Jens Weidmann: The German economy – dealing with structural shifts

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the hail and farewell ceremony at the Regional Office in North Rhine-Westphalia, Düsseldorf, 25 September 2013.

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1. Economic policy challenges facing Germany

When asked recently whether or not it was possible to slowly but surely wrap up the topic of structural reform, the president of the Bundesbank's Regional Office in North Rhine-Westphalia replied, "We're not done yet." One such item of unfinished business for the Bundesbank in North Rhine-Westphalia is the building of the new superbranch in Dortmund, which, as the largest branch in Germany, will take over cash operations from five other branches in North Rhine-Westphalia.

"We're not done yet" – let me take up this slogan and refer it to the German economy. On the surface, the situation is quite pleasing: Germany's economy is in infinitely better shape than just ten years ago, when Germany was regarded by many as "the sick man of Europe". Germany came through the crisis better than other countries: whereas real German GDP in the last quarter was 2¼% above its pre-crisis level, it was only ¼% higher in France, and in Italy and Spain, it was even just under 9% and 7½% below pre-crisis levels respectively. And this is despite the fact that, in 2009, Germany's GDP dropped by over 5%, one of the most severe slumps among the major advanced economies.

And it is precisely this experience and the evidence it provides of the success of earlier reforms as well as of the employment-oriented cooperation between the social partners which has made Germany a model for many abroad – a model whose competitiveness is so high that some even see it as part of the problem.

To be sure, central bankers do have the reputation of regularly pouring water into the wine whenever the economic situation puts policymakers and the public in a partying mood.

I do believe, though, that there are good reasons for a more level-headed assessment – especially when looking through the cycles as perceived by the public and reported on in the news and seeing some years into the future.

Advancing globalisation, shifts in energy policy, high government debt and aging societies will also – or even specifically – present challenges to Germany – even if the current crisis and its burdens are overcome rapidly.

Let us look at globalisation: the emerging market economies' share of global economic output rose from 37% to 50% between 2000 and 2012. This trend will continue, and enterprises in those countries will continue to catch up in terms of technology, thus increasing competitive pressure on the established market leaders in the industrial countries. That will be all the more so since Germany has been traditionally strong in terms of patent activities in high technology but not in cutting-edge technology, where emerging market economies are, in some cases, slower to catch up.

Now to energy policy: the desired massive upgrading of renewable energy will initially cause high macroeconomic and fiscal policy costs while, at the same time, new technologies such as "fracking" have made international competition a whole new ballgame worldwide.

And now to government debt: this year, German general government is likely to present a more or less balanced budget, with structural surpluses planned for the coming year. However, the debt ratio, at over 80% of nominal GDP, is still very high in Germany, too – not just compared with the Maastricht reference ratio of 60% but also when looking at the implications of an ageing society for public finances and growth.

According to estimates by the OECD in its report entitled “Looking to 2060”, Germany will show the second slowest growth of all 42 countries in the study by 2030, followed by the slowest growth up to 2060 – mainly owing to demographic trends. Per-capita growth is looking somewhat better because of the falling population; however, here too, Germany is mired in mediocrity by European standards, according to the OECD.

Not accounting for migration, there will already be one and a half million people fewer on the labour market in 2020. This is a decline of 2.5%. Such a decline would reduce annual potential growth by nearly 0.3 percentage points, causing potential losses to accumulate over time. In 2020, economic output will thus be nearly €70 billion lower than if this demographic effect had never occurred.

That is the problem facing us. However, if we set the right wheels in motion, we can master these challenges. And this is not only in the interests of Germany, but also in the interests of the Bundesbank and European monetary policy – and that is why I am discussing this topic as President of the Bundesbank.

Germany is the anchor of stability in the euro area, without which many of the efforts to stabilise the euro area would have no credibility. Germany is campaigning for stability-oriented fiscal and economic policy. The strength of its voice also rests on the strength of its economy. It is in the interest of stability-oriented monetary policy for euro-area fiscal policymakers to be in a position to fulfil their responsibility to the euro. We must also not permit the build-up of any new macroeconomic imbalances which could sow the seeds of the next crisis.

To achieve this, the ability to adjust and innovate has to be improved; sustainable government finances and social security systems have to be secured on a long-term basis; and, in order to reverse the age-related growth slowdown, additional growth forces have to be mobilised – both regarding the labour potential and also regarding public and private capital stock and productivity growth.

There are ultimately numerous starting points in order to achieve those objectives. I wish to proceed by picking out four areas where I see a particular need for action: labour markets and immigration, education and infrastructure, reforms to federal financial relationships, and corporate taxation: more specifically, differences in the tax treatment of investment depending on the method of financing and the legal form. I am well aware that I am only scratching the surface of these topics and omitting other important areas entirely – such as the energy U-turn or financial market regulation.

1.1. Labour markets and immigration

I have just outlined how demographic trends will place a burden on future growth. There are two ways to combat this – by increasing the labour force or by increasing productivity.

Let me begin by going into detail on how labour market policy measures or a targeted immigration policy could be used to halt the decline in the labour force. Demographic trends will tend to lead increasingly to shortages of skilled labour. However, this development was halted briefly because labour force participation has grown strongly and more and more people have immigrated to Germany in the past few years to work here.

This is the path for the future. There are labour force reserves, particularly among women and the elderly. A further expansion of childcare and care for the elderly could improve options for women to take up or increase their paid employment. The system of taxes and transfers can also get in the way of higher labour force participation. On the other hand, the increase in labour force participation among older workers following the elimination of early retirement shows the potential impact of targeted reforms.

The discussion that is still ongoing in some quarters – about raising the retirement age to 67 – also shows how politically charged the matter is. Measures to make employment more attractive to women are no less charged: the childcare supplement, splitting income taxation between couples and non-contributory inclusion in statutory health insurance and long-term care insurance cover mean that having a job is less worthwhile. On the other hand, separate political objectives are being pursued by means of these instruments, which have to be weighed against the foregoing.

Only policymakers can strike this balance. However, my point is to remind people that these measures make it less attractive to take on paid employment and thus can cost us macroeconomic growth. This price has to be borne in mind.

Whatever decision is made by policymakers and society at large, simply making family life and work life more compatible is not enough to maintain or even improve the standard of living in an ageing society.

An important step towards stabilising labour force participation is the raising of the retirement age to 67, which I mentioned earlier. Compared to a pension age of 65, this will mean that 2.7 million more people will be of working age in 2030. Calls to reverse this reform therefore worry me. It is a fact that we cannot do without the expertise of older members of the workforce. We therefore have to go to even greater lengths to integrate them more tightly into the economic process.

The fact that employment in Germany has reached a new all-time high is due not only to greater labour force participation but also to immigration. A systematic approach to attract skilled labour from abroad, whose expertise is needed here, would represent a major contribution to helping cushion the impact of an ageing society on the labour market.

Yet it is just as important not to surrender any of the progress that has already been achieved on the labour market. This applies, for instance, to the current debate on the wider application of minimum wages. The academic literature is quite divided on whether a minimum wage will increase unemployment, especially as the answer to that question will depend decisively on the size of the wage and the rest of the framework, such as the social safety net for unemployment or job protection.

However, even if a minimum wage does not affect unemployment directly, it may still have a negative impact on employment trends There is a risk that enterprises will take on fewer new staff in periods of economic upturn.[1] That primarily affects those sections of the labour market that a minimum wage would actually be intended to help. It will worsen the opportunities for low-skilled workers and the long-term unemployed to find work and will make it more difficult for those who do not yet have strongly-developed professional skills to obtain access to the labour market.

In order to improve the opportunities of low-skilled workers and the long-term employed, there is another, more promising path. The goal must be to reduce the gap between well-protected regular jobs subject to social security contributions and other types of employment and to channel the demand for labour more towards jobs subject to social security contributions than before.

In principle, the role played by special forms of employment such as temporary employment in a functioning labour market which "breathes" over the business cycle should not be underestimated. These forms enable rapid adjustments to be made on both the supply and the demand sides: job-seekers are given the chance to re-enter the ranks of the employed quickly, and enterprises can cope with peaks in orders in a flexible and low-cost manner.

Yet it is particularly the favourable treatment, particularly with regard to taxes and levies or to job protection, which can make the transition to regular employment considerably more difficult. There is a similar problem in the rules for additional earnings alongside

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1 See also Meer, J and West, J (2013), Effects of the minimum wage on employment dynamics, NBER Working Paper No 19262.

unemployment benefit II which make it very unattractive for “income boosters” to segue from low-paid part-time work to regular jobs subject to social security contributions. It would therefore be a good idea to eliminate these distortions, for instance, along the lines of the proposal already put forward in 2006 by the German Council of Economic Experts.[2]

The previous flexibility-increasing measures taken both by policymakers and the social bargainers have made enterprises, in particular, more resilient to temporary slumps in demand, such as during the economic crisis – when it makes sense to retain experienced workers and their expertise.

That was surely a major contribution to enabling Germany to overcome the economic consequences of the financial crisis comparatively quickly. But the challenges that lie before us are about more then that: they are about the ability of the German economy to deal with structural shifts. They are about enabling workers from shrinking industries to migrate as smoothly as possible to new growth industries. However, this is possible only if the labour market is flexible in the mainstream and not just at the margins.

1.2. Education and infrastructure

Only a well-functioning labour market can mitigate the economic burdens of demographic trends, too. However, if we want to not only slow down the decline in growth but even accelerate growth, more needs to be done.

When, in future, fewer workers will be at our disposal, it will be all the more important for them to be trained as well as possible. This will require an education system that meets high standards which are comparable across Germany and which will give children, youth and young adults the breathing room and the assistance necessary to develop their talents to the fullest.

Studies show that adolescent educational achievement in Germany is closely correlated with social background, which also impacts on subsequent chances of success in the labour market. Educational achievement is often decided, in particular, in pre-school education. It therefore makes sense to push support for infants and pre-school students more into the focus of public financing. I believe this focus is justifiable because academic education programmes often culminate in high-skilled and well-paid employment. This will enable those affected to foot a larger share of the costs of their own education.

However, education is just one element of public investment. An effective infrastructure is also decisive for economic development. Although international comparisons usually show that Germany has a good infrastructure on the whole, particularly in transport, the bird’s-eye view for a closer look reveals regional gaps or shortages – which possibly contrast with overcapacity elsewhere.

Local governments are the main investors in fixed assets. Those that require a large volume of investment are not always able to raise the requisite financial resources. It is therefore necessary to strengthen the ability of hitherto particularly afflicted local governments to make investments.

In order to ensure prudent use of resources and to maximise the value added for society, new scope for spending should be used only after a thorough weighing-up of the costs and benefits and only to fill current gaps in a targeted manner. New spending projects should not be allowed to lead to an increase in government debt.

The demographic burdens on public budgets will soon grow sharply. Reducing the debt ratio is therefore a matter of urgency in order to combat this. After all, to quote German politician

[2] Arbeitslosengeld II reformieren: Ein zielgerichtetes Kombilohnmodell, Expertise im Auftrag des Bundesministers für Wirtschaft und Technologie, September 2006.

Kurt Biedenkopf: “New debt is tantamount to issuing bills of exchange which my grandchildren will pay off.” However, many tend to agree more with Groucho Marx, who is reputed to have asked himself, “Why should I care about posterity? What has posterity ever done for me?”

1.3. Reform of federal financial relationships

Sound finances are important not only for central government but also for state governments. The debt brake will enter into force for the federal states, too, in 2020. The rules for the state government revenue-sharing scheme will also expire at the same time – at least if the motion by Hesse and Bavaria before the Federal Constitutional Court is struck down. Follow-up provisions will have to be adopted pursuant to the Basic Law.

The discussion about reforming the states’ financial relationships is very complex. It should therefore begin early, especially in order to achieve genuine structural improvement and not to get stuck at questions purely relating to distribution, which are at the forefront of short-term reforms. What is important is the creation of better incentives to increase regional tax-generating capacity, in terms of transferring less from additional tax receipts.

1.4. Equal taxation of debt and equity capital

Targeted public investment in education and infrastructure can strengthen the forces of growth. In the area of private investment, the government’s most important job is to set suitable framework conditions that minimise distortion. Here, too, there is room for improvement.

On the topic of corporate taxation, the focus is mostly on tax avoidance and the use of accounting options by multinational groups. I do believe this to be an important point. And it is clear that economic returns on entrepreneurial activity should be properly taxed. International cooperation is of central importance in order to avoid undesired evasion and distorting accounting options.

However, I do wish to bring to mind another aspect which has been on the agenda for quite a long time – in both academia and the policymaking world – for which a solution has not yet been found: differences in the taxation of investment depending on the type of funding and legal form.

This runs counter to the fundamental principle of like taxation of like economic quantities. Entrepreneurial decisions should be oriented to economic criteria irrespective of the enterprise’s legal form and funding. Therefore, we need to work more on limiting the current tax treatment favouring debt financing over equity financing and thus, at the same time, encourage enterprises to strengthen their capital base.

Strengthening the capital base is, naturally, also a central theme in the banking sphere. Insufficiently capitalised banks, in a pinch, can be an even greater hazard than insufficiently capitalised enterprises since this can pose considerable risks to financial stability as a whole. This became painfully clear during the crisis. However, the task of ensuring that financial institutions’ capital adequacy is primarily a regulatory task. Although progress has been made, much surely remains to be done.

2. Conclusion

Ladies and gentlemen, the euro crisis has drawn attention away from Germany and to other countries. Those who are currently thinking of Germany are not thinking of the sick man of Europe.

However, an economic advantage can dissipate very quickly. This has been demonstrated by the experience of current euro-area crisis countries such as Ireland and Spain, once hailed as model euro-area economies.

Unlike those two countries, Germany is not suffering from the fallout of a burst real-estate bubble and ailing banks. However, the demographic burden and the economic catch-up in other countries could lead to a creeping erosion in the competitiveness of the German economy.

As a central banker, I cannot be unconcerned about such a scenario, for the euro area can only be strong and economically productive if its individual member states are, too.

In keeping with the bonmot that “a speaker should exhaust the topic, not the audience”, I am aware that I have asked a lot of you.

I would therefore like to thank you especially warmly for your attention.