Axel A Weber: Challenges to the financial system - ageing and low growth

Opening address by Professor Axel A Weber, President of the Deutsche Bundesbank, at the Third Conference of the Monetary Stability Foundation on "Challenges to the financial system - ageing and low growth", Frankfurt am Main, 6 July 2006.

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1. Introduction

Ladies and gentlemen!

I am pleased to welcome you to the third conference of the Monetary Stability Foundation here in Frankfurt.

As in previous conferences, I am again very delighted that so many distinguished speakers will share their thoughts with us during the forthcoming panels.

This year's conference is entitled "Challenges to the financial system – ageing and low growth". One might ask: Why is this topic of interest to the Monetary Stability Foundation, whose aim is to maintain and promote public awareness of the importance of stable money?

The reason is that maintaining the intrinsic value of money requires that we look not just at short-term developments that have a direct impact on inflation dynamics; in fact, we also need to closely monitor long-term developments that might ultimately affect

- inflation
- the transmission process of monetary policy
- or financial market developments in general.

Low growth and the ageing phenomenon are examples of such long-term developments and therefore quite suitable topics for this year's conference.

During my opening address, I would like to outline the general topic of the conference and its likely implications. In doing so, I hope to pave the way for the forthcoming panels that will elaborate on several aspects in more detail.

2. Ageing and low growth – interrelated phenomena and real economy implications

If one were asked to rank the two phenomena of ageing and low growth in order of public awareness in Europe, low growth would most likely come out ahead of ageing.

The picture is quite clear: While the world economy continues to see strong growth, the euro area's economic upswing remains by comparison rather sluggish. A special matter of concern is the fact that not only euro area's actual growth, but also its potential growth has visibly declined over the past few years.[1]

In parenthesis: This development stands in stark contrast to the objectives of the Lisbon Strategy, which was especially developed to tackle low productivity and low economic growth in the euro area!

Whereas the challenge of low growth is widely discussed, the phenomenon of ageing generally does not receive as much public attention. Evidently, it is very difficult to convince people and policy makers of the importance of a phenomenon that is emerging very slowly and is thus not so obvious.

Nevertheless, the economic repercussions of a steadily ageing population are among the key economic and social policy challenges facing modern industrial societies.

There is undoubtedly considerable uncertainty about estimates regarding the demographic developments over the next 50 years. Developments over the next 20 to 30 years, though, are

[1] Average of the European Commission's, IMF's and OECD's estimates for potential output growth in the euro area over the years 1990-94: 2.4%. For 2005-06: 1.9%

comparatively easy to forecast. Therefore it would be highly remiss of us not to take the core implications of the currently available forecasts seriously.

From an economic viewpoint, the longer-term demographic problem is mostly attributable to the permanent shift in the age structure of the population and the relative contraction of the potential labour force. The shift in the age structure of the population has been evident for a long time and is virtually irreversible. Even major adjustments in the birth rate or in migration movements would not suffice to halt the ageing process in the next two to three decades.

This shift will negatively impact on social security systems as well as potential economic growth. Thus, the ageing of society and low growth are not separate, but interrelated phenomena.

Recent estimates expect ageing-induced expenditures to rise significantly in the euro area by the year 2050.[2] This will pose a dramatic threat to the sustainability of the (already stretched) public finances of most EMU member states. In addition, average potential growth is expected to decline sharply, from around 2% at present to slightly above 1% (between 2031 and 2050).

Both developments urgently call for adequate policy reactions. The challenge is to find timely and appropriate economic and social policy answers to the economic risks and burdens resulting from demographic change. In doing so, a key aim should be to strengthen the foundations for economic growth so that the "demographic burdens" can be absorbed as much as possible. Therefore, policy measures should aim at raising not only labour productivity but also total factor productivity in general.

The ongoing demographic change is not only impacting directly on the real economy. It is also putting social security systems under massive pressure. Especially PAYGO pension systems are being affected very adversely. A transition to fully-funded pension systems is an obvious necessity in the medium to long term.

Additionally, the demographic change is very likely to affect the financial system as well, namely:

- economic and financial relationships
- the financial structure and
- the effectiveness of monetary policy.

3. Impact of demographic changes on the financial system

3.1 Ageing and financial returns

Let me start with the impact of ageing on financial returns – or, to be more precise, with its impact on real interest rates. Real interest rates are one of the most prominent indicators used by central bankers, as they reflect investors' expectations about economic activity.

All other things equal, theoretical and empirical studies alike suggest a decrease in real interest rates due to a higher capital-labour ratio. This effect would be amplified by a shift from pay-as-you-go to funded pension systems – which would be equivalent to an increase in private savings – and also by an allocation of funds to bonds. To what extent the real interest rate is likely to decline is, however, the subject of heated debated.

In my view, only a slight decrease is to be expected. First of all, integrated financial markets and internationally mobile capital should open up new ways of capital utilisation. Secondly, the worst-case scenario of an asset meltdown (ie the assumption that the retiring baby-boomer generation will start dissaving, thus putting immense downward pressure on asset prices) is unlikely to occur: Not only

[2] Economic Policy Committee and European Commission, The impact of ageing on public expenditure, European Economy Special Report 1/2006. If projections for education expenditures and unemployment benefits are excluded, the increase in ageing-induced spending amounts to 4.6% of euro-area GDP, ranging from 0.4% to over 10% of GDP for individual countries.

does a longer life expectancy imply higher individual saving rates of workers, but retirees are also not expected to dissave – as would be assumed by the underlying life-cycle model.[3]

3.2 Ageing and financial structure

Apart from financial returns, ageing also impacts on financial systems. The large capital inflows into pension funds and other institutionalised forms of saving since the 1990s have been the driving factor behind this development.[4] They reflect the noticeable increase in saving for retirement by the baby-boomer generation as well as the partial transition from pay-as-you-go to funded pension schemes. In sum, these large capital inflows should accelerate the shift in EU financial systems from a bank basis to a capital-market basis.

In general, the transition to a more capital-market based financial system is expected to enhance financial stability. One prominent reason for this effect is that the efficiency, depth and liquidity of markets can be assumed to improve with their growth. In addition, the diversity in types and sizes of institutional investors should increase. Finally, it is likely that institutional investors will process information available to the general public more efficiently than private investors.

At this point, however, let me utter two words of warning. They are necessary as the growing importance of institutionalised forms of saving does not necessarily lead to increased stability.

Firstly, the rising number of institutional investors could potentially be accompanied by a greater risk of herding behaviour which, in turn, might increase volatility in financial markets. This is just one example why financial stability issues are at the top of central banks' agendas.

The second word of warning also applies to financial stability issues. The transition from pay-as-you-go schemes to funded pension schemes certainly supports fiscal sustainability – but introduces a new reason for concern: a decline in the financial strength of suppliers. This risk became apparent in 2000-02 when – due to falling equity prices – pension funds and also some life insurance companies became significantly underfunded.

The episode prompted policy changes in areas such as asset liability management and financial accounting. However, the resultant need to match long-term liabilities with suitable assets might now trigger shifts in the asset allocation of pension funds and life insurers. Two questions evolve out of that:

1 Will there be a shift from equity to bond markets?

   Indeed, such a shift – or other investors' (eg hedge funds) anticipation of it – is commonly cited as a "special factor" explaining what appear to be excessively low levels of global long-term interest rates. But even if such a shift is plausible in countries where equity allocation in the investment portfolios predominates (for example, in the US, the UK or Canada) empirical evidence of such a closing of the duration gap is neither clear nor uniform across countries.[5]

2 Is there a scarcity of financial instruments that enable pension funds and life insurers to manage duration, inflation and longevity risks?

   This is the reasoning underlying the occasional call for the government to act as a catalyst for private issuance of inflation and longevity hedges. I do not object to authorities issuing ultra-long fixed and inflation-indexed bonds at market prices. But governments should refrain from issuing longevity bonds. Not only do governments lack a suitable hedge for longevity risks, but – due to national pay-as-you-go schemes – they already face a huge demographic burden which should not be exacerbated needlessly.

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[3] For Germany, Axel Börsch-Supan states that, in the later stages of life, the saving ratio stabilises at about 3% to 5% – a fact which might be explained by lifetime uncertainty and provision for old age (see A Börsch-Supan (2005), Risiken im Lebenszyklus – Theorie und Evidenz, Working Paper of the mea – Mannheimer Forschungsinstituts, No 069-05).

[4] Even in Germany, where pay-as-you-go schemes and a bank-based financial system still prevail, the share of households' financial assets invested in mutual fund shares (accumulated with insurers and pension funds) has risen from 4% (1/5) in 1991 to 12% (1/4) in 2005. At the same time, overall financial assets increased from €34,000 per household in 1991 to €69,000 in 2005.

[5] See OECD (2006), Pension fund demand for high-quality long-term bonds: Quantifying potential scarcity of suitable instruments, in: Financial Market Trends, April 2006.

3.3 Ageing and monetary policy

The final question, ie the impact of ageing on monetary policy, is a research issue still in its infancy. The generally assumed impact of a demographically-induced overall increase in savings is three-fold:

- Central banks will have to take into account the gradual decline in real interest rates (though its extent is hard to quantify).
- The relative strength of the transmission channels is likely to shift: wealth effects are likely to become more important as the sensitivity of consumption and investment to asset prices is expected to increase.
- The pressure on central banks to keep inflation low and asset prices stable is expected to rise.

Although the pace of demographic change is expected to be glacial – as already noted by Charles Bean, the chief economist of the Bank of England[6] – it might be possible that its effects are slightly accelerated through a more rapid shift from pay-as-you-go to funded pensions systems. Indeed, research has shown that such a development supports the shift to a more capital market-based financial system, thereby enhancing households' saving propensity and risk aversion.[7]

In the same vein, we might ask ourselves how the interrelationship between increased private savings and the role of banks is going to develop. As this interrelationship is crucial to the transmission of monetary impulses, the following questions are worth answering. Will the importance of bank deposits shrink, and what would be the implications? To what extent will bank and bond market financing be substitutes? And how readily will banks be able to adapt to their ever-changing environment? I hope that these issues might capture researchers' curiosity. They are of particular interest in the euro area, where bank-dominated financial systems still prevail.

To sum it up, the Eurosystem will increasingly need to monitor demographically-induced changes in the financial system. Based on these insights, the Eurosystem will provide a stable, non-inflationary macroeconomic environment – which is the best contribution to economic growth it can and does make.

4. Concluding remarks

To stimulate our panel discussions, I have highlighted some examples of how ageing, low growth and financial systems interrelate. To be sure, there are still more questions than answers. However, that should be the ideal starting point for such a conference. Moreover, conferences like this will sharpen political awareness of the demographic burden. In this respect, I wish you a lively discussion and a productive conference. Thank you for your attention.

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[6] See C Bean (2004), Global demographic change: some implications for central banks, Overview Panel, FRB Kansas City Annual Symposium, Jackson Hole, Wyoming.

[7] See D Miles and A Černý (2006), Risk, return and portfolio allocation under alternative pension systems with incomplete and imperfect financial markets, in: The Economic Journal, April 2006.