Kai Behrens in Beyond the Obvious podcast

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Interviews

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Daniel Stelter: Dear Mr Behrens, I am very pleased to welcome you to the podcast.
Kai Behrens: Yes, hello, Mr Stelter, I'm pleased as well. Thank you very much for the invitation.

Daniel Stelter: Mr Behrens, what I find interesting is: why is the ESM actually interested in this topic? Because I thought the ESM is primarily focused on European financial stability. Why are questions about stimulus programmes and the labour market relevant for the ESM?

Kai Behrens: Financial stability in Europe is influenced by this topic, through two channels. First, when public investment and reforms are not well aligned, high government spending can lead to rising public debt without a corresponding increase in economic growth. That increases countries' vulnerability to interest rate shocks or financial market volatility. That's the first channel.

The second one is macroeconomic dynamics. In ageing societies with structurally tight labour markets, investment becomes problematic if it leads to wage and cost increases that undermine competitiveness. That in turn puts pressure on public finances and on banks. That is why the topic is also very important for the ESM.

Daniel Stelter: So, in plain language, you're saying your study contributes to financial stability because it identifies risks that arise if the sequencing of reforms and public spending is not correct.

Kai Behrens: Exactly. It affects debt sustainability and the overall macroeconomic dynamics when reforms and investments are not coordinated in ageing societies. That's the context in which the study operates.

Daniel Stelter: What is genuinely new about your study, Mr Behrens?

Kai Behrens: Empirically, I believe it's the first study to demonstrate these effects in this way. What may also be interesting is the somewhat counter-intuitive thinking involved. In Germany, we've had a stagnating economy for many years, and the reflex is to stimulate demand. But if stagnation does not come with additional capacity or does not release capacity, then stimulus only works under certain conditions. That's the new aspect in the context of a tight labour market.

We did not look specifically at Germany, although it's certainly an interesting case. What we did was a comparative study across all 27 EU member states. The question we examined, also relevant for Germany, is: how can the state use public investment to promote growth? And that question is not trivial. Especially in an ageing society, it is not at all guaranteed that public investment leads to *sustained* growth.

Before we go deeper, perhaps a few numbers for perspective. Forecasts suggest that Germany will lose around three to four million workers over the next ten years due to demographics. Recently, we had just under 46 million employed. That means the labour market will lose 6-8 % of its workers in only ten years. And other European countries face similar patterns.

For future growth, that is obviously a problem. In demographic decline, maintaining prosperity depends on two developments: first, how fast total labour input falls, and second, whether the decline can be compensated for by capital deepening and productivity gains. Summarised in a sentence: the faster an economy ages, the more urgent investment and structural reforms become in order to maintain prosperity.

Daniel Stelter: I believe that immediately. I mean, potential growth, the German government says potential growth is around 0.4–0.5 %, precisely because demographics are poor and the labour supply is shrinking. Productivity growth has also not been great.

Against that background, one understands the need to invest; and anyone living in Germany can see with their own eyes how infrastructure has deteriorated. So, we must invest. In that sense, one might say the government is doing the right thing, finally investing, even financed by borrowing, and things should improve.

Kai Behrens: The question is: how should it be done? And what reforms should accompany it to make the investment as efficient and effective as possible?

Daniel Stelter: So, it isn't enough for the state simply to spend more. You're saying reforms must accompany spending to make it effective.

Kai Behrens: Exactly. What we did was examine the impact of public investment under different labour market conditions, with and without labour market reforms. We first show that ageing societies tend to have tighter labour markets, which limits fiscal policy effectiveness. Second, we show that in demographically tight labour markets, growth is constrained primarily by supply rather than demand. Third, we show empirically that public investment mainly promotes growth when accompanied by reforms that improve labour supply, for example incentives to work, flexibility, training.

Two additional points, not covered in the study but well established in the literature:

1. The quality of public investment matters a lot.
2. Reforms should ideally precede investment, so that sufficient labour is available for the new capital stock.

If these conditions are not met, investment may generate costs without significantly raising potential output, and thus fail to deliver optimal growth effects.

Daniel Stelter: Would you say that in tight labour markets, the earlier discussed crowding out effect is occurring, that government investment displaces private investment? Or is it purely inflationary, things simply become more expensive?

Kai Behrens: Crowding out is one possible effect in a tight labour market. Interest rates may also rise, inflation can increase, prices and wages can increase when you invest in a tight labour market without freeing up labour. And there is always the danger, especially in ageing societies, that negative expectations intensify: if growth is already low and government spending doesn't raise it, distributional conflicts worsen, and governments may actually end up cutting investment.

Daniel Stelter: Looking at your study of past data, European countries are all moving into the same demographic situation. Italy is somewhat older than we are; France has slightly better demographics. Was there a country in your sample that really got it right, a best practice case where they first implemented labour market reforms and then invested? Or did you only find examples of what *not* to do?

Kai Behrens: The classic example is Japan, though it's not in our sample. Demographically, they are 15–20 years ahead of us and did not rely on labour migration, but they managed to raise productivity, something we often overlook, and at least preserve their standard of living despite a shrinking workforce. They became more modest and did not promise 2% growth anymore, but they maintained prosperity.

In Europe—yes, Italy, as you mentioned. Finland is another demographically advanced country. But learning from others is difficult. Institutions are very country specific. The press often claims one can copy Scandinavia, Flexicurity and so on, but these institutions are unique. We aggregate tendencies; concrete reform guidance requires country specific case studies.

Daniel Stelter: As a layman, I'd say: if I raise demand in an economy already at full capacity, I should not be surprised when it doesn't work. That's how I think. So, I wasn't surprised by your study. If I'm at the output limit and increase demand, I'll get displacement or inflation or both.

But as you said, the point is the mix, combining supply and demand side policies. Ensuring the supply side can react elastically. In Germany, for example, abolishing early retirement, raising the retirement age, more annual working hours, incentives or tax cuts to make people want to work more. That's supply side. And then complement that with public investment that absorbs the increased labour supply. Is that the ideal sequence?

Kai Behrens: Fundamentally, the debate about whether we have a demand problem or a supply problem is still unresolved. In Germany, unemployment is rising; we're slightly above 6% now. A few years ago, when unemployment was between four and 5%, the labour market was fully utilised. Now we have slight underutilisation. But our study shows that in ageing societies, labour markets become structurally tighter. We look to the future, not just today.

If you rely only on demand stimulus in structurally tight labour markets, it can backfire. Spending meets capacity limits, drives up prices, and reduces investment effectiveness. Effective policy likely requires a combination: stimulate demand *and* strengthen supply and productivity, through capital investment and reforms that better integrate labour.

Daniel Stelter: Now in Europe we face the following situation: we have had unsatisfactory economic performance for a long time, especially compared with the US. Germany has been stagnating for six years. So, there is a desire for more stimulus. At the same time, we *must* spend more, for example on defence. Europe has to spend much more on defence, regardless of the current Iran war; we already knew this.

So, government spending is going up, *not* for stimulus, but out of necessity. Based on your study, the conclusion seems to be: either this spending is purely inflationary, or it crowds out other spending. That would mean: more defence spending, fewer private investments. No one wants that. Or it means less private consumption, also undesirable.

Can anything in your study help us understand how to deal with this challenge? The challenge being: the state *must* spend more, regardless of whether it wants to stimulate the economy.

Kai Behrens: Growth, GDP growth, is not the only objective of government action. That’s absolutely right. You’ve just mentioned defence; others might point to climate protection. One way to approach this is by dividing public investment into two groups.

The first group includes investments that directly increase production potential: classic infrastructure projects, digital networks, or investments in education. These types of investment expand the public capital stock or increase human capital.

And then there is the second group of investments, which primarily provide public goods, such as security. These investments do not necessarily increase the measured production capital stock directly, but they fulfil essential societal functions.

What does that mean from the perspective of our study? One conclusion might be: the more is invested in public goods, and the less in capital stock, the more efficient the investments in capital stock must be. And the more urgent labour market reforms become, to ensure that sufficient labour is available and to maintain public support for investing in public goods. Because if investment only leads to inflation without increasing growth, it achieves nothing, and very quickly you get distributional conflicts and criticism of these measures.

Daniel Stelter: Now, neither of us would necessarily conclude from this that Mr Merz is right when he says Germans should simply work more, that’s a bit too simplistic, but I would say this: one takeaway is that increasing the quantity of labour supply in a shrinking population is basically the prerequisite for everything else. That would be my first conclusion.

And the second would be that quality matters too, the quality of labour. You mentioned quality of investment, which we’ll come to, but also the quality of people. You mentioned Japan, and indeed I’ve seen figures showing that GDP per worker in Japan has developed surprisingly well, possibly even better than in the US, because they focused heavily on raising productivity per worker. That relates to education and similar factors. So, the supply side has to expand not just in quantity but also in quality.

Kai Behrens: I would add a third dimension: labour market flexibility. There are different measures here: parttime models, support for mobile workers, employment protection rules that make it easier for workers to move from one sector or firm to another with higher productivity. And in a tight labour market, this probably also means higher wages and salaries, so it’s also in workers’ interest.

The two other dimensions you mentioned: increasing total labour input and the employment rate, for example through incentives for longer working lives, and raising worker productivity. That is crucial, because you cannot extend working hours indefinitely. Productivity is ultimately the key to success. That is where investment in skills, retraining, digital competences and similar areas comes into play. Those are the three main approaches you can pursue.

Daniel Stelter: Exactly, and that is an important takeaway for me, because if we look at the political debate, especially the current government, the SPD doesn’t want to touch anything related to the labour market. At the same time, it relies heavily on public spending. One would really have to say to them: your public spending will largely fizzle out. You even said earlier that it may ultimately heighten distributional conflicts, which I would agree with, because if money is spent but does not generate growth, we end up with more debt, higher interest burdens, and consequently more distributional tension.

But you also said earlier that there are studies showing that the quality of investment matters. We have just said there are defence investments, which do not increase production potential, and others that do. So, what do you mean by “quality of investment”?

Kai Behrens: Here, “quality” does not mean good or bad in the usual sense. That’s not what is meant. Rather, quality refers to two types of investment: investments in production capital on the one hand, and investments in public goods on the other. Without implying that one is better or worse than the other, and without commenting specifically on the German situation.

Daniel Stelter: Now, of course, we don’t want to talk one-sidedly about Germany or comment on it too much. I understand that. You work at a European institution, which means you also have access to European decisionmakers. So how do these considerations and the findings of your study actually feed into political discussions at the EU level?

Kai Behrens: The key actor when it comes to structural reforms and coordinating economic policy within the EU is naturally the European Commission. For example, there is the European Semester, where "country specific recommendations", that's the EU jargon, are issued, addressing structural reforms and fiscal policy measures. That's the central player in this regard.

These recommendations are ultimately adopted by the Member States themselves in the Council. And we, as a European organisation and part of the European financial safety net, are of course in regular exchange with colleagues at the Commission and the ECB. We read each other's analyses, we meet at conferences, and so on. But institutionally, responsibility lies with the European Commission.

Daniel Stelter: Mr Behrens, I understand. It's exciting to conduct these analyses. But of course, it would be even better if they weren't only read by me, listened to by my audience, or appreciated by your colleagues. It would be nice if they also influenced policy. So, what conclusions would you draw? What political action areas follow from your analysis?

Kai Behrens: I would say there are several approaches.
First, investment and reforms must be coordinated. That is essential. Even investments in infrastructure, education, or research only achieve their full growth potential if labour market bottlenecks are reduced at the same time, for example through higher labour force participation, targeted training, and so on.

Second, sequencing matters. Reforms should ideally be implemented *before* or at least in parallel with investment programmes, in order to avoid labour market bottlenecks and to maximise the impact of investment.

And third, the larger the share of public investment going into pure public goods, security, climate protection, etc., the more urgent the accompanying reforms that enable growth become. Those are the main areas of political action that follow.

What is also important is communication, the long-term perspective of such policies, which ultimately benefit everyone: workers, today's pupils and students who will enter the labour market later, and also pensioners, who also benefit "when the pie grows," as economists say.

Daniel Stelter: In principle, what you're saying is that the ideal way to make the pie grow is to pump as much flour and sugar and raw materials into the system as possible, while ensuring there are enough hands to do the baking.

Kai Behrens: That's about right. And in this case, many cooks do not spoil the broth.

Daniel Stelter: Hopefully not. Mr Behrens, thank you very much for your time and your explanations. I find it a highly fascinating study, and I hope it will indeed find its way into policymaking and help create the insight needed to get the highest return from investment. Because I think the best case is: we spend money and raise productivity. The worst case is: we spend money, get inflation but no productivity gains, and end up with bigger distributional conflicts in the medium term, which would be unfortunate. So, thank you very much. Fascinating research. I hope it will be widely read.

Kai Behrens: Thank you, Mr Stelter.

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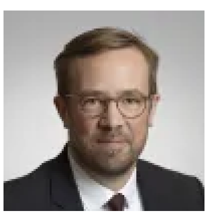

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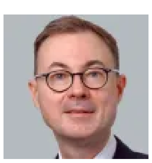

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