Jens Weidmann: Strengthening forces for growth – reforms geared towards boosting prosperity

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the economic summit of the Süddeutsche Zeitung, Berlin, 28 November 2014.

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1. Introduction

Dear Mr Kister, Ladies and Gentlemen, thank you for inviting me to this event. It gives me great pleasure to be here with you today.

I wonder if any of you have heard of Will Rogers. The man I refer to was a very well-known figure in the USA back in the twenties and thirties. Beginning his career as a lassoo artist, he went on to become one of the first big names in Hollywood. He was also a renowned documentary maker and newspaper columnist. In short: He was a true all-rounder.

What is more, he was a humourist whose aphorisms are still popular as quotations today because many of them remain topical. For example, he once commented that mankind's three greatest inventions were first fire, second the wheel and third central banks.

He made this assertion in 1920, in other words seven years after the Federal Reserve was established. However, its message is surprisingly relevant to today's world where many people appear to believe that central banks hold the key to resolving all our economic woes. Nowadays, central banks are viewed as the font of all wisdom in the fight against financial and sovereign debt crises and economic deficits in general. Indeed, some observers deem them to be the only capable actors gracing the stage. People's expectations of monetary policy, especially of European monetary policy, are correspondingly high.

But let me make one thing clear: central banks are not magicians. And they have no wand to make all our wishes come true. In particular, it is fanciful to believe that monetary policy tools can sustainably lift the growth potential of an economy or permanently create new jobs. These goals can only be achieved through structural reforms as growth and employment are generated by innovative enterprises that offer competitive products combined with a well-trained and highly motivated workforce.

In my opinion, Japan is a good illustration of this fact, although it is undoubtedly still too early to make a final assessment of that country's economic policy strategy, known as Abenomics.

This approach, characterised by an expansionary monetary policy coupled with a short-term stimulative fiscal policy and growth-inducing structural reforms, was designed inter alia to shift the Japanese economy onto a higher growth path on a lasting basis.

However, the preliminary effects of Japan's expansionary monetary policy and its stimulative fiscal policy are in danger of dissipating as the economic upturn was partly attributable to clear anticipatory effects prior to a VAT hike. What is more important, however, is that the announced structural reforms, notably measures to liberalise the services market and to expand labour force participation, have not actually been implemented yet.

Monetary policy cannot solve structural problems. Such problems can only be remedied by political means, through growth-friendly reforms. And that is why I would like to talk to you today about what we can actually do to raise the growth potential of our economy. Please note that the observations I am about to make are not exhaustive.

For example, I will not broach the subject of energy policy which is particularly relevant for German enterprises in terms of how it affects competitiveness. Nor will I be commenting on the consequences of demographic change, which I already addressed in my speech yesterday.

Returning to Will Rogers' aphorism, today I intend not so much to focus on central banks per se as on the forces of fire and the wheel. For both of these inventions have galvanised productivity. Without fire we would have no energy and without the wheel there would be no mobility.

It was the American Nobel prize-winning economist, Robert Solow who first showed how inventions, or technological progress as we would probably say today, and economic growth are connected, to which end he used his own model. The acclaimed Solow Growth Model may be over 50 years old but it has lost none of its effectiveness in giving crucial insights into how growth, investment and technological progress interact.

2. Investment and growth

One of the key insights provided by the Solow Model is that in the early stages of an economy's development, growth is driven by the accumulation of capital, whereas at a more progressed stage of its development, the chief determinant of growth is the rate of technological progress.

But there is another more decisive factor at play: in the long run, it makes little sense to invest in a mature economy unless it is technologically advanced or has an abundant supply of labour at its disposal. For these two factors are key to inducing higher income expectations on the part of enterprises.

Which brings us to the crux of the debate about growth-friendly economic policy in Germany and the euro area. This debate has often prompted calls for increased investment as the best way to foster growth, the argument being that such investment would raise the productive capital stock, thus stoking long-term growth potential.

At the same time, it would also push up the demand for machinery and equipment and in so doing stimulate the economy, both at home and abroad. Thanks to the globalised economy, greater investment in Germany, for example, would also benefit the rest of the euro area. Without doubt, the import content of private investment is at least higher than the rather modest content constituted by government expenditure, another reason why I am against calls for a government stimulus package in Germany aimed at boosting the economy in the euro area.

That said, if we take a closer look at the Solow Model we see that, more often than not, quite the reverse is true. In a market economy, demand for investment cannot simply be conjured up by decree with a view to boosting growth potential. Conversely, it is also true that increased growth and therefore higher income expectations enhance enterprises' willingness to invest.

Hence, expectations pertaining to growth and income are of pivotal importance. In the case of Germany, however, demographic change has tended to exert a dampening influence, its shrinking labour force being a paramount factor hindering economic growth. For example, enterprises are finding it increasingly difficult to recruit the specialists they require. This has prompted many German enterprises to invest abroad, as reflected in Germany's high current account surpluses.

Regarding the low level of investment in Germany, many commentators point to public investment, the scale of which can be directly influenced by the state. But here, too, the nexus identified by the Solow Model applies. Rates of investment lying above the growth potential of a developed economy are unlikely to increase prosperity, a fact that applies not just to public investment but also private investment.

Since public net investment has been negative for some time now, there would nevertheless actually seem to be room for improvement in this area as well. No less important than the question of how much should be spent on public investment is the question of how this

money should be spent. Because, as every private investor is aware, not every investment is ultimately worth the money, and the same holds true for the public sector.

In any case, public investment only represents a relatively small share of total investment. And as I already indicated: such investment cannot be steered arbitrarily but should instead reflect demographic trends and productivity gains.

This brings me to the all-important question: how can an economy's productivity be maximised? Here, I would like to cite another economist who delivered some major input regarding growth theory: I refer to Joseph Schumpeter, who described the growth process as one of "creative destruction" under which an entrepreneur develops a new product or a cheaper method of production which then enables him to steal the market from his competitors. As a result, less productive businesses disappear from the market. Overall, this serves to boost economic output.

Viewed from this perspective, the competitive forces unleashed by innovative enterprises are the engine of growth – and there is ample evidence to support this assessment. For example, as a rule, the prosperity-boosting effects of the European Union have not arisen from higher trading volumes, as one might perhaps assume. Rather, studies[1] show that the upturn in growth is mainly due to the fact that the expanded single market has intensified competition. And this increase in competition has in turn led to more innovative and therefore more productive enterprises.

3. Common market for services

This insight leads us directly on to several possible ways of increasing growth potential in Germany and Europe.

The single market has proven extremely successful at simplifying trade in goods. As a result, competition here is intense. Enterprises' market power does not enable them to charge large mark-ups on top of their costs; levels are similar to those in the USA, for example.

Creating a transatlantic market – the TTIP is a keyword here – could thus provide even more stimulus in this regard. The USA is the EU's largest export market and its third most important import partner for trade in goods. As far as trade in services is concerned, the two regions share even closer connections.

And it is precisely in the area of services that the EU still has some catching up to do in terms of intensifying competition. Mark-ups on the cost of services are on average higher than in the USA. One could say that the European Commission's Services Directive has not lived up to expectations. Creating a single market for services thus promises considerable economic benefits.

The original intention behind the Services Directive was to anchor in law the "home country principle", which already applies to trade in goods within the EU. This principle states that a service provider shall no longer be hindered by regulations in the importing country if it complies with national regulations in its home country. However, this principle did not make it into the final version of the directive. Yet implementing the home country principle for services, too, would have great potential – after all, services account for over two-thirds of value added in Europe.

Another way to leverage growth potential were if the single market were to fully enter the digital age. Fragmentation is still part and parcel of the digital economy, in particular for legal aspects such as protecting privacy and personal data, content and copyright, the liability of

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1 H Badinger (2005), "Growth Effects of Economic Integration: Evidence from the EU Member States", Review of World Economics 141, pp 50–78.

online intermediaries, electronic payments and electronic contracts. The EU does not yet consist of one digital single market but 28 individual digital markets.

Studies[2] show that creating a harmonised and well regulated digital single market has the same potential as implementing the single market in its original form, which is to say an upturn in growth of as much as 4%. In Germany alone, as many as 420,000 new jobs could be created between 2015 and 2020.

4. Barriers to market entry

However, in the services sector barriers are not just at the European level. In Germany, they also exist for business start-ups in the form of red tape – things like mandatory administrative formalities, approval periods and fees incurred. In the World Bank's Doing Business table, Germany ranks 114th in the "ease of starting a business" category. In other words, there is plenty of room for improvement.

Even though an enterprise's direct costs may appear to be manageable at first glance, the economic cost of difficulties entering the market and, as a result, weaker competition should not be underestimated. Studies[3] indicate that the relatively small differences between costs of entering the market in the USA and in the EU could still account for 10% to 20% of the EU's productivity shortfall. The costs of removing red tape are comparatively low and could strengthen growth.

5. Venture capital markets

New, innovative enterprises are key to an economy's productivity and highly competitive position. It is thus all the more important for these enterprises to have sufficient funding. A comparison between the USA and Europe shows that there is still some way to go here.

New, innovative enterprises are often too small and banks frequently struggle to assess them, so they regularly raise capital in the form of equity. Venture capital has an essential role to play in this connection.

The business model of a venture capital fund is based on gaining expertise in a particular business area and then investing in several start-ups in this area. Although a high percentage of these start-ups fail, profits are high if they succeed.

For this business model to work, though, the market has to be large enough to enable venture capitalists to adequately diversify their investment. Furthermore, measures must be in place to ensure that lenders' rights are sufficiently protected. This is the only way to ensure that they can reap the benefits of a successful investment.

There is room for improvement on the venture capital market in Europe on both accounts. On the one hand, it is highly fragmented which reduces opportunities for diversification. On the other hand, there are varying levels of protection for lenders' rights. The United Kingdom, which has by far the largest venture capital market in the EU, also has the highest level of protection. By contrast, Germany offers minority investors only a medium level of protection. However, decisions regarding protection for different groups of investors always have to be weighed up carefully.

Overall, the venture capital market in the USA is five times as big as that in the EU. This could also be why innovative enterprises in the USA, measured in terms of the number of patents granted, have much easier access to capital.

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[2] Copenhagen Economics (2010), The Economic Impact of a European Digital Single Market, Final Report.

[3] Markus Poschke, "The Regulation of Entry and Aggregate Productivity", Economic Journal, Royal Economic Society, Vol 120(549), pp 1175–1200, December 2010.

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 – as highlighted again in the German Council of Economic Experts' latest report – is not very helpful either.

6. Capital market union

However, it is not just in terms of growth that greater integration of European capital markets is promising. It can also help to make monetary union as a whole more resilient.

Another comparison with the USA shows that equity holdings there are dispersed much more widely throughout the entire country. If a negative shock hits an industry or a specific region, then this loss is spread widely beyond that region.

The same applies to positive developments, which are reflected in higher dividends. Equity investors participate directly in economic risk and in gains and losses. Creditors, on the other hand, are not exposed to losses – except in the case of insolvency.

In the USA, the integrated markets for capital cushion around 40% of total cyclical fluctuations between the US federal states. If a regional economic downturn were to occur, the enterprises' loss in earnings in one state would then be distributed between shareholders in other states, just as these would also benefit from increased profits in a boom.

Only 25% of cyclical fluctuations are smoothed via the credit markets, where losses are shared only in the event of an insolvency. Fiscal mechanisms cushion just 20% of economic shocks.[4] Studies for the German federal states come to similar conclusions.

Deeper integration of European capital markets could thus make a key contribution to improving the absorption of macroeconomic shocks and the impact of heterogeneous economic developments in the euro area.

The more the capital markets exercise this buffer function, the less fiscal policy will be responsible for stabilising the economy, which has a knock-on impact on government debt. After all, experience has shown that in an upturn it is often not possible to repay debt that was incurred in a downturn to stabilise the economy. In turn, there is less pressure on monetary policymakers to support expansionary fiscal policy by easing monetary policy. Monetary policy can thus become more stable.

7. Closing remarks

Ladies and gentlemen, while monetary policy is able to have a short-term impact on demand in terms of safeguarding monetary stability and thus to support the economy, it cannot solve the central challenge facing the euro area, namely weak growth prospects.

There will only be a sustained rise in growth and wealth in our monetary union if we cut existing red tape and promote competition.

To conclude, I would like to again quote Will Rogers. "There is no better place in the world to find out the shortcomings of each other than in a conference." If I have understood correctly, I believe that it is now up to you to do just that in the next few minutes, Mr Kister. I look forward to our discussion!

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[4] M Hoffmann and B Sorensen, Don't expect too much from EZ fiscal union – and complete the unfinished integration of European capital markets! VoxEU, 9 November 2012.