

## **Prospects for the economy**

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### **1 Welcome**

Mr Frieze  
Dr Bennecker  
Dr Günster  
Ladies and gentlemen

Many thanks for your kind welcome. Seeing as we are well into the fifth season of the year, as the Carnival period is known here in this part of Germany, and unmistakably so when I see the festive decorations festooning this venue, one or two of you might be expecting a traditional, witty Carnival speech, or at least be hoping, deep down, to hear something equally entertaining.

Well, I'll have to disappoint you on that score, I'm afraid. Central bankers are widely regarded as somewhat dreary speakers, especially so because of the dry topics they drone on about. They ramble on about monetary policy transmission channels, financial pro-cyclicality and macroprudential instruments. Worse still, they love to use acronyms like PSPP, TLTRO or SSM – terms which, for the uninitiated, often mingle to produce an indigestible alphabet soup.

And wasn't it former Bank of England governor Mervyn King who once posited that "few are braver than those who choose to listen to a central banker"? It's all the more cheering, then, to see that there are so many brave souls in and around Mainz ...

Perhaps that's because central banks have been credited with a political role that extends far beyond the narrow field of monetary policy. After all, in the midst of the crisis, central banks were repeatedly described as the only institutions capable of taking action and had new tasks outside the remit of monetary policy thrust upon them.

Or maybe it's also because the current monetary policy stance is directly affecting you, ladies and gentlemen, in one way or another. You will have felt the impact of the low-interest-rate policy at close quarters, no matter whether you are an entrepreneur, a taxpayer, a property buyer, or a saver or member of an occupational pension scheme whose concerns Dr Bennecker has already outlined.

And the entrepreneurs among you, especially, will naturally also be wondering which way the economy will go in the foreseeable future and what the future holds for the single currency.

These points pretty much cover the range of topics my speech today will address. But unlike Martin Luther, who you, Mr Friese, mentioned earlier on, I would like to stick to just three theses:

1. For all the intense political uncertainty worldwide, the German economy is in good shape. But these halcyon days give us no grounds for complacency. Germany is not leveraging all its growth potential, and demographic developments hold major challenges in store.
2. If we intend to preserve monetary union as a lasting union of stability, more joint liability is the wrong path to take as long as political union is not on the cards. Instead, the principle of independent national responsibility needs to be bolstered.
3. It is incontrovertible that the ultra-accommodative monetary policy has contributed to the economic recovery in the euro area and in Germany. But it cannot resolve the deeper-seated problems weighing on Europe and needs to be brought to an end as soon the objective of price stability permits – even if that monetary policy "cold turkey" causes many a finance minister to break out in a cold sweat or gives financial markets the shakes.

## **2 German economy in good shape**

Ladies and gentlemen, your own business results will probably have told you that Germany's economy is on a sound upward trajectory. It is chiefly being driven by brisk domestic consumer demand on the back of the upbeat labour market situation and increasing incomes.

However, the German economy looks set to lose a little momentum in the short run, especially as mounting energy prices are eating away at consumer purchasing power. So consumers will have to pay more again at the pump and to keep warm. Still, that doesn't change the fact that the German economy will continue to post decent growth rates in the region of 1½% over the next two to three years.

A more vibrant global economy should also boost export growth again, despite the fact that the international environment is fraught with political uncertainty at the same time.

But at least we now have a slightly clearer picture of how the UK government sees Britain's future relationship with the European Union. That is, the UK will leave not only the EU but the single market as well. Trade with the EU, so the thinking goes, will then be governed by a comprehensive free trade agreement.

That would put the UK further away from us, economically speaking, than Switzerland, say, or Norway, which both, it is worth noting, have access to the EU single market. And that's without

knowing for sure whether the UK and EU will even be capable of hammering out the broad thrust of a free trade agreement within the space of two years.

Yet what already seems clear is that this move, this "hard Brexit", will mainly leave the UK worse off at the end of the day. But that is not to say that Brexit won't leave the German economy unscathed – the UK is, after all, the third most important export destination for the German economy.

Uncertainty is more intense still over the shape and possible repercussions of future economic policy in the United States.

It was mainly the invigorating effects of the prospect of higher government spending and lower taxes which won plaudits in the markets, but traders have so far turned a blind eye to the economic damage that would be wrought by looming trade barriers and an increasingly interventionist economic policy.

And yet open markets and a competitive economic system are the very qualities that underpin our prosperity. And the notion that as many people as possible should benefit as a result is the core idea of the social market economy, which Ludwig Erhard so neatly encapsulated with the phrase "Prosperity for all!". Instead, we are seeing mounting scepticism over globalisation, a sentiment by no means confined to the United States. In Europe, too, the fear of globalisation is on the rise and people are increasingly shunning open markets.

Public concerns like these need to be taken seriously. But it's safe to say that barriers and exclusion would be the wrong response. That's because open markets boost prosperity as a whole, but not necessarily for each of us all the time. If the social market economy is to live up to its promise of delivering inclusive prosperity, we will need to prime enterprises and their employees to harness the opportunities presented by globalisation and technological progress. Wherever social hardship arises, a target-driven and transparent tax and transfer system like the one we have in Germany should step in and act as a cushion.

In any case, I find the protectionist rhetoric coming out of Washington very worrying, especially as Germany is increasingly in the sights of the US.

Accusations that Germany is taking advantage of the United States and other countries with an undervalued currency are more than absurd.

While there is a kernel of truth in the argument that the US dollar is strong, the United States has, up until recently, enjoyed a very favourable competitive position for almost a decade. These ups and downs in exchange rates, and thus also in terms of price competitiveness, are entirely within the realm of normal fluctuations.

In any case, the thesis that foreign currency manipulation is to blame for the strength of the US dollar at the moment is definitely not backed up by the facts. I might also add that the most recent

increase in the value of the dollar will probably be a home-grown phenomenon, having been triggered by the new administration's policy announcements.

The fact that Germany's economy is highly competitive certainly isn't the outcome of manipulative policy, either. Its competitiveness does, however, have something to do with the external value of the euro, which, besides other factors, is being depressed by the ECB's monetary policy, which has not been undisputed in Germany.

It's a fact of life that the single monetary policy is geared not to the above-average economic situation in Germany, but to the weaker euro-area average.

The German economy's price competitiveness at the moment is roughly 6½% higher than its long-term average, as measured since 1975. But German enterprises are above all competitive because they are excellently positioned in global markets and boast innovative products.

And it's not just businesses like BASF, Boehringer Ingelheim or Schott we should be thinking about here. Germany is also home to hidden champions, remember – small and medium-sized enterprises which, outside the public eye, have risen to become global leaders in their respective markets – many of which are based here in the state of Rhineland-Palatinate.

Now, you don't need me to tell you that Germany doesn't just export a great deal – we also export far more than we import. This means that we have a very high current account surplus, which has been held against us in the European and global arena on repeated occasions, not just of late by the new US administration.

But what should we make of it?

Let's begin by saying that a current account surplus indicates that a country is saving more than it invests domestically. Of course, it does not make sense for a national economy to produce more than it consumes and invests.

Because of the foreseeable demographic change, current account surpluses for Germany are, however, quite appropriate at the present time, as this is how Germans provide for old age, amongst other things. The assets held abroad will later be depleted as more and more employees retire and run down their savings.

This way, German investors harness the higher returns on offer in regions with faster-growing economies. Non-residents – and that also includes the United States, incidentally – benefit from this German funding and the investment and jobs it creates locally: German foreign direct investment in the United States comes to around €270 billion, covering more than 4,700 US businesses with more than 800,000 employees. If I may use a piece of business jargon, that looks to me like a win-win situation.

That said, a surplus of well above 8% of GDP, which is the level we are seeing today, cannot be put down to demographics alone. And the low oil price, which has diminished the cost of imports, explains only part of the high surplus.

It would nonetheless be wrong in my eyes to scale back this surplus by adopting economic policy measures that deliberately erode the competitiveness of German enterprises or by embracing debt-fuelled government spending, as some have been calling for. With capacity utilisation currently running at above-average levels, a government expenditure programme would not only be pointless; it would also be of little benefit to other countries. The ripple effects would be too small for that.

Instead, it would be a good idea to create an investment-friendly climate in order to encourage greater private investment here in Germany, too, as elsewhere, as this would kill two birds with one stone, by damping the current account surplus and improving long-term growth prospects.

Amidst the swirl of optimism about business activity, one thing must not be forgotten: Germany's long-term economic outlook isn't all that rosy; Germany is currently underperforming. According to a long-term projection by the OECD, no major industrial country will grow as slowly as Germany up until 2060.

One of the primary reasons is demographic change, which will hit Germany particularly hard. Even today, every year 200,000 more people are retiring than young people entering the job market.

Though the massive influx of refugees is currently shielding the labour market from the impacts of demographic trends, the adverse effects of demographic change will even amplify in the future. The only way to make up for the age-related decline in the labour force is for more people to take up employment and for us, with life expectancy growing, to work longer as well.

However, even in terms of per capita growth, most OECD countries and emerging market economies are outpacing Germany. It is now up to politicians to set the proper gears in motion in economic, labour market and social policy in order to create higher, sustainable growth.

Alongside demographic change, the integration of refugees into the labour market and weak trend growth, we face a raft of additional economic policy challenges. I am thinking, in particular, of digitalisation, which will disrupt entire sectors of the economy, and the energy U-turn, the specific design of which will determine whether energy remains affordable.

### **3 Strengthen national responsibility in monetary union**

A further challenge is to find a long-term solution to overcome the euro-area crisis. It would, at any rate, be illusory to believe that, just because the situation has calmed down and other topics are currently at the centre of attention, the crisis has been banished for good. This brings me to my second thesis.

The Maastricht Treaty was signed 25 years ago to the day. This treaty pretty much created the regulatory framework of European monetary union.

Maastricht was founded on the idea of creating a single currency for Europe but allowing member states to continue setting their own economic and fiscal policy independently.

However, its founding fathers probably assumed that monetary union would sooner or later evolve into a political union. Speaking before the Bundestag in November 1991, Chancellor Helmut Kohl remarked that "the idea of sustaining economic and monetary union over time without political union is a fallacy" – incidentally, a view shared by the Bundesbank at the time.

The expectation that the euro will be no more than a stepping stone towards deeper political integration has not yet become reality, however. 18 years have passed since the creation of monetary union, and there is still no sign of a political union.

I believe, however, that monetary union can also function without political union. But for this to work, the security precautions envisaged by the founding fathers to protect the stability of the single currency need to actually function: member states committed to keep their finances on a sound footing and prohibited central banks from resorting to the printing presses to help out ailing governments. In addition, the member states inserted contractual clauses ruling out the possibility of mutual bailouts.

A set of convergence criteria was created to ensure that only those countries whose economies were ready could join monetary union. In other words, they were supposed to be economically and fiscally healthy.

Most member states wanted to join the single currency area as quickly as possible and therefore sought to comply with the catalogue of criteria – by hook or by crook. Once this objective had been achieved – in some cases also thanks to a generous interpretation of the criteria – convergence efforts flagged again, however.

Historian Harold James compared this vividly to the aftermath of a wedding: "It was like what happens to couples who, once married, abandon some of their romantic and utopian intentions in day-to-day married life. At the most trivial level, men now leave unwashed socks lying around and women drop towels on the floor. This spiral often continues to turn – culminating in divorce."

To stay within this metaphor, a serious marital crisis actually did occur a few years back. The euro rescue packages and Eurosystem measures were the only way to ultimately prevent the crisis from escalating.

These measures, however, did not make monetary union crisis-proof once and for all. On the contrary: by introducing elements of mutual liability, they have softened the principle of independent responsibility. The relationship between actions and liability for their consequences has got out of kilter.

You already mentioned it, Mr Friese: actions and liability for their consequences go hand in hand. For an entrepreneur, especially in a market economy, this goes without saying. Walter Eucken,

founder of the Freiburg school and a pioneer of the social market economy, even declared this to be a constitutive principle of our economic order and condensed it into a simple formula: "Whoever reaps the benefits must also bear the liability."

In terms of monetary union, this gives us two options. Either all member states give up decision-making powers to the community – which in and of itself does not guarantee that decisions will be made in a stability-oriented manner – or each country is responsible for the consequences of its own decisions. And if you ask me, only one of those options is realistic – at least for the foreseeable future.

The will to cede sovereignty to Brussels is currently just as low as it was back when the Maastricht Treaty was signed. The way the rules of the Stability and Growth Pact are being treated shows that even powers that have already been granted to the European level are being called into question time and again – especially where there are calls for more joint liability.

And this is why I say: if we want to preserve monetary union as a union of stability, we have to strengthen the principle of independent national responsibility. We have to return to the original ideas of the Maastricht Treaty and eliminate the flaws in this regulatory framework.

The first step in doing that must be to strengthen the binding force of the debt rules. Admittedly, that was precisely the objective of the last reform of the Stability and Growth Pact. However, it ended up creating considerable discretionary scope, mainly for the European Commission.

Torn in two directions in its dual role as a political institution and guardian of the treaties, the Commission is frequently inclined to compromise at the expense of budgetary discipline.

In the area of fiscal surveillance, the Commission is echoing Marx. Not Karl Marx, but US comedian Groucho Marx, who is supposed to have said of himself that "These are my principles. If you don't like them ... I have others."

The binding force of the debt rules is ultimately weaker now than ever. France has breached the deficit rules for the ninth time in succession – and always with the Commission's blessing. Ditto for Spain. Italy's mountain of debt has risen by one-third since the financial crisis, and the promised debt reduction is nowhere to be seen.

A more rigorous interpretation of the rules could be achieved by giving responsibility for fiscal surveillance to an independent authority instead of the Commission. At the very least, that would clearly show where unbiased analysis ends and political concessions begin.

Past developments have made it abundantly clear, however, that political agreements alone are not enough to ensure sound public finances. For, in the end, the decision on possible sanctions rests with European finance ministers, which would ultimately mean, as German journalist Hans Barbier put it succinctly 20 years ago, "sinners passing judgement on fellow sinners".

The founding fathers did not want to rely on this alone. This is why they adopted the no-bailout principle: so that the financial markets could exert disciplinary force.

However, this hasn't worked all that well in the past, either. The financial markets apparently didn't expect the no-bailout principle to be etched in stone, as seems to have been evidenced, at least, by the fact that, for a long time, the interest rates paid by poor-quality sovereigns were hardly above those of good-quality sovereigns – and, in the end, investors' assessments were not entirely off the mark.

For investors to be able to take responsible decisions and to demand different interest rates for different types of risks, they have to be told in a more credible manner in future that they could lose their money if they buy bonds issued by sovereigns whose fiscal policies are not sound.

And this is why, for quite a long time already, the Bundesbank has been proposing that an automatic extension of the maturity of government bonds be triggered whenever a sovereign applies for ESM assistance. As things now stand, a large share of the assistance loans are being used to pay off the original creditors. This means that the original creditors, such as banks, are then off the hook. Automatically extending maturities, however, would leave them on the hook, and they could be held liable in the event of a debt restructuring later on.

Admittedly, it has to be assured that the default of a sovereign does not immediately rattle the entire euro-area financial system. Doing this means, in particular, severing the nexus between banks and sovereigns. It is precisely in times of crisis that banks have a huge appetite for government bonds, preferably domestic ones. And we have to curb this appetite.

It would already help if banks needed to hold capital against government bonds the same way they do against loans to the private sector, ie if the preferential regulatory treatment of government bonds were discontinued. If it wasn't already clear beforehand, the financial crisis has told us this: government bonds are not a risk-free investment.

There's no question about it: establishing a stable monetary union is no simple task. But I am convinced that a monetary union in which the principle of individual national responsibility is consistently implemented can enjoy enduring stability – provided the political will for it exists.

I don't buy the argument that the only option open to a Europe faced with uncertainty in the foreign policy sphere is to close ranks by increasing mutual liability. A strong and united Europe is a goal worth striving for. However, this objective most certainly cannot be achieved if what is agreed is treated with contempt and what was once a union of stability evolves into a transfer union.

There would be reason to fear that central banks would be forced to pick up the pieces over and over again, even if that came at the cost of price stability.

#### **4 Bring a timely end to ultra-accommodative monetary policy**



And that brings me to monetary policy and my third thesis: ultra-accommodative monetary policy cannot resolve the deeper-seated problems weighing on Europe and needs to be stopped as soon the objective of price stability permits – even if the higher interest rates cause the sustainability of public finances in individual countries to go downhill or trigger price volatility in financial markets.

The aim of monetary policy is well known: to maintain price stability. The Maastricht Treaty mandates this as the Eurosystem's primary objective. However, the Treaty is silent on the issue of what exactly is meant by price stability.

That's why the ECB Governing Council issued its own definition: to keep the inflation rate in the euro area at a level below, but close to, 2% over the medium term. While this target rate may seem somewhat arbitrary to you, there are thoroughly reasonable grounds for promoting moderate inflation and avoiding zero inflation.

Hans-Werner Sinn once colourfully described it in the following words: "Inflation is an economic lubricant. Too much oil in the engine soots up the spark plugs; not enough causes piston seizure." Excessively high inflation comes at a high economic – not to mention social – cost, which is why the oil should be used sparingly. On the flip side, however, the oil cannot be allowed to run out. Targeting zero inflation is not a viable option, however tempting it may sound to consumers.

That's because an inflation rate of zero would mean that individual industries or entire economies that need to claw back a loss of competitiveness would face the daunting prospect of having to push through nominal, rather than merely real, wage cuts. That's a tall order, though, because people tend to think more in nominal terms than in real dimensions.

But there's something else besides that: if monetary policymakers strive for slightly positive inflation rates, the overall interest rate level will be somewhat higher, creating a certain safety margin to the lower bound on interest rates. As we now know, this bound is not exactly at zero, nor is it significantly below that level. If the inflation target is too low, a central bank's scope for stimulating the economy by means of its interest rate policy may be exhausted too quickly.

Headlines reading "Inflation is back" have spiked in recent weeks, and inflation rates really are soaring once again – particularly in Germany. In January 2017, goods and services in Germany were 1.9% more expensive than one year earlier. In the euro area as a whole, too, the rate of inflation jumped to 1.8%.

However, this is primarily due to higher oil prices and the fact that prices bottomed out one year ago. The effect of this rise will wash out of the inflation rate over the course of the year, provided oil prices do not continue to climb and there are no second-round effects.

Leaving the oil price effect to one side for a moment, domestic price pressures are still comparatively low right now. Core inflation, which excludes energy and unprocessed food, last stood at around 1%.

However, the Eurosystem's projections suggest that domestic price pressures – boosted by monetary policy – will also pick up gradually, pushing the inflation rate into the target range of below, but close to, 2%, on a lasting basis in 2019.

In my view, recent price developments clearly show that deflation – that is to say, a downward spiral of falling wages and prices, which was conjured up by some in the past and used to justify the purchase of government bonds – is now a mere blip on the distant horizon. Even prior to this, I viewed the risk of a downward price-wage spiral as rather remote.

Against this backdrop, an expansionary monetary policy stance is appropriate for now. That said, one can certainly wrangle over whether we should be keeping the monetary policy gas pedal to the floor.

The recent rise in inflation caused the real interest rate, ie the price-adjusted interest rate level, to further contract, which has made the monetary policy stance even more expansionary. What's more, the only means of pursuing such a highly expansionary monetary policy stance is by implementing non-standard measures, most notably government bond purchases.

However, the cost-benefit calculation of non-standard measures, in particular, is quite different from that of our standard monetary policy instruments. This is why I have always cast a critical eye on government bond purchases and said that, to my mind, such large-scale purchases serve purely as an instrument of last resort to be used, for instance, to avert deflation.

Quite apart from the fact that I neither see nor saw the risk of such a downward spiral arising, the major drawback of such purchases is that they blur the boundaries between monetary and fiscal policy.

The extensive purchases have made the euro area's central banks the largest creditors of its member states. This has thrust monetary policymakers deep into the realm of fiscal policy – in my view, too deep.

Because, in the end, it is the Eurosystem that decides how much interest euro-area countries pay on large swaths of general government debt. And this interest rate is broadly the same for all countries, irrespective of their credit rating. As a result, monetary policy also ultimately neutralises the second stability anchor for public finances. This is because a large part of general government debt is no longer subject to the disciplining effect of the capital markets.

The Eurosystem's low-interest-rate policy also runs the risk of finance ministers being taken in by an illusion of sustainability. They see the debt burden as being lighter than it would be in a "normal" interest rate environment. Compared with the interest rate level back in 2007, euro-area countries have altogether saved almost €1,000 billion in interest from that time on, which is virtually on a par with Spain's annual GDP.

Even in this setting, some countries lack either the ability or the inclination to comply with the deficit ceilings set out under the Maastricht framework. Especially the large euro-area countries such as France, Italy and Spain, which will only just hit the 3% ceiling, if at all, have channelled all of the interest they've saved into higher general government expenditure rather than, for example, paying off debt.

That's why I've been saying for some time now that this could ultimately lead to the ECB Governing Council being subjected to political pressure to postpone any normalisation of monetary policy out of concern for public finances. And one thing should be clear to us: the longer we stay in ultra-accommodative monetary policy mode, the more its positive effects will diminish and the more visible its undesired side-effects will become.

And those don't just include the risk of unsound public finances – low interest rates also pose a risk to financial stability. The crisis made it crystal clear that bouts of financial market turbulence can also have a detrimental impact on price stability. That's why it would be wrong of us to disregard such risks.

Or, to put it another way, if monetary policymakers only have non-standard instruments in their arsenal, they can also make do with waiting a little longer for inflation to return to a path that is consistent with the definition of price stability.

After all, the ECB Governing Council stipulated quite intentionally its inflation target of below, but close to, 2% is its medium-term objective that need not be achieved at all times, whatever the cost. Particularly in the aftermath of a severe crisis, there's a good case for seeing patience as a virtue.

## **5 Conclusion**

Ladies and gentlemen

I would like to bring my speech to a close by saying that you have truly been brave souls for staying with me this far.

Given the colourful range of professions gathered here at this reception, the occasionally gloomy topics covered by my speech and, above all, the festive Carnival-themed decorations here at this venue, I think I will round things off with an entertaining anecdote after all.

A doctor, an architect and an economist meet and start arguing over who out of the three has the most honourable profession.

Says the doctor, "It's obvious. God used Adam's rib to create Eve – he must have been a surgeon."

Says the architect, "Well, before Adam and Eve, order had to be brought out of chaos to create the universe. Who other than an architect would have been capable of doing such a thing?"

Says the economist, "That's all well and good, but who do you think created all that chaos?"

I do hope that my speech has helped to bring a little order to the chaos, and I thank you for being such an attentive audience.