Slaying *the*

TIE's exclusive interview with Bundesbank President Axel Weber.

TIE: **What is your view of the risks of inflation versus economic growth in both Germany and the Eurozone? The Eurozone as a whole is experiencing inflation above 3 percent and some of the confidence indicators are mixed.**

Weber: On inflation it's true that recent figures have tended up quite a bit, and in Germany we saw inflation at 3.1 percent for the consumer price index, and at 3.3 percent for the harmonized European measure in November. These rates have caused some discomfort because people in Germany haven't seen inflation that high since 1994. However, you have to take into account that roughly half of German average inflation in 2007—that is, 1.5 percentage points—is caused by the recent VAT increase, so it's a one-time effect. In addition, there are some base effects due to oil and food price increases from last year that have led to higher inflation. Our expectation is that inflation in Germany and in the Eurozone will start moderating after the turn of the year, but it will take some time for it to fall below 2 percent. Thus, inflation is likely to be above 2 percent on average in 2008 and it may fall below 2 percent again only toward the end of 2008.

With this kind of hump-shaped figure for short-term inflation, which can also be observed in the Eurozone as a whole, it is important to note that part of the spike in inflation is transitory. Nevertheless, there is also some underlying momentum in core inflation, now slightly above 2 percent.

In addition, the risks over the projection horizon of two to three years are to the upside and include the risk of a new round of oil price increases (in particular with a view to geopolitical risks and continuing high international demand for energy) as well as tense food markets. The hump-shaped figure for inflation corresponds to a short-term dip in output growth rates which are then likely to increase again over the course of next year and into 2009.

So we have a U-shaped output profile over the medium term, with growth rates being somewhat more moderate in the fourth quarter of 2007 and possibly in the first half of 2008 than they will be in the medium

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Inflationary Dragon

term. Through 2008 and 2009, the Eurozone is likely to grow slightly below potential and output growth in Germany is expected to moderate somewhat towards potential growth over the next two years on average.

For me, the medium-term outlook is that the European and German economies are still on a solid footing. The confidence indicators suggest that growth momentum is somewhat fading but still at a level which is consistent with our long-term growth potential.

TIE: **The Eurozone economic outlook has been confusing lately.**

Weber: Business and consumer sentiment indicators in the Eurozone are still at relatively high historical levels. But the momentum has gone down. It's simply a sign that with higher inflation and in particular higher oil prices, the way forward is not viewed as optimistically anymore. Thus, the euro area economy will lose some of its momentum. But it will not weaken markedly.

TIE: **As the Eurozone expands to include the Eastern European economies, do you see them as more tolerant of a higher inflation rate? Do you want to factor in any change in the European Central Bank's forecast?**

Weber: No, I am sure that our medium-term objective will remain the same. We look at the Harmonized Index of Consumer Prices (HICP) headline inflation rate for the medium term. We don't take out on a systematic basis the effect of energy prices. We aim at medium-term inflation on average below but close to 2 percent.

Taking into account recent experiences of the European convergence process, new EU member countries with higher inflation than the Eurozone average partly owe their inflation performance to convergence-related higher growth rates. They should manage their convergence process before entering into monetary union so as to reach a level of economic development and a soundness of economic and financial policies that enable them to cope with the challenges of the common European currency.

I don't think there will be a change in the Eurosystem's attitude towards inflation, simply because the entire convergence process is based on the philosophy that a country must move in the direction of the

Eurozone's best three inflation performers. We want the Eurozone to be a price stability zone.

TIE: **Is the ECB left in the unfair position of having to carry the load of adjustment for the world's imbalances? As the United States weakens, the rest of the world is beginning to diversify away from dollar assets. It's complicated because if the Chinese diversify out of the dollar they are shooting themselves in the foot to a certain extent. In the event of further euro appreciation, the German economy could compete under a stronger currency, but what about some of the weaker Eurozone economies? Will Europe price itself out of a globally competitive position—with the exception of Germany and possibly France?**

Weber: It is not an aim of the Eurosystem for the euro to play a greater international role, but simply markets are at work here and the euro is increasingly becoming an international currency. The exchange rate for us in the Eurosystem is part of our data frame, not an element in our objective function. It's merely one variable we look at when we make decisions about monetary policy. And it's mainly through its impact on inflation, on the real economy, and on exports in particular that the exchange rate plays a role.

It is wrong to think that it only becomes important to look at the level of the exchange rate in macro terms if it reaches some sort of threshold. For firms, different levels of the exchange rate will trigger different firm-specific adjustments to the given macroeconomic environment. The exchange rate is one variable—production costs, production technology, global diversification of production locations, and pricing to market all play a role as well. The firm at the micro level has many tools available for fostering its competitiveness. But these are medium-term firm-specific adjustments, and therefore it is difficult for firms to cope with very short-term and excessively volatile exchange rates. So we as central banks don't welcome excessive and abrupt exchange rate adjustments because they interfere with medium-term-oriented firm-specific adjustments and thus make them less efficient.

It is striking that the first signs of the crisis resulting from the United States showed up in Europe among some banks that had very weak risk management.

But one thing you mention is absolutely true. We at the Bundesbank have been finding out in our research that the importance of price competitiveness for German exports has actually decreased strongly over the 1990s. Some of them face a relatively price-inelastic demand. As a consequence, the markets in which firms are present and the product range on which firms focus are much more important for competitiveness than some of the macro issues that we have been talking about.

So for me, the major adjustment opportunities for firms are to be found at the micro level. However, policy adjustments are also important at the country level. It is notably those countries where structural reforms have not been implemented in a rigorous way that have experienced a decline in competitiveness. These countries find they're not that flexible and therefore not that competitive due to their labor market conditions. Some countries still have very regulated labor markets, with relatively high wage increases over the past and bargained thirty-five-hour working weeks. In Germany in the last round of labor market reforms, we lifted the average working time without compensation increases, which is a major competitive factor both at the macro and at the firm-specific level. The labor market framework matters for firms' competitiveness.

Countries need to supplement the firm-specific restructuring processes and cost-saving programs with country-specific labor market reforms, with product-market reforms, and with more flexibility in general. Lasting gains in competitiveness are not won in the foreign exchange market, but at the firm-specific level supported by a firm-friendly macroeconomic environment that is supportive for job creation.

TIE: **Is fear of euro appreciation being exaggerated? Industrialists and politicians complain how the euro has appreciated to dangerous levels, but they never say from what point the appreciation began. From its lowest point? From its introduction? From the beginning of the calendar year? There's also the issue of whether they're talking about the effective trade-**

weighted basis for the euro. How does the ECB as an institution view the aggregate level for appreciation of the euro?

Weber: It's important to make one key distinction. Is what we've seen in the foreign exchange market over recent months transitory or permanent? When the euro was at its all-time low against the dollar, a lot of firms could expand their profit margins because of the more favorable situation in the international markets. Now, to the extent that some of the dollar depreciation could be viewed as transitory, this transitory part can be absorbed by lowering profit margins of firms. By contrast, the permanent part of exchange rate movements—the more important part—causes restructuring of firms on the cost side.

This is very important for firms to keep in mind because ultimately the exchange rate is part of the data frame within which firms operate. If they want to be competitive on the international markets rather than focused on the domestic economy, then they need to foster strategies for coping with developments on the foreign exchange markets. And clearly in the areas of product quality, unique products, competitive products, and design issues, there are many firm-specific levers that business firms can move in order to become competitive.

As I already indicated, German industry over the last five or six years has done a major restructuring effort to become more competitive at the firm-specific level rather than relying on changes at the macro level. Other countries and their firms need to follow that example. You need cost efficiency in order to stay on top in the international markets. For example, some of the cost-effectiveness of German firms was achieved by outsourcing some of the production of labor-intensive input factors to new member countries in the European Union so that a large part of the input for cars and other manufactured goods is now produced in a more cost-efficient environment. Breaking up the product chain and building up cost-efficient structures in the new EU member states has been very important for German firms.

TIE: **From a macro standpoint, has the strong euro been a kind of de facto anti-inflationary tool?**

Weber: Even with the upward movement of the real effective euro exchange rate that we've seen in the past two years, inflation pressures have surged in the euro area. The surge of inflation is a matter of concern for us.

By comparison, the problems we saw in Germany were small relative to the exposures and the losses that were announced by some of the core financial institutions in the United States and the United Kingdom.

TIE: **As the subprime crisis unfolds, there is still a sense that the U.S. financial system lacks transparency. Are you worried that the German as well as the overall European financial system hasn't done enough self-evaluation? What seemed at first merely a U.S.-contained problem now appears to be more global.**

Weber: Let me remind you that regarding exposure in the subprime market, because of the very nature of the securitization and distribution process it has become a world-wide phenomenon. Financial institutions worldwide are exposed to subprime risk. Some of the early problems in Germany occurred long before we saw major problems in other financial institutions. But by comparison, the problems we saw in Germany were small relative to the exposures and the losses that were announced by some of the core financial institutions in the United States and the United Kingdom.

It's also an ongoing process. The valuation of these products is difficult because some of the underlying markets are not liquid anymore. Also, parts of the financial industry have underestimated the complexity of the structured finance products and therefore time is needed to really do a proper valuation of them.

In a very uncertain environment banks have initially been to some degree reluctant to disclose the full extent of their losses. We've seen what could be described as a salami tactic, with some early announcements of exposures and losses and then some later announcements of further exposures and losses partly due to a continued worsening of markets. At this juncture markets are still fragile and tense and any set of bad news could lead to increasing uncertainty yet again. Some of these tensions will only dissolve after the turn of the year, possibly in February or March with the release of the testified 2007 financial accounts.

Rating agencies need to play a role when addressing some of the problems we had in the recent financial market tension

TIE: **The business model for today's banking sector creates a distance between the lender and the customer doing the borrowing. With securitization, the banks now slice up the risk and send it out the door in a mad grasp for fee and bonus income. This leaves a lot up to the judgment of the rating agencies.**

Weber: On the general business model of securitization, we need securitization because it's a convenient and necessary way to diversify risk. But we have to reduce vulnerability to risks such as market liquidity risk at the later end of the credit cycle. We've not actually had a full credit cycle for some of these new financial products, and we're now finding out in an admittedly painful manner that some of these new products have structural weaknesses that need to be dealt with when we talk about the way forward.

One of the issues is a more risk-sensitive framework in particular for liquidity lines to asset-backed commercial paper conduits. It was a remote possibility that these liquidity lines would be called, but when it happened, it happened to a large extent. We need to factor these liquidity lines better into the general risk management of financial institutions. If financial institutions know they need to have some capital underwriting for liquidity lines, then the amount of liquidity lines and the size of such financial exposures is likely to be much more limited than it was in the recent year and therefore it will lead to a more reasonable risk management over a full credit cycle.

A new set of regulations is underway and coming into force. Basel II will actually deal with some of the shortcomings the recent financial market turmoil has revealed in the system. Even so, it doesn't deal with all of them. We may need to adjust some of the details of that new regulation, but before we discuss that we should fully implement Basel II at the global level.

TIE: **How do you evaluate the rating agencies? Currently they have no incentive to be correct and no disincentive if they're proved wrong.**

Weber: Rating agencies need to play a role when addressing some of the problems we had in the recent financial market tension, in particular in the structured finance market. But our main focus is on regulating banks. Risk management in banks cannot function well if a rating issued by a rating agency is taken as a substitute rather than a complement to a bank's own risk assessment. Alternately, investors are in charge of their financial investment decisions and they should have prudent risk control and risk management in place. Rating agencies can help, but if firms are investing in markets where they don't have a comprehensive understanding of the underlying structured finance products and simply take a rating at face value, this has nothing to do with proper risk management.

Also, we need to review rating agencies for financial conflicts of interest. If rating agencies issue ratings of complex financial instruments and, at the same time, provide input for the securitization process, then conflict of interest becomes an issue.

As to the nomenclature, we might think about a separate rating scheme for structured products. It's not just counterparty risk that is relevant, but also market risk and liquidity risk.

TIE: **There's this sense of uncertainty about the stability of the safety net. How do we define the safety net, particularly in light of the fact that now the British government seems to be guaranteeing the entire British financial system? We keep expecting Merrill Lynch to announce it's now a British financial institution, headquartered in London. In a financial world where loans are securitized and risks are diversified, what sort of safety net or assurance should be offered?**

Weber: "Financial safety net" may be the wrong expression. We must distinguish between liquidity operations for financial institutions where central banks try to secure the functioning of the money market, and bailing out financial institutions which raises moral hazard problems. What we have done in the Eurosystem was not a bailout because it was not institution-specific, but instead we conducted various refinancing operations geared toward preserving the functioning of the money market. I could describe it best by saying we did business as usual in unusual environments. We didn't change our operating tools.

The Eurosystem as a young institution has two big advantages over longer-established central banking systems. First, we have a very broad range of counterparties. Practically all credit institutions in the euro area can access our main refinancing window. Second, we do our main refinancing operation with a broad set of collateral including asset-backed commercial paper. Other central banks in the world use only a limited set of collateral but have special access windows like the discount window at the Fed where they can accept a broader set of collateral, or the Bank of England in the standing facilities. For us, the question of changing the rates of our standing facilities, in particular that of the marginal lending facility, was never an issue, because practically all credit institutions have access to lending at the main refinancing rate. And we have also from the start made use of both main refinancing operations with a weekly refinancing horizon and also supplementary long-term refinancing operations with a three-month maturity. I would like to stress again that what we've done has nothing to do with institution-specific liquidity needs. It was done using our general and broad framework in the usual way but in an unusual environment to secure market liquidity.

TIE: **In the post-Glass-Steagall age, the American banks seem schizophrenic. On the one hand, they want to be commercial banks and have all the privileges of a bank charter. On the other hand, they want to act like hedge funds or a private equity firms because taking on greater risk provides enormous profits and compensation. The subprime crisis has raised the question: What is a bank's role in the twenty-first century?**

Weber: In Germany, we've always pursued the concept of universal banks, where banks can offer both banking and investment banking services. This concept allows banks on the one hand to diversify their risks and their income structure and on the other to meet the changing needs of their customers. In this respect, the role of banks in the economy of the twenty-first century has not changed: banks act and will continue to act as financial intermediaries as only a limited number of their customers (especially large-sized firms) have direct access to capital markets. The products and instruments to conduct banking and investment services, however, have changed over the time. This evolutionary process will certainly continue. I regard it as vital that supervisors and regulators keep pace with this development and ensure that the regulatory framework remains appropriate and adequate.

TIE: **Everyone is trying to come to terms with the concept of sovereign wealth funds. The excess savings economies are now looking beyond buying government debt. They're also looking for hard assets. On the positive side, in a time of global crisis the sovereign wealth funds will probably be the first called by authorities for help. Moreover, sovereign wealth funds tend to have taken more of a long-term view in a lot of their investments. But these funds are in many cases run by non-democratic regimes with strategic global interests. They will eventually no doubt ask for seats on corporate boards and access to proprietary information. Where do you see the sovereign wealth funds debate going in Europe?**

Weber: It's a trendy debate. The sheer size of these funds and the very limited amount of information available on them makes disclosure a big issue. One should be careful not to throw all sovereign wealth funds into the same category, however. For example, the Norwegian sovereign wealth fund, which is managed by the central bank, is very transparent, very open. There is no strategic political investment. They do not exercise shareholder rights. They are in fact a model for best practices which can be followed.

I attach more importance at this point to the positive contributions some of these sovereign wealth funds can make.

The key issue is finding a balance between fear over national security concerns versus the positive effects of free capital movement at the global level. As you mentioned, some of these sovereign wealth funds could be very stabilizing forces because of their long-term, non-strategic outlook and their largely non-leveraged investments. I attach more importance at this point to the positive contributions some of these sovereign wealth funds can make.

But in order to reap the maximum benefits, we have to move forward in terms of some best-practices guidance for their management. The International Monetary Fund and the World Bank are good fora to discuss best practices for sovereign wealth funds. Discussions could evolve into a voluntary code of conduct. Transparency and disclosure would both need to be improved.

The Chinese foreign exchange situation is clearly unsustainable at the current pace of increasing its flexibility.

German politicians recently proposed allowing the government the ability to stop sovereign wealth funds from buying over a quarter of a domestic company. This only puts us at the same level as some other countries.

However, the German economy has profited very much from the internationalization both of trade in goods and services and in financial securities. The European Union is one of the most open economies in the world in terms of financial flows and flows of goods and services, and the European Commission will rigorously defend free capital movements with third countries and only allow member states small exceptions from this general rule. At the same time, there are certain risks to being very open. International standards would be the best way to go because then we do not get into regulatory arbitrage on these issues between EU member countries and non-EU countries around the world.

***TIE:* On the issue of Chinese currency, how sustainable is this situation with the Chinese only very slowly allowing their currency to adjust? Is this a ticking time bomb? China's economy is growing at a tremendous rate, but is the growth out of control? We can see this in their commodities purchases, and in the explosive growth of the financial sector. Commodities are piling up, almost detached from the issue of global supply and demand. Will the Chinese bubble burst, resulting in a huge disinflationary or deflationary force? Or can officials there continue to manage things through administrative edict?**

Weber: The Chinese foreign exchange situation is clearly unsustainable at the current pace of increasing its flexibility. All G7 meetings have led to one basic statement over the recent years: that foreign exchange rates should reflect fundamentals. If a country pegs the exchange rate and doesn't allow for flexibility, the exchange rate simply doesn't reflect these fundamentals. At the G7 level we agreed that progressive acceleration of the yuan's appreciation against the dollar and against the euro would be a good way for China to foster a rebalancing of its economy away from foreign orientation and towards domestic demand. This is in the best interest of China and the Chinese people, and the only way to attain a more sustainable domestic growth pattern.

Second, as China becomes a more global player, it has a responsibility to the international community. It has to live up to its obligations by playing an important part in the smooth resolution of global imbalances. Whatever the short-term motives, in the long run the current exchange rate regime is unsustainable and clearly not in the Chinese interest.

***TIE:* China faces tremendous demographic problems because of its one-child policy and aging society. How can the Chinese increase domestic consumption given this demographic constraint?**

Weber: China's demographics are no different than those of a lot of other countries facing a strongly aging and declining population. In Germany we have 1.3 children per family, much like Japan and Italy. Aging problems will begin impacting on the economy in a meaningful way after 2015. It's a long-term issue and it needs to be resolved by long-term policy orientation. The current level of economic growth we've seen in China is unlikely to continue at its current pace for anywhere near long enough to solve the aging problem. An economy cannot outgrow an aging problem.

What needs to be done is to achieve a more sustainable balancing of growth towards domestic investment and domestic consumption.

Let me give you an example. We recently saw a very strong increase in food prices in China. Investment in China's agriculture industry—which at this stage is not very developed—could produce efficiency gains in that sector. Many areas of investment outside export-oriented investment could benefit the Chinese people. China cannot in a sustainable way focus its development strategy only on exports to the rest of the world. The effects of an economic slowdown in the United States on the major trading partners of China are still untested. It is in China's own interest to have a second leg to stand on by having dynamic domestic demand supplement the current strong export orientation.

***TIE:* That brings up a final topic. To what extent do you think the world is decoupling economically from the United States?**

Weber: We've not seen a major decoupling from the largest economy in the world. All the data recently show that the U.S. housing market is in a recession, affecting the financial markets and feeding into other sectors of the economy. If the availability of credit tightens in the United States, that will have implications for the real economy. It is therefore likely that we will see some sizeable deceleration in short-term growth prospects in the United States.

The medium-term perspective is more positive. Financial institutions will have to write off the losses from wrong investment decisions of the past, but if they have reasonable risk management in place this should not threaten the existence of these institutions. They'll face somewhat weaker business and somewhat more drain on their capital in the next few months and this will lead them to be more cautious in terms of new credit risks that they are willing to add to their balance sheet.

Most likely, the U.S. economy will grow and approach potential growth again from below over the next two years and this will have a dampening effect on the rest of the world. It will definitely have a dampening effect on countries such as China which have a lot of export geared to the United States. The impact on Europe will be weaker because Europe's exposure is less, but if the United States slows, it will also be felt in Europe.

I don't think that we will see different behavior than we've seen in previous cycles. There are two types of economists: One type looks for new phenomena in each cycle that will show how this particular episode differs from all previous ones; and the other looks at different cycles to try to detect the regularities that have been there more or less consistently. I'm looking at both regularities and exceptions. And despite all peculiarities of the recent financial market turmoil, my impression is that if the largest economy in the world slows this will be felt by all countries that are export-oriented, including Europe, but in particular by China, because the United States has been the consumer of last resort in the world economy.

In a very uncertain environment banks have initially been to some degree reluctant to disclose the full extent of their losses.

***TIE:* Our sense is that Europeans overestimated the decoupling because they underestimated the extent of U.S.-European financial integration.**

Weber: Absolutely. We now live in a world of global capital markets. It is striking that the first signs of the crisis resulting from the United States showed up in Europe among some banks that had very weak risk management. It's now moved to the core financial institutions in the world's largest economy. The financial market turmoil will have some effect on U.S. consumption and therefore on demand for goods produced worldwide and exported to the United States.

Having said that, I don't see a big risk of very adverse developments. We're talking about a moderation of growth rates that have been very vibrant in the last five years. Now we're moving into a more normal environment. We're not moving into a very at-risk environment. The odds are that it will be a moderation toward more sustainable growth rates on both sides of the Atlantic and the Pacific.

***TIE:* Thank you very much.** ◆