Andreas Dombret: The German economy and the demographic factor

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the forum WHU - Otto Beisheim School of Management, Vallendar, 17 November 2017.

1. Welcome

Ladies and gentlemen, dear students

Thank you very much for inviting me to this event examining Germany’s future on the world stage.

One key factor which is set to have a huge bearing on Germany’s economic future is the impact of demographic change. In my speech here today, I will therefore be discussing the outlook for the German economy, focusing some of my remarks on the implications of demographic change.

I’m a baby boomer, a member of the generation born prior to the “baby bust” – the sharp decrease in the birth rate attributed to the introduction of the contraceptive pill in the second half of the 1960s.

In actual fact, the pill was arguably less to blame for the decline in the birth rate than economic and societal developments were.

For example, women’s increasing desire to have a career of their own at a time when it was difficult to balance professional and family commitments resulted in fewer children being born.

By the end of the next decade, most of the baby boomers will have retired, and this will have grave implications for our social welfare systems.

It will add substantially to the number of people already drawing a pension, while the number of people whose contributions are expected to fund these pension entitlements will remain static or decrease. On top of this, life expectancy is climbing ever higher, which means that the average pension-drawing period is getting longer.

Whilst insured persons who retired in 1960 at the age of 65 could look forward to living a further 13½ years, this figure now stands at almost 20 years. And medical advances suggest that this figure will rise still further in the decades to come.

The gradual increase in the statutory retirement age to 67 by 2031 has made the pension insurance scheme more sustainable, but it hasn’t put the scheme on a sound footing once and for all. That’s why it is not necessarily pessimistic to believe that further reforms are required to address the post-2031 period. It’s safe to say that the reforms enacted during the last legislative period – I’m talking here about full pensions for persons with an exceptionally long insurance record, and mothers’ pensions – did nothing to boost the sustainability of the statutory pension scheme.

Assuming a far lower pension level and a far higher contribution rate are out of the question in the future, policymakers will probably have no option but to push retirement age higher still.

The pension system and other social security funds aren’t the only areas where demographic change is making itself felt; it also weakens the forces of growth in our economy.
So the positive state of the economy right now should not blind us to the huge challenge which demographic change is also presenting in the sphere of economic policy. In any case, the upbeat economy is no reason to be patting ourselves on the back or resting on our laurels.

2. The German economy

The German economy is currently in very good shape. Sentiment is also fine: the Ifo business climate index rose to a new all-time high in October. Businesses are looking ahead with great optimism.

According to the latest projection of the German Council of Economic Experts, the German economy will experience real growth of 2% this year and 2.2% next year.

The Council of Economic Experts thus finds itself in line with other institutions which have made similar predictions.

Economic output, then, is outpacing production capacity, which means that utilisation is continuing to increase.

A positive factor is that the upturn in Germany is not only ongoing, but also becoming broader: besides private consumption, export demand and investment are also making a contribution to growth.

The German economy is benefiting from the fact that the global economy, including the countries in the euro area, is regaining momentum following years of crisis-induced sluggishness.

According to IMF forecasts, the global growth rate, which was 3.2% last year, will go up to 3.6% this year and 3.7% in 2018. This means that world trade, too, will finally gain more impetus, with growth accelerating from 2.4% last year to 4.2% this year.

That is good news for German exporters. The debates on trade restrictions, which are being conducted in some countries, are causing headaches for export-oriented enterprises, however. Protectionist tendencies, alongside geopolitical conflicts, are among the most significant downside risks to global economic activity.

Economic activity, especially in the euro area, is also being buoyed by what remains a very accommodative monetary policy.

And let me add that, with inflation still muted, I believe that an accommodative monetary policy stance is still appropriate for the euro area. Views can differ over the correct degree of monetary policy expansion and the proper instruments, however.

As you know, the Governing Council of the ECB has decided to halve its monthly bond purchases from January 2018 onwards, but to continue them until at least September 2018.

Furthermore, the Governing Council has announced that interest rates will remain at their present levels “well past the horizon” of its net purchases.

It is clear that monetary policy will remain very accommodative even after the net purchases have ended, as the Eurosystem already has a very large volume of bonds and the Governing Council of the ECB has taken the decision to reinvest the proceeds of the bonds as they mature.

Given positive economic growth in the euro area and gradually increasing inflationary pressure, the Bundesbank believes that discontinuing the net purchases more rapidly and with a clearly communicated end-date would have been appropriate. The main reason I say that is that purchasing sovereign bonds in the monetary union is something we have been viewing critically for a long time anyway: in a single currency area, sovereign bond purchases blur the very
important distinction between monetary policy and fiscal policy. The Eurosystem central banks have now become the countries’ biggest creditors. That could ultimately lead to political pressure being exerted on the Eurosystem to persist with the very loose monetary policy and low interest rates for longer than would be appropriate with regard to price stability.

Low interest rates are designed to encourage consumers to save less and consume more for a temporary period.

German consumers are, in actual fact, in a first-class mood for spending. It is true that the propensity to spend, as measured by the market research institute Gesellschaft für Konsumforschung (GfK), has declined slightly of late, but it is still at a very high level.

This is due chiefly to the positive situation on the labour market and income trends in Germany, which are also being favoured by the very accommodative monetary policy: households’ disposable income went up by 2.8% in 2016 and by as much as 3.6% in the first half of 2017.

The number of people in employment is at an all-time high. The unemployment rate has fallen to its lowest level since 1991; the seasonally adjusted unemployment rate stood at 5.6% in October.

In some industries and regions, enterprises are finding it increasingly difficult to fill vacancies. The shortage of labour in manufacturing and the main construction sector has worsened noticeably of late: the percentage of firms whose output is being hampered by a labour shortage has climbed to its highest level since German reunification. This is a trend that is likely to go on intensifying as demographic change takes hold.

Against this backdrop, it may be somewhat surprising that wage growth has so far not been stronger in Germany.

The increasing scarcity of labour would normally suggest that wage growth should be stronger.

Obviously, countervailing factors are at play here.

One of the main factors dampening wage growth is net immigration of labour from other EU countries. Another is that it is evident from pay negotiations that the labour side is setting somewhat different priorities than it did earlier. Employees are now placing greater value on more flexible or fewer working hours, for example.

The most recent collective bargaining agreement for the railways, for instance, gave employees a choice between 2.6% more pay or six additional days of holiday: more than half (56%) opted for more holiday.

Given a continuing decline in unemployment for the coming years, the pace of wage growth may nevertheless be expected to accelerate.

But public finances, too, are benefiting from positive economic growth and low rates of interest. Demographic change is not yet making itself felt here, especially since it is still those born in the post-war era in years that tended to have lower birth rates who are now entering retirement.

The aggregate general government budget is running a surplus, and that will remain the case in the coming years, as long as the new Federal Government does not embark on a noticeably more expansionary fiscal course.

The government debt-to-GDP ratio, which went up to more than 80% of GDP in the wake of the financial crisis, has now gone down to 66%. It could therefore soon, in a few years’ time, fall below the reference value of 60% enshrined in the Maastricht Treaty.
Regrettably, the majority of euro area countries are unable to claim that about themselves. In France and Spain, government debt stands at almost 100% of annual economic output, with the figure for Italy being as high as over 130%.

Debt-to-GDP ratios provide no more than limited information on the sustainability of public finances, however. That is because, behind explicit government debt, there is concealed government debt in the form of pay-as-you-go social security funds, principally in pension and long-term care insurance. But the pension rights of civil servants also represent implicit government debt if no reserves are formed for them.

Experts estimate that the German government’s implicit debt is more than twice as high as its explicit debt. These are burdens that we are shifting onto the taxpayers of tomorrow and the day after tomorrow. With this in mind, a further reduction in debt is especially important.

3. How demographic change affects potential output

Demographic change is not just an issue of interest for public finances, however. It will also act as a drag on the medium to long-term growth prospects of the German economy.

The declining population and rising average age of the labour force will cause the potential growth rate to shrink.

An economy’s potential output is determined by its inputs of labour and capital as well as production technology. Potential output is understood to mean the highest possible level of economic output that can be achieved with a given level of technology using the available production factors of labour and capital at normal capacity.

The percentage change in potential output therefore denotes an economy’s trend rate of growth.

I am telling this even though I expect you will have already heard about it in one of your economics lectures, but you know, you can’t always remember everything ...

Graphically, this change is usually illustrated as follows: a line shows trend GDP growth over time, while actual GDP sometimes grows faster and sometimes slower, which is shown by a cyclical curve along the trend line. If the potential output growth rate increases, the line becomes steeper, and if it decreases, the line runs flatter. The latter is what happens when demographic change takes hold.

Bundesbank economists estimate that demographically-induced trends in the potential number of hours worked are a major factor in the slowdown in potential growth: from a mean of almost 1¼% over the last five years to just over ¾% in the first half of the 2020s.

Now that doesn’t sound all that remarkable, but in the long run, it will make a considerable difference to output, particularly since most other industrial countries, not to mention the emerging market economies, will be running at significantly higher trend growth rates over the coming decades.

According to a long-term OECD forecast for 42 economies, by 2060 not a single country will be growing at a slower pace than Germany, and this is mainly down to the demographically-induced decline in the number of hours worked. Per capita growth looks somewhat better because of the shrinking population, but here again, Germany ranks no better than mid-table compared with its European peers, according to the OECD.

Our economists’ estimate of potential output I mentioned just now is based, then, on the best possible forecast of how the labour supply will develop in the years ahead.
Notable shifts in the composition of the labour supply will be evident within the space of just a few years.

The working-age population is a relevant factor for determining potential output. This labour force potential is defined relatively broadly, with ages ranging between 15 and 74.

Depending on which net immigration flows one assumes, this potential will pass its peak between 2020 and 2023.

Given cumulative net immigration of 2.5 million people, the labour force potential in 2025 will be roughly as high as today’s.

The age structure will have changed considerably, however.

The number of people aged between 60 and 74 will have risen by more than three million, but the number of employed people will have increased by just one million, assuming that labour force participation in this age cohort remains unchanged.

By contrast, the 45 to 54 age cohort will have fallen by 3½ million. Because labour force participation is very high in this age group, the decrease will push down the labour force to almost the same degree. This can be blamed on the decline in the birth rate in the 1960s that I mentioned earlier, so it has long been expected.

Another population decline has been forecast, this time in the under-35 age cohort, though much of this particular effect will be offset by immigration.

Migrants tend, on average, to be far younger than the existing population. One out of two migrants since 2010 has been aged between 20 and 30 years old.

The strong influx of refugees to Germany in 2015 even caused the average age of the population in Germany to fall for the first time since reunification: from 44 years and four months to 44 years and three months.

Labour force participation will presumably continue to rise in certain age groups. Increasing the statutory retirement age should therefore see to it that the actual age when people retire goes up as well. The proportion of physically demanding jobs is also on the wane, so older people will be able to stay in work for longer. The “flexi retirement” scheme launched this year is also making it easier for retirees to earn additional income and thus encouraging them to keep working.

Yet another area offering potential is the participation of women in the labour force, where improved conditions for balancing work and family commitments have already sent participation levels sharply higher. The difference between the ratios of women and men in employment has more than halved within the space of two decades, and the higher the level of education, the narrower the gap between women and men.

However, there continues to be a much higher proportion of women who work part-time compared to men. Almost half of all women work part-time, compared with just one in ten men.

Because age cohorts with a stronger tendency to work part-time will be larger, the average weekly working hours per employed person are likely to decline slightly by 2025. The potential number of hours worked, then, is likely to be somewhat lower, and this will likewise drag on potential growth in the German economy.

The projected potential growth rate of just over ¾% will originate primarily from productivity growth, where it is assumed that labour productivity will move at a less dynamic pace as demographic change makes itself felt. This means that productivity growth will mainly be propelled by technological progress.
One factor to be considered when it comes to labour productivity is that physical and cognitive capacities deteriorate after a certain age, though this can be offset by experience. As the saying goes: young people run faster, but seniors know the shortcuts.

Another factor is that as society ages, parts of the value added chain will shift from goods production to the services sector, moving chiefly into the long-term care sector.

This also tends to dampen productivity growth, however, because experience has shown that service providers are less productive than the production sector.

Of course, potential output depends not just on the number of hours worked and labour productivity, but also on capital investment, and at the end of the day, demographic trends also impact on fixed capital formation.

So the investment restraint observed in recent years might have something to do with the impending demographic change.

Put more simply: why should a company invest in new machinery if, looking ahead, it won’t have the employees it needs to operate this machinery? And wouldn’t it make more sense to invest in regions with more vibrant economies where the relevant end customers can also be found?

It’s also worth considering the German economy’s high current account surplus in a demographic context.

At €260 billion, Germany ran the biggest current account surplus in the world last year.

This was primarily down to the large surplus in the goods account. And yet you can also interpret a current account surplus as a savings surplus, as saving up abroad.

And for a rapidly ageing society like ours, that makes perfect sense: assets accumulated abroad by way of a current account surplus enable the German economy to share in what are potentially more dynamic economic developments in other countries.

Those external assets can be run down at a later point in time as more and more employees retire and draw on their savings. This is how Germans are providing for their old age.

But still, demographic trends can’t explain a current account surplus of over 8% of GDP. That needs to be stated quite clearly.

Other forces have been driving the surplus higher in recent years, above all the much lower oil price, which has diminished the cost of imports.

The jury is out on the extent to which Germany should embrace an activist policy stance to reduce this surplus. There have been repeated calls from abroad for Germany to adopt a more expansionary fiscal or wage policy, but Germany regularly sweeps them aside.

The Bundesbank also sees little logic in them, particularly since simulations show that measures designed to bolster demand in Germany would have negligibly small spill-over effects on countries saddled with chronic current account deficits.

A more prudent course of action would be to introduce policies that make Germany more investment-friendly. If businesses had incentives to boost domestic investment, this would act to temper the current account surplus, while at the same time increasing potential growth.

4. Consequences for economic policy

Which brings me to the concluding question: what can policymakers actually do to stem the
decline in potential growth driven by demographic change?

As I pointed out earlier, improving the framework conditions for investment is a good place to start. Here I am thinking in particular about digitalisation, which holds many a promise – especially in the face of demographic change. As far as digital infrastructure goes, some countries are way ahead of us.

According to OECD figures, in 2016 only 2% of all broad-band connections in Germany were based on glass fibre technology, while the average was 20% in the OECD countries with the figures in Japan and Korea even exceeding 70%. The demographically-induced decline in the potential labour force can be counteracted by measures to further increase labour force participation.

Incentives to stop working early, such as the option to retire on a full pension at 63, are no longer in keeping with the times and should be phased out. At the same time, employers have to create suitable conditions and lay the right groundwork to enable people to actually work for longer. This includes measures for promoting health management or providing an appropriate workplace, for instance. We also have to commit to a culture of lifelong learning so that people can adapt more quickly and more successfully to an ever changing environment.

This would make it easier for employees who lose their job at 50 plus to find new employment. In times where specialised labour is in short supply, older employees should be held in higher esteem anyway – and I'm not just saying that because I am one of them.

The participation of women in the labour force can be increased by further improving conditions for balancing work and family commitments. Expanding the provision of all-day schools across the country would enable more women to work full time.

But that's not the only reason why investment in education is essential. When, in future, fewer young people join the workforce, it will be all the more important for them to be trained as well as possible. For this, we need an education system that meets high standards and gives young people the opportunity to realise their full potential.

By choosing to attend an internationally renowned business school, you, of course, have already heeded Benjamin Franklin's advice: "An investment in knowledge always pays the best interest."

But this does not just apply to investment in academic training. Studies have shown that educational achievement in Germany is still closely correlated with social background, and this also has a negative impact on subsequent employment prospects. Because educational achievement in later life is often decided to a significant degree at the pre-school stage, society as a whole would reap the benefits of investing in education for infants and pre-school students.

Education also plays a key role in the integration of immigrants.

But immigration is certainly not the answer to our demographic problems. Yet, it helps to curb the decline in the potential labour force. That is why a systematic approach to attract labour from abroad with the qualifications that are needed here would go a long way towards cushioning the impact of an ageing society on the labour market.

To sum up, it is essential that the German economy's current excellent condition does not blind us to the major challenges that lie ahead.

The demographic factor will increasingly take a toll on growth and welfare. Softening this blow, at the very least, will be a key task over the coming decades.

Thank you for your attention.