

# **Jens Weidmann: Demographic challenges in Germany**

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Wirtschaftsgespräche am Main economic talks, hosted by Wirtschaftsinitiative Frankfurt / Rhein-Main e.V., Frankfurt am Main, 27 November 2014.

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## **1 Introduction**

Mr Bender, Ms Reinhardt-Lehmann, ladies and gentlemen.

It gives me great pleasure to be here with you today and thus to be able to accept the invitation which Mr Bender and Ms Reinhardt-Lehmann sent me some time ago.

Not only did planning ahead play a role in finding a date for today's economic talk, it will also be the central theme of my remarks today. As you will no doubt have gathered from the invitation, I would like to talk to you today about the demographic challenges that Germany faces, a topic which is also likely to be familiar to you by another name: the ageing of the population.

On the subject of ageing, the American poet Ezra Pound once said, "The older one gets, the more one appreciates the art of constructive silence." In this regard, it appears that I am obviously not yet old enough. And what is more, silence is not particularly entertaining, especially if you have been invited to deliver a speech.

The subject of ageing makes most of us uneasy, both with a view to ourselves and to society as a whole. This is probably mainly because getting older is unavoidable and, as well as ideally bringing the wisdom that comes with old age, is also associated with other, more negative side effects. And anyway, who wants to resign themselves to the inevitable? But it is precisely because it is inevitable that we must face up to it.

For the next few minutes, I would therefore like to show you, from an economic perspective, how demographic change in Germany will develop, what macroeconomic impact it may have and how policy-makers should try, as far as possible, to deal with this impact. The political response to the demographic challenge will help to decide whether the German economy can retain its leading position in many areas.

## **2 Demographic trends in Germany**

Let me first briefly outline the demographic trends that await us, with the help of the Federal Statistical Office's 12th coordinated population projection from 2009.

Based on certain assumptions regarding the birth rate, life expectancy and net immigration, the Federal Statistical Office predicts that, by 2060, Germany's population will shrink by up to 20% from today's figure. Although we know that Germany has become more attractive to immigrants since this study was published, we also know that immigration can only cushion the demographic process in Germany, not prevent it.

However, even more important than the contraction process in itself is the fact that the decrease in the population is accompanied by a distinct ageing of society. One of the reasons for the ageing of the population and the shift in the balance between young and old is, of course, that life expectancy is expected to carry on increasing, which is certainly a positive development for those concerned. However, the fact that the numbers of younger people are decreasing sharply is having a much larger impact. In comparison to 2008, the decline in Germany's birth rate will almost triple by 2060.

Similarly, the working-age population will contract significantly and will also age. In other words, there will be fewer people of working age and considerably larger numbers of elderly people in future. Or, to quote a comparison once made by the demographer Herwig Birg,

“Our country is like a rowing boat. The number of rowers is falling, while the number of older passengers will increase for a number of decades.”

Ladies and gentlemen, the demographic trends I have just outlined have basically already been evident for a long time and are practically irreversible. For example, even if the birth rate were to rise again significantly in the medium term, the trend towards a shrinking and ageing population over the next few decades would not be reversed. The reason that the demographic trend is so strong is that, because Germany’s birth rate has been falling for decades, those who would now perhaps be thinking about having children were never actually born.

Even though demographic forecasts are somewhat uncertain by nature, the demographic trend is clear and we must ask ourselves how we intend to tackle it using social policy and what implications it will have for economic policy. I would now like to focus on this second point in particular, highlighting various areas and pointing out possible courses of action for each. Let us first consider the labour market.

### **3 Impact and economic policy implications**

#### **3.1 Labour market, labour force participation and immigration**

As the working-age population shrinks, the total number of hours that can be worked also decreases, which has a dampening effect on aggregate output and therefore on gross domestic product. The first implication of this trend for economic policy is obvious. To counteract the decrease in the number of hours worked, we need measures that raise Germany’s labour force participation.

In Germany, reserves for this are most likely to be found among the elderly and people with family commitments. Measures aimed at improving the work-life balance are therefore a step in the right direction in terms of both social and economic policy.

Looking at the elderly population, the decision made a few years ago to gradually raise the retirement age to 67 also helped to keep people in this age group in work for longer. Labour force participation among the over-60s has already risen significantly over the last few years.

However, allowing workers to draw a full pension after 45 years of contributions has now somewhat blurred the signal sent out by raising the retirement age to 67. “Retirement at 63” is something which favours age groups that are currently close to retirement to the detriment of younger generations. This brings to mind a quote by the American comedian, Groucho Marx, who died almost forty years ago: “Why should I care about future generations? What have they ever done for me?”

But retirement at 63 is not only a step in the wrong direction in terms of our demographic challenges. In the short term, it also means that workers who are still needed in the labour market are retiring. The shortage of skilled workers is already inhibiting growth in many regions of Germany. Companies in the Rhine-Main region now also appear to be expressing support for bonuses for workers who find them new employees.

Ladies and gentlemen, given the ever decreasing number of skilled workers in Germany, the topic of immigration has attracted more and more attention over the past few years. I have already spoken briefly about the pleasing development of stronger, labour market-oriented immigration.

And, in fact, encouraging the immigration of skilled workers is a useful economic policy to combat the growing shortages on the labour market and to better meet the demand for qualified employees. But, on a realistic scale, immigration of this kind can only mitigate the demographic change taking place in Germany – it cannot stop or even reverse the trend. However, as a society, we should certainly remain open to the rest of the world and thus continue to be an attractive choice for people who decide to live and work in Germany.

### **3.2 *Labour productivity, education and innovation***

Ladies and gentlemen, aggregate output depends not only on how many hours are worked, of course, but also on labour productivity. Given that the ageing effect I have already mentioned is also taking place among the labour force, we must ask ourselves how this group's labour productivity is likely to develop. Is it true that productivity drops as the labour force ages, as has often been suggested?

The answer appears to be "no". More recent empirical studies in this area suggest that the level of labour productivity of employees who are getting older is likely to remain largely the same. Although physical and cognitive capacities generally decrease with age, they are compensated for by growing professional and practical experience. As a result, the contrasting productivity effects are likely to more or less balance each other out. Or, in a nutshell, the young can run faster but the old know the shortcuts.

But this does not mean that overall productivity will remain unaffected by demographic change in the long term. Growing fiscal burdens and a potential decrease in innovation may have a restraining effect. As well as measures to increase aggregate productivity through greater competition and stronger technological progress, measures aimed at increasing labour productivity in the economy are also needed. Such measures would at least cushion the negative impact of demographic change.

Qualifications and education are – and will remain – a cornerstone of this, in addition to an economy's capacity for innovation and thus its technological progress. It cannot be said often enough: education and innovation – supplemented, of course, by curiosity and the urge to explore and discover – are the crucial driving forces behind human and economic development. They therefore play a key role in increasing the growth potential of the economy. In an ageing society, each individual must retain their ability and willingness to be open to new ideas.

For education and innovation to actually fuel progress, society must be free, democratic, competitive and growth-inducing. Expanding knowledge and education will require an education system that meets high standards which are comparable across Germany and which will give children, teenagers 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 employment prospects. This contradicts an important social principle – equal opportunities for all members of society – and is damaging in terms of economic policy. Because educational achievement in later life is often decided mainly at the pre-school stage, it makes sense to increase the resources spent on education for infants and pre-school students and to devote more public funding to it than in the past.

### **3.3 *Economic growth, investment and growth strategy***

Ladies and gentlemen, when we look at things from an economic perspective, what is known as potential growth is a particularly relevant factor. Potential growth is normally defined as the aggregate growth that can be achieved when utilisation of all production factors is normal over time.

Economic potential growth cannot be observed directly, meaning it cannot be measured directly either. Instead, it has to be estimated as precisely as possible. I don't intend today to go into the methods used and the imponderables they entail. However, I think the connection between demographic trends and economic potential growth can be summed up with the following words. Regardless of the uncertainty surrounding estimates of this kind over long periods of time, German potential growth is likely to be weaker in future than in past decades due, above all, to the demographics-driven decline in the number of hours worked.

And yet, the question does arise in this context whether, given the declining and ageing society, the expansion rates of past decades can serve as a suitable yardstick for advanced economies.

Ultimately, however, this has been a valid question in Germany for quite some time now. If we compare the average growth rates of the last few decades, we find a consistently downward trend. In the 1970s we were at just under three per cent. Since the turn of the century, it has been little more than one per cent on the whole.

Thus, when looking ahead, it would probably be more useful to adopt a per capita perspective and compare Germany's relative growth position with that of similar countries.

But such a forward-looking comparison does not put Germany in a particularly good light either. According to estimates by the OECD in its report entitled *Looking to 2060*, the German economy will generate the second slowest growth of all 42 countries in the study in the period up to 2030, and the slowest growth up to 2060. Per capita growth looks somewhat better because of the falling population. However, here too, Germany is mired in mediocrity by European standards, according to the OECD.

Faced with these prospects, our economic policy-makers would do well to follow the path of sustained growth all the more vigorously and hence to fight back. To this end, measures need to be taken which heighten the ability primarily of the private sector to adapt, innovate and invest.

There are ultimately a number of different approaches towards achieving those objectives. These include the areas I have already looked at, namely the labour market, immigration, education and the capacity to innovate. To this list I would add the physical infrastructure.

It goes without saying that an efficient infrastructure is vital for economic development. International comparisons show that Germany does indeed have a good infrastructure overall, particularly in the transport sector. However, if we turn our attention away from the overall picture to the details of the individual components, shortcomings or constraints in infrastructure are clearly evident in some regions, while overcapacities may exist elsewhere.

In the public debate, clear calls have been made for higher investment expenditure. But in order to use taxpayers' money prudently and maximise the value added for society, more public funds should be spent only after thoroughly weighing up the costs and benefits of a specific infrastructure project. Not every investment undertaking is worth the money, as you as entrepreneurs know all too well. And that applies to public investment as much as it does to private investment.

At the same time, higher public investment spending should be counter-financed by making savings elsewhere. Because demographic change also makes heavy demands of public finance – and I will come back to that in a moment.

Ladies and gentlemen, to promote growth and competition more strongly also requires measures that make business start-ups easier and remove barriers to market entry. A constituent element of our market economy is that enterprises must also be allowed to fail and, in consequence, to exit the market. At the end of the day, only if entrepreneurs are held liable for their business decisions will they make those decisions responsibly.

Yet it is crucial for market processes that new enterprises step in to replace those that fail. The economist Joseph Schumpeter, who died in 1950, called this concept "creative destruction". Where no new businesses are set up, however, a market economy loses its creativity – with negative implications for innovation and growth as well as for employment and income opportunities.

There is still considerable scope in Germany to facilitate new business start-ups, as is shown – for instance – by the table the World Bank prepares once a year as part of its *Doing Business* report. In the sub-category of the report that compares the time, cost and procedures involved in setting up a new business, Germany ranks a lowly 114th – faring markedly worse than many other euro-area countries.

Conversely, this means that measures to ease the process of establishing a new business and, where necessary, of removing red tape, are unlikely to cost much money, yet would boost growth potential appreciably.

Ladies and gentlemen, when we talk of setting up new businesses, the question of financing them is never far away. Because young innovative enterprises entail a higher level of economic risk, they need capital more than anything else. From a growth perspective, therefore, measures would probably be useful which promote investors' willingness to put up venture capital.

In this context, Europe-wide – which is to say cross-border – efforts would certainly be the most promising. The venture capital market here in Europe is in poor shape, unlike in the United States, for example. One of its weaknesses is that it is often still segmented along national borders – a situation that different investor protection and insolvency regimes help to perpetuate.

And with regard to the willingness to raise capital, the fact that business tax laws in Germany provide for different tax treatment of debt and equity capital is not very helpful either.

Moreover, growth forces could be mobilised by applying at the European level the principles of the single market more strongly to the market for services, and by bringing the single market into the digital age.

#### **4 Public finances under increasing pressure**

Ladies and gentlemen, strengthening growth forces is also an issue of great relevance for public finances, as they, too, will feel the severe impact of demographic trends – and not only because the politically crucial median voter is going to grow older, which could incentivise policy-makers to shift burdens into the future.

Despite the great complexity of the issue when viewed in detail, I can be rather brief here as the overall picture is quickly summed up. On the one side of the picture are the revenues: in Germany, the working-age population bear the brunt of the government's financing burden in the form of taxes and social contributions. On the expenditure side, the simple fact of the matter is that those of retirement age tend to be net recipients of government benefit payments.

Because of the ageing of the population I have just talked about and the effects it is likely to have on economic growth, public revenues will grow more slowly in future. At the same time, expenditure will rise as a result of demographic change. The bottom line is that public finances will come under increasing strain and, in the absence of adjustments, are not sustainable. The options are either higher social contribution burdens or more debt.

As the German Council of Economic Experts explains in its latest annual report, public debt in 2060 would total around 247 per cent of aggregate output unless changes were made to the status quo. By way of comparison: at the end of 2013, it was estimated at just under 77%. However, to continue building up new debt would be, as Kurt Beidenkopf, the former Minister President of Saxony, once put it, "tantamount to issuing bills of exchange which my grandchildren will pay off".

It is therefore evident that there is no way around a more stringent fiscal policy and corresponding reforms to ensure that public finances remain on a sound footing. Against this backdrop, the retirement age should not be lowered, but ought gradually to be lifted. In fact, it would be worth considering carrying out such a measure in future subject to certain rules, for example by adjusting the retirement age according to further life expectancy.

#### **5 Demographic trends, the independence of monetary policy and the culture of stability**

Ladies and gentlemen, faced with the far-reaching economic repercussions of demographic change, we must assume that it will have implications for monetary policy, too. Although the

ECB Governing Council defines the monetary policy for the entire euro area, meaning that country-specific developments only have an indirect influence, I would like to say a few brief words about potential monetary policy problems. There is justification in that because all the large euro-area countries will be affected by an ageing society.

Given the growing strain on public finances that I spoke of a few minutes ago, there is a danger that monetary policy will also experience greater political pressure to safeguard the government's solvency. What I mean is that the central bank could be pressured into pursuing a laxer monetary policy, primarily one of low interest rates, to keep government financing costs as low as possible. In this way, an increase in the real debt burden would at least be curbed via higher inflation.

In an extreme scenario, this could even lead to a situation known as "fiscal dominance", whereby monetary policy is harnessed to the service of fiscal policy and made to subordinate its policy to the interests of government financing. Price stability could suffer as a result. Both theory and practice teach us that in a stability-oriented economic order, the distribution of roles should be quite the opposite.

This means that the task of fiscal policy-makers is to see to sound public finances, leaving the central bank free to focus its monetary policy, with as few restrictions as possible, on its own primary task of ensuring monetary stability. After all, stable money benefits everyone. This is something the founders of monetary union also realised. Indeed, the Eurosystem's independence and the fiscal policy rules that are enshrined in the treaties of the European Union are designed to allow the Eurosystem to concentrate on safeguarding price stability.

It is clear, therefore, that the Eurosystem's independence is an important pillar for stable money. Yet independence and commitment to stability aren't worth very much if this principle is not shared by the population as well. Otmar Issing, who was a member of the Directorate of the Bundesbank and went on to become the ECB's chief economist, once said that every society eventually gets the rate of inflation that it deserves – and that it ultimately wanted. Demographic change, too, can play a role in this context.

It seems reasonable to suppose that an ageing population would attach greater importance to monetary stability, as they would not want to see the savings accumulated during their working life and their current pension benefits eaten up by inflation. The findings of a Bundesbank study indicate – at least for Germany and the euro area – that older investors hold a greater share of assets that would be devalued through inflation.

Thus, if an ageing society really does develop a stronger aversion to inflation, a stability-oriented monetary policy can look forward to growing support. Monetary policy-makers will then be better able to stick to a course of monetary stability.

Ultimately, then, we are seeing two opposite effects – political pressure driven by rising debt and a growing aversion to inflation demonstrated by the ageing societies of the euro area.

## **6 Conclusion**

Ladies and gentlemen, Mark Twain once said that it's a terrible death to be talked to death. So let me leave you with the image of the rowing boat I mentioned earlier. Because demographic change means that there will be fewer and fewer people to do the rowing, it is imperative that the economic policy direction we are rowing in is the right one.

Measures that promote growth, productivity and technological progress and measures that contribute to the consolidation of public finances are the right course to take.

Thank you for your attention. I now look forward to answering your questions.