The German Economy in the Autumn of 1996

An abridged version of the Evaluation of the Economic Situation by the following members of the working party of the German Economic Research Institutes, Berlin, Germany

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The cyclical weakening of economic growth that hit Germany and virtually all the other industrialised countries last year has been overcome. The overall output trend in Germany has been expansionary since the spring. The pace of cyclical recovery has, however, been exaggerated by compensatory knock-on effects that occurred primarily in the construction industry following the unusually long and cold winter.

As in comparable cyclical phases in the past, the recovery was initially induced by strong growth in foreign demand. The decisive factor behind this was a change in inventory trends, manifesting itself in rising demand for inputs. Yet foreign private sector investment has also clearly increased once more – since the end of 1995 – as shown by higher orders for investment goods from German suppliers. Domestic demand for inputs, on the other hand, did not expand until later, while the demand for equipment has remained subdued. Since the beginning of the current year, private consumption, boosted by tax cuts, has expanded perceptibly and thus bolstered economic development.

Of decisive importance for the global turnaround was the improvement in the framework of monetary conditions. Capital market rates, which rose everywhere in 1994 and thus made a major contribution to dampening economic trends last year, eased substantially in the course of last year. In most countries they had, by the end of last year, almost reached the nadir recorded at the turn of 1993/94, at least in nominal terms. In addition national monetary authorities relaxed their policy stance; base rates were cut, in some cases to historic lows. In Germany, moreover, a substantial positive impact emanated from the normalisation of exchange rate parities. The appreciation of the D-Mark against the US dollar and a number of European countries that occurred in spring 1995 has been completely reversed. The effective real exchange rate of the D-Mark is now roughly equal to its level at the end of 1994.

All in all, German fiscal policy exerted a slightly expansionary effect on economic activity. The budget deficit – adjusted for special factors – rose markedly, despite the imposition of austerity measures. This was primarily due to the effect of the built-in stabilisers, i.e. the acceptance of cyclically induced lower fiscal revenues and higher public spending. In addition, considerable revenue losses occurred due to the reduction of the tax burden on private households – the exemption of minimum subsistence income from income tax, expansion of the family benefit system and the abolition of the special tax on electricity to finance the burning of German coal ("coal penny"). Pay bargainers, whose high wage settlements in 1995 had contributed to the deterioration in the economic climate took account of the less favourable economic situation in this year's pay round.

In the six months to the end of October 1996, real GDP grew at an annual current rate of 4%. To a significant extent, however, this figure is due to the knock-on compensatory effect of weather-related output losses in the construction industry during the winter. Allowing for this effect, GDP, extrapolated to an annual rate, is likely to have grown by around 2½%; this puts overall output growth in line with the growth of potential output for the first time since the 1994 upturn. Inflation has remained subdued; the year-on rate of consumer price inflation has recently been of the order of 1½%; a lower figure has not been recorded since 1988. Unemployment has continued to rise during the year, however. In September registered, seasonally adjusted unemployment was recorded at almost 4 million. This represents 10.4% of the domestic labour force.

In west Germany the cyclical recovery has led to a marked rise in industrial output and rising capacity utilisation. The growth of inputs was particularly strong – a trend that reflects the change in stock movements both at home and abroad. The output of investment goods, on the other hand, expanded only slightly as the domestic demand pick up has been hesitant. Construction output has remained weak in terms of the underlying trend: the pronounced expansion in the spring primarily reflected the prior weather-related output losses. It is service areas that have profited most from the expansion of private consumption, less so the producers of consumer goods and the trade sector.

In east Germany the catching-up process is increasingly running out of steam. There is still no sign of a self-sustained upturn. Since government support measures have ceased expanding, output growth in the construction industry – previously one of the prime beneficiaries of support – has declined in particular. In manufacturing industry, too, there are signs that the forces for expansion are grinding to a halt. Although industrial output has remained buoyant, the volume of incoming orders is only marginally higher than last year. The absence of an internal dynamic behind the catching-up process in east Germany is still largely a question of the lack of competitiveness of many enterprises. A very substantial number of firms has failed to move into the black because the productivity gains achieved have been rapidly eaten away by wage rises. Unit labour costs for the east German economy as a whole – an average that conceals substantial differences even within individual industries – are still around one-third higher than in west Germany. Only just over half the west German productivity level has been achieved. Moreover, the rates of productivity growth in east and west Germany are increasingly converging. The productivity gap cannot be closed and thus the excessive unit labour costs reduced without a fundamental change in the framework of conditions. As there is, as yet, no sign of this, the new federal states cannot be expected to achieve rates of economic growth similar to those achieved on average between 1992 and 1995, even if the west German economy picks up. Quite clearly, the fears repeatedly expressed by the German economic research institutes that the catching-up process in east Germany could run out of steam were justified.

Although east German output picked up slightly during the summer, this was due in no small measure to compensatory knock-on effects following the hard winter. The underlying trend in the construction industry, especially business and public-sector construction, has been sluggish. Industrial output in the second quarter was 8% up on the same period the previous year, but here too the knock-on effects of the hard winter played a significant part, given the importance of construction-related industrial branches in the region. The east German labour market experienced employment growth of around 50 000 during the six months to the end of October, largely as a reaction to the sharp decline in the winter; unemployment fell by a similar order of magnitude. Even so the unemployment rate over this period averaged 15.4%.

Cyclical recovery consolidated

The conditions are favourable for the cyclical recovery in the western industrialised countries to continue in 1997. This is particularly true of the monetary framework. There is no threat of inflation for the foreseeable future. In most industrialised countries capacity utilisation remains far below cyclical normal rates, unemployment is still high, the pressure on profits from wage rises will decline further. Price rises on international primary goods markets will remain within strict limits, and any exchange rate changes are likely to be gradual. Under such conditions, central banks, particularly those in Europe and Japan, will stick to their expansionary course. Nor is a rise in capital market rates to be expected, at least to judge by the fundamental data on the leading western economies. Even so, it is important to consider the risks for economic development that could force economic policy makers to take action.

This applies, firstly, to fiscal policy in Europe. It cannot be precluded that, by a major force of will, virtually all the EU Member States will attempt to achieve after all – at the last minute, as it were – the reference value for the current budget deficit (3% of GDP). Intensified and hasty measures whose sole aim is to reduce the size of the deficit could make it more difficult for economies to move from a moderate cyclical recovery to a lasting growth phase. A renewed slow-down in European economic growth would serve to entrench the continent's labour market problems further, as deskilling and discouragement would make it more difficult for jobseekers to reintegrate into the primary labour market.

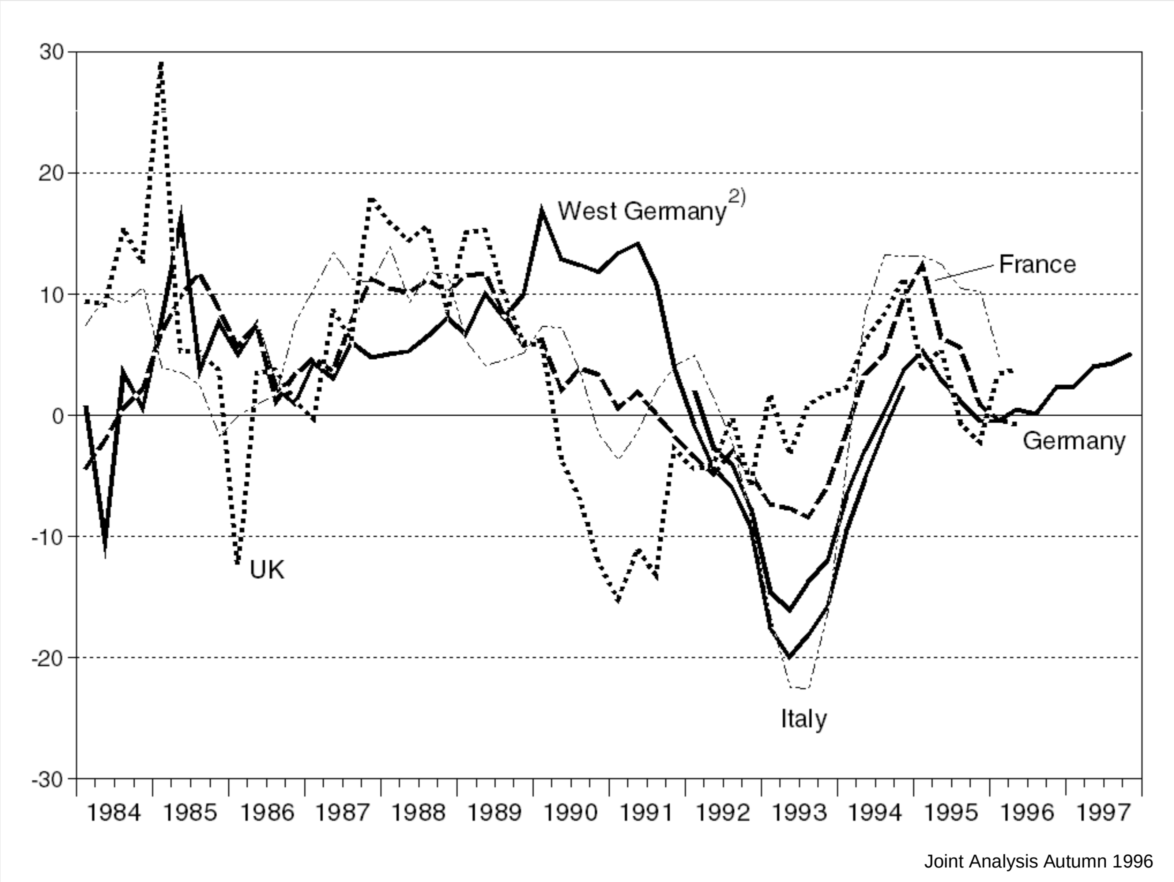
A second risk, one that is very difficult to evaluate, derives from the fact that the business cycle in the United States is at a later stage of the upturn than that in Europe and Japan. If, contrary to the assumptions made in the Institute's prognosis for the world economy (cf. the previous report in this volume), economic growth in the United States were to accelerate and wages to rise strongly – the US labour market is currently at virtually full employment level – the US Federal Reserve would certainly not hesitate to raise short-term interest rates to a greater extent than assumed here in order to counter the threat of inflation. In such a case, the danger of a substantial rise in long-term interest rates – similar to that which occurred in 1994 – could not be precluded. This could dampen economic activity, just as investment is beginning to pick up in Europe, as occurred in 1994/95.

Investment activity in the leading European economies since the last recession clearly shows the impact of the rise in capital market interest rates in 1994 (cf. figure 1). Fixed capital formation had begun to bottom out, a normal cyclical recovery would have been expected in continental Europe given more favourable conditions on the money and capital markets, as had been observed earlier in the USA and Great Britain. The same is true of Germany, where due to the sharp appreciation of the D-Mark in the spring of 1995 and the prior unification-induced boom, investment activity remained weaker than in the rest of Europe.

Figure 1

Investment in Equipment[1)] in the Large European Industrialised Countries

Percentage change on previous year



1) At 1991 prices. — 2) Official statistics only available for 1994.
Sources: OECD; Federal Statistical Office; calculations by the participating Institutes; 2nd half of 1996 and 1997 forecast by the participating Institutes.

If these risks do not materialise or if economic policy makers are able to cushion the negative effects emanating from them, a lasting upturn, gaining in strength as it proceeds, is likely.

Vigorous export growth

Exports have clearly got under steam once more since the spring. The decisive factors behind this were the improved competitive position of German exporters due to the normalisation of the exchange rate and the renewed pick up of the European business cycle. In recent months demand from the central and east European reforming countries, on which the sluggish economic developments in the industrialised countries had left their mark, also picked up perceptibly. Trade with these countries has intensified considerably in recent years, especially with the central European reforming countries. In 1995 the central and east European countries accounted for as significant a proportion of German exports as the USA (cf. table 1). In addition, goods exchange with the dynamic south-east Asian region has also expanded markedly.

The framework of conditions for exports will remain favourable on the whole. In western Europe the phase of economic weakness has been overcome. Not least due to the expected increase in investment here, German exporters have particularly favourable opportunities given their specific product range: the products of the investment good sector account for around 55% of German exports. Demand from other regions, especially the advanced central European reform countries and those

Table 1

Germany's Foreign Trade[1)] by Region

Shares in %

	Exports			Imports		
	1993	1994	1995	1993	1994	1995
Total	100.0	100.0	100.0	100.0	100.0	100.0
Western industrial countries	79.0	78.8	77.9	78.8	78.1	77.4
EU[2)]	49.8	49.3	48.3	48.2	47.5	47.9
USA	7.4	7.8	7.5	7.1	7.2	7.1
Japan	2.5	2.6	2.7	6.0	5.5	5.5
Developing countries	12.4	12.6	12.9	12.2	11.9	11.6
South-east Asia[3)]	5.5	6.0	6.6	6.5	6.4	6.4
NICs[4)]	3.2	3.5	3.7	3.8	3.7	3.7
ASEAN[5)]	1.6	1.9	2.1	1.9	1.9	1.9
Latin America	2.4	2.4	2.6	2.1	2.3	2.4
Reforming and state trading countries	8.4	8.5	9.1	8.9	9.9	11.0
Central and eastern European countries	6.8	7.0	7.5	6.4	7.3	8.3
Poland, Czech Republic, Slovak Republic, Hungary	3.8	4.1	4.8	3.7	4.2	5.2
Other[6)]	3.0	2.9	2.8	2.7	3.0	3.1

1) Special trade. — 2) Excl. Sweden, Finland and Austria. — 3) India, Pakistan, Sri Lanka, NICs and ASEAN. — 4) Singapore, Hong Kong, Taiwan and South Korea. — 5) Malaysia, Indonesia, Thailand, Phillippines and Brunei. — 6) Bulgaria, Romania, Albania and former Soviet Union.
Sources: Federal Statistical Office; calculations by the participating Institutes.

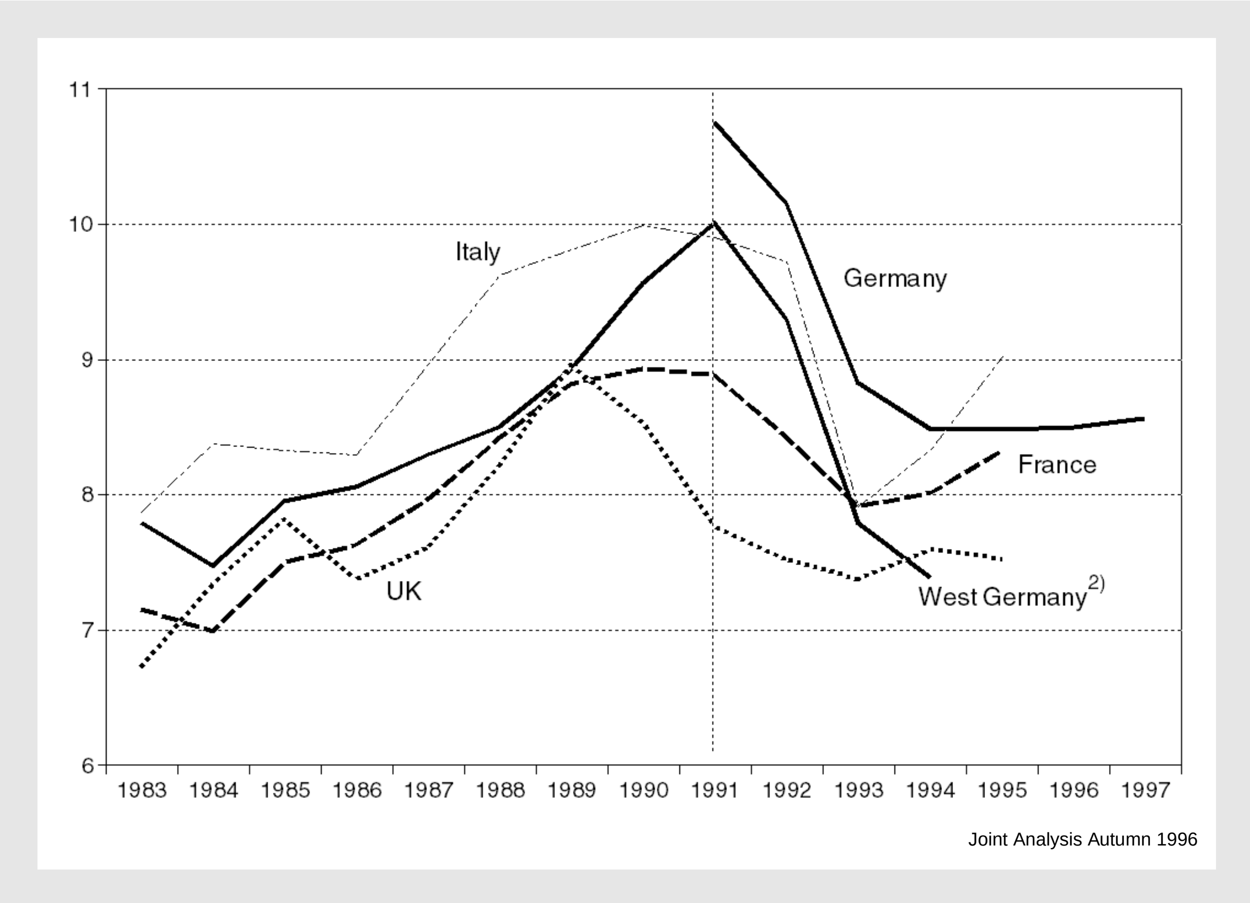
in the Asian-Pacific region, will remain buoyant given the high growth dynamic observed there. Stronger demand impulses are also expected from the east and south-east European reform countries that have been lagging behind in the transformation process, primarily because the pick-up in global economic activity will improve the export receipts of these countries from primary goods and unsophisticated intermediary goods.

The competitive position of German firms, which has improved substantially once more following the reversal of last year's appreciation of the D-Mark, remains favourable. Moderate wage trends and rapid productivity growth are restraining the rise in costs. The D-Mark will tend to weaken against the US dollar; there are no signs of significant shifts in parities within the EU currency grid. Under these conditions export growth is expected to be rapid; the rate of export growth is likely to approximate to that of world trade. Even so, on annual averages goods exports – on special trade definitions – will expand by just 4½% in 1996 compared with the previous year due to the relatively weak growth in the first half of the year; export growth of around 6% is expected for the coming year.

Rising investment in equipment

Following the decline in investment in equipment during the course of 1995, a pronounced expansionary trend has established itself this year. Capital market rates, following the sharp increase in 1994, fell substantially at the start of this year. The appreciation of the D-Mark has been reversed and, as the economy in the rest

Figure 2
Investment[1)] to Output Ratios in the Large European Industrialised Countries
in %



1) At 1991 prices. — 2) Official statistics only available for 1994.
Sources: OECD; Federal Statistical Office; calculations by the participating Institutes; 2nd half of 1996 and 1997 forecast by the participating Institutes.

of the world has picked up, incoming orders to German manufacturing firms have risen sharply since the autumn of 1995. Wage settlements in the spring of this year were decidedly moderate compared with those in the previous year. Capacity utilisation in the industrial sector has risen since the spring. Together with the continued efforts at rationalisation, this has led to a substantial improvement in the rate of return on real capital relative to that on financial investment. All in all, the conditions for investment are far more favourable than last year.

During the coming year west German firms will steadily expand their fixed capital formation; investment activity in east Germany, by contrast, will stagnate in this period. The initial impetus from the completion of new productive capacity has attenuated. Most of the investment commitments given to the Treuhandanstalt in the course of privatisation have already been met. Many firms, particularly small and medium-sized enterprises, lack a "cushion" of profits or the scope for borrowing.

In Germany as a whole, investment in equipment, against the background of a marked increase in current rates, will increase by 4% on annual averages in the coming year. This year investment growth will be marginal, despite the substantial recovery over time, because at the start of the year the level of investment in equipment was below the average figure for the previous year.

Investment in buildings remains weak

Output in the construction industry expanded rapidly during the spring and summer months, although this was due solely to work on building projects that had been postponed during the unusually hard winter. The underlying output trend in the construction industry was one of contraction. All sectors of the construction industry – housing, commercial and public sector construction – are experiencing declining output in west Germany. In east Germany investment in public and commercial construction is also on the decline, whereas housing construction continues to expand somewhat due to the still generous public support for multi-unit apartment buildings and the vigorous expansion of the demand for semi-detached and detached housing; the rate of growth is much lower than previously, however.

Investment in west German multi-unit housing will also decline in the coming year. The renewed deterioration in yield expectations means that the propensity to invest in this area will decline further. The demand for owner-occupier housing, on the other hand, will continue to expand against the background of favourable mortgage conditions and virtually constant building costs. Yet even together with the slight rise in modernisation investment in the existing housing stock, this trend is insufficient to bring to an end the contraction in west German housing construction as a whole.

In the coming year investment in east German housing will decline for the first time. The special depreciation allowance for the construction of new housing for rent is being reduced from 50% to 25%. This will lead to a substantial fall in investment here, although the full effect will not be felt next year, as the tax concessions granted until now can still be utilised in 1997 providing an initial payment on the construction project has been made by the end of the current year.

The commercial construction trend is likely to move in opposite directions in west and east Germany in 1997, expanding in west Germany along with the upturn in investment in equipment and continuing to decline in east Germany. Here the sharp increase in the supply of hotels, office buildings, trade and storage premises has led to a decline in returns, and investors have become more cautious. On top of this comes the fact that many east German firms are not yet economically healthy enough to be able to finance additional investment.

Public capital spending on buildings will continue to contract due to the tight fiscal position in both west and east Germany. The rate of decline is almost certain to be markedly lower, however. Following the introduction of the second stage of the social care insurance scheme which provides for an increase in the provision of institutional care services, local government – the most important level of government for capital spending – will benefit from a substantial reduction in the burden of minimum subsistence benefit and is to receive investment grants in order to build care institutions.

All in all, the decline in construction investment in 1997 will be less pronounced than in the current year. Whereas the contraction in east Germany will intensify, construction investment in west Germany will bottom out in the wake of the cyclical recovery in the economy as a whole.

Continued growth of private consumption

At the start of 1996 minimum subsistence income was exempted from income tax, child benefit and the child tax allowance were increased and the so-called "coal penny" abolished. Following the sharp rise in disposable incomes to which these changes gave rise at the start of the year, incomes have expanded only relatively weakly in the course of the year, primarily due to the only moderate rise in collectively agreed wage rates, declining employment and the only small increase in pensions. In the second half of the year private consumption – given an unchanged savings to income ratio – will expand far less substantially than in the first. Retail trade sales will at best stagnate; sales of automobiles, though, are still on an expansionary trend.

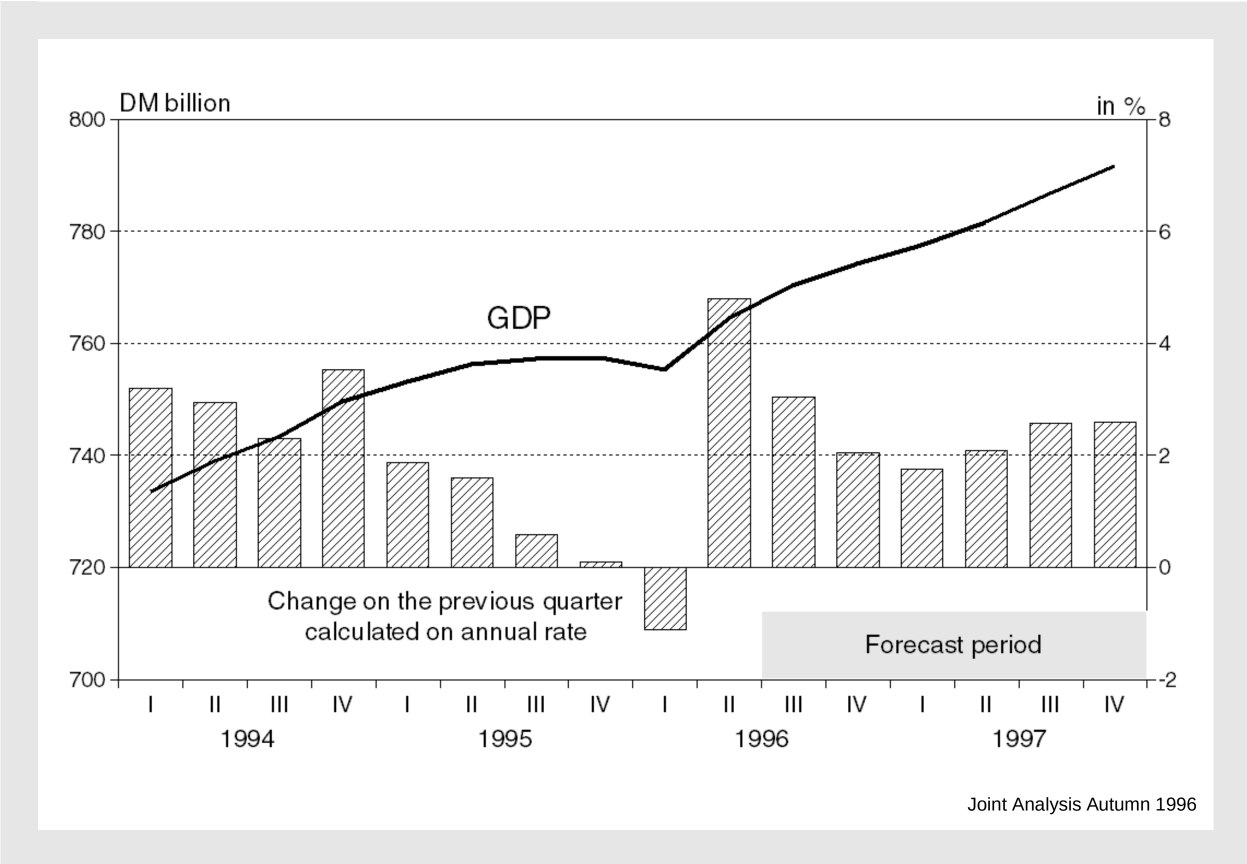
Next year's pay settlements are expected to be just as moderate as in the current year in the face of the continued tensions on the labour market and the high degree of price stability. There will be no further fall in employment, however. As a result gross wages and salaries will increase slightly faster than this year. In the light of government attempts at fiscal consolidation, however, government transfers will expand less strongly. Given the improved overall economic situation, the growth of distributed profits and capital income is likely to be substantially faster than in 1996. Overall disposable income will be around 3% higher in 1997 than in the current year. Overall, the increase in real incomes will, at 1½%, be virtually unchanged; private consumption will expand by the same order of magnitude.

Inflation remains low

Inflation in Germany as a whole will remain low. Given the moderate cyclical recovery and the still underutilised productive capacity, competition is still tough. Nor do wage trends provide a significant impetus for price rises. The same is broadly true of imports, all the more so in view of the fact that the price of oil will decline once more.

Price rises in east Germany will also be moderate, although there will be a slight acceleration at the start of the year in the wake of renewed rent increases. Overall the annual average rate of inflation in 1997, at 1½%, will be just as low as in the current year.

Figure 3
Real GDP in Germany
Seasonally adjusted and adjusted by daily working hours



Sources: Federal Statistical Office; calculations by the participating Institutes; 2nd half of 1996 and 1997 forecast by the participating Institutes.

Output recovers

Following the phase of economic weakness that began in the first half of last year, total output has been clearly expansionary since the spring. The sharp rise in GDP over the summer months (cf. figure 3) exaggerates the underlying cyclical trends, however. Around one-third of the increase results from attempts to make good the output losses suffered during the winter; in the construction industry this figure is even higher. Yet even allowing for this effect, there has clearly been a recovery with GDP increasing at a current annual rate of 2½ % in west Germany where industrial output increased in particular, while the underlying trend of construction output has remained weak.

There has also been output growth in east Germany, although the decline during the winter and the subsequent compensatory knock-on effects were substantially more pronounced than in west Germany, due to the far greater relative importance of the construction industry and related industrial sectors. The underlying trend, however, has been towards a marked slow-down in the rate of growth; this is particularly true of the construction sector, less so for industry.

Against the background of still favourable monetary conditions, the cyclical recovery in Germany will continue next year, in spite of the generally restrictive influence of fiscal policy; the expansion will lack dynamism, however. In particular, investment activity will remain rather subdued compared with earlier upturn phases. In west Germany the cyclical recovery will accelerate slightly in the course of the coming year, given sustained strong foreign demand and somewhat more buoyant investment activity. This is particularly true of industry; in the construction industry the contraction will at least come to an end.

For east Germany, on the other hand, a slight weakening of the pace of output growth is expected. The decisive factor behind this development is the output trend in the construction industry. As government support diminishes, particularly for housing construction, construction activity will be noticeably dampened. While industrial output will receive some slight impetus from the improvement in the economic situation in west Germany, output growth will remain moderate. The competitive position of east German firms remains unsatisfactory and the unfavourable trend in the construction industry has a significant knock-on effect on manufacturing due to the quantitative importance of this sector.

All in all, real GDP will grow by 2½% in 1997 on annual average figures, following this year's 1½%. East German output growth is likely to be somewhat lower next year than this. The "catching-up process" in the new federal states has ground to a halt.

Labour market prospects little brighter despite cyclical recovery

Irrespective of the onset of economic recovery, the situation on the labour market remains extremely problematic. At least the decline in employment, which worsened again during the winter, came to an end during the summer months. Even so, unemployment has recently been rising at an accelerated rate.

Employment trends vary significantly between east and west Germany. In west Germany the decline in employment has merely slowed – albeit significantly; in east Germany employment rose once more during the summer months. Although this was to a far greater extent than in west Germany this partly reflects the compensatory effects in reaction to the hard winter. These effects were also the prime reason why, unlike in west Germany, east German unemployment has fallen slightly since the spring.

The labour market situation will improve only marginally in the coming year, despite the continued economic recovery. In the latter of 1997 registered unemployment in Germany will fall slightly as the economic recovery gathers steam, but on annual averages will again reach 4 million. With respect to the domestic labour force this represents an unemployment rate of 10.4%. The east German unemployment rate will rise slightly to 16% (1996: 15½%).

Improvement in the current account deficit

This year goods exports will expand markedly more strongly than imports, leading to an increase in the surplus on the balance of trade. 1995 saw a change on the services account: income rose far more substantially than expenditure, due not least to higher earnings from insurance and financial services, so that there was scarcely any further increase in the deficit, that had widened considerably in earlier years. This trend will continue in 1996. Export growth will again be brisk in 1997 in the wake of the cyclical recovery in the industrialised countries. Although imports will also expand at a faster pace as demand and output in Germany pick up, export growth will be stronger, so that the surplus on the balance of trade will again widen. The surplus is expected significantly to exceed an order of magnitude of DM 95 billion in 1996 and DM 115 billion in 1997. A renewed turnaround in service transactions with the rest of the world is unlikely: the deficit will not change significantly. The trends towards a rising deficit on labour services and capital income will at best weaken slightly. Even so the current account deficit will again narrow due to the continued and strong growth of the trade surplus. By 1997 it will be of the order of DM 15 billion, just half the figure recorded in 1995.

Government budgets under the influence of intensified consolidation efforts

In view of the tight fiscal position – to which the sluggish economic trend had made a major contribution – central, state and local government have adopted numerous measures in the course of 1996 in order to limit the rise in spending and prevent the budget deficit increasing. Capital spending projects have been postponed and budget "ceilings" imposed in virtually all areas. Benefit cuts have also been imposed (unemployment assistance, minimum social benefit), although these were quantitatively relatively unimportant. Last but not least, government managed significantly to limit the rise in public sector wages and salaries. Despite all these efforts, though, the overall government deficit, adjusted for special factors,[1] will be greater in 1996 than in the previous year. Additional expenditure is required due to higher unemployment, while sluggish economic growth will reduce fiscal revenue.

On national accounting definitions the budget deficit in 1996 will amount to DM 144 billion, more than DM 20 billion higher than last year. Due to the ongoing and substantial deficits, outstanding government debt will rise to DM 2 140 billion by the end of the year. The

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1 As they are in the national accounts the transfer of the debts incurred by the Treuhandanstalt and part of the debts accrued by the east German housing sector (together DM 234.6 billion) to the *Erblastentilgungsfonds* and the assumption of the capital of the *Deutsche Kreditbank* by central government (DM 5.6 billion) in 1995 are not considered here as a transfer from government to the private sector and the private sector to government respectively.

Table 2
Labour-Market Balance Sheet
in thousand persons

	1994	1995	1996	1997
Germany				
Employment (domestic concept)	34 979	34 868	34 580	34 590
Self-employed	3 586	3 622	3 650	3 670
Employees	31 393	31 246	30 930	30 920
of which:				
on short-time working	372	199	275	215
Unemployment	3 698	3 612	3 945	4 000
Unemployment rate1)	9.6	9.4	10.3	10.4
Net “commuters“	–11	–37	–45	–55
Employment (national concept)	34 968	34 831	34 535	34 535
West Germany				
Employment (domestic concept)	28 665	28 482	28 250	28 290
Self-employed	3 086	3 099	3 110	3 120
Employees	25 579	25 383	25 140	25 170
of which:				
on short-time working	275	128	200	140
Unemployment	2 556	2 565	2 785	2 800
Unemployment rate 2)	8.2	8.3	9	9
East Germany				
Employment (domestic concept)	6 314	6 386	6 330	6 300
Self-employed	500	523	540	550
Employees	5 814	5 863	5 790	5 750
of which:				
in job-creation schemes	280	312	280	260
on short-time working	97	71	75	75
Unemployment	1 142	1 047	1 160	1 200
Unemployment rate2)	15.3	14.1	15.5	16
Early retirement	650	374	180	60
Further training	241	243	230	210

1) Unemployed as a % of domestic employment (employed and unemployed). — 2) Unemployed as a % of employment at national concept (employed and unemployed).
Sources: Federal Statistical Office; Federal Labour Office; calculations by the participating Institutes; 1996 and 1997 prognosis by the participating Institutes; figures rounded.

budget deficit will amount to around 4% of GDP, government debt to rather more than 60%. This means that in 1996 Germany will fail to meet the fiscal policy reference values set out in the Maastricht Treaty.

In the spring of 1996 the German government put together a package of savings the aim of which was to consolidate public finances. Under the programme public spending on national accounting definitions is to be

Table 3

Federal Republic of Germany: Key Forecast Figures

	Federal Republic of Germany			West Germany			East Germany		
	1995	1996	1997	1995	1996	1997	1995	1996	1997
Gross domestic product[1)] (% change on the previous year)	1.9	1.5	2.5	1.6	1.5	2.5	5.3	2.0	2.0
Employment[2)] (% change on the previous year)	0.3	1.0	0.0	0.6	1.0	0.0	1.1	1.0	0.5
Unemployment (in 000s)	3 612	3 945	4 000	2 565	2 785	2 800	1 047	1 160	1 200
Unemployment rate[3)] (in %)	9.4	10.3	10.4	8.3	9.0	9.0	14.1	15.5	16.0
Consumer prices[4)] (% change on the previous year)	1.8	1.5	1.5	1.7	1.5	1.5	2.1	2.5	1.5
Unit wage costs[5)] (% change on the previous year)	1.1	0.5	0.5	0.9	0.0	0.5	1.6	1.5	1.0
Public sector financial balance[6)] (DM billion)	122.6[a)]	144.0	126.5	-	-	-	-	-	-
Balance of payments[7)] (DM billion)	30.1	26.0	15.5	-	-	-	-	-	-

1) At 1991 prices. — 2) Domestic employment. — 3) Germany: unemployed as a % of domestic employment (employed and unemployed); west and east Germany: unemployed as a % of employment at national concept (employed and unemployed) in the respective region. — 4) West and east Germany: price index for the cost of living of all private households; Germany: private consumption deflator. — 5) Gross wage and salary income created in the domestic economy as a % of real GDP. — 6) On national accounting definitions. — 7) On balance of payments definitions. — a) Excl. the revenue arising out of the assumption of the capital held by the Deutsche Kreditbank (DM 5.6 billion) and excl. the transfer of assets to the business sector of DM 234.6 billion resulting from the assumption of the debts of the Treuhandanstalt and the east German housing sector.

Sources: Federal Statistical Office; calculations by the participating Institutes. 1996 and 1997 prognosis by the participating Institutes; figures rounded.

cut by a total of DM 12 billion – equal to 0.3% of GDP – in 1997. The growth of public spending, which reached 5.4% in 1995 will flatten out, declining to just over 3% in the current year and an expected 2% in 1997.

At 3½%, overall government revenues will expand significantly faster in 1997 than in 1996. Tax revenues will increase once more in the wake of the cyclical recovery following the decline in the current year. The changes in taxation laws – abolition of net worth tax, abolition of trading capital tax and the increase in inheritance tax, real estate acquisition tax and road vehicle tax – will reduce revenues only marginally. Receipts of social insurance contributions will expand due to the increase in the contribution rate to the pension insurance scheme and the mid-year increase in the contribution rate to the social care insurance scheme. Given the still strong spending growth in the health sector, there will be little scope for cutting contribution rates to the health insurance funds. The burden of taxes and social insurance contributions will remain locked at the high level of 43% of GDP.

On national accounting definitions the overall budget deficit is expected to fall by DM 17 billion to DM 127 billion; this improvement largely reflects spending cuts and the increase in social insurance contributions. Even so the deficit will be equal to around 3½% of GDP. Thus it appears at present that Germany will again fail to meet the Maastricht reference values for the current budget deficit and outstanding government debt in 1997.

German economic policy

The cyclical downswing that occurred last year in Germany – and in several other European countries – has been overcome. Since the spring the economy has gathered steam once more. Against the background of favourable monetary conditions, the cyclical recovery will continue next year, broadening out as it does so. Yet compared with many earlier upswings, it will initially lack dynamism. This is essentially due to the rather moderate growth of investment. There has as yet been scarcely any improvement in a number of important conditions set by economic policy and these continue to depress the prospects for investment; this is particularly true of fiscal policy.

The economic recovery does not mean that economic policy makers can now relax. The most pressing problems – the high level of unemployment and the fact that the catching-up process in east Germany has come to a standstill – remain unsolved. Given the moderate pace of economic growth, no lasting improvement in the labour market situation can be expected next year. Such an improvement is contingent on a far higher economic dynamic, maintained over a period of several years, than is at present conceivable.

Even a strong economic recovery in western Germany will not suffice to solve the problems facing the east German economy. The serious weakening of the forces for economic expansion in the new federal states primarily reflects the still inadequate internal dynamic of the catching-up process; this is now becoming evident as the impulses provided by German government diminish. The reason behind the inadequate internal dynamic lies above all in the still serious general (i.e. irrespective of significant variation between individual firms) lack of competitiveness in the region. Rapid upward wage adjustment has prevented both a reduction in unit labour costs to the west German level and the creation of adequate profits, which, in a market economy, are the motor behind economic development. This supply-side deficiency has become particularly readily apparent in the phase of weak demand. Yet an upturn will not remove them. Thus east German labour market prospects remain bleak. If the interruption to the catching-up process in east Germany persists, it will constitute a constraint on economic development in Germany as a whole. Consequently economic policy makers must quickly find an appropriate response.

The rapid approach of European Monetary Union (EMU) generates a particular problem for economic policy. Given that it is 1997 economic data that constitute the basis for the decision on participation, the federal government is seeking to meet the fiscal policy reference criteria set out in the Maastricht Treaty to the letter. This year the budget criteria in particular, will be missed by a wide margin; the Institutes forecast that the 1996 deficit will be equal to around 4% of GDP. Even allowing for the measures already announced, the deficit is only likely to fall to 3½% in the coming year.

Any attempt at consolidation should be embedded in a medium-term concept that enables the deficit – in accordance with the intentions of the Maastricht Treaty – to be maintained at a low level permanently. Yet at present, fiscal policy efforts are focusing on bringing down the deficit as fast as possible. The proposals for ways to fill the persistent gaps in the budget are frequently ill-considered and led by a desire to be "seen to be doing something"; meanwhile there is the danger that medium-term concepts will be lost sight of. This diminishes rather than restores confidence, all the more so because most proposals focus on tax increases or the reversal or postponement of already envisaged tax cuts. It cannot be precluded that this will increase resentment against European Monetary Union.

The problem of fiscal consolidation is being exacerbated by developments in east Germany. The fact that the catching-up process there has come to a standstill is making it increasingly difficult to reduce transfers to east Germany as intended under the longer-term consolidation concept. In order to get this process moving once more, an increase in the resource allocation for public capital spending – for a strictly limited period of time – is probably unavoidable. If it is to be effective, however, it must be linked to a binding commitment to a fundamental change of course on wages. Merely feeding the consequences of incorrect behaviour on the part of collective wage bargainers will not promote the growth process in east Germany.

So far collective wage bargainers in east Germany have failed to make a change of course. Although productivity growth has increasingly declined to west German rates, so that virtually no further progress is being made in closing the productivity gap, the adjustment of east German wages to west German levels is continuing apace, so that the gap in unit labour costs has widened further to the disadvantage of east Germany. If the economy is to recover in a lasting way it is essential that the level of collectively agreed wages does not rise for a number of years. Productivity growth would then create the scope for an improvement in profitability, which, in turn, is a necessary precondition for investment and the creation of competitive jobs.

The west German collective bargaining system, which last year contributed to the deterioration in economic prospects, has changed course in the face of the renewed rise in unemployment and is taking greater account of employment-policy requirements. Pay settlements in the current year were substantially lower than in 1995, progress was made towards a flexibilisation of working time, and greater scope was created for solutions at plant level. In order to ensure that the upturn continues, the growth dynamic increases and labour market prospects increase in a lasting way, wage trends must remain moderate and oriented primarily to employment-policy requirements. Wage trends on this pattern would substantially reduce the danger of a collision with the monetary authorities, which in the past has repeatedly led to a the recovery being choked off and, in the final analysis, to a stabilisation recession.

In recent months there have been repeated calls for tangible wage cuts in west Germany in order to meet the challenges resulting from the increased globalisation of production and growing competitive pressure from the low-wage countries of central and eastern Europe. A wage cut means a decline in per capita income. This may, similarly to a strategy of currency depreciation, improve competitiveness in the short term; in the final analysis, however, it is a sign of a loss of quality as a production location. Increased competitive pressure should be countered in an offensive way. It requires of firms higher investment and of employees greater training and the ready willingness to adjust and work flexibly. In addition, greater wage differentiation would be desirable in order to maintain employment opportunities for the low skilled and to increase the chances for the unemployed of finding a job. The consequence of higher skills and a larger capital stock is productivity growth, which means that real wages can increase. A highly developed economy can only respond to the challenges of globalisation and the growing pressure from low-wage countries by such an "innovation offensive". Given such a strategy, the growth dynamic creates the scope for higher employment because it is precisely through international goods exchange – as trade with the central European countries shows – that new markets are opened up for the products produced by highly developed economies.

Fiscal policy

German fiscal policy is currently characterised by hectic activity. According to the Maastricht Treaty the 1997 budget deficit of countries wishing to qualify to participate in EMU should not exceed 3% of GDP. In spite of the numerous measures implemented in Germany in order to limit the rise of public spending, and, more frequently, to increase taxes and social insurance contributions, this year's budget deficit exceeds the reference value set out in the Maastricht Treaty very considerably. In the first half of this year a package of measures was adopted for 1997 the aim of which is to reduce additional spending and generate additional fiscal revenue. Now, in the autumn, it is clear that the budget plans cannot be met and that the year's net deficit will almost certainly be greater than envisaged, partly, although only to a minor extent, because the package of savings cannot be fully implemented due to resistance from state governments. The cut in the solidarity supplement on income tax planned for the middle of next year has thus been postponed; this, taken by itself, will reduce the deficit by DM 3.5 billion. Ways are being sought to reduce central government spending by a similar degree.

Due to the weakness of economic activity, in both 1995 and 1996 government has been faced with additional expenditure while the growth of fiscal revenues has slowed. In the coming year the economic recovery will ease the pressure on public budgets. Even so, and despite the recent measures adopted, the deficit seems set to exceed the reference value set out in the Maastricht Treaty.

In its day-to-day activities German fiscal policy is in danger of increasingly deviating from the course it has set itself for the medium term, namely to reduce the extent of public sector activities and to ease the burden of taxes and social insurance contributions. In the wake of German unification, public spending has grown far more rapidly than the economy as a whole. In terms of GDP, German government now lays claim to more than half of the economy's resources. These resources are then no longer available to private sector firms and households and are thus no longer directly subject to private profitability and rationality considerations. Although in the final analysis these resources flow back to the private sector, their use structure has changed. This is an intentional act on the part of the state as it sets itself targets that cannot be achieved – at least this is believed to be the case – by markets and competitive processes.

Only for a small proportion of government activities can it be claimed that they consist of the provision of public goods that are complementary to private economic activity and therefore indispensable – in other words the public infrastructure in the widest sense. Public spending is dominated by items that have a "social policy" and consumption-oriented character. The state's claim on economic resources for spending of this type generates effects which – compared with a purely private resource deployment – in sum serve to hamper economic growth. To some extent this can be tolerated, as solidarity with the weaker members of society can readily be accepted as a social goal. Quite clearly public sector activity is not least an expression of the wishes of the population, and these preferences are to be followed where possible. Last but not least, German unification has made very special demands on the state. Yet this does not mean that government activity of the order of magnitude prevailing in Germany is justified. Given that unification will require a high level of transfers to the new federal states in the coming years, public spending priorities must be redefined. Preferences should still be respected, but government can now meet fewer wants. Moreover, there is sufficient evidence that many items of social spending do not meet exclusively or primarily justified social goals, i.e. do not serve their real ends. Similar question marks must be placed against the wide-ranging tax concessions and subsidies granted by government in order to induce firms and individuals to take measures that they would otherwise not take, or not to the same extent – certain forms of investment, for example, or construction measures or saving – or to support activities which otherwise would not, or not to the same extent, be able to survive on the market – such as agriculture, coal mining or shipbuilding.

Consequently the allocative distortions resulting from the state's claim on economic resources have not declined, but have risen following the strong growth of public spending since unification. Yet there is no reason for refraining from a critical examination of transfers to eastern Germany. It is vital that in future a greater proportion of the transfers to east Germany are used for those purposes. According to various calculations the proportion of the transfers dedicated to investment-related purposes has remained more or less constant in recent years and currently accounts for around one third of the total. Any increase in resources should be restricted to investment, and consumption-oriented transfers must be reduced in favour of investment-related deployment. At the same time both the government support for investment and direct support to state and local government should be examined and streamlined with regard to their allocative and efficiency aspects. Moreover it is apparent that a "subsidy mentality" is in danger of taking hold in some areas. Support should focus on additional measures to extend public infrastructure. Without changes in pay bargaining, even a substantial increase in transfers and a simultaneous increase in the efficiency of individual measures is doomed to failure.

In all this it is necessary to bear in mind the reduction in the incentives to invest and to work that result when taxes and social insurance contributions have to be raised in order to finance government activities. The government has set itself the fiscal policy target of bringing about a fundamental turnaround here: the taxation system is to be reformed, tax exceptions removed, the tax basis broadened and tax rates cut substantially. The Institutes consider these tasks urgent.

The marginal burden of taxes and contributions for almost three-quarters of all working households – including social insurance contributions and the solidarity supplement on income tax – is more than 40% (of gross income), for around half more than 50%. At 57% (including the solidarity supplement) the top rate of tax is also high in international terms; only in Japan of the G7 countries is the top rate higher. The rate of corporation tax on retained profits is also high, now that many other countries have cut their rates.

Tax concessions and special regulations that serve to undermine the tax basis for income tax and thus virtually necessitate high marginal tax rates should be rigorously cut back. While it is true that these regulations substantially alleviate the effective tax burden in Germany, they distort competition and lead to resource misallocation. Thus their removal would strengthen the forces for economic growth, at the same time simplifying tax laws and rendering them less opaque, not least for foreign investors.

Efforts to reduce the budget deficit began back in 1992. Yet in spite of some attempts towards a more reticent spending policy, public expenditure has risen markedly; any success achieved in consolidation has, in the final analysis, been due to higher taxes and contributions. Measures to reduce spending are again envisaged for the coming year: public sector labour costs, labour market policy and health. The package of savings reduces government consumption and social benefits by DM 12 billion. Yet total public spending will again rise markedly, although – after allowing for special factors – less than in 1996. Although taxes are to be cut or abolished and the structure of the taxation system is to be improved by abolishing the net worth and trading capital taxes, the solidarity supplement on income tax – important because of its broad-based effects, not least for many small firms – is not being cut, and social insurance contributions – given the planned sharp increase in the contribution rate to the pension insurance scheme and a slight cut in the health insurance rate – will increase on balance to such an extent that the overall tax and contribution burden as a share of output will remain unchanged at its current high level. In the coming year public spending as a proportion of GDP will decline slightly for the first time since unification – by 0.4 percentage points to just under 50% – nominal GDP will grow by about one and a half percentage points faster than public spending. This means that public spending will be about DM 15 billion lower than would have been the case at the 1995 public spending/output ratio. This first step towards reducing this ratio once more to the level recorded at the end of the 1980s, i.e. by four further percentage points to just under 46%, is a small one, however, given that such a ratio, in terms of 1997 GDP, would mean that public spending would have to be DM 160 billion lower, a cut of around one-eleventh.

If public spending as a proportion of GDP is to be reduced by the year 2000 to the extent planned, spending growth must be severely dampened. Although it is to be expected that economic growth will accelerate considerably, the savings target remains highly ambitious. A lack of political will to reduce spending now would send a signal to private firms and households, who would respond by reducing investment and consumption, with increasing demotivation.

Although an initial step towards overcoming the growth weakness of the German economy has been taken, it seems that the lasting reduction in the burden of taxes and contributions announced with the aim of strengthening Germany's position as a production location is to be postponed, as fiscal policy makers clearly do not have the strength to reduce the budget deficit primarily by cutting spending. The more rapid economic growth since the spring of this year is due largely to the improvement in the business cycle abroad and in the framework of monetary conditions. There are as yet no signs of an accelerating growth trend, one which would go beyond the 2.5% GDP growth forecast for the coming year. Even so, the fiscal situation will ease somewhat in future for cyclical reasons; this, together with the improvement in the economic situation in general, raises the danger that the efforts to reduce spending will diminish.

Thus the fiscal policy measures considered appropriate in the medium term should, where possible, be brought forward, i.e. spending growth reduced sharply, in order to facilitate the economy moving on to a higher growth trajectory at an early stage and thus also, in doing so, making progress in reducing government deficits. In other words, the planned comprehensive cuts in taxes and contributions should not be seen as the crowning achievement of fiscal policy efforts, but as a precondition for more rapid economic growth and a lasting improvement in the state of public finances.

Allowing for the fiscal policy measures announced so far, an additional DM 15 billion would have to be saved in the 1997 budgets if the reference value set out in the Maastricht Treaty were to be met. Fiscal policy must pursue a strategy of simultaneous give and take, i.e. reduce both spending and taxation. If such a strategy is to be successfully implemented, politicians must enter binding commitments which can only be broken at the cost of a loss of credibility or government must pass on responsibilities it currently meets onto the private sector by requiring greater individual responsibility. It should now set out a timetable for the tax reform and the reduction in the tax and contribution burden.

An attempt to achieve the latter has been started in the health sector. In order to induce the health insurance funds to spend their income from contributions in an economic way, to axe superfluous services and benefits and thus help to stabilise the contribution rate to the health insurance system, a number of measures are planned: increases in contribution rates are in future to be linked to a sharp rise in the extent to which patients bear a share of the medical costs; following an increase in contribution rates the insured are to be granted the right to leave one health insurance fund and join another; and the funds' scope for determining the services and benefits it wishes to provide are to be extended. In addition, in future the funds are to be allowed to establish rules on reimbursing contributions and higher patient contributions within individual service types. The increase in participation by individuals in costs and the increase in the funds' scope for rule-making aim to reduce steering deficiencies in the health sector. This constitutes an improvement within the existing system, although many costly inefficiencies remain in both in-patient and out-patient care, and competition between funds will remain inadequate. The measures do not mean a change to a market-based health system, although this is an urgent requirement. The demand for health services is expanding strongly in all highly developed economies, and there is no sense in limiting spending on health for as long as the willingness to pay is ensured. Problems arise, however, when, as is the case within the German health system, individual claims on benefits and services are virtually completely decoupled from the level of contributions, when doctors and hospitals can exert an influence on the expansion of demand, and when indirect labour costs increase along with contributions. All the same, the measures in the health sector do at least illustrate that government can – in stages withdraw from areas it once occupied if the will to do so is there.

Wage policy

Collectively agreed wage and salary rates have risen markedly more slowly this year than last in both west and east Germany. In west Germany annual average wage increases have amounted to just over 2%, compared with 4½% last year. In east Germany there was a further rise of almost 6%, compared with increases of around 9% in each of the two previous years. The decline in the rate of wage growth is expected to continue next year in both the old and the new federal states. Wage growth in the western collective bargaining districts will probably be under 2%, while in the eastern areas wage growth of around 4% is expected; this is due to the ongoing effect of a number of upward wage-adjustment steps already agreed. However, in view of the marked slow-down in the rate of output growth in east Germany, the rates of productivity growth are coming into line in west and east Germany to a far greater extent than those of wages. Following east German productivity growth of more than 8% and over 6% in 1994 and 1995 respectively, a further marked slow-down is inevitably in 1996 and 1997. In west Germany, by contract, productivity growth of around 3% is likely in both the current and the coming years in the wake of economic recovery.

Unit labour costs, i.e. labour costs per unit of GDP, will decline in west Germany in 1997; in east Germany, on the other hand, they will increase further – by about 1%. This means that, in each year since 1994, unit labour costs in east Germany have increased more than in west Germany. Prices for the overwhelming majority of goods produced in east and west, however, have more or less equalled out and are overall just 1½% above the previous year's level. Thus the divergence between unit labour costs means that profits in west Germany, calculated per unit of GDP, will increase strongly vis à vis those in the new federal states, despite the fact that it was corporate profitability that, from the very outset, has been the decisive barrier to rapid transformation in east Germany.

In the 1970s the west German economy was characterised by a massive redistribution of income in favour of employees. This changed fundamentally at the start of the 1980s. Real wages consistently – with the exception of the recession year 1993 – increased less significantly than labour productivity. In east Germany the centrally planned economic system, as with all systems of this type, was characterised by bottled up inflation. Wage costs in such a system – as was pointed out by the Institutes back in 1990 – are excessive, because the state attempts, by means of high nominal wages and low prices, to create the impression that real incomes are high. Yet due to the inadequate returns earned by firms and the inappropriate incentive mechanisms, the supply of goods on domestic markets is far less than the purchasing power at the disposal of the population. The visible manifestations of this are queues in front of shops or long waiting lists for products in heavy demand. Thus one of the central tasks of the transformation to a market economic system was to enable profits to be earned by ensuring that real wages lagged behind productivity.

This indispensable correction in terms of income distribution has not yet occurred. As can be seen from the figure 4, there has been only a marginal narrowing of the gap between wages and productivity in east Germany since 1990. The relation there between wage costs and productivity is 1:1.3; the corresponding figure in west Germany is 1:1.7. Only if a fundamental correction towards a relation corresponding to that in west German is realised in east Germany can a self-sustained growth process be expected. Only then will it be possible to reduce transfers.

Establishing a wage cost/productivity relation similar to that prevailing in western countries is, however, no guarantee that the east German economy will catch up, but only that it will be able to avoid losing touch with the dynamic in west Germany. Thus even if collective wage bargainers come to reconsider their past approach, German government will still be called upon to create incentives for investors to become active in east Germany.

If this fundamental disequilibrium on wages is not corrected quickly, the government support currently being made available will to a considerable extent be without longer-term effect. The problems facing east German firms in gaining access to markets, the particular vulnerability of small- and medium-sized firms, the high bankruptcy rate, the generally inadequate equity capital base, or the dependence on western parent companies, all these phenomena are, in the final analysis, a consequence of the fundamental problem of an excessive wage level, and there is therefore little prospect of being able to combat them if the central problem remains unresolved. Any increase in the level of support for east Germany envisaged by economic policy makers must, therefore, as the Institutes have repeatedly emphasised, be made conditional on a commitment by wage bargainers to a policy turnaround on wages.

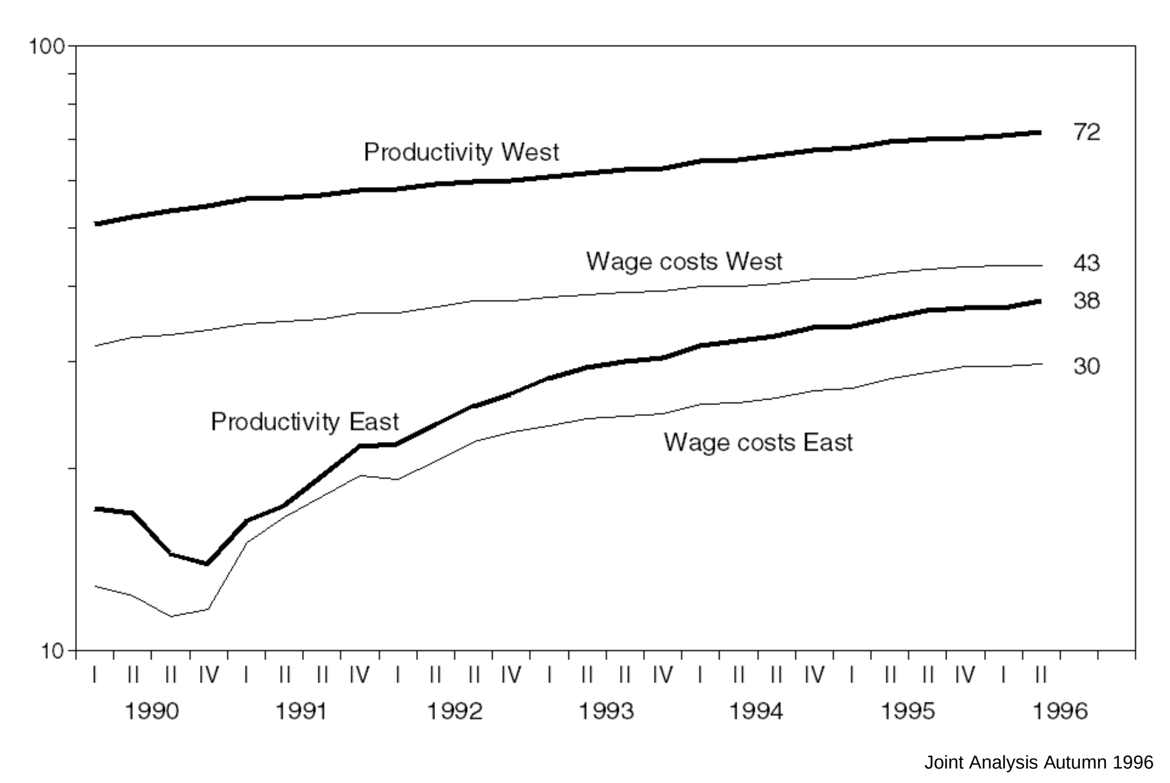
The wage and competitiveness relations between east and west Germany show that a country with high wages need in no way automatically be at a disadvantage in international trade if the wage level corresponds with the productivity level in such a way that adequate profits can be earned on competitive markets. Rapid wage increases can be borne if productivity is growing at a similar rate. The majority of firms in a given country only suffers a loss of competitiveness when wage increases exceed productivity growth, and where this is not the case with its trading partners.

Public opinion frequently supposes that wages in Germany must generally decline in order to be able to compete with countries in eastern Europe and south-east Asia, whose wages are far lower even than in east Germany. This is an incorrect deduction. Countries whose nominal and real wages differ widely can still trade freely with one another. After all, the principle of international trade is that each region can utilise its specific advantages provided they do not infringe the rule that wage growth = productivity growth. Developing coun-

Figure 4

Wage Costs[1)] and Nominal Productivity[2)] in West and East Germany

DM per hour, logarithmic scale



1) Gross wage and salary income per employee working hour; seasonally adjusted. — 2) Nominal GDP per working hour (employed and self-employed); seasonally adjusted.
Sources: Federal Statistical Office; calculations by the participating Institutes.

tries tend to export products whose production requires little specialised knowledge, such as primary goods and those products that can be produced particularly cost-effectively with unskilled labour. Because poorer countries lack a highly developed capital stock – and thus high labour productivity – they cannot compete across the whole range of products traded on world markets with the industrialised countries. Consequently, they tend to import primarily products from the developed countries, the aim of which is to help develop their capital stock.

These considerations also apply to competitor countries in central and eastern Europe. The central and east European reform countries have become important trading partners of Germany within a short space of time. At 8½% they now account for a greater proportion of German exports than north America. Yet despite the impressive wage differentials, this trade is not a one-way street. Since the borders were opened Germany has regularly exported more to this region than it has imported from it, whereby the relative importance of the different commodity groups reflect the expected pattern exactly. In 1994, for example, Germany registered a trade deficit in mining products and basic goods of DM 12 billion; at the same time it earned an export surplus of DM 16 billion on investment goods. It is significant that this trade benefited west German producers almost exclusively. In spite of its frequently postulated traditional advantages in trade with eastern Europe, east German industry has lost market shares there. This also shows that the "monopolistic structures" in west Germany that have often been the subject of complaint are far less responsible for the lack of success of east German firms than the general lack of competitiveness of east German firms.

Under the conditions of open markets, international structural change proceeds in a manner that has frequently led to misunderstandings. In free competition between firms from countries with very high wages and those with extremely low wages, countries at the top of the wage pyramid are constantly losing part of their production to low-wage countries. This occurs both directly – producers in the high-wage countries are forced out of the market by imports from developing countries – and due to the relocation of production from a high-wage to a low-wage country and the deployment of machinery and plant there. At the same time, though, they gain new markets.

The catching-up process of the newly industrialising countries inevitably means that the traditional high-wage countries will lose market shares. There can be no catching up without a loss of market shares among traditional suppliers. This is not in itself problematic. The dynamic of the system as a whole enables all participants to experience rapid real wage growth, even if their relative positions shift. If the low-wage companies make progress in the catching-up process, they gradually begin to create more and more capital as corporate profits expand and the savings-to-income ratio of the workforce rises. As capital is formed and productivity rises, wages in these countries also rise: the role of the low-wage country is assumed by another country.

In times of persistent unemployment and stagnating real incomes, the international division of labour regularly becomes a topic of discussion regarding economic policy in the high-wage countries. Yet equally regularly it is not international structural change that should be made responsible for difficulties, but rather domestic economic policy failure. The globalisation and internationalisation of production is – at the macro level – always an opportunity, and not a threat. It is true, though, that an ongoing deepening of the international division of labour, as is the case with any structural change, requires flexibility of both firms and employees. The greater the willingness to adjust on the part of the individual, the higher the benefits from this division of labour. This is as true for vocational qualification as it is for regional and sectoral mobility.

It is not an appropriate strategy for a high-wage country to seek to abandon its place at the top of the "wage hierarchy" and, by cutting wages, to reduce the competitive pressure of developing countries. Such a strategy robs the country of the chance to earn temporary monopoly profits from new products and new production processes, which tend to occur at the leading edge of structural change. If such an opportunity is not taken, productivity will sooner or later decline. Yet falling wages and falling productivity do not ease competitive pressure, because the other places in the wage hierarchy are also occupied; the country then competes with regard to different products, but the competition is no less tough.

Monetary policy

During the first half of the year the supply of M3 grew extraordinarily rapidly; the rate of growth in the first six months was equivalent to an annual rate of more than 10%. This puts money supply growth above the target corridor set by the Bundesbank. Even so, in mid-April the Bundesbank cut the discount and the Lombard rate by half a percentage point each to 2.5% and 4.5% respectively. In order to nourish expectations of further interest rate cuts, given the still weak expansion of the economy and the low inflation climate, it initially left the repurchasing rate – which is particularly important in monetary policy terms – at 3.3%. Not until the end of August, when the current rate of M3 growth had fallen to around 7%, was the repurchasing rate cut in a substantial step to 3%. Since the end of August long-term interests rates have fallen markedly: at 5.3% the running yield reached a very low value in long-term comparative terms in mid-October. Measured against current inflation rates, real interest rates at the short end are, at around 1.5%, just as low as in comparably cyclical phases in the past. Measured against the current rate of inflation, real capital market rates are still higher than they were prior to the start of the upturn in 1994. In the medium term, however, the capital markets are expecting a slight increase, rather than a further fall, in the rate of inflation. Allowing for this fact, the long-term rate of interest cannot be considered as a barrier to a continuation of the upturn. Currently the indicators suggest that monetary policy is exerting a clear expansionary effect on the economy.

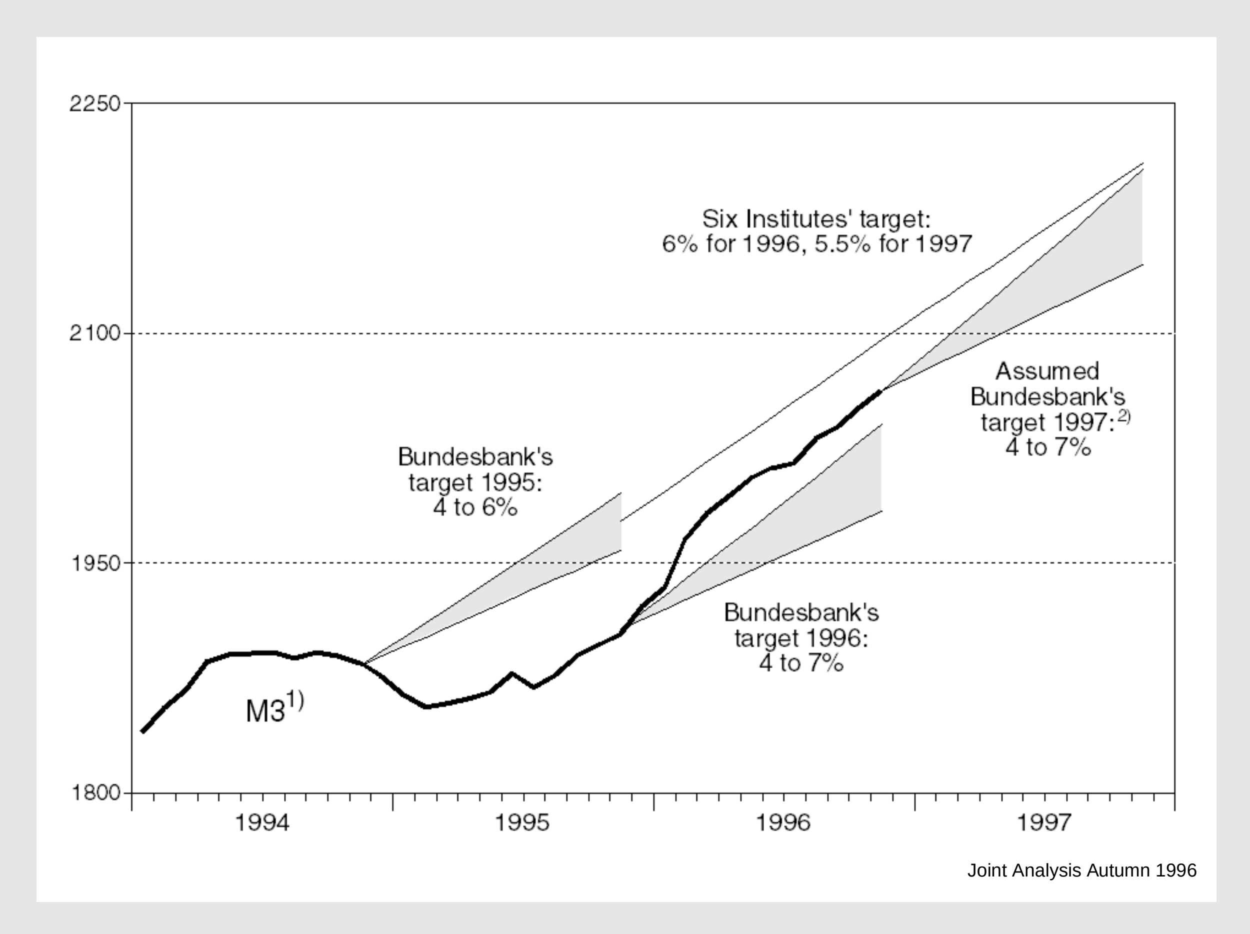
A further boost to demand comes from the fact that the D-Mark has depreciated against the dollar in the course of this year. This is largely because the interest-rate differential between dollar and D-Mark financial investments has widened. Unlike the Bundesbank, the US Federal Reserve – in view of the higher prevailing rates of capacity utilisation – saw no scope for further interest rate cuts; indeed, it even considered raising rates slightly in order to counter from the outset any acceleration of inflation due to higher economic activity.

Of the components of the monetary aggregate M3, savings deposits at statutory notice, alongside sight deposits, have expanded very strongly in the course of this year. This is due to the fact that special forms of saving subsumed under this item have become increasingly attractive. Savers are frequently granted a bonus on top of their interest entitlement if they hold their deposit for longer than three months, for instance. The sharp increase in short-term savings deposits was not only at the expense of longer-terms forms of investment such as savings certificates and bearer bonds from the banks which are not incorporated in M3, but also at the

Figure 5

Money Supply Targets: The Bundesbank and the Institutes' Joint Report

DM billions



1) Monthly average figures, seasonally adjusted. — 2) Equal to the 1996 target.
Sources: German Bundesbank; calculations by the participating Institutes.

expense of short-term time deposits, which form part of M3. The incentive for the banks to expand the volume of savings deposits at statutory notice results above all from the comparatively low minimum reserve requirements. For investors such special forms of saving offer important advantages, particularly at the present juncture: they are readily available, earn a relatively high yield and there is no risk of capital loss.

During the rest of this year M3 is likely to grow at the slower pace recorded during the summer months. There is little likelihood of dampening effects from a significant increase in money capital formation given the prevailing low level of interest rates on the capital markets. Thus the supply of M3 at the end of the year will almost certainly be higher than the Bundesbank intended with its target corridor of between 4 and 7%. However, the Institutes take the view that there is no cause for alarm in spite of the failure to meet the target. The extremely strong growth of the money supply this year is to a considerable extent due to the fact that, in the light of fears of capital losses on long-term financial investments, investors have increasingly preferred risk-free short-term investment. Last year the opposite occurred: a large volume of short-term investments – included in M3 – were converted into longer-term investment forms that do not form part of M3. The result was very slow growth of M3.

For this reason the Institutes recommended in their autumn 1995 report that the money supply target for 1996 should be based not on the value of M3 actually achieved at the end of 1995, but rather on the median value of the 1995 target corridor. If the reference path recommended by the Institutes is taken as the guideline, at the end of this year the supply of M3 will actually be slightly below the target value, despite the strong growth over the year. In reviewing the money supply targets in mid-year the Bundesbank itself took the view that, from a longer-term perspective, the money supply has indeed increased in line with potential output despite the acceleration at the start of 1996.

In calculating the target corridor for M3 for 1996 the Institutes based their result on potential economic growth of 3%, an acceptable increase in the price level of 2% and a "bonus" for the secular decline in the velocity of circulation of one percentage point. Thus money supply growth of 6% was considered in line with potential growth. As far as the target for 1997 is concerned, it is only the growth of productive potential that needs revision: the Institutes consider that in the new federal states it will now expand markedly less rapidly. For this reason a rate of just 2.5% is assumed for the growth of German productive potential; accordingly the target rate for the growth of M3 is reduced to 5.5%. Calculations indicate that currently productive potential is growing slightly less strongly. Yet it seems likely that to some extent this reflects cyclical influences: the capital stock has expanded slightly more weakly than previously as a result of the generally less dynamic investment activity. Monetary policy should be oriented towards the medium-term scope for output growth.

Traditionally the Bundesbank bases its choice of the reference point for its money supply target on the actually achieved value for money supply in the fourth quarter. As described above, this initial value for the 1997 monetary target is slightly below the path, commensurate with potential growth, recommended by the Institutes. Having said that, the difference is far less significant than it was last year. Assuming that the Bundesbank once more announces a target of between 4 and 7%, at the end of 1997 the upper edge of the corridor would be very close indeed to the target trajectory recommended by the Institutes.

At the current juncture the Institutes take the view that neither measures to raise, nor to cut, interest rates are necessary. If, however, in the course of continuing economic recovery, M3 were to overshoot the appropriate target path over an extended period, the central bank must not hesitate to raise interest rates slightly. If a cautious interest rate hike does no more than return the money supply to a path commensurate with potential growth, there is no danger that it will put an early end to the upturn.

European Monetary Union

In their reports in the spring of this year and the autumn of last year, the Institutes dealt extensively with European Monetary Union (EMU), which is to start on 1 January 1999.[2] These reports pointed out the danger of turbulence on the financial markets in the run up to EMU if the markets are left in the dark about facts they consider important. For this reason the Institutes warned, among other things, that the approach to be taken in converting national currencies to the common currency should be clarified as soon as possible, and in particular how the exchange rates that will be irrevocably fixed at the start of monetary union are to be determined. They emphasised that a number of additional precautions need to be taken to ensure that the value of the European currency remains stable. In particular, they underlined the concern that confidence could be lost in the run-up to EMU if the precise way in which participation in the monetary union is to be determined remains unclear. The Maastricht Treaty can be interpreted in such a way that the fiscal policy reference values – a current budget deficit of 3% and outstanding government debt of 60% of GDP – can be exceeded on entry into monetary union. Depending on the precise interpretation, monetary union could begin with widely differing participants; indeed, it could be postponed if not enough countries qualify, or certain countries fail to qualify for participation.

The Institutes have shown how important the stability of public finances is for the success of the currency union. Yet the Maastricht Treaty stipulates merely a weak sanction mechanism in the event that, following entry into monetary union, countries post budget deficits in excess of the then obligatory reference value. Indeed, the Treaty contains no sanctions whatever on countries exceeding the reference value for outstanding government debt. It states merely that, on entry into monetary union, the reference value may not be exceeded, unless government debt as a proportion of GDP is diminishing sufficiently and is approaching the reference value at a satisfactory pace.

In the case of Ireland and Denmark, which have reduced the government debt-to-output ratio significantly, although they are still considerably in excess of the reference value, it has been decided that they meet the fiscal policy criteria of the Treaty. Other countries are now also making efforts to reduce outstanding debt, in order to be able to point to a diminishing trend and a sufficiently rapid decline. As already stated in the spring report, the Institutes consider it vital that the efforts to reduce outstanding government debt are continued after entry into monetary union. High outstanding government debts make it more difficult to keep down current budget deficits, and signal that the state is making a heavy claim on economic resources, to the det-

[2] To be precise, it is the third stage of EMU that is due to commence on this date. Because this is the decisive stage, however, the expressions entry into EMU and EMU will be used in the following to mean the third stage.

riment of private firms and households and thus of economic growth. Consequently the Institutes here repeat their proposal that with regard to government debt the future members of EMU should enter into a commitment: "This commitment should consist of a fixed time schedule for reducing government debt to the reference value and of an obligation to privatise state-owned firms and other assets in order to achieve this end" (Spring Report 1996).

The Institutes consider it vital to ensure that current budget deficits do not exceed the reference value set out in the Maastricht Treaty – which provides for sensible, justified exceptions for special circumstances – following entry to monetary union. This implies that the deficit on the current budgets should be kept so low that even in cyclical downturns the reference value of 3% is not exceeded. In last year's autumn report the Institutes proposed binding sanctions in order to enforce budgetary discipline and for the event that the deficit exceeds the 3% mark.

In negotiations at EU level the German government has proposed a stability pact under which for every percentage point that a deficit exceeds the reference value per year a sum equal to 0.25% of GDP would have to be deposited interest free with the Commission. The country would forfeit this "stability deposit" if the reference value were exceeded for three years running and a renewed deposit would be required. The Commission of the European Communities has now itself put forward a proposal for a stability pact. According to this proposal, the procedures, envisaged in the Maastricht Treaty, to establish whether a deficit is excessive should be rendered more precise and shortened, and an early warning system set up. Once the Council, in accordance with Article 104c (7) of the treaty, has decided by qualified majority that a Member State has posted such a deficit, it initially makes "recommendations to the Member State concerned with a view to bringing that situation to an end". If the Member State does not follow these recommendations, the Council may finally decide that within another specified time limit "measures for the deficit reduction which is judged necessary by the Council" are to be implemented (104c (9)). If the member State does not yield to this decision, the Council may introduce sanctions (104c (11)). In line with the proposal by the Commission (Articles 4 and 5), the time period between the identification of an excessive deficit and the imposition of sanctions against a recalcitrant Member State should last no more than twelve months. This at least marks a concreticisation with respect to the Treaty, which does not specify the length of the periods.

According to the way in which the proposal is formulated (Article 4), the Council will, as a rule, decide that sanctions should be imposed against the Member State in question if the conditions for this under Article 104c (11) are met, and – also as a rule – an interest-free deposit by the Member State would be required (Article 7 of the proposal). This deposit is to consist of a fixed component of 0.2% of GDP and a variable component (Article 8). The latter is to be set at one tenth of the difference between the current deficit and the reference value. In total the deposit should not exceed 0.5% of GDP, however, as this would be, it is argued, untenable, would lead to a loss of credibility and would thus be counterproductive. As a rule the deposit will be converted into a fine after two years if, in the view of the Council, the excessive deficit has not been corrected by then (Article 9).

The Commission's proposal is much weaker than Germany would like. Restricting the deposit to 0.5% of GDP means that deficits do not lead to additional sanctions if they exceed 6% of GDP. There would therefore be no sanction against increasing lack of discipline. Above all, the sanctions are not automatic in nature. This is linked, however, to the fact that the procedure proposed by the Commission is tied into the approach stipulated by the EC Treaty, according to which it is always the Council that must take certain decisions. Clearly, this is also a weakness of the German proposal, for here, too, the Council must decide that the conditions of Article 104c (11) of the EC Treaty have been met. Even so, once the Council had taken such a decision, sanctions would automatically be due, unlike in the Commission's proposal, without additional decisions having to be taken. Although under the Commission's pact, stability-oriented Members States of EMU would have a better platform for demanding measures against stability-endangering behaviour by other countries, and the Council would find it difficult – particularly with regard to public opinion – to tolerate gross infringements of budget discipline, majorities would have to be found for these sanctions, and in the final analysis – as in the EC Treaty – it largely remains the prerogative of the European Council to decide whether and if so what measures to implement. This makes it very likely that the proceedings will be politicised and that sanctions will become a question of opportunism and degenerate to a bargaining counter. The German proposal does nothing in principle to change this, it would merely shift it to an earlier stage of Council decision-making, before the automatic mechanisms take effect. The only way to resolve this fundamental problem, it appears, is to commission independent third parties with the task of determining excessive deficits and all the subsequent decisions leading finally to automatic sanctions.

It is perfectly conceivable that it is decided to embark on EMU on 1 January 1999 with a circle of countries, not all of which – perhaps not even a majority of which – meet the reference value. Under such conditions it is scarcely likely that members of the Council will immediately impose sanctions on countries for whose fiscal policy they themselves bear responsibility.

Precisely because of the danger that the reference values may well not be met from the very outset, a binding mechanism is required in order to make it credible that in future financial solidity will be the order of the day in the Union. The mechanism should begin to apply immediately on entry into European Union. It is evident that a number of countries are increasingly seeking, by means of various forms of manipulation, to force down artificially the deficit and government debt figures for the year 1997, the year whose figures are decisive in determining qualification to participate in EMU. Because most countries are experiencing great difficulty in attaining the reference values, there seem to be a certain mutual tolerance for such measures in many countries. This, too, is evidence of just how great the temptation is to infringe – consensually – the intentions of the Treaty, where this appears appropriate and possible. The Commission of the European Communities, as the guardian of the Treaties, and the European Central Bank should not tolerate such manipulation.

On the first day of the third stage of EMU, the exchange rates between the participating countries will be irrevocably fixed. While the Maastricht Treaty does not specify how the conversion rates of the various currencies to the ECU, which will be converted on this date to the euro on a 1:1 basis, are to be determined, it stipulates that the external value of the ECU may not change due to the conversion. The decision on the way in which the conversion rates are to be set is likely to be taken in the spring of 1998, together with that on the participating countries. It is important to prevent the conversion rates being determined solely in a political coordination process and thus the danger of them becoming "bargaining chips". The question as to the way in which the conversion rates are to be determined is not merely of a purely technical nature, for at least in the short term it can exert effects on the price competitiveness of firms in the various countries.

The following procedures for determining the rates of conversion between national currencies and the euro are conceivable: the rates on a certain day are taken, the use of an average of previous exchange rates between the currencies and the ECU, or a gradual narrowing of EMS bands. If the exchange rate parities prevailing on a specific day were to be chosen, the last day of the second stage would seem most appropriate, as this would ensure that the external value of the ECU would not change. The choice of another day would also be possible, but would not necessarily lead to a constant external value. The danger of this approach is that serious fluctuations in exchange rates may be induced in the weeks prior to the day in question, and that particularly high or low rates, compared with earlier or later periods, could be set irrevocably.

This danger is substantially smaller if average rates over an extended period are used. Moreover, it is to be expected that, once it has been announced that such a procedure has been selected, exchange rate fluctuations would diminish over time. The more data from the past enter into the calculation of average rates, the less the foreign exchange markets will be willing to agree on current rates that deviate from this. Prior to the start of EMU, the future conversions rates would, de facto, crystallise out on the market. In such a case the condition that the external value of the ECU remain unchanged would also be fulfilled. The central question with such a procedure is how long the period selected for calculating the average conversion rate should be. On the one hand a long period would be helpful, as it would stabilise expectations. On the other, the special efforts being made at present by some countries to meet the Maastricht criteria will have knock-on effects on exchange rates which, if a long period were chosen, would have little impact in determining the exchange rate.

One further means of setting conversion rates would be gradually to narrow the band widths around the EMS central rates following the announcement on which countries are to participate in EMU. However, the central rates often differ significantly from market rates and central banks would have to enter into an open-ended intervention commitment in order to maintain them within the band. This would be de facto to anticipate EMU before it starts. Under certain circumstances, exchange rates that differ markedly from those that would have prevailed had they been determined on the market would be stabilised and used as the basis for conversion on entry into EMU.

The prevailing uncertainty in the run-up to EMU depends to a large extent on whether a large or a small-scale monetary union occurs. A small-scale solution between countries whose currencies have largely remained relatively constant for years is far less at risk of exchange rate fluctuations than a large-scale union including countries whose currencies can appreciate or depreciate prior to currency union depending on the success or otherwise of attempts at consolidation. This aspect can be important in the context of the question as to how long the period over which average exchange rates are calculated should be. If there is little change in exchange rate parities, this question is of relatively minor importance.

In the light of the disadvantages of taking rates on a given day and of narrowing band widths described above, the Institutes are in favour of determining conversion rates to the euro by means of an average of past market rates. It could be decided in the spring of 1998 to base calculations on the exchange rates over a period of between one and two years. The advantage of this rather long period is that the scope for individual countries to exert an influence on the conversion rate via monetary policy is limited. At the same time, the exchange rates can start to adjust in the wake of the convergence process which observation shows to be currently under way.

There is scepticism on the financial markets and within the population at large whether the euro will be as stable as existing currencies. Particularly in the initial stages of monetary union, the financial markets will observe very closely the extent to which the European Central Bank (ECB) fulfils its responsibility for price stability. Much will depend in the difficult initial phase on whether the central bank manages to keep down investors' inflationary expectations. This poses the question as to the monetary policy strategy most suited to achieving this aim.

One conceivable strategy would be for the ECB to orientate its activities towards the tried and tested behaviour of the central bank responsible for emitting the lead currency within the European currency system, namely the Bundesbank, and to pursue a money supply concept. The conditions for the success of such a concept over the medium term are not unfavourable. It may well be, for instance, that the stability of the demand for money, which is of great importance for a money supply concept, is actually greater over the longer term in a European currency area encompassing the core countries than in the case of individual national currencies. The instabilities resulting from shifts between various European currencies would certainly no longer arise.

However, in the initial phase, a policy oriented solely towards the money supply could create problems. This is because it is virtually impossible to estimate how the euro money supply will initially develop. For example, at first there will be no euro banknotes. Thus it seems highly doubtful whether the reduction in cash holdings that would be expected from a uniform currency will occur in the short term. Moreover, it is unclear how much confidence investors in Europe and overseas will have in the new currency. An additional fact is that the introduction of the euro will lead to changes in important institutional conditions – examples include changes in payments transactions, in the spectrum of investment forms and the system of minimum reserves – which may exert an influence on financial investment behaviour. It would therefore not be advisable for the ECB to base its monetary policy decisions solely on money supply trends in the initial phase. Incorrect monetary policy decisions due to the erroneous interpretation of money supply trends would be likely to damage confidence in the money supply concept not only in the short term, but also permanently.

Accordingly the central bank should take account of other, supplementary indicators in support of its monetary policy measures. In view of the time lags before monetary policies make their effects felt, these indicators must be closely related to future economic and price trends. A broad-based analysis of the macroeconomy, for example, enables inflationary dangers to be recognised at an early stage. Careful observation of the financial markets is also helpful in this context; trends on the futures markets or the interest rate structure can, for example, provide information on investors' views of the danger of inflation. In all this it is vital that the central bank makes public both its indicators and its interpretation of them and so enables market participants to form a view on the future course of monetary policy.