Governor's Statement No. 22

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Statement by the Hon. **JENS WEIDMANN,**
Governor of the Fund for **GERMANY**

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Governor of the Fund for Germany

Mr. Chairman,
Fellow Governors,
Ms. Lagarde,
Mr. Kim,
Ladies and Gentlemen

I.

First of all, I would like to thank the authorities as well as the IMF and the World Bank Group for their outstanding hospitality and excellent organization of these Annual Meetings. Moreover, I would like to take this opportunity to thank IMF and World Bank management and staff for their dedicated work in pursuing the mandates of these very important global institutions, and also express my gratitude for the work of the Independent Evaluation Office of the IMF which accompanies the Fund's work by contributing to keep the IMF an effective and well-focused institution.

II.

Global growth in the first half of 2014 was weaker than expected. In the second half of this year and for 2015 we expect a moderate expansion of the global economy. Financial conditions, helped by highly accommodative monetary policy, are supportive for economic growth. But those favorable financial conditions have not yet led to a strong growth of private investment in advanced economies.

Downside risks to the global economic outlook have risen in recent months. Geopolitical tensions have the potential to become a major threat to the world economy. Highly accommodative monetary policies in advanced economies have supported demand and risk-taking. Against this background, financial market risks have increased in recent months, as asset prices are elevated, risk spreads in bond markets are compressed and volatility is low. This situation bears the danger of mispricing of risks and could lead to a sudden reversal in asset prices and capital flows. If downside risks materialized, the policy response would be complicated by the high level of private and public debt in many countries and the zero-lower bound of nominal interest rates in advanced economies.

In advanced economies public debt in relation to GDP is at a historically high level. High debt levels hold back a stronger global recovery, hamper resilience in an already fragile

environment and pose a risk for the outlook. Although expansionary fiscal and monetary policies are able to increase demand in the short term they cannot increase longer-term growth. Instead, they risk a further deterioration with regard to the sustainability of public debt, financial stability and reform effort.

Maintaining a solid and stability-oriented fiscal policy is important to strengthen confidence and to crowd-in private investment. More generally, we should strengthen confidence by abiding by the rules we agreed to and fulfill our commitments. The "G20 Brisbane Action Plan" will contain many structural reform commitments including labor and product market reforms but also the fiscal strategies of G20 members. We have to implement these reforms and our fiscal strategies rigorously.

The euro area has made important progress in surmounting the crisis. Tensions in sovereign bond markets have abated not at least due to the measures taken by the Eurosystem, confidence has returned and the economic situation has improved in several peripheral countries. Determined policy action in several fields has laid the ground for the observed progress. Over the past years, significant progress has been achieved in fiscal consolidation, in restoring competitiveness, and overcoming labor market distortions.

At the same time, there is no room for complacency. Some large euro area countries are afflicted with persistent weak growth and the economic recovery in the euro area is still modest and heterogeneous. Moreover, high debt levels and elevated deficits in many countries imply that continuing growth-friendly consolidation is required. Combined with structural reforms, this will not only further foster confidence and improve the economic situation, but will also increase the euro area's long-term growth prospects. This process will make the European economy more robust and shock-resistant and thus contribute to improving global financial and economic stability. The creation of a European Banking Union has the potential to increase financial market resilience considerably.

III.

Germany's economy is overall in good shape. After strong GDP growth in the first quarter by 0.7 per cent (price, seasonally and calendar adjusted compared to the previous quarter) which was positively affected by mild winter weather, real GDP declined by 0.2 per cent in the second quarter, mainly because of the reverse effect in the construction sector. While the underlying momentum remains positive, firms have revised down their expectations on future business in recent months, and geopolitical tensions could impair economic activity through different channels, suggesting that GDP growth in 2014 and 2015 will be presumably lower than expected in spring.

Domestic demand remains to be the main driver of economic growth. In particular, private consumption will be supported by the steady increase in employment and rising real wages on the back of low inflation housing investment may also continue its upward

trend, although at a slower pace than in the recent past. In the absence of major adverse shocks, business investment is expected to continue its modest recovery.

A sound fiscal position as well as the commitment to bring down the high debt ratio continuously also supports Germany's economic development. The general government budget is broadly balanced since 2013 and is expected to stay so in 2014 and 2015. The federal government's net borrowing will be brought down to zero from 2015 onwards.

IV.

The balance between economic and financial risk taking is becoming increasingly skewed. Prices have risen and volatility has fallen in a highly correlated manner over a broad universe of assets. The high-yield segment in particular has seen unprecedented issuance volumes, spurred by high investor demand, and price and non-price indicators show a tendency of exuberance in some corners of the market. It is only reasonable to assume that a correction will eventually take place. If this happens abruptly it could lead to considerable losses for market participants and have broader effects on the economy. Notably the less well-regulated segments of the financial sector may be a source of vulnerability and deserve heightened scrutiny. Overall, the current financial market environment poses an increasingly important challenge for policymakers and we will remain alert with regard to emerging risks.

After the financial crisis in 2008, we have made important progress to build a stronger and more resilient financial system. In particular, we have improved the soundness of the banking sector. However, our job is not finished. Going forward, priorities are to continue to address the too big to fail problem on a global level by defining the terms and conditions for additional loss absorbing capacity of systemically important institutions. Also, we need to advance our efforts to appropriately monitor and supervise the shadow banking sector and reforming the over the counter (OTC) derivatives market will help to reduce systemic risk and increase transparency. Full and consistent implementation of internationally agreed reforms will be crucial to further strengthen the financial system. Beyond that, we see merit in further exploring links between financial institutions and sovereigns and possible implications.

Bond and CDS spreads have declined markedly in the euro area, but we will be careful. The process of reform and repair is far from finished. Private and public balance sheets are still weak in many member states and could cause renewed uncertainty. In this context, we underscore that we are on track to implement the Banking Union, one of the most ambitious recent projects in the European Union: The results of the comprehensive assessment will be published soon and, once completed, the ECB will take up its supervisory role. In the wake of the comprehensive assessment, we have already witnessed efforts by banks to strengthen their resilience. In case the comprehensive assessment identifies additional needs, it will be important to react swiftly. Finally, we

would like to emphasize that the new regulatory framework in the European Union is an important step to move away from bail-outs by taxpayers to bail-ins involving shareholders and creditors.

V.

Since our last Annual Meetings, the IMF has made some progress towards completing its 2010 quota and governance reviews. It is welcome that since then about 10 additional members have consented to the quota reform and about five additional members have accepted the governance reform. However, the required level of support for implementation has still not been achieved. This has prevented a timely conclusion of these important reform steps and required the Board of Governors to adopt a new resolution postponing the deadline. I therefore urge all members that have not yet done so to subscribe these reforms quickly as they are important to further enhance the credibility and legitimacy of the Fund.

Implementing the 2010 reforms would also help to rebalance the Fund's financial resources and thus help to preserve the IMF's quota based financing principle and would also foster consistency of the Fund's financing and governance structure which is important for the legitimacy of the IMF. While the Fund continues to remain well-equipped with quota and NAB resources, it would re-establish the NAB's character as a "reserve tank" for emergency situations and reduce the need for its continued activation. In this context it needs to be emphasized that the repeated activations of the NAB since April 2011 were also made necessary by the prolonged use of FCL arrangements which heavily strains the Fund's resources beyond the envisaged short-term use of this instrument. I call on the IMF to timely address the obvious exit problem under the FCL facility which currently binds about 60% of the Fund's committed resources.

While some pledges made by IMF members in 2012 have not been translated into Borrowing Agreements and some arrangements have been made conditional on the 2010 reforms, we are pleased by the broad-based response to the Fund's request that almost all of the pledged bilateral credit arrangements have eventually been finalized and approved by the Board. Since these credit arrangements were established for a special period of exceptional uncertainties, we do not consider them a "bridge" or a relevant measure for discussions on a possible general quota increase under the 15th General Review of Quotas.

Looking ahead to the pending 15th General Quota Review it will be important to take into account the interests of the broader and quite diverse IMF membership when presenting proposals and scenarios. This will facilitate the discussions on the quota review. With regard to the quota formula we believe that it should be based on variables which have a strong link to the Fund's mandate that is closely related to the interconnectedness of countries in the world economy. Against this background,

Germany finds it imperative to continue to attach large weights to the two most important elements of the formula, GDP and openness.

VI.

Germany is supportive of efforts to strengthen surveillance as a core function of the IMF and its primary tool for crisis prevention. We welcome the results of the 2014 Triennial Surveillance Review (TSR) and concur with the finding that on the whole the Fund has made good progress through implementing the recommendations from the 2011 TSR. Nevertheless, looking ahead further efforts will be needed, including in the areas of integrating bilateral and multilateral surveillance activities and better understanding macro-financial linkages. On the former, our understanding of both inward and outward spillovers can be deepened further without prejudice to domestic responsibilities of policy-makers. A deeper and broader external balance assessment, mindful of the limitations of quantitative methods, would be beneficial in this regard.

A stronger emphasis on macro-financial surveillance will be a challenging but important undertaking when considering how to best conduct surveillance in the period ahead. Critical will be a firmer understanding of how to utilize macroprudential policy tools most effectively and to be able to apply this consistently and even-handed within the surveillance process.

Germany also welcomes the aspiration to increase the traction of the Fund’s policy advice, which crucially hinges on its perceived quality and relevance, by providing more concrete and actionable advice based on country specific conditions. These endeavours will be essential toward preserving the Fund’s role as a trusted advisor.

Building on the Communiqué of the last meeting of the IMFC, we emphasize the importance of regular consultations between the Fund and all its members, which are part of the obligations of IMF membership. These consultations are necessary for a comprehensive assessment of risks to the global economy stemming from possible imbalances domestically which call for policy adjustments and to give other members the opportunity to gauge and discuss the country’s economic situation and policies and potential spillovers. Excessive delays undermine the integrity of the surveillance process. Thus, we welcome that the Executive Board will explore more meaningful actions to address these delays and uphold the responsibilities of IMF membership.

VII.

Highlighting the importance to reach out to all stakeholders and members, we encourage the Fund to continue its engagement with low-income countries and welcome the Fund’s engagement with states in a fragile situation in line with its mandate.

Debt Limits in Fund-Supported Programs are a key part of the Fund´s conditionality toolkit. We highly appreciate staff´s ongoing efforts to propose a reform that is

acceptable for the broader membership. While the Fund's policy should not unduly constrain member countries' ability to secure adequate external financing to support their development needs, a robust ex-ante mechanism is necessary to prevent a build-up of unsustainable debt.

Furthermore, the reform of the Debt Limits Policy needs to be closely aligned with the World Bank's Non-concessional Borrowing Policy to ensure the effectiveness of the policy.We welcome the reform initiative underway that is aimed at establishing a unified debt limits framework encompassing both concessional and non-concessional borrowings since both components may worsen a country's debt situation.