Jens Weidmann: Monetary and economic policy challenges

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank and Chairman of the Board of Directors of the Bank for International Settlements, before the Industrie-Club Düsseldorf, Düsseldorf, 2 May 2019.

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1 Introduction

Dear Mr Scheele, ladies and gentlemen,

Thank you for your invitation, and I am glad to be here with you in Düsseldorf — on this first working day of my second term of office.

The title of my speech is a dead giveaway regarding what is in store for you, but, as my former UK counterpart Mervyn King once said of central bankers, “boring is best”.

Monetary and economic policy challenges are on the agenda. In this regard, there is no shortage of topics. I wish to begin by focusing on competition and digitalisation as challenges facing economic policy before turning to monetary policy.

But first, let me take you on a short trip back in time, to the sunset of the 19th century in the United States. This was the era of the rise of the major industrial tycoons whose names bear historical resonance, such as the shipping and railway magnate Cornelius Vanderbilt, the steel magnate Andrew Carnegie and the oil baron John D. Rockefeller. They controlled their respective markets and accumulated massive stockpiles of wealth.

At the same time, however, the social disparities widened, and large segments of the population were living under precarious conditions. Many took umbrage at these developments, including a certain Ms Elizabeth Magie, a stenographer and inventor who lived near Washington, DC.

In her view, one of the reasons for tensions in society was that property ownership was concentrated in the hands of a very few. She wanted to show people the consequences of the unequal distribution of land. The medium she chose, however, was not a pamphlet or a newspaper opinion piece. Instead, she created a board game which she called “The Landlord’s Game”. In 1904, Ms Magie’s invention was patented.[1]

The game gained some popularity among university students and was even used by some professors as teaching material, but failed to take off. Its complexity might have been one of the reasons. Over time, various versions of the game were in circulation, and in 1935 a major manufacturer marketed a similar game. Its packaging bore the name that you all now know as “Monopoly”. It would soon become one of the most successful board games of all time.

The bitter irony of the story is that little remained of Elizabeth Magie’s pedagogical purpose of illustrating the negative repercussions of monopolies – on the contrary: the game is often seen as the outgrowth of unbridled capitalism.

What is true is that Monopoly shows what can happen if markets are left entirely to their own devices. Once all other players have been eliminated, Monopoly is over, and with it the fun. In the real world, the actual monopoly status would be just the beginning. As the only provider, you could raise your prices and margins – gouging consumers without having to fear any annoying competition.

2. Competition – heart and soul of the social market economy

This illustrates impressively that functioning competition is the heart and soul of our social market economy. It prevents the concentration of welfare gains in the hands of a very few and instead allows consumers and workers a share of the spoils. Competition for customers leads to lower prices; competition for labour to higher wages.

As Ludwig Erhard put it succinctly: "'Prosperity for all' and 'Prosperity through competition' are inseparable; the first postulate indicates the objective, the second the way to this objective.'"[2]

It is not only a matter of distribution, however. Competition also guarantees the ability of our market economy to perform. Unlike in a board game, however, the result does not hinge on the luck of the dice. For competition motivates firms to develop new products or more efficient production processes. This enhances their productivity and boosts long-term economic growth.

Andreas Mundt, president of Germany's Federal Cartel Office, boiled it down to this: "The innovative power of competition is at its most apparent where competition is absent." He cited as an example the market dominance of a software giant in web browsing at the beginning of the 2000s; its browser did not evolve for a full five years: "Five years of stasis in one of the most innovative areas of our time."[3]

It is all the more disconcerting to see more and more studies which find evidence for the United States of firms acquiring growing market power and set them in relation to various macroeconomic trends.

First, US firms have successfully raised their mark-ups over their marginal costs sharply: according to a widely discussed study, from an average of 21% in 1980 to 61% in 2016.[4] Increasing market concentration has been identified as a key factor in this expansion of margins. The OECD estimates that a 1% increase in the largest firms' market share will raise the price mark-up by 1.1% to 1.7%.[5]

Second, the labour income share, i.e. workers' share in national income, has dropped in the United States. Around one-third of the total decline in the services sector can be attributed to the increase in market concentration.[6]

Third, productivity gains have suffered: if price mark-ups attributable to market power are eliminated, according to one calculation this could increase what is known as total factor productivity in the United States by up to 20%.[7]

The results of these studies should undoubtedly be taken with the proverbial grain of salt. Estimating profit margins is always fraught with uncertainty. And it is not always possible to infer the actual intensity of competition in the market from observed market concentration. In addition, other factors, such as the globalisation-induced outsourcing of activities, could have contributed to higher price mark-ups.[8]

However, these findings do indicate the potential impacts of diminishing competitive intensity and rising market power. Even though the conclusions are not readily applicable to Europe, we do need to keep these factors in mind.

Some time ago, the Bundesbank already investigated mark-up trends in firms in individual European countries (including France, Germany and Italy). It found no evidence of a long-term increase in price mark-ups.[9]

The process of European integration is likely to have made a contribution to this, as the single European market has led to intensified competition. European competition law and its rigorous application are an additional factor. These factors have collectively borne fruit: our markets today often appear less concentrated than those in the United States.[10]

Despite these successes, some see the European Commission's controls on mergers as being too strict and are proposing, for instance, giving national policymakers the right to veto bans on mergers. At all events, the numbers do not indicate excessive strictness: in the past ten years, some 3,000 mergers were approved and only a mere nine blocked.[11]

As I see it, European competition oversight is an attainment which should not be rashly called into question. It is particularly in the interests of Europe's consumers and thus helps all to benefit from the single market.

3 Digitalisation: a challenge for...

3.1 ...competition policy

But it is equally clear that an effective competitive framework cannot be carved in stone but needs to adapt to changes in the environment. Competition law therefore needs to evolve in order to be effective in the digital age as well.

Platforms are a central business model of the digital economy. Nearly all major internet companies have transformed themselves into platform providers, be they Google, Facebook, Amazon or Alibaba. Markets in the platform economy, however, have a tendency to become concentrated. For two reasons.

Returns to scale are one reason. Most of the time, the goods being sold are information-based goods sold globally via the internet. This involves substantial fixed costs but minimal variable costs. Consider search engines, for example. Once they have been set up, they can serve tens of thousands of users inexpensively. There are certainly some costs associated with any search query. However, the total costs rise relatively slowly compared with the number of users.

Network effects are another factor. The more people use it and the more data it contains, the greater the attractiveness of a platform. Both properties favour the market leader and make it difficult for new entrants to gain a foothold in the market.

Such network effects occur even in cases where the platform's users are not in direct contact with one another. For example, consumers are drawn to platforms offering an attractive array of goods and services. Sellers in turn flock to those platforms in large numbers where they can find a broad base of possible purchasers of their products. The economist Jean Tirole has therefore compared digital platforms to large cities: Even though most of their residents don't know each other, they all benefit from the fact that cities are home to many firms and offer a rich cultural life.[12]

Network effects and returns to scale in the digital sphere enable individual firms to prevail. Mention is often made in this connection of the rise of "superstar" firms which can use their market power to reap higher profit margins and make it difficult for competitors to enter the market.

In future, policymakers and antitrust regulators will need to pay particular attention to these problems of digitalisation to prevent the markets from becoming a real-life game of Monopoly in which only one player wins and all others lose. Indeed, such steps towards modernisation are being investigated. The European Commission, for instance, has just received an expert report, and Germany's Federal Government has created a commission for Competition Law 4.0.

On the other hand, digitalisation also provides opportunities to boost competition: vendors from all over the world are located in online marketplaces and are thus competing with bricks-and-mortar merchants. Price comparison websites allow consumers to scan the entire market in just a matter of clicks, thus enhancing transparency. Although only around 10% of German retail sales are transacted online, 86% of consumers use the internet to obtain information on goods and services. All in all, this enhances competition and potentially reduces the margins of online and offline vendors, as well as consumer prices. Thus, for instance, a study by the ECB concludes that the increasing use of online trade in the EU has reduced non-energy industrial goods inflation by 0.1 percentage point each year since 2003.[13]

The bottom-line impact on inflation of the contrary effects of digitalisation cannot yet be quantified with any real certainty. Current research indicates a dampening but relatively low impact.[14]

3.2 ... economic policy

Digital transformation has thus far failed to result in a significant acceleration in productivity gains, either. That is why some refer to this as a paradox. An academic debate is still raging between optimists and pessimists as to whether the new technologies simply need more time for their impact to fully unfold or whether their growth potential is smaller than during earlier waves of innovation.

It is also clear, however, that digitalisation involves profound structural change which presents both risks and opportunities. In order to take advantage of these opportunities in Germany, policymakers need to plot the right course.

For example, many digital technologies require access to a fast internet connection. And Germany is lagging behind other industrialised countries in this respect. In particular, the expansion of the fibre optic network is making only slow progress. To wit, in mid-2018 fibre optic lines made up nearly 80% of all stationary broadband connections in Korea, just over 50% in Spain, but a mere 2½% in Germany – more than 20 percentage points below the OECD average. High time, therefore, for Germany to vigorously expand its digital infrastructure.

In other areas, too, Germany is not stacking up well against the rest of the world. The bureaucratic hurdles to starting a business are relatively high. According to the World Bank's current Doing Business Report, in this category Germany comes in at 114th place – behind Mali, the Bahamas and Nepal. Starting a business in this country requires nine separate procedural steps. New Zealand, the leader in this category, can get it done in a single administrative act.

Reforms to make it easier for start-ups to enter the market would also enhance competition and spur innovative power. Lower barriers to market exit would have a similar effect. Both types of reforms are decisive elements of the economic process of change, namely what Joseph Schumpeter once described as "creative destruction".

It is certainly a core task of general government to eliminate competitive distortions and repair market failure. Moreover, economic policy-making overall needs to create an environment which is conducive to growth.

Research is one area in which general government can provide a boost through targeted promotional measures. Basic research is often the first step in the chain of innovation. It yields new knowledge on which firms can later build. This area of research is not only expensive but also entails a high degree of uncertainty. Most of the time, it is impossible to tell at first whether such research will yield commercially marketable results. However, once new knowledge has entered the world, it can be used by others without having to bear the costs and risks of research. Under these conditions, less research is conducted by the private sector than would make sense from an economic perspective. This is where the state has to step in.

The state, of course, can itself invest in basic research, for instance through its universities. However, firms have to become active in transforming academic knowledge into marketable innovations. The state can create the appropriate framework conditions for this to happen, particularly by protecting intellectual property rights.

And tax breaks for research can also help to create an environment conducive to innovation. The Federal Government has now addressed this issue specifically by putting forward draft legislation. As the legislative process rolls on, it will of course be vital that the rules are not worded in a way that is overly detailed, not least in order to keep the effort required of firms and tax administrations within manageable parameters. On the other hand, the “free rider problem”, amongst other issues, needs to be avoided.

That notwithstanding, we must not lose sight of corporate taxation. Tax reform in the United States has stoked international tax competition. Other countries, such as France and Belgium, have since initiated tax cuts.

When it comes to taxes on corporations, Germany is edging its way to the top of the international league table. In 2018, the effective tax rate in this country was, on average, 29%. To put that into proportion, France’s rate will be around 25% going forward, and the US rate will be even slightly lower than that thanks to immediate depreciation of investments.

A case can be made for slightly above-average tax rates in Germany, since Germany also provides better-than-average framework conditions, such as infrastructure or the skills its workforce possesses. But if the difference between Germany and other similarly high-performing economies becomes too great, our attractiveness as a business location will suffer.

The Scientific Advisory Board at the Federal Ministry of Finance therefore recommends that improvements be made to the tax conditions for investment in Germany.[15] Such conceivable improvements might include funding for research or a return to the declining-balance method of depreciation This would benefit all firms investing in Germany.

The solidarity surcharge also weighs on firms. Transfers to the east German states will expire this year, which would actually make it advisable to do away with this surcharge altogether.[16] This will naturally lead to tax shortfalls, and, as is always the case, has to be weighed against other fiscal policy objectives. Yet a competitive, growth-friendly and employment-friendly tax system is also an important goal.

Provided there is a will to undertake a fundamental reform of corporate taxation, a European approach would be helpful, in my view. EU-wide rules for the tax base have the potential to make taxation in the internal market more transparent and efficient. The European Commission has already presented proposals to this effect, and Germany and France have expressly thrown their weight behind this initiative.

4. Monetary policy

Ladies and gentlemen,

As you see, there are various levers with which the long-term outlook for growth can be improved. They all have one thing in common, though: they are in the hands of policymakers and beyond the reach of central banks. It is up to economic policy to strengthen potential growth.

This would also ease the pressure on monetary policy. For stronger potential growth correlates with a higher level of the natural real interest rate and – with given inflation expectations – a correspondingly higher nominal interest rate level. An increase in the gap between the nominal interest rate and its lower bound will widen the scope for conventional interest rate policy. This reduces the likelihood – all else being equal – of monetary policymakers having to resort to non-standard measures to remain capable of effective intervention.

The topic of monetary policy flexibility has acquired growing importance in the euro area over the past few years, given that low inflation has been an after-effect of the crisis. In order to ensure that inflation returns towards its target over the medium term, monetary policy became extraordinarily accommodative – including by means of non-standard measures such as the asset purchase programme.

One thing is clear to me: monetary policy will need more water under its keel again going forward.

In December of last year, the Governing Council of the ECB decided to discontinue its net purchases of assets. This first step towards monetary policy normalisation was only logical because the price outlook at that time was largely consistent with our medium-term definition of price stability.

In the meantime, the short-term economic outlook in the euro area has taken a perceptible turn for the worse. In early March, the ECB staff projected economic growth of 1.1% this year. For the next two years, however, the experts are predicting growth to accelerate to around 1½% for each of those years.

A weak economy in Germany has contributed in major share to the dip in euro area growth this year. It cannot be explained merely by the oft-cited problems in the automotive industry. Owing to dampened foreign demand, exports have likewise provided no meaningful stimulus since early 2018. In addition, household consumption went on to grow at only a sluggish pace.

However, given the excellent situation in the labour market and rising incomes, I expect private consumption in Germany to overcome its slump. Initial signs of this are already visible: in the first quarter, retail trade saw a sharp increase in sales. As things stand today, there are many signs that the economy is only suffering a temporary slump and that, once it gets over its setback, growth will accelerate.

Such soft patches have occurred time and again in the past without culminating in a recession. For the euro area, the ECB has counted a total of 50 soft patches since 1970 but only four recessions.[17] An earlier study by the Fed counted 69 soft patches – and ten recessions – for the United States from 1950 to 2011.[18]

Owing, above all, to weaker short-term growth, in its latest projections the ECB staff has forecast euro area inflation to rise somewhat more slowly than initially expected up until 2021. These projections explain the relatively cautious overall approach to monetary policy at present. For this reason, the Governing Council of the ECB announced new measures back in March and reaffirmed this cautious stance in April.

It is the task of monetary policy to maintain price stability in the euro area. This means responding to weak domestic price pressures but also continuing along the path of normalisation and not prolonging it unnecessarily, the inflationary outlook permitting.

An extremely accommodative monetary policy stance cannot be allowed to go on forever, not least as it entails risks and side-effects. One is that, in a setting of low interest rates, financial market actors will tend to take greater risks in search of higher yields. If this produces overvalued asset markets, this could end up leading to abrupt price corrections.

And even in the real economy, too, the long-run effects of low interest rates are not only positive. Thus far, studies have shown that the very favourable financing conditions can keep afloat unprofitable firms which, if interest rates were higher, would have to exit the market.[19] As a result, this would mean valuable resources being stuck in unproductive uses.

However, current research is also warning that low interest rates could be a potential feeding ground for higher market concentration. One reason could be that large firms are more highly leveraged.[20] They therefore, so the reasoning, would benefit in particular measure from low interest rates and would be able to expand their market position and make it difficult for start-ups to enter the market.

5. Conclusion

Board games and speeches have one thing in common: at the beginning, nobody knows exactly how long they will take. The longest-ever game of Monopoly is said to have lasted over 1,680 hours, or 70 days. Don't worry – my speech will not be that long – for I am coming to the conclusion now.

Monopoly may be a fun game to play, but in the end there can be only one winner and many losers. Thankfully, this is not how our social market economy works. However, it needs clear rules and a fair referee. This is where the state comes into play. It has to take on a key role, and not only in competition policy, but also in the spheres of infrastructure, education and social protection.

At the same time, competition is – as Hayek puts it – a discovery procedure whose "results are unpredictable and (...) different from those that anyone would have been able to consciously strive for".[21] In other words, The state should not attempt to pre-empt the outcome of this "discovery procedure". Instead, it should give people like Elizabeth Magie the opportunity to use their creativity in a continuous process of invention, to be successful in their efforts and to partake in the prosperity of our society.

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

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