Jens Weidmann: Germany - current economic policy debates

Keynote speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, at the joint IMF-BBk conference "Germany - Current Economic Policy Debates", Frankfurt am Main, 18 January 2018.

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1. Introduction

Ladies and gentlemen

I welcome you all to the joint IMF-Bundesbank conference on current economic challenges. It is a pleasure to have you here.

Germany has posted four years of positive growth, record levels of employment, and the lowest unemployment rate since reunification. The casual observer might therefore be forgiven for thinking that Germany's economic challenges don't look so pressing after all.

But I know that Managing Director Christine Lagarde is very fond of John F Kennedy's saying that, "the best time to repair the roof is when the sun is shining". And in the face of imminent demographic shifts in Germany, prudence requires that we take this wisdom to heart. I am more than happy that Christine will chair today's concluding panel, guiding the discussion on a possible post-crisis agenda for Germany and the euro area.

Right now, Germany is still enjoying the calm of what is referred to as the "demographic pause". But starting from 2020, the effects of an aging society will begin to kick in strongly. Over the course of the next decade, the dependency ratio will rise from about one retiree per two employees to about one retiree per employee.

Without comprehensive policy action, this implies a significant slowdown of potential growth. And the repercussions will not be limited to Germany. A marked reduction in the growth potential in the euro area's biggest economy would be a burden for the overall state of the euro area economy. It could also translate into lower long-term interest rates in the monetary union. This in turn would not make matters easier for monetary policymakers.

Germany's balanced budget, saving decisions or, more broadly, its current account surplus as a consequence, is largely driven by demographic considerations. But what makes sense from a domestic perspective might spell trouble for the euro area and the world at large, as it might detract from international demand. This is a worry voiced by some observers, the IMF among them.

Are these worries valid? Do Germany's policies need to change in order to accommodate international concerns? And are there policy options that could strengthen Germany's growth potential and provide a boost to international demand at the same time – thus killing two birds with one stone? In the next 15 minutes, I will briefly sketch out some possible answers to these questions.

2. Wages and inflation in Germany

Despite the very favourable economic situation in Germany, inflation has not quite kept pace with the expansion. And while I am pretty sure that Arthur Okun, inventor of the misery index, would marvel at this remarkable combination of low inflation and low unemployment, this is nonetheless something of an economic conundrum.

Standard economic theory would suggest strong wage growth in the face of increasing labour market tightness. And in time, higher wages would translate into higher inflation as well. But wages have been growing at a moderate pace even in the presence of a positive output gap. Notwithstanding that wage growth is now slightly above the long-term average, indicators of labour market slack would suggest higher wage settlements.

What can explain the modest wage growth in Germany? Bundesbank research suggests that migration from other EU member states partially accounts for dampened wage pressures in Germany. Trade unions' higher weight on requests for reduced working time or more training probably also plays a part. I'm sure the upcoming discussion will delve deeper into this as well.

But when it comes to modest wage growth in the face of tight labour market conditions, Germany is by no means unique. It seems to be a rather widespread phenomenon, characteristic of the current situation in the US, the UK, Japan and Sweden, for example.

This suggests that the factors responsible for holding back wage growth are not only idiosyncratic, but at least partly international as well. Recent research by the Bank for International Settlements, for example, suggests that the greater contestability of labour markets via the proliferation of global value chains puts a lid on wages.[1]

More research is needed here, however, to determine which factors are the most prevalent, and whether they are temporary or secular in nature.

3. Fiscal policy

What can be said with confidence in my view, however, is that a positive output gap does not signal a need for an expansive fiscal policy stance. Rather, to heed Kennedy's advice would be to maintain a safety margin to the existing fiscal rules in the face of the looming demographic challenges.

Yet this does not mean that there is no need for action on fiscal policy. Action is warranted to counteract the demographic drag on growth – but action not with regard to the overall stance, but with regard to how the money is spent.

Targeted investments in research, education and, especially, digital infrastructure are required to raise growth potential. And pension reforms that tie retirement age to life expectancy would help to maintain a high pension level while mitigating losses in labour supply.

Most of these measures require a shift in public expenditure from consumption to investment, rather than additional spending. Just as repairing a roof on a beautiful, sunny day, this may not be the most attractive thing to do. But it would be the right thing to do, in my opinion.

As I mentioned earlier, calls for a more expansive fiscal stance in Germany are informed by hopes of its stimulating effect on overall demand in the euro area. Such an attempt, however, seems likely to disappoint. As the import content of public expenditure is low, spillovers to other euro area countries are likely to be small, even when accounting for equilibrium effects.

4. Germany's current account surplus

By a similar token, raising public spending in order to reduce Germany's current account surplus would likely be a futile undertaking as well.

Macro-econometric simulations show that a deficit-financed expansion of public investment in Germany by 1% of GDP over two years would have a very small impact on other euro area countries. The current account balance for the rest of the euro area would rise by less than one-tenth of a percentage point – and this is on the assumption of no monetary policy response. Given endogenous monetary policy – which would imply a tightening on that occasion – the stimulus would have barely any impact at all.[2]

The German surplus has been the subject of much economic debate in recent years. Of course, neither current account surpluses nor deficits are a bad thing *per se*. Current account surpluses and deficits reflect net foreign lending and borrowing, respectively; and depending on the circumstances, both can be rational as well as non-detrimental for a given country.

In Germany, for example, the period following reunification saw substantial domestic demand and substantial capital requirements that pushed the current account into the red for an extended period of time. On the other hand, it is now appropriate for Germany to be running surpluses, since demographic change will hit the economy particularly hard.

According to long-term OECD projections, no major industrial country will grow as slowly in economic terms over the next decades as Germany. Foreign assets accumulated will enable the German economy to participate in the potentially more dynamic economic growth elsewhere.

Of course, demographics alone cannot explain the entire German surplus – according to IMF estimates, aging accounts for about three percentage points – but it should be taken into consideration.

Additionally, it should be noted that the latest distinct rise in Germany's trade surplus was due to the low oil and commodity prices and a relatively weak euro. And with regard to the latter, the heightened trade surplus is also a reflection of the ECB's very accommodative monetary policy stance regarding the euro area on average.

Bearing that in mind, it is disputable whether the national current account balances of member states in a monetary union are meaningful at all. On a global scale, it would be more appropriate to refer to the euro area balance, which is significantly lower.

While the German current account surplus is projected to decline over the next few years, the current account is not expected to become well-balanced. It will be interesting to see whether the experts in our afternoon session conclude that there is a need for active policy measures by the German authorities. And I am curious to learn what measures would be seen as appropriate, if any.

After all, the German surplus is the result of millions of decisions made by enterprises and consumers in Germany and abroad. I do not know of any misaligned incentives such as protectionist measures to impede imports or promote exports. And there is obviously no manipulation of the exchange rate to create current account surpluses in Germany; the euro is a free-floating currency.

Of course, a current account surplus reflects a surplus of savings over investment. To the extent that capital is flowing out of the country due to missed investment opportunities, public policy action is certainly called for.

The way to go, then, is to create a more investment-friendly environment in Germany. The panellists possibly share my view that improving efficiency in engineering the policy switch to renewable energy or in fostering digitisation, for instance by broadband network expansion nationwide, could serve to stimulate private investment. Additionally, removing barriers to entry in the services sector and opening up closed professions could provide an impetus for stronger productivity growth.

5. Strengthening the euro area's resilience

Facing economic challenges head-on will not only prove a boon to citizens' prosperity. It will also raise the equilibrium real interest rate. And this will make the job of a central bank substantially easier, as it adds distance to the zero lower bound.

But while raising growth potential in Germany and the other member states will do much to strengthen the euro area, it is not the end-all to making the monetary union more resilient.

When it comes to resilience, one has to talk about risk sharing. How can shocks that hit individual member states particularly hard be cushioned?

In the United States and other large currency areas, shocks are spread through the distribution of business profits and losses throughout the currency area, because company owners are often resident in other states.

Another channel of private economic risk sharing comes through saving and lending. Enterprises and households take out loans in different US states during an economic downturn to bridge a slump in earnings. Risk sharing through fiscal policy takes a back seat by comparison. Only 10% to 25% percent of all risks are shared by a common fiscal policy in federations like the US orCanada.[3]

Clearly, much could be achieved in the euro area by strengthening cross-border corporate equity funding. To tear down the walls in European capital markets by standardising national insolvency regimes is, in my view, just one particularly important step. Investors need to be able to count on a level playing-field existing throughout Europe. Not only will that promote private risk sharing; it will also reduce capital flows to less productive businesses and stimulate flows to more productive ones. That will boost economic momentum, as OECD research confirms.[4]

Additionally, as Christine Lagarde has pointed out, "there is an inherent debt bias embedded in the global tax system". The development of equity markets, including in Europe, is suffering from the preferential tax treatment given to debt over equity capital.[5]

Interest payments can be deducted from taxable income; equity costs cannot. Eliminating this bias, which I admit would not be trivial in political terms, would encourage businesses to make greater use of equity capital as a funding instrument. And that, in turn, would facilitate greater private risk sharing whilst at the same time reducing the debt bias.

Another way in which risk could potentially be shared might be for enterprises and households to take out cross-border loans in times of crisis. Yet this mechanism hardly worked at all during the crisis in the euro area.

One of the steps taken in Europe to prevent the repetition of a financial crisis was to create the Banking Union. With its Single Supervisory Mechanism and rules on bailing-in creditors in the event of bank failures, the Banking Union bolsters the banking sector's resilience. This makes a loss of confidence in national banking systems less likely. And less danger of a fragmented financial system stabilises lending, particularly in turbulent times.

A common European deposit guarantee scheme could, in theory, even heighten this confidence. However, as with any insurance policy, one would have to make sure in this case, too, that the insurance does not cover losses which have already occurred, like bad loans already on banks' books, and that the insurance does not encourage careless behaviour in the future. And, in my view, the preferential treatment of sovereign debt on banks' balance sheets has to be done away with in Europe to avoid a mutualisation of sovereign risks through the back door. Credit to general governments is not risk-free, as the sovereign debt crisis reminded us in no uncertain terms.

One precondition for a European deposit insurance scheme, then, is that the size of government bond portfolios that banks hold on their books is limited. Credit to sovereigns should not be treated any differently from credit to enterprises or individuals.

6. Conclusion

Ladies and gentlemen

On that note, I would like to conclude by recalling something else President Kennedy said: "There are risks and costs to action. But they are far less than the long-range risks of comfortable inaction." To me, that aptly describes the situation Germany and the euro area find themselves in.

I now look forward to exploring promising avenues of action with you, and wish us all an exciting and rewarding conference!

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1 Raphael Auer & Claudio Borio & Andrew Filardo, 2017. “The globalisation of inflation: the growing importance of global value chains", BIS Working Papers 602, Bank for International Settlements.

2 See Deutsche Bundesbank, The international spillover effects of an expansion of public investment in Germany, Monthly Report, August 2016, pp. 13-17, and studies with similar results cited there.

3 Allard, C, P K Brooks, J C Bluedorn, F Bornhorst, K Christopherson, F Ohnsorge, T Poghosyan and an IMF staff team (2013), “Towards a Fiscal Union for the Euro Area", IMF Staff Discussion Note, 13/09.

4 Adalet McGowan M and D Andrews (2016), “Insolvency Regimes And Productivity Growth: A Framework For Analysis", OECD Economics Department Working Papers No 1309.

5 German Council of Economic Experts (2017), “Towards a future-oriented economic policy".