German economy: rising to the challenges

Speech delivered at the invitation of the German association of family businesses

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Check against delivery.

1 Introduction

Ladies and gentlemen,

I am delighted to be able to speak before you today, as representatives of Hessian family businesses. Family businesses play a significant role for the German economy and German society.

In cooperation with the audit firm EY (Ernst & Young GmbH), the University of St. Gallen in Switzerland compiles the Global Family Business Index.[1] It lists the 500 largest family businesses in the world. And, last year, 78 businesses on this list – nearly 16% – were located in Germany. This puts Germany in second place behind the United States, which, however, has nearly five times the GDP (gross domestic product) of Germany. According to EY (Ernst & Young GmbH) data, these 78 businesses generated the equivalent of just over €1 trillion in revenues in 2023.[2] Germany's share of total revenues is therefore just over 10%. And, let it be noted, these are merely the largest and highest-revenue family enterprises.

However, when we talk about family businesses, it is naturally not just numbers that come to mind. It's about much more than that, not least about tradition. What I often hear in this context is that "family businesses think in terms of generations, not quarterly reports". For me, staying power is a good and important quality to have in order to comprehensively rise to challenges and overcome them sustainably. And we are currently facing our share of challenges; of that there is no doubt. I am referring to macroeconomic challenges, which also matter to family businesses.

Once a year, the Society for the German Language (Gesellschaft für die deutsche Sprache) chooses several terms as "Words of the Year". Krisenmodus – "crisis mode" – took first place last year.[3] The term Krisenmodus will probably ring a bell if you look back across the past few years: the COVID (coronavirus disease)-19 pandemic, disintegrating supply chains, high energy prices. This has also left its mark on economic growth, which, this year, will remain weak as well.

In my speech, I want to discuss in depth the factors that are still continuing to gnaw away at growth. These factors can be either temporary or also permanent in nature. My focus will be on the permanent factors, as we have to address these structural factors in order to make long-term progress. I will subsequently discuss which economic policy measures can specifically help overcome the current weak growth. However, let me first put the current period of economic weakness into context. How serious is the situation really?

2 Are Germany’s days as an industrial superpower coming to an end?

In the first half of 2024, like last year, Germany ranked among the laggards in terms of growth in the euro area. German GDP (gross domestic product) more or less stagnated in the first six months of the year, whereas the euro area average picked up markedly. Germany does not come off favourably in a global comparison, either. The advanced economies’ collective GDP (gross domestic product) rose by 0.5% in the spring, and of these, the United States even saw a 0.7% increase.

Third-quarter economic figures for Germany have likewise remained weak. All the while, the media seem to be trying to outdo each other with horror stories about the German economy. “Germany’s days as an industrial superpower are coming to an end” was, for instance, the title of a Bloomberg article in February on the current economic situation in Germany.[4] We read further on in that story that the ”underpinnings of Germany’s industrial machine have fallen like dominoes”.

Just a cursory look back over the history of our economy shows us this: there is nothing inherently new about such headlines and debates. Germany weathered a pronounced slump around the turn of the millennium. Bloomberg Businessweek titled the cover page of its February 2003 issue “The decline of Germany”.[5] And, at the end of 2004, German author Gabor Steingart published a book titled Deutschland – der Abstieg eines Superstars (Germany – The decline of a superstar).[6] Is that painful crisis threatening to repeat itself? Are we in decline?

Without wanting to get ahead of myself: we are undoubtedly in a midst of a difficult transformation process. But it’s a process we have the power to shape. And if we shape it right, then my clear response is: No, in my opinion Germany is not in decline! How is today’s situation in Germany different from that at the turn of the millennium? Let’s take a look at the numbers.

At that time, the unemployment rate as calculated by the International Labour Organization (ILO (International Labour Organization)) stood at over 9% on average; it is now 3.3%, and thus also well below the euro area average of 6.5%. Back then, the most pressing labour market problem was unemployment; now, it is the shortage of skilled workers.

Moreover, German firms’ profitability and capital base are much better now than they were 25 years ago. As a case in point, the average capital ratio was 23% then, whereas in the 2020 to 2022 period it averaged 30%. The profit margin went up from 3.4% at the time to 4.5% in the 2020 to 2022 period. These data are subject to a major time lag, which is why we do not yet have any numbers for 2023.

However, what are the reasons for the current feeble growth dynamics? The energy crisis had an outsized impact on Germany, an exporting country where manufacturing has a special status. As, before the outbreak of Russia’s war of aggression against Ukraine, dependency on inexpensive Russian energy deliveries was high – too high. Moreover, the fallout from the high inflation weighed on the economy. Many consumers kept their purse strings tight. In addition, the restrictive monetary policy is dampening economic activity. And last but not least, industry continues to be impacted by weak foreign demand, particularly because our euro area trading partners’ imports rose less strongly than world trade. What we know for sure is that some of these factors are only temporary. We therefore assume that Germany’s economy will be able to slowly regain some momentum.

3 Structural challenges

Some factors, however, have a longer-term effect. We are facing extensive structural challenges which can likewise dampen growth. To wit, energy costs are set to remain higher than before Russia's war of aggression against Ukraine for quite a while to come. The price of natural gas fell from some €240 per kilowatt hour in August 2022 to €30 in early 2024, before then bouncing back up to around €38 in August of this year, still well above the average price of €13 in the pre-crisis year of 2019.

But the desired transition to a carbon-free energy supply will be costly as well, at least over a relatively long transition period. Plus there are further challenges such as demographic change, the reduction of unilateral dependence on imports and fragmentation of international trade.

The transition to a climate-neutral economy, above all, will require massive investment. On this point, a study commissioned by the KfW (Kreditanstalt für Wiederaufbau) Group estimated the volume of investment needed to reach Germany's net-zero targets by mid-century. The result: around €5 trillion. [7] A McKinsey study even puts the figure higher still, at €6 trillion.[8] And just like when you retrofit an old building to improve its energy efficiency, that number includes investment that will be made in any event. But the estimated incremental investment is considerable, too. The KfW (Kreditanstalt für Wiederaufbau) study puts this at around €72 billion per year, or just under 2% of German GDP (gross domestic product).

And even though the comprehensive digitalisation process that needs to take place will offer huge opportunities, it, too, will require investment, not to mention training or reconceptualising of processes and business lines. But how is investment faring in Germany at the moment? Let's take a look at the statistics.

They show that investment in buildings, machinery and equipment, and other assets in Germany has not grown over the past few years. And declining investment was a key factor behind the slight contraction in economic output in the second quarter. But not just that: in a recent analysis the audit firm EY (Ernst & Young GmbH) found that the number of foreign investment projects in Germany has dropped for the past six years in a row.[9] All things considered, despite the aforementioned challenges and the need for investment that they entail, there is currently no indication of an investment boom.

But what are the reasons for this weak investment propensity? We have investigated this question through our business survey, the Bundesbank Online Panel – Firms. In it, around 7,400 German firms were asked in the third quarter of 2023 about their motives for investment. We published the results in the May edition of our Monthly Report.[10]

The poor macroeconomic setting was evidently the key reason for declining investment. This was closely followed by high energy and wage costs, a shortage of skilled workers, uncertainty about regulation, and high taxes and public levies. Low public funding, inefficient public administration and poor digital infrastructure played a lesser role. These findings may be a year old, but there is much to suggest that they remain valid.

4 The tasks of economic policy

This brings us to the following question: what can economic policy do to remove barriers to investment, or at least mitigate them? One thing it certainly cannot do is directly influence the challenging global setting. For certain other barriers, however, it is very much possible and preferable to tackle them through economic policy. I would like to address three such areas: energy and climate policy, bureaucratic hurdles and the labour market.

4.1 Energy and climate policy

The first area primarily concerns planning certainty and reliability in energy and climate policy. The terms planning certainty and reliability were not plucked out of thin air, as shown by the Economic Policy Uncertainty Index. Developed by the economists Scott Baker, Nicholas Bloom and Steven Davis, this index is based on the analysis of pertinent newspaper articles.[11] According to the index, economic policy uncertainty in Germany has risen much more strongly over the past few years than the average for Europe.[12] Deciding to invest in green technologies is mostly tied up with irreversible costs. So where there is uncertainty about future policy, firms understandably hesitate before making such decisions.

Now, there is no doubt about the basic direction we're heading in: we have to become carbon neutral if we care even just a little for the welfare of subsequent generations. But when it comes to the details, there is indeed uncertainty. How will the costs of fossil fuels develop? How will the costs of environmentally friendly energy develop and will there be a reliable supply? What will government regulation, taxation, and support look like?

To reduce these kinds of uncertainties about the energy transition, it is vital that we have a transparent, purposeful and consistent overall framework. This framework includes having sufficient capacity to import and store climate-neutral energy, and back-up power plants for the event that a dunkelflaute – a period with no wind or sunlight – coincides with a period of high energy needs. And, of course, an efficient energy grid. It will therefore be increasingly important, too, to expand power lines connecting Germany from north to south, but also connecting us to our neighbours in Europe.

The Bundesbank believes that the key instrument to achieve climate objectives should be a price on carbon emissions. This is because carbon pricing ensures that savings and investment are made where it is possible to do so with the lowest costs. However, the crucial thing is to apply carbon pricing as broadly, uniformly and predictably as possible.

Ambitious carbon pricing not only creates incentives for the use of renewable energy, but also for greater energy efficiency. Our April Monthly Report showed how important advancements in energy efficiency are to not missing climate targets.[13] Increases in energy efficiency reduce aggregate energy intensity and thereby boost aggregate production. They thus counteract the activity-dampening stimuli likely to emanate from a higher carbon price.

So the production losses or gains that would be associated with achieving climate goals depend not least on energy-saving technological progress. Besides carbon pricing, subsidies for research and development are one conceivable instrument to increase energy efficiency. However, subsidies should be used in a measured and purposeful manner.

I'm not just concerned about the burden on government finances, which we naturally have to keep an eye on as well. When government interventions become too complex and too extensive, they can significantly distort market incentives. It is possible, for example, that firms keep putting off the necessary investment in the hopes of receiving future subsidies. Some subsidies still in place in the energy and transportation sectors actually run counter to the climate goals. To a certain extent, they therefore act in the same way as a negative carbon price.[14] And last but not least, excessive government intervention ultimately leads to bureaucratic hurdles.

4.2 Bureaucratic hurdles

That brings me to the second area where economic policy can improve the investment climate: the burden of bureaucracy. We should make a distinction between two different aspects here. First, there is the extent of requirements placed on firms. For example, there has recently been intense debate about the Supply Chain Act and questions surrounding data protection. In this respect, politicians should make sure they don't throw the baby out with the bathwater. Even if the objectives are legitimate, the ability to implement measures has to be borne in mind.

Second, the speed of bureaucracy is important. In Germany, congestion occurs not just on the motorways but also in approval processes. It can sometimes take years for a wind turbine to go into operation, say. When it comes to the pace and efficiency of bureaucracy, especially, we should consider digitalisation as a huge opportunity. Digital technologies can simplify and streamline administrative processes. Incidentally, that is very much in the interest of the administration seeing as it, too, is affected by the shortage of skilled workers. It would appear somewhat logical to bundle more processes when it comes to the digitalisation of administration.

That means the targeted transferral of responsibilities to central units, which develop harmonised approaches in a cost-effective way. This would open the door to achieving economies of scale, if the relevant costs per process are reduced thanks to a larger area of application, say. What I'm thinking about here is the digitalisation of the tax administration, for instance. It could likely leverage efficiency reserves if certain tasks were delegated to a single unit. A modern form of federalism could also help us to leverage efficiency reserves, specifically when those responsible actually learn from the best practices of others.

And I'm speaking on this not just as an economist, but also as the president of a large public authority. Dismantling bureaucracy and driving digitalisation often require enormous effort and persistence. But they also present huge opportunities. There's a reason why the Society for the German Language listed "AI boom" as another "Word of the Year" in 2023, ranking it number eight.

4.3 Labour market

The third area where economic policy can play an important role is the labour market. You, as operators of businesses, have been complaining of a shortage of skilled workers for many years now. Quite apart from the current bout of economic weakness, the problem has been increasingly exacerbated by demographic change. And it will become even greater in the future.

The number of vacancies per unemployed person is often used as an indicator of tightness in the labour market. Up until 2014, there were around three vacancies for every 10 unemployed persons.[15] At the moment, there are roughly six jobs available for every ten unemployed persons. And the number of vacancies has also climbed to an all-time high since the end of the pandemic and is barely coming down. There is a shortage of skilled workers, and a shortage of labour.

There is a host of conceivable measures to reduce this shortage: open up better employment opportunities for women and older people, make a targeted play for skilled workers from abroad, strengthen vocational and further training, and do a better job of getting the long-term unemployed and immigrants into work.

Equally, we shouldn't lose sight of the groups that so far haven't participated in the labour market – known as the "hidden reserve". According to the Federal Statistical Office, Germany's hidden reserve recently came to almost 3.2 million people.[16] Close to 60% of them have a mid to high-level qualification. Looking at the hidden reserve, there are significant differences between the genders. For example, many women state that they cannot work because they care for children or family members. We should make better use of this untapped potential labour force. Expanded care facilities for children or dependants requiring care are an important way to help more people enter the labour market.

I am certain that many of you have already taken steps at your businesses to make it easier to reconcile work and family life: you operate kindergartens or have spaces reserved at other childcare facilities, offer flexible working time models or the option of working from home – the list of possibilities is long.

The number of older persons in employment could be increased as well, for example if the statutory retirement age were linked to life expectancy after 2030. This would allow the ratio of retirement to working years to be more or less stabilised. Without this link, the ratio would carry on growing as life expectancy continues to rise. Also, in the short term, it might be worth considering limiting the financial incentives to take early retirement.

After all, in the interests of preserving a good employment and investment climate, it is important to see to it that the tax burden on labour and capital remains reasonable. Germany, for instance, has a high corporate tax burden in comparison to other countries.[17]

The Federal Government has the three economic policy areas I have just spoken about on its radar. This can be seen in this year’s growth initiative from 17 July. The bundle of 49 measures is intended – amongst other things – to increase incentives to work, including making it more attractive for older people to remain in work, accelerate the reduction of bureaucracy and secure the further expansion of renewable energy generation. The growth initiative is an important step in the right direction if Germany wants to rise to today’s challenges. Much depends on its implementation, however. And there is still much to be done.

As an economist myself I must of course not forget what the term “budget constraints” implies: it is not easy to deal with all these challenges when the public purse is light. This being as it is, a critical evaluation of economic policy priorities is almost certainly unavoidable, and that evaluation will remain on the agenda even if the debt brake were to be reformed. The Bundesbank would tolerate a reform if it would continue to guarantee sound government finances. And we have proposed some stability-oriented reforms.

4.4 More financing via the capital markets union

I have gone over what politics and politicians can do to improve the investment climate in Germany. But whether or not an investment will pay off over the long term is not the only important factor. Any investment project must also be funded.

That brings me to the European perspective. Because, all too often, businesses come up against internal European borders in their search for funding. An integrated capital market across the whole of Europe could give European businesses access to more funding for important private investments. But to forge that integrated pan-European capital market, we must make swift progress on both the banking and capital markets unions.

To demonstrate my point with figures: securitisation markets in the EU (European Union) saw a volume of around €800 billion in 2020. In the United States, this volume was at around US (United States)$3.2 trillion, excluding government-guaranteed products.[18] So that’s a different magnitude altogether, even though the United States and the EU (European Union) have comparably large economies when measured by purchasing power parity.[19] The European securitisation market fell apart following the financial crisis and has never fully recovered since. The securitisation volume in the United States, on the other hand, has already exceeded pre-crisis levels, with the caveat that American market structures are not perfectly comparable with European ones.

You may be thinking that securitisation has a bad reputation. And you would be right. After the 2008 financial crisis it was the poster child for “bad financial market innovations” and mainly brought to mind the sale of potentially non-performing loans to unsuspecting investors. As the head of the Bundesbank’s financial crisis management team at the time, I had an unmatched position from which to examine the dynamics of the crisis in detail.

The financial crisis did indeed lay bare the weaknesses in the securitisation process, which can particularly come to bear in highly complex securitisation transactions. These related to deficits surrounding transparency, risk management and valuation methods. Properly structured and well regulated, though, securitisation vehicles can definitely offer added value to our economy. Securitisation markets complement other sources of long-term financing in the real economy. They give enterprises the opportunity to broaden their funding.

This particularly applies to small and medium-sized enterprises, because securitisation gives them indirect access to capital market investors. Moreover, securitisation can relieve the pressure on bank balance sheets and open up additional scope for lending to the private sector. Well-regulated and structured securitisation markets could improve the allocation of resources in an economy and ensure a better distribution of risk.[20] This could reduce funding costs and increase economic growth.

Support for the securitisation market is thus an important element of EU (European Union) plans for a capital markets union. But there are others. The creation of integrated financial supervisory structures is planned. National insolvency rules, accounting and securities law are to be harmonised. The goal is to create a level playing field for all financial market participants operating at the EU (European Union) level. And so long as this goal remains abstract, pretty much nobody has a problem with it. As soon as concrete decisions and negotiations enter the picture, however, unity often dissipates. Harmonising national rules is impossible without compromise, after all.

Happily, more and more European policymakers are coming around to the view that we urgently need a common capital market. There's been some movement on that front in the last few months. I think, for example, that we have made good progress towards developing a European securitisation market. We need to break down the barriers separating European capital markets one by one!

5 Conclusion

Ladies and gentlemen,

As far as the structural challenges are concerned, we need to set the necessary changes in motion and make them fit for purpose. I am certain we can achieve that. The underpinnings of Germany's industrial machine are still intact, and Germany's position as an industrial and investment location is better than its present reputation implies. After recording sluggish growth at the turn of the millennium, Germany ranked as an economic powerhouse in Europe for more than decade.[21] Perhaps that should inspire us to invest shrewdly and sufficiently in our future.

Economic policymaking can lay a solid foundation for that investment, but it is not all-powerful. It all comes down to enterprises and their employees in the end. Academic studies show that family businesses have greater resilience when in crisis mode than other enterprises.[22] I therefore firmly believe that all of you, as operators of family-owned businesses, continue to play an important role in ensuring the German economy rises to the challenges it faces today. And thus in ensuring that Germany remains ready for what the future holds

Footnotes:

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