts. However, where banks have taken advantage of the banking stabilisation measures provided by the government and coordinated by the Financial Market Stabilisation Fund (SoFFin), these losses either have already burdened the fiscal budget or might do so in future.

This leads me to the next footprint of the financial crisis. Public debt has risen sharply. As in almost all industrialised countries, this was a consequence of the sharp economic downturn as well as the extensive fiscal support measures necessary in order to stabilise the economies. Starting from an almost balanced budget in the years 2007 and 2008, public finances in Germany worsened significantly in 2009. At 3.3% of GDP the public deficit went back above the EU reference value of 3%. As the majority of the revenue losses caused by the economic downturn will accrue with a time lag to the business cycle, the prospects for public finances in this year are even more dire, with the public deficit expected to hit 5% of GDP.

Finally, we have to bear in mind that the financial crisis brought to an end a period of very prosperous but ultimately unsustainable global economic growth. And it may well take some time before global output and world trade return to a solid growth path. This development will also affect the German economy, most obviously through lower foreign demand. But potential output is also likely to be significantly lower for some time than in the years preceding the financial crisis. Whether this reflects a temporary adjustment process towards a new equilibrium potential output level or whether potential output growth will stay impaired for a protracted period of time will largely depend on the capacity of the German economy to adjust to the new global economic environment.

To sum up, some of the gains from the last upswing have clearly been lost due to the financial crisis. Compared with other countries – especially some euro-area member states – Germany is in a relatively good position, as its economy and public finances were in comparatively good shape when the financial crisis broke out. In a sense, Germany reaped the fruits of previous reforms also during the crisis. In addition, the German economy was spared additional burdens encountered due to lack of structural imbalances in the domestic economy, such as a pre-crisis boom in the construction sector or a housing price bubble

bursting during the financial crisis. Still, the deterioration in public finances as well as the altered conditions for global economic growth pose substantial challenges in the coming years.

3. The "business model debate" and challenges in the fields of economic and fiscal policy

The debate about those challenges and the discussion surrounding possible solutions are currently closely linked to critical statements about the German "business model". This criticism is voiced in the context of global imbalances as well as divergences among EMU member states. It is argued that Germany's pre-crisis export strength had been fuelled by excessive wage moderation and had been built up at the expense of other countries. Moreover, the export strength is held responsible for Germany's current account surpluses, which in turn are said to have aggravated the financial crisis. In my view, this debate is misleading, the reasoning is flawed and the resultant policy suggestions are harmful. We would be ill-advised to deduce from the recent experience a need to actively prop up domestic demand, be it via encouraging higher negotiated wages or via fiscal policy measures.

First of all, export strength and current account deficits have been unjustifiably linked. High or growing export shares are not necessarily associated with current account surpluses. In the case of Germany, there are different drivers for both developments. The export strength was mainly a result of the high quality of the products and the strong world trade growth during the last upswing. The current account surpluses stemmed from relatively weak domestic demand, but this weakness was not due to macroeconomic demand management or general unwillingness of Germans to spend. Rather, it was a by-product of the correction of the structural problems mentioned before: Wage growth remained low even as rising employment reduced structural unemployment, and fiscal policy was restrictive in order to bring down excessive public deficits. Normally, domestic demand could have been expected to accelerate as the correction proceeded and the upswing matured, but before that the global financial crisis intervened.

Secondly, the expression "business model" is misleading, as it gives the impression that German export strength is the result of an active policy strategy. However, that was not the case. Wage moderation, corporate restructuring and policy measures, which were favourable for Germany's price competitiveness, were not explicitly aimed at promoting export performance but the response to structural problems which became more and more pressing. Consequently, direct measures to counter Germany's export strength are neither possible nor advisable – all the more so as the high export share reflects, first and foremost, the comparative advantages of German firms stemming from their specialisation in consumer durables and high-end capital goods which were largely in demand during the last upswing. The impact of price competitiveness on Germany's export strength, by contrast, is often overestimated.

Finally, the external surpluses by definition also imply that total investment in Germany was lower than total saving. Given that Germany's population is shrinking and growing older, persistent current account surpluses leading to an increase in net foreign assets are a rational reaction to smooth the burdens of aging over time.

Therefore, the problem has been less about the emergence of current account surpluses in Germany and more about how they have been used abroad. In some euro-area member states and in particular those with large pre-crisis current account deficits, the benefits of monetary union, such as lower interest rates and the elimination of exchange rate risk, have not always been used wisely, and have tempted some countries to live beyond their means. Now that the financial crisis has revealed the unsustainability of this development, the need for domestic adjustments is becoming more and more apparent. Given this, attempts to blame Germany for problems in those countries and policy recommendations of symmetrical

adjustment needs are questionable. Rather, the adjustment process that Germany underwent in the decade preceding the financial crisis and which I described earlier may serve as an example.

This is not to deny that major challenges for economic and fiscal policy in Germany remain. But instead of artificially propping up demand, economic policy should strive to enhance the framework for economic growth. To that end, obstacles to a market-induced and smooth reallocation of resources have to be removed, which would facilitate the necessary adjustments to the changed external environment. Three areas of policy action are key going forward: Firstly, deregulation to abolish barriers in the services sector might strengthen domestic demand and thus broaden the basis for German economic growth. Secondly, with respect to the labour market, important adjustments in the area of temporary and short-term contracts have already been implemented in order to combat high structural unemployment after the last recession. This success, however, should not be jeopardised by a partial reversion of past labour market adjustments. On the contrary, broader labour market flexibility is desirable in order to facilitate domestic reallocation of workers to more profitable sectors.

Thirdly, the contribution fiscal policy can deliver to enhancing the framework of economic growth – the rapid consolidation of public finances – is undisputed and without alternative. It is not least the financial crisis and most recent events which have highlighted the importance of fiscal scope of maneuver in times of crisis and the risks of unsustainable public deficits. Therefore, it is of utmost importance that fiscal policy makers use the improved economic outlook to regain their scope of action. In addition, confidence in the soundness of public finances is an important prerequisite for the anchoring of stable and moderate inflation expectations.

The European stability and growth pact as well as the new “debt brake” (“Schuldenbremse”) bill in Germany have set out necessary and passable consolidation paths in order to reverse the persistent trend towards ballooning debt and prevent further delays in the structural consolidation of public finances. Germany has to stay the course in order to regain its fiscal scope of action, to be prepared for the future fiscal burden of an ageing population and, last but not least, to set an example for consolidation in Europe. In my view, the failure to initiate a credible and ambitious consolidation process soon could be at least as great a risk to the recovery as removing the stimulus measures too early.

4. Conclusion

Ladies and gentlemen,

the challenge the German economy faces by the financial crisis is well known: adjusting to an external environment characterised by flatter, but hopefully healthier, expansion, and fiscal consolidation. The success Germany had in economic adjustment prior to the financial crisis is a particular example of how unfavourable economic conditions can also contain the seeds of positive change. The lesson we can learn from this is that market-based corrections, even of severe domestic structural problems, are possible if the necessary reforms are implemented. This should encourage fiscal and economic policy makers in Germany and in other euro-area member states alike to undertake the necessary reforms and to swiftly reduce fiscal deficits. The effort and inconvenience associated with those adjustments will pay off in the end by leading to a stronger economy in the individual member states and the euro area as a whole.