Jürgen Stark: Investing today in the world of tomorrow

Welcoming speech by Dr Jürgen Stark, Deputy Governor of the Deutsche Bundesbank, for the Deutsche Bundesbank Spring Conference 2000, held in Frankfurt on 28 April 2000.

*   *   *

Ladies and gentlemen,

I am happy to welcome you here at the Bundesbank's second Spring Conference, also on behalf of the President who unfortunately is unable to attend. I am glad that you have come, some of you from very far, to join us in a discussion of problems which are of great interest to academics and economic policymakers alike. This Spring Conference is indeed designed to promote an exchange of views between economists and politicians from Germany, Europe and overseas.

Last year's conference, which took place shortly after the start of monetary union, focused on the monetary transmission process in general and in Europe in particular. This year's conference will focus on investment.

There are certainly enough reasons for choosing this topic in a world where technological progress and a modern capital stock are often considered to be the key to prosperity and where the basic investment conditions are changing in many ways. At the same time it is probably not going too far to say that many questions as to the behaviour of investors still remain.

If this conference helps us to better understand *investors' behaviour*, to judge the significance of some *basic conditions* more adequately and to assess more precisely the *impact of investment decisions* on economic growth and prosperity in our countries, it will surely have been worth the trouble of coming to Frankfurt.

Academics and economic policymakers have been debating the importance of investment and its determinants for a long time. Some of the topics discussed are similar all over the world, for example implications of globalisation for the investment process. On the other hand in some respects focal points of the debate in the US differed from those in Europe. In the US formerly an unsatisfactory productivity growth and more recently the debate on the New Economy played a key role.

In Europe we had some other main topics. Let me just briefly sketch some of the issues which have time and again played a role in Germany and in Europe over the past few decades.

After the investment ratio declined distinctly in connection with the first oil price shock in the *mid-1970s*, interrupted only by the reunification boom in Germany, low investment resurfaced in Germany and other countries as a matter of concern. In the second half of the seventies the situation was given a name in Germany, "investment backlog", and an improved framework was called for in order to solve this problem. Quite often investment was discussed from a short-term perspective focusing on its contribution to demand. Since then, there has been a growing awareness that the supply side plays a predominant role, where investment is a guarantee of a sufficiently high and modern capital stock and is a prerequisite for growth.

In the *1980s* and *1990s* the focus has again shifted somewhat in Europe. Given the high level of unemployment, the question now concerns not only the link between investment and growth but also that between investment and the demand for labour.

Of course the link between investment or the capital stock, on the one hand, and employment, on the other, is complex. Substitutability must be taken into account, as does complementarity. The significance of investment for an economy's production potential, labour productivity and a country's international competitiveness are all key issues.

On balance, I believe there is no doubt that sufficient investment is a basic prerequisite for mastering the labour market problems in Europe. Of course this is not to say that changes in the pool of available labour, such as improving job-seekers' professional qualifications, are not necessary as well. And certainly the relative factor prices must also contribute to solving the problem.

In this connection the future problems of an ageing population should also be borne in mind. Economists have been warning us about this problem for a long time, and now the general public is becoming more and more aware of this issue. The resulting challenges can be mastered more easily, the more productive capital and labour become. This again highlights the key role of investment.

Having made these brief comments on the significance of investment, I do not need to give further reasons as to why we have chosen the *determinants of investment behaviour* to be the main topic of our conference.

If one asks what the determinants of investment are, a number of variables come to mind: the demand situation faced by the enterprises, financial factors including the profitability of real investment compared to other forms of investment, the risks associated with investments, etc.

Let me start with the *role of government,* since it affects investment decisions in many ways and because it is an important topic for economic policymakers - they can make many mistakes but also quite a few positive contributions in this regard.

Government regulations can have a variety of effects on investment behaviour. Tax legislation in a broader sense, that is including write-offs and subsidy provisions, is a well-known example. Ever since the studies by Hall and Jorgensen in the mid-1960s, if not before then, economists have thoroughly researched these effects on the user cost of capital and hence on investment. What are the consequences if government amends the legislation governing the user cost of capital or the internal financing possibilities? Relatively reliable answers to these questions must be found before we can turn to the follow-on subject of whether government should pursue such objectives, and if so, how.

In this context we should also give some thought to the role of inflation and price stability in investment, for instance in the case of a biased tax system that leads to the taxation of phantom profits arising from inflation.

Another aspect of this complex issue is government itself in its role as an investor. In the last few years we have witnessed a wave of privatisation in Europe. This development and the associated deregulation are a response to familiar demands - not least those made by many central banks, including the Bundesbank - that the state should concentrate on its "core operations". It is hoped that private investors will increasingly utilise the leeway thus opened up to bring about a general increase in prosperity and new dynamism in our economies.

Besides, the fact that such a more deregulated economy based on the principles of free competition usually facilitates the task of maintaining price stability is, of course, a very welcome feature from the central banks point of view.

However, it also goes without saying that government has to make investments. It is generally assumed that public investment in infrastructural projects is an important means of raising the productivity of private investment. The interesting question as to the extent to which this is the case and regarding which of these investments are to be seen in a more positive or negative light will certainly also be addressed during this conference. It is of special interest against the background of structural changes in our economies, which may be facilitated but sometimes also hampered by such government "input", particularly if you bear in mind that those investments are not cost-free.

If a central bank had staged a conference on investment in the past the debate would have focused on *the interest-rate sensitivity of investments*. It was frequently regarded as the hub of the monetary transmission process. Over the last few years this assessment has changed somewhat. I believe it was not a coincidence that this issue remained virtually unmentioned - at least not explicitly mentioned - at the Bundesbank's conference on the transmission process last year.

There are probably a number of reasons for this development. For one thing, the concept of the optimum conduct of monetary policy has evolved. The issue on the agenda today is the search for monetary policy rules, transparency and credibility. The sometimes too mechanistic views of the past on the fine-tuning effects monetary policy has on economic activity have thus taken a back seat. The transmission process has also turned out to be much more complex than originally thought and cannot be restricted to one or only a few parameters. Nevertheless a central bank must not disregard the sensitivity of investment when trying to estimate its impact.

In the light of sometimes heated debate surrounding the relevance of the user cost of capital in explaining investment behaviour, other links between monetary policy and investment decisions have gained increasing weight in the last few years. The importance of *financial constraints and their main origins* are now being debated extensively. The participants in this conference will surely have a few things to say on this issue.

In this area the institutional pattern of relationships between enterprises and an economy's sources of financing is of major importance.

How significant is it if enterprises borrow funds more through banks or on the capital markets? How important is sufficient capitalisation for enterprises? What role does the balance-sheet structure of banks or competition among banks play in the willingness to grant loans? These and many more questions are vital and are by no means only of theoretical interest nowadays.

It has frequently been predicted that the structure of financial systems and corporate finance will change in the wake of the technological progress in the financial markets and possibly also in connection with European monetary union.

In the past, bank loans played a predominant role in corporate finance in Germany and in most other countries in continental Europe. This has changed somewhat of late and a further development towards increasing direct financing through the capital market is to be expected. There is wide speculation as to how this will affect investment. For instance, will more direct access to a broad capital market tend to ease the financial constraints - or, conversely, will the investment process become more disruption-prone owing to the diminished role of bilateral relationships between banks and enterprises? Will some enterprises profit by such changes and others be at a disadvantage? And so on.

Naturally, the structure of the financial system is shaped by many factors, and the legal framework is only one of many aspects. Before a decision is taken on the actual formulation of these legal provisions, the central banks will certainly be consulted. Therefore, it is important for us at the central banks to assess the probable impact of a changed financial system on investment behaviour in the corporate sector and on the effectiveness of monetary policy.

In this connection it is also vital for such a legal framework to be reliable. The general relevance of uncertainty for investment behaviour has recently attracted quite some attention, and it will be interesting to observe how events will unfold in this field.

A "one-size-fits-all" assessment of the determinants of investment behaviour would certainly oversimplify the issue. Construction investment is only comparable with investment in machinery and equipment to a limited extent, while stockbuilding is a different matter altogether.

Investment in research and development is becoming a particularly important element in ensuring a future-proof economy. In addition, there is good reason to assume that this type of investment is governed by a different set of rules, either because of the higher risks involved or because it pays off only after a relatively long time or because investors in this field have few realisable assets to offer to their lenders as collateral. Against this background, an analysis of investment in research and development would appear to be particularly important. I am glad that this conference will devote particular attention to that aspect.

Today's world is characterised above all by globalisation. National borders are much less of a barrier for the markets than they used to be. This is a result of technological progress, which enables us to overcome time and space much more quickly, and of the triumph of the market economy. Nobody can afford to reject it unless he is willing to make massive sacrifices in terms of welfare. In Europe we have actively promoted this already existing trend by creating the single market and by establishing European monetary union.

The innovations associated with investment have made a crucial contribution to an increased convergence of the markets. Conversely, worldwide integration is exerting a strong influence on the determinants of investment. Competition has become tougher; today investment decisions no longer depend solely on local conditions but on international conditions. From the early nineties to 1998 cross-border investment all over the world tripled.

This development has been viewed with concern by some. Domestic investment by non-residents has sometimes been debated in terms of “selling out the country” and has at times raised fears that such investment is solely intended to eliminate troublesome competitors. In turn, investment abroad has raised fears of domestic jobs being lost. Even though these concerns cannot be brushed aside lightly, and hardships may occur in individual cases, it is important to keep driving home the fact that, on the whole, the integration of economies contributes to the more efficient use of resources, the dissemination of knowledge and the growth of global prosperity.

I think my introduction has spanned a wide range of topics. As you can see, we have many unresolved issues. Although nobody can expect that all these issues will be resolved once and for all by tomorrow night, I am confident that by the end of this two-day conference we will have a clearer idea of the interdependencies which we will need to monitor especially closely in the future. And maybe one of these discussions will also bring us closer to knowing that we have a better understanding of investment behaviour after this conference. With this in mind, I wish us all a successful conference.