The German Economy in the Spring of 1998

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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Economic development in Germany continues to follow a clear expansionary trend. During the last quarter of 1997 and the first quarter of 1998, real GDP, adjusted for the influence of special factors, grew at an annual rate of around 2½%. The upswing in Germany has remained largely on the back of export growth. Exports have been particularly stimulated by the economic expansion in Europe, while the marked improvement in Germany's international competitiveness continues to have a positive effect. The D-Mark has depreciated substantially since mid-1995 and, in addition, overall unit labour costs have declined in the past two years, due to rapid productivity growth and moderate wage trends.

Since the autumn of 1997 domestic demand has also picked up, broadening the base for the economic upturn. The decisive factor here is increased corporate investment activity, with investment in equipment and machinery expanding rapidly since the middle of last year. The more favourable sales and profitability prospects and the improved relationship between profits and interest rates are clearly increasingly making themselves felt. Private consumption is beginning to gather steam, albeit hesitantly. During the first months of this year consumer spending actually rose strongly, but this was partly due to purchases being brought forward prior to the increase in value added tax on 1 April 1998.

Investment in buildings, taken as a whole, has continued to contract. This was particularly true in east Germany, where government support for construction was cut back significantly. The decline in construction output was the decisive reason why real GDP growth in east Germany has lagged behind that in the western federal states. Progress in the "catching up" process was made in industry, however; at around 10% last year, manufacturing output grew more than twice as fast as in west Germany, and stronger growth of foreign sales was recorded, albeit from a very low level.

It seems that the stabilisation of the economic upturn has led to a turnaround on the labour market. The decline in employment came to a halt in the autumn of 1997. Since the start of the current year slight employment growth has been recorded for the first time for several years. On seasonally adjusted figures, unemployment has also declined since the start of the year, but to some extent, as with the rise in employment, this has been due to the mild weather. Moreover, the improvement in the labour market situation is restricted to west Germany. In east Germany, where the contraction in the construction industry has had a particularly sweeping effect, the best that can be said is that, ignoring special influences, the pace of employment decline and of the rise in unemployment have fallen.

External parameters remain favourable

Favourable monetary and external economic conditions have played a decisive role in the consolidation of the economic upturn in Germany, as in other European countries. The adoption of EMU will not lead to fundamental changes in monetary conditions. Given subdued inflation and the risks to economic growth posed by the crisis in south-east Asia, it is unlikely that the monetary policy reins will be tightened to a significant degree in the run-up to monetary union. The levelling out of the still existing differences in short-term interest rates between the participants in EMU will occur primarily via a cut in interest rates in the high-interest countries, Italy, Spain, Portugal and Ireland; only a marginal rise in base rates is to be expected in the D-Mark block. The Institutes expect that EMU will commence at a money market rate (three-month money) of just under 4%. No increase in short-term interest rates is expected for the coming year. All in all, monetary policy will continue to exert a slightly expansionary effect.

In recent months long-term interest rates have fallen perceptibly, due to the slowing down of economic expansion in some areas of the global economy and a transfer of capital out of the crisis regions in Asia to the "safe havens" of the industrialised countries. The fall has been more pronounced than among short-term rates, significantly narrowing interest-rate differentials. Given low inflation, for the time being capital market rates are not expected to increase again to any significant extent. Although the consolidation of economic recovery in Europe will raise the demand for capital, this will be offset by a weakening of economic growth in the USA; the US Federal Reserve is unlikely to raise interest rates. In
the course of the coming year overall demand for capital is likely to increase once more, as the situation in south-east Asia improves; this is certain to involve an outflow of capital from the industrialised countries. This will almost certainly lead to a slight rise in long-term interest rates in the industrialised countries, although this is not expected to damage growth prospects in Europe.

The external economic environment has become rather less favourable due to the crisis in south-east Asia and its repercussions. The growth losses in the countries affected directly and indirectly by the crisis will dampen the demand for German exports. Moreover, the price competitiveness of firms located in the south-east Asian countries hit by the crisis has improved significantly by virtue of the sharp fall in the external value of their currencies. However, the retarding influences of the Asian crisis, which are likely to weaken significantly next year, are being offset by persistent strong stimuli from the ongoing upturn in Europe. Moreover, the improvement in Germany's competitive position over recent years will continue to make its effects felt, albeit to a declining extent. During the prognosis period the competitive position will improve slightly, but only in terms of domestic cost pressure; unit labour costs will again decline slightly this year, and next year will increase more slowly than in most other industrialised countries and even Germany's partner countries in the EMU. All in all, exports will continue to receive substantial impulses.

Last year German fiscal policy was oriented towards the goal of achieving the reference values for the fiscal criteria set out in the Maastricht Treaty; its overall impact was markedly restrictive. Although the consoli-
datory stance will be maintained, it will no longer be pursued with the same intensity, as, for example, the recent expansion of labour market policy measures indicates. Fiscal policy will therefore be less restrictive. Although the measures adopted last year to curb spending increases will continue to exert an impact during the current year, and value added tax was raised on 1 April of this year, these effects must be seen against the cut in the "solidarity supplement" on income tax and the increase in the basic tax-free allowance at the start of this year. Next year, further reductions in the tax burden in the form of a further increase in the basic allowance are planned, and social insurance contributions are to be reduced. According to the information currently available, the fiscal policy stance in 1999 will, at most, be only slightly restrictive.

The pace of wage growth has declined markedly in recent years under the influence of the unfavourable labour market situation. On the basis of the collective agreements already reached, which will broadly determine wage trends this year, only moderate increases in nominal wages are to be expected during the current year; for the economy as a whole they are likely to lag slightly behind productivity growth. Given the persistently high level of unemployment, a change in the course of wage trends is unlikely. Next year, however, wage growth can be expected to be somewhat faster than in the current year as the economic situation improves and employment rises slightly.

Against this background the economic upturn in Germany will strengthen and broaden out. Although

| Table 1
| Real Construction Investment$^1$ in Germany |
| Shares as a percentage of the year 1997 | % change on previous year |
| | 1997 | 1998 | 1999 |
| Housing construction | 56.0 | –0.3 | –0.6 | 1.0 |
| West Germany | 59.0 | –0.7 | 0.5 | 2.0 |
| East Germany | 47.5 | 0.7 | –4.0 | –2.1 |
| Commercial construction | 30.2 | –2.2 | –3.7 | –1.4 | –1.5 | –0.3 | (0.8) |
| West Germany | 28.8 | –0.9 | –1.9 | 0.8 | (0.8) | 1.3 | (2.0) |
| East Germany | 34.1 | –4.7 | –7.2 | –6.1 | –6.4 | –3.8 | (–2.0) |
| Government construction | 13.8 | –8.9 | –5.8 | –1.2 | –1.1 | 2.2 | (0.0) |
| West Germany | 12.2 | –9.1 | –6.9 | –1.2 | –1.2 | 2.1 | (0.6) |
| East Germany | 18.3 | –8.7 | –3.7 | –1.3 | –0.8 | 2.5 | (–1.2) |
| Construction investment total | 100.0 | –2.2 | –0.9 | 0.4 | 1.8 |
| West Germany | 100.0 | –1.9 | 0.4 | 1.8 |
| East Germany | 100.0 | –2.9 | –4.3 | –1.9 |

$^1$ At 1991 prices. The figures in brackets have been adjusted for the extraordinary real estate transactions between the government and the business sector.
export growth will flatten out, this will be more than offset by a faster growth of domestic demand. Inflation will remain very low.

Labour market turnaround restricted to west Germany

The labour market situation improved slightly at the start of 1998. During the first quarter of 1998 unemployment fell on seasonally adjusted figures by around 100 000. This marks the first improvement on the labour market since the start of 1995, although it is limited to west Germany. The decline in the level of employment came to halt in west Germany during the second half of 1997, and it began to rise slightly during the winter months. The turnaround on the west German labour market is largely due to a stabilisation of employment in manufacturing industry. Employment in the service sector has continued to grow. In the construction industry the job losses observed since the start of 1995 have continued.

In east Germany, by contrast, the labour market situation has continued to deteriorate. Although here, too, unemployment has fallen slightly (cf. figure 2), this is almost certainly due exclusively to the mild winter. Employment continues to decline. In east German manufacturing industry employment contraction appears to have virtually come to a standstill at the end of last year. On the other hand, employment is now falling not only in the construction industry and the public sector, but also in private services.

The situation on the German labour market will continue to improve slightly in the course of this year; on annual average figures, however, domestic employment and the level of unemployment will remain at similar levels to those in the previous year. West Germany has experienced moderate growth in employment in the course of this year, now that the scope for increasing working hours and raising productivity have been largely exhausted. Over the course of the year as a whole, around 140 000 additional jobs can be expected to be created in west Germany. In contrast to this, there is no sign of a turnaround on the east German labour market in 1998. Although there will be slight employment growth in manufacturing industry in the region, all the other sectors of the economy will shed labour, increasing the pressure on the primary labour market.

Employment trends in eastern Germany are still influenced to a considerable extent by the deployment of labour market policy measures. Following the sweeping cutbacks in recent years, the budgetary allocations have now been expanded once more. According to the plans of the federal labour ministry, an additional DM 3.3 billion (32%) have been earmarked for job creation measures (including structural adjustment measures) in east Germany this year. Again according to the plans, 70 000 people (annual average) more than last year could be placed in employment. However, an increase in the number of jobs of such an order of magnitude is not in fact to be expected because the organisations implementing the measures have scaled down their infrastructure following the cutbacks of recent years. Even so, the increase in funding will have a positive employment effect on the secondary labour market (cf. figure 3). During the remainder of this year up to 150 000 persons could find additional employment with the help of publicly supported measures. In terms of annual averages, this would increase the number of people in job creation measures to around 250 000. Continuing and further training measures are expected to make an even greater contribution to easing pressure on the labour market. For this reason registered unemployment will decline to a greater extent than the increase in employment. Overall, employment will increase by 20 000 in the remainder of this year, allowing for the expansion of labour market policy measures. In annual average terms, however, this still means a decline of 90 000 or 1½% on the 1997 average. The expansion of active labour market policy measures will lead to a slight decline in unemployment in the course of the year, but on annual averages unemployment will rise to 1.43 million.

For 1999, employment is expected to rise in west Germany at a similar pace to the current year. On annual averages registered unemployment will be at around 2.8 million and the unemployment rate 9.1%. As far as east Germany is concerned, the prognosis of employment and unemployment trends is based on the assumption that no further expansion in the funding of labour market policy occurs in the coming year. Given a constant budget, fewer people can be supported in job creating measures in 1999 than at the end of 1998. This means that there will be a decline in the numbers of supported persons in such measures in the course of the year. Although employment in the primary labour market will cease to decline during the second half of 1999, the reduction in the number of participants in public employment measures will lead to a renewed decline in the overall level of employment. On annual average figures employment will remain at roughly the same level as in the current year, while unemployment will decline slightly (cf. table 2).

Current account moves back into surplus

Imports expanded strongly during the winter months. Reasons for this included an expansion of inventories,
brisker demand for investment goods and the export boom. Imports will continue to grow during the prognosis period, although at a reduced rate, despite the expectations of a lasting strengthening of domestic demand; because German exports have a high import content, the flattening out of export growth will lead to a reduced growth of the corresponding imports. The improvement in the competitiveness of German firms will pull in the same direction. On annual average figures goods imports will increase by 9% in 1998, partially reflecting the base effect, and in 1999 by around 6½%.

Given that there will be little change in the terms of trade, this trend will lead to a considerable widening of the surplus on the balance of trade; namely, from just over DM 30 billion last year to around DM 155 billion in the current year and DM 170 billion in 1999. Because, on top of this, the deficits from invisible trade (services) and transfers of earned and property incomes will decline, the current account will record a surplus this year for the first time since 1990; it will be of the order of DM 25 billion and can be expected to rise further next year.

Public budgets:
Further decline in the deficit

German public budgets in 1997 were completely overshadowed by the efforts made to achieve the Maastricht reference value for the government deficit of 3% of GDP. In 1996 the figure had been 3½%, and some commentators had expressed doubts that Germany would qualify for monetary union. The Institutes had, at heart, never shared these doubts, largely because they laid greater emphasis on the direction of budgetary trends than on the "pin-point landing" on 3.0% that played such a central role in the public debate. In the event, the deficit was actually successfully forced below this "magical" figure. This reflected both intensified efforts to make savings and so-called "one-off" measures.

Last year public spending virtually stagnated in nominal terms; in real terms it contracted. In both the current and the coming year it is expected to increase by

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1) Change on previous quarter, expressed as an annual rate, right-hand scale. — 2) Figures: % change on previous year.
Sources: Federal Statistical Office; calculated by the participating institutes; 1998 and 1999: prognosis by the Institutes.

See the Institutes' Joint Reports of the Spring and Autumn of 1997.
around 2% in nominal terms, implying slight real increases in public spending. As a share of output, public spending will decline further, falling from just under 49% in 1997 to 48% in the current and just under 47½% in the coming year.

Following last year’s stagnation, government consumption will increase by 1½% in the current year. Within the statutory health insurance system the cutbacks contained in the first and second restructuring laws will continue to make their effects felt; the impact of the higher cost of medicine since the middle of last year will only reduce the rates of spending growth during the first half of the year, however. Spending on procurement by the three tiers of German government will be scarcely less tightly restrictive than last year. There will be a slight increase in spending on social care insurance. Continued low wage increases and a reduction in public sector staffing levels mean, however, that the public sector wage bill will increase only marginally.

Next year the rate of growth of government consumption will accelerate to 2½%; this is based on the assumption that public sector wages will rise slightly faster than in the current year.

At less than 2%, government expenditure on transfers will expand similarly moderately in 1998 and 1999 compared to last year. Pensions will rise only slightly; in the current year because of the slow growth of net wages and salaries, and in the coming year because of the cutbacks introduced within the framework of the pension reform. The brightening prospects on the labour market and the impact of the savings brought about by the law reforming the Labour Promotion Act will dampen the rates of growth of spending by the unemployment insurance fund. Additional expenditure will be required in the current year, however, as additional funding has been earmarked for job creation measures in east Germany; such measures had been cut sharply in previous years.

Public capital spending is expected to contract slightly once more in the current year. This downward trend has now persisted since 1993. The main reason for this was the difficult fiscal position facing local government due not least to their reduced tax receipts. Following last year’s stagnation, government consumption will increase by 1½% in the current year. Within the statutory health insurance system the cutbacks contained in the first and second restructuring laws will continue to make their effects felt; the impact of the higher cost of medicine since the middle of last year will only reduce the rates of spending growth during the first half of the year, however. Spending on procurement by the three tiers of German government will be scarcely less tightly restrictive than last year. There will be a slight increase in spending on social care insurance. Continued low wage increases and a reduction in public sector staffing levels mean, however, that the public sector wage bill will increase only marginally. Next year the rate of growth of government consumption will accelerate to 2½%; this is based on the assumption that public sector wages will rise slightly faster than in the current year.

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Public capital spending is expected to contract slightly once more in the current year. This downward trend has now persisted since 1993. The main reason for this was the difficult fiscal position facing local government due not least to their reduced tax receipts. Given that the revenue situation will improve somewhat in the current and particularly the coming year, as tax revenues rise, local authorities will be able to attend to some of the unmet needs for capital investment accumulated over recent years. Next year public capital spending should rise slightly, at least in west Germany.

The statistics on public gross fixed capital formation in 1997 (-9½%) exaggerate the extent of the decline as they are distorted by a high volume of sales of real estate.
In both the current and coming year government interest payments will increase by 3½%, that is once again more than proportionately. This is partly because this year an unusually large volume of short-term loans reached maturity in which interest payments are due at the end of the payback period. A countervailing effect will be exerted by debt restructuring measures taken by government in order to profit from the prevailing low rates of interest.

In both 1998 and 1999 tax revenue will expand increasingly rapidly in the wake of the economic upturn. The various changes in tax policy have served both to reduce tax receipts (cut in the solidarity supplement on income tax: DM 7 billion; increase in the basic tax free allowance on income tax: DM 1½ billion) and to raise tax revenues (increase in the rate of value added tax: DM 9 billion) in 1998, such that there will be little overall effect on government revenues.\(^3\)

In the coming year value added tax (VAT) receipts will increase more than proportionately because it is not until then that the VAT increase of 1 April 1998 will make its effects felt for a full year (additional revenue: DM 15 billion). The renewed increase in the basic tax free allowance will, however, reduce revenue by around DM 4 billion.

Receipts from profit taxes, which in both of the previous years were extremely depressed, primarily due to the extensive recourse to tax allowances (e.g. special depreciation allowances for investment in east Germany), will increase substantially, as many companies will earn considerably higher profits. The increase in corporation tax revenue in the current year will, however, still be retarded by the fact that current profits can be set off against previous losses and firms are still receiving tax reimbursements.\(^4\) Receipts from non-

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\(^3\) In the current year the reform of business taxation introduced at the start of the year will be largely revenue-neutral. In the coming year it will generate additional revenue of DM 2½ billion.

\(^4\) Firms are now entitled to refunds for profits retained between 1990 and 1993 and originally subjected to a tax rate of 50%; the reimbursement amounts to the difference between the then prevailing tax rate of 50% on retained profits and the currently prevailing tax of 30% on distributed profits.
assessed taxes on profits, on the other hand, will grow strongly in 1998 due to the higher dividend payments.

On fiscal statistics definitions, overall tax revenue in the current year is likely to be around DM 3 billion higher than the forecast in November 1997 by the official working party "Taxation forecasting". In 1998 tax revenue will increase by 2½% and by 4½% in 1999. The relative tax burden (tax receipts as a share of GDP) will remain virtually unchanged in 1998 and 1999.

For the first time since 1990, during the current year there will be no further increase in the burden of social insurance contributions. For the coming year it is expected that the burden of social insurance contributions will be 0.4 percentage points lower than in 1998. The financial position of the statutory health insurance funds has improved in the wake of numerous cutbacks, permitting marginal cuts in contribution rates. By the end of 1998 the statutory pension insurance scheme will have created the necessary reserves; the signs for 1999 are for a favourable financial situation due to the economic recovery and a higher federal government grant. Even so, overall revenue from contributions is expected to increase slightly faster in 1999 than in 1998 (2.2% compared with 1.7%). The decisive factor here is the improvement in the labour market situation; wages will also rise slightly faster than in 1998.

In 1998 the Bundesbank will transfer profits of around DM 9½ billion to central government (1997: DM

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<th>Table 3</th>
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<td>Labour Market Data</td>
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<td>annual averages, in thousand persons</td>
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<td>Germany</td>
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<td>Self-employed</td>
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<td>Unemployment rate</td>
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<td>Further training</td>
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1) Unemployed as a % of the domestic labour force (domestic concept). — 2) Unemployment as a % of the labour force in the region (place of work concept). — 3) Including jobs for which wage cost subsidies under §249h of the Labour Promotion Act are paid.

Sources: Federal Statistical Office; Federal Labour Office; calculations by the participating Institutes; 1998 and 1999: prognosis by the Institutes; figures rounded.
The Bundesbank's windfall profit resulting from the revaluation of its foreign currency reserves will, if it is distributed, as is assumed here, not be counted as government revenue in the national accounts; it will reduce government debt as a share of output, however.

Overall government revenue will expand at a slightly accelerating pace over the forecasting period; the increase is likely to amount to around 2% in 1998 and around 3½% in 1999. The decisive factor here is the economic upturn; there will be little change in the overall tax and social insurance burden.

The budget deficit, which last year fell markedly in the wake of the attempts at consolidation and the "one-off" measures taken in an effort to meet the deficit criterion, will continue to narrow in both the current and coming year. This is because tax revenues are beginning to flow more freely, while the rise in spending remains limited. According to the definitions used in the European System of National Accounts, the deficits will decline from 2.7% of GDP last year to 2.5% in the current and 2% in the coming year. This means that it is increasingly falling below the ceiling set by the Stability and Growth Pact of 3%. Government debt will remain at its current level of more than 61% of GDP, and would, indeed, rise further in the absence of the receipts expected from privatisation and the revaluation of the Bundesbank's dollar reserves.

Monetary trends
The Bundesbank has not changed its base rates since the rise of 0.3 of a percentage point in the re-purchase rate in October 1997. The discount, Lombard and re-purchase rates remain at a low level (2.5%, 4.5% and 3.3% respectively).

In the middle of 1997 the growth of M3 slowed perceptibly. Between then and February of this year, the rate of monetary growth, expressed as an annual rate, slowed from 4.5 to 2.5%. Only more recently has monetary growth began to pick up once more. Currently the stock of M3 is roughly in the middle of the target corridor of between 3 and 6% set by the Bundesbank for 1998. Recently the various components of M3 have been

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Figure 3
Employment Building Measures\(^1\) and Unemployment\(^2\) in East Germany

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<thead>
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\(^1\) General job-creation programme and structural adjustment programme. \(^2\) Seasonally adjusted figures.
Sources: Federal Labour Office; calculated by the participating institutes; from 2nd quarter 1998 onwards: prognosis by the institutes.
expanding broadly in parallel, following an extended period in which their trends were very heterogeneous. No significant shifts between money capital and M3 were observed. Currency in circulation has declined, though, rather than increasing as would be typical in an upturn. This trend is probably due primarily to the declining importance of the D-Mark as a parallel currency in central and eastern Europe. An additional factor is the secular trend towards non-cash forms of payment.

The differential between long-term and short-term interest rates, which for some time had been substantially positive, has narrowed significantly. At the start of last year the difference between the running yield on fixed-interest securities and the interest rate on three-month money amounted to around two percentage points; currently it lies at just 1.2 percentage points. This narrowing is partly due to a rise in short-term rates, but primarily reflects the decline in capital market rates. Inflation has subsided in recent years in Germany, as in other leading industrialised countries. Moreover, the crisis in Asia has led to an inflow of capital into western industrialised countries, reinforcing the trend towards lower long-term interest rates. At 4.8% the running yield on fixed interest securities in Germany is currently at a low level.

Following the decision taken at the start of May 1998 on the participating countries and the fixing of bilateral conversion rates, European Monetary Union has de facto already begun. In the case of long-term interest rates the convergence process has already been virtually completed. The short-term interest rates of the participating countries can be expected to converge completely in the near future. The Institutes take the view that this convergence will occur primarily in the form of interest rate cuts in countries whose rates are currently higher (Italy, Spain, Portugal and Ireland); in the D-Mark block, on the other hand, short-term interest rates will be raised only slightly. Money market rates (three-month money) in 1999 will be at around the level recorded at the start of this year (4%). By the end of 1999 long-term interest rates will have increased by more than half a percentage point; this is largely because capital that had been transferred from Asia to the industrialised countries will begin to return, as the repercussions of the Asian crisis gradually subside. The interest-rate differential will once again increase slightly. All in all, monetary policy will again exert a slightly expansionary effect on the economy in the coming year.

Contrary to the fears that have been expressed in certain quarters, we do not expect that the euro will depreciate in the coming year. Indeed, given the interest-rate trends we have assumed for "euroland" and unchanged base rates in the USA, the euro may well appreciate slightly against the US-dollar. This is also suggested by the fact that, in contrast to the EMU countries, the USA will continue to post a substantial current account deficit, and inflation rates there will be slightly higher than in the euro area.

Economic policy in Germany and in the European Monetary Union

The cyclical recovery in Germany has strengthened further, and its base has broadened now that domestic demand, too, is expanding more rapidly. Private-sector investment in machinery and equipment, in particular, is on a strong upward trajectory. On the German labour market it seems that a turnaround has now occurred, following a long period of contraction. The economic policy parameters and the generally favourable evaluation taken by firms of economic prospects suggest that the upturn will continue in the coming year and, indeed, will accelerate slightly. This will occur against the backdrop of virtually stable prices.

The labour market situation in Germany remains precarious, however; this is particularly the case in east Germany, where economic growth has become bogged down. Overall output growth there has actually been below that in west Germany. The prospects for a continuation of the "catching up" process are now bleaker. All in all, economic policy makers continue to face major challenges.

The fact that the economy is on a growth trajectory and is developing largely without tensions should be seen as an opportunity to orient economic policy towards the medium term, to free it from hectic short-term responses to external pressures, and to make progress in achieving fundamental reforms. The start of European Monetary Union will change important parameters for certain policy areas. The need for policy action emphasised by the Institutes in their reports for some considerable time now, is likely to increase further as a result. What is needed is to establish the conditions for a stronger growth dynamic and in particular for a higher level of employment.

At the start of May the heads of government of the EU Member States decided to embark on the third stage of EMU on 1 January 1999. As had been expected by the Institutes, 11 countries will participate in monetary union. The currency conversion rates have been set and

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6 The German Institute for Economic Research (DIW, Berlin) takes a different view of the division of tasks between economic policy makers, both in Germany and in the European Monetary Union, than the other Institutes. This view is given at the end of this report.
decisions were taken on the appointments to the Board of the European Central Bank. The establishment of the European Central Bank (ECB) brings to an end national sovereignty over monetary policy. The Bundesbank will lose its role as the central bank issuing Europe's reserve currency; the influence of the central banks of the other countries on European monetary policy, on the other hand, will increase.

As was the case with the Bundesbank, the ECB is to pursue the goal of price stability, in the accomplishment of which, according to its statute, it enjoys a high degree of independence, in particular from influence by national governments. It is an essential element of this independence that the President and the Board members are appointed for eight years. The nature of the debates on the appointment of the first President of the ECB was far from helpful with a view to the reputation of the ECB, and may raise doubts about the independence of the central bank.

The monetary policy pursued within the EMU will depend on economic developments within the currency area as a whole. The ECB cannot take account of regional differences in, for instance, incomes, prices and costs. The European orientation of monetary policy does not mean, however, that a complete synchronisation of the cyclical patterns of the national economies participating in EMU is inevitable. Differences will remain, just as in the past when a number of central banks, through their exchange rate policy, followed the course adopted by the Bundesbank. This is because national fiscal policies and pay trends will continue to influence economic developments; economic shocks, too, such as drastic changes in primary goods prices, can lead to deviations in cyclical patterns, not least due to the different economic structures of the various countries. Last but not least, there are national differences in structures within financial sectors, for example with respect to the maturity structure of private and public sector debt. Although it is to be expected that these structures will gradually converge, during the transitional phase a change in base rates may have different effects in different countries.

The ECB is commencing its activities at a time when economic development in Europe is largely free of tension. It has to face neither a depressed economy nor inflationary trends, both of which would give rise to discussions on major changes in interest rates. Even so, fundamental problems exist during the transition phase. The interpretation of various monetary policy indicators, for instance, may well prove particularly difficult. The ECB, particularly in the initial phase of EMU, will be subject to critical examination not least for this reason, both by politicians and the markets. This makes it all the more important that it enters into a dialogue with the public, as central banks in most countries have done in the past. It would be conducive to the ECB's credibility if it were to provide detailed justifications for its decisions, which initially will be taken under conditions of particularly great uncertainty. Inevitably its measures will be subject to criticism. The public debate must not have the effect, however, of compromising the independence of the ECB. The chances of a successful, stability-oriented central bank policy will be seriously reduced if national governments or other institutions exert pressure for a change of course. The provisions of the Maastricht Treaty clearly provide for the ECB's independence from external instruction.

The irrevocable fixing of exchange rates means that the countries participating in EMU have relinquished an autonomous national monetary policy. However, for most countries this does not mark a decisive change compared with the situation in recent years. After all, exchange rates within the so-called D-Mark block have been virtually stable over an extended period; in other words a monetary union already existed to all practical purposes between these countries. Western Europe has experienced major changes in exchange-rate parities primarily when national monetary and fiscal policy pursued different courses, or the exchange rate was maintained at a certain level for too long in defiance of market forces. These were the primary reasons for the crises within the European Monetary System (EMS). Specifically, exchange rates were adjusted whenever inflation rates diverged. A common monetary policy will remove a central reason for changes in exchange rates. In addition, fixed exchange rates will, from the very outset, make it impossible for a single country to attempt to avoid or postpone adjustment of real wages to a real-economic shock by means of inflation coupled with currency depreciation.

The Institutes are of the opinion that the fixing of conversion rates at levels determined by the central rates within the EMS is the best way to embark on monetary union, not least because it will stabilise expectations (see the Institutes' Autumn Report 1995). It is not to be expected that, at these parities, substantial new adjustment processes will be induced in individual countries. For the bilateral exchange rates, which approximate to the central rates of the EMS, have been stable for some time now, without this having led to major external economic disequilibria. This is shown not least by the fact that no significant intervention on the foreign-exchange markets in support of currencies has been necessary. Although nominal exchange rates have been irrevocably fixed, productivity, prices and costs in the countries participating in EMU can evolve differently, just as they have in previous years; this means that real exchange rates may change. This has repercus-
sions for the competitiveness of individual Member States which in future will influence economic activity in these countries, and thus possibly also within EMU as a whole.

In recent years the fiscal policy pursued by the countries participating in EMU has, with a view to the Maastricht Treaty, been oriented primarily towards reducing government deficits. Many countries introduced measures to raise taxes and social insurance contributions and to reduce public capital spending, which have had the effect of reducing economic growth, not least in Germany. Although at the end of the day all the Member States met the reference value for the deficit as a share of GDP, the consolidation policies frequently bore little resemblance to a coherent fiscal policy oriented towards medium-term requirements; government measures were determined largely by estimations of the magnitude of new budgetary shortfalls.

The Stability and Growth Pact imposes an continuing restriction on national fiscal policy. Deficits in the EMU countries are to be brought down to such an extent that in the event of a recession the reference value of 3% of GDP is not exceeded. For a number of countries, including Germany, this implies the necessity of further reducing the current borrowing requirement. Indeed, the Stability Pact envisages a balanced budget over the medium term. Moreover, the reduction in budget deficits is necessary if the built-in stabilisers are to be allowed to work in the event of cyclical fluctuations, without the deficit rising above the 3% mark. This would help to stabilise cyclical trends.

The Stability Pact relates to the budget deficit as a whole. Yet this variable tells us little about the quality of fiscal policy. In Germany, too, the fiscal-policy course does not meet the conditions that would be required for more growth and employment to a sufficient degree. The Institutes have consistently emphasised that this calls for a marked reduction in marginal tax rates and in social insurance contributions, and a cut in state spending as a share of output. According to the current prognosis, in 1999 public spending will represent over 47% of output, 1 ½ percentage points lower than in 1997; this is an important step in the right direction. Yet the Institutes consider that a further significant reduction in the burden of taxes and contributions is necessary. A major reform of taxation should contain measures to reduce marginal tax rates significantly and to broaden the tax base perceptibly by removing tax concessions. The more it proves possible to force down public spending as a share of output, the greater the scope for reducing the overall tax burden. Government subsidies, in the widest sense of the term, offer a substantial potential for savings. In many cases this may lead to hardship for the recipients of subsidies, but many branches currently find themselves in a favourable cyclical situation. Besides this, it remains an important goal of fiscal policy to render the structure of spending and revenues more conducive to growth (qualitative consolidation). These requirements cannot be met by a fixation with the overall magnitude of the budget deficit alone. Moreover, most countries in the EMU face the problem of uncertainty surrounding the long-term financing of the social insurance system in the face of demographic trends. Consequently, any budgetary consolidation must encompass a reform of, in particular, pension insurance.

In Germany, neither tax reform nor pension reform should be made conditional on the steps taken by other governments within the EMU area. The principle holds that in the area of fiscal and social policy, the choice of the appropriate system should not be restricted by union-wide regulation. Decentralised forms of regulation enable countries to learn from one another; those strategies that prove their worth with respect to reducing the barriers to growth can be adopted sooner or later by other countries. Such a learning process would be precluded by the alternative strategy of harmonisation – in the sense of far-reaching uniformity – which some commentators have called for. The introduction of minimum standards for tax rates or social norms could, moreover, make it more difficult for those countries with a comparatively low per capita income to close the gap on the richer countries. After all, the idea of European integration is targeted precisely at the possibility of such catching up processes. It should be possible for the less highly developed countries to realise the opportunity to achieve higher growth by means of an attractive taxation system involving low tax rates and incentives for investment. There is currently no danger that such competition will lead to a situation in which tax cuts go too far. They will come up against a limit at a level at which the state is no longer able to perform its important tasks, in particular the provision of public goods. For a sufficient provision of public goods, in particular infrastructure, is an important criterion in determining national competitiveness.

Taken by itself, the introduction of the euro changes nothing with regard to the problem of high unemployment in Europe or Germany. The Institutes have repeatedly put forward proposals for approaches to solving the unemployment problem, most recently in the Autumn Report 1997. The majority of the Institutes take the view that wage trends play a decisive role here. If the labour market situation is to be improved, continued wage moderation is required. This is just as true for individual countries as for the currency area as a whole. In Germany, the parties to collective bargaining have met these requirements to a significant degree in the past two years, and in so doing have made an impor-
tant contribution to the improvement in the employment situation that is now beginning.

The differences between European countries in the level and rate of growth of productivity are substantial. They far exceed, for instance, the differences between the different federal states in Germany. Accordingly, wages at European level must be negotiated in such a way that they take account as far as possible of differences between regions and industries. Convergence of wages without regard to productivity would exacerbate the labour market problem facing Europe. The example of east Germany confirms this. Moreover, not least in Germany, collectively agreed wages have in the past frequently been raised in many branches considerably faster than productivity. To the extent that they cannot be under-bid, they assume the nature of minimum wages, which reduce employment opportunities for the unemployed, particularly the low-skilled. If such minimum standards were imposed, within the framework of a unified collective bargaining system, unemployment in Europe would increase and, what is more, become more entrenched.

The completion of the Single European Market, which is to be crowned by EMU, will serve to intensify competition. This is highly desirable with regard to the aim of faster growth. The intensification of competition will also affect individual labour markets. This will require them to react all the more flexibly to the challenges that individual industries or regions in Europe have to face. Further, it cannot be squared with the spirit of European integration that specific countries or regions are not to be permitted to exert greater wage moderation than others, in order to improve their employment situation. This has nothing to do with "wage dumping". It must be possible for countries to catch up with others in terms of employment, too.

The majority of the Institutes do not see a danger that, in the wake of such competition, a race for more employment via a generalised policy of wage moderation in all countries will occur, with damaging effects on Europe as a whole. Firstly, the ECB can ensure that the inflation rate does not fall significantly below the norm of 2%; thus the threat of deflation is precluded. Secondly, the demand for labour will be stimulated, creating new jobs and thus higher incomes. Consequently, the majority of the Institutes expect that wage moderation will lead to a significant decline in unemployment in Europe; the employment intensity of economic growth would be higher.

At the end of April 1998 the German government presented an "Employment Action Plan", which, among other things, took stock of the economic policy pursued in previous years. The measures listed aim to improve supply-side factors and thus the conditions for growth; to this extent, in terms of their general conception they mark a move in the direction urged by the majority of the Institutes. However, it did not prove possible to implement one particularly important measure, namely tax reform. On top of this, fiscal policy, in view of the risk of failing to meet the reference values for the fiscal criteria set out in the Maastricht Treaty, took measures that were not in accordance with the overall concept. The only new element in the Action Plan was a marked expansion of funding for labour market policy measures, whose origins go back to the decisions taken by the European Council in Luxembourg in November 1997. The expansion of active labour market policy measures, which had been severely cut back in the previous year, will temporarily ease pressure on the labour market, particularly in east Germany. However, it is doubtful whether large numbers of the unemployed will be integrated into the primary labour market; past experience, at least, causes one to be rather pessimistic. Also in view of its relatively high costs, this measure should therefore be deployed sparingly.

The "catching up" process in east Germany

In the autumn of 1995, five years after the political unification of Germany, the Institutes took stock of the "catching up" process in east Germany to date. At that time they noted that the return to normal cyclical patterns in west Germany and the high rates of growth in east German were leading policymakers to the erroneous conclusion that "... that due attention has by and large been paid to the economic aspects of German unification, the catching up process in east Germany has been set on its way and that there is therefore nothing standing in the way of a reduction in the public transfers from west to east Germany." Yet the Institutes commented: "This belief is mistaken, however." They called for "the concentrated attention of economic policy makers" in order to ensure that the "task of stabilising the catching up process of the east German economy vis à vis that in west Germany" was successfully mastered.7

This has not occurred, however. As had been predicted by the Institutes, the "catching up" process in east Germany rapidly ground to a halt. In 1996 the rate of growth in the new federal states was, at just under 2%, still marginally higher than in western Germany; already by 1997 it was lagging behind the west Germany result, at just 1.6%, and no fundamental change

can be expected either in the current or the coming year. In per capita terms, nominal value added in east Germany remains at less than 57% of the west German level. Productivity has so far risen to only 60% of the west German level. Labour costs per employee in the current year represent just under 75% of the average figure paid in west Germany (cf. table 4). Contrary to the impression given by these figures, household income is expected to have drawn closer to the west German level, reflecting higher transfers and a slightly higher labour market participation rate.

There will be little change in these relative figures unless the "catching up" process, i.e. higher growth in east than in west Germany, is resumed. Under the pressure of public opinion, the trade unions have accepted that the continued improvement in the situation merely of those in employment does not, in the final analysis, constitute a viable way forward, all the more so given that in recent years more and more firms have begun paying wages below collectively agreed rates. In response the unions have adopted a moderate approach and in most cases have postponed the upward adjustment of wages to west German levels. Next year, the Institutes believe that collectively agreed wages in the region will rise scarcely faster than in west Germany. The population is frustrated about the lack of progress and particularly the labour market situation. Economic policy makers are forced to confront these problems of the "catching up" process.

Frequently, the fact that growth rates in eastern Germany are lagging behind is seen as an inevitable normalisation, one that, particularly in the construction industry, was to be expected following the boom in the years after unification. The fact that the "catching up" process has ground to halt in the course of this normalisation shows that the brief initial growth push represented not a self-sustaining upturn, but rather an artificial process that had been stimulated exogenously. Yet for as long as one could point to high rates of growth, this aspect was not the focus of economic policy considerations. Developments in industry have differed from those in construction: whereas for many years manufacturing growth rates lagged behind those in the other sectors, industry now exhibits an above-average dynamic, with value added growing at rates of more than 10%. Yet here, too, one needs to be cautious about interpreting this as confirmation that east Germany will automatically catch up on the West. To some extent the positive developments recorded in the statistics are the result of one-off effects. For example, many investments in large-scale plant are only now coming on stream. Consequently, high rates of output and productivity growth are currently being recorded, but it is far from clear that they can be projected into the future.

A look at some data on the economic fundamentals suggests that one must still be sceptical regarding the chances of east Germany catching up under its own steam. The relationship between labour productivity and labour costs is still far from the figure typical of western industrialised countries. In nominal terms unit labour costs in the region as a whole are still 23% above the west German level. Industry has, however, experienced a rapid adjustment process to the conditions prevailing on global markets. During the current year an average level will be reached corresponding to that at which west Germany holds its own in global competition. If the data on which such calculations are based are correct, then – in absolute terms – a gradual improvement in east Germany's position is to be expected, because the region will be incorporated into the general growth trend in Europe; this does not necessarily mean that the region will be able to catch up, however.

There is no automatic mechanism by which a poorer region can close the gap on a richer one. The poorer region must exhibit advantages that induce investors to invest more there than in wealthy regions. Such advantages include, for example, a lower general wage level, because then capital productivity is relatively high, and profitability expectations are particularly favourable if investors can combine their modern technology with comparatively cheap labour. By this means additional jobs are created. Yet in east Germany this advantage exists only to a minor extent, due to the rapid upward adjustment of wages in the initial phase of translation. This problem is exacerbated by the fact that in immediate proximity to the new Länder western investors can find countries offering far more favourable conditions with respect to the wage level.

East Germany has been able to offer significant advantages in terms of government support for investment activity and of the rapid development of its infrastructure. It must be doubted, however, whether these advantages will suffice to induce a continuation of the "catching up" process once the normalisation in the construction sector has been completed. Although support measures are still far more generous than for structurally weak regions in west Germany, for example, for many years east Germany will continue to exhibit historically determined disadvantages that must also be offset by the government support provided. Many years of experience with regional policy in the west does not suggest that such support can exceed the compensation of disadvantages to a great extent in the weaker regions and thus induce catching up processes.

On the other hand, the donor states in west Germany have recently raised demands for transfers to east Germany to be cut back. This would make prospects there even bleaker. Yet even if this does not occur, an increase
in support such as is in all likelihood necessary to revitalise the catching up process is inconceivable in such circumstances. In view of its particular historical circumstances, east Germany cannot pull itself up out of the bog of sluggish growth by its own bootlaces. If the act of political strength called for by the Institutes back in 1995 does not materialise, the east German economy will continue to lag behind, merely approaching the rates of growth generated in the west of the country. In this case, the living conditions of the population would improve and their wealth increase, but whether, given the continued existence of the gap between east and west, this would be sufficient to offer them a reassuring prospect for the future, must remain a moot point.

In view of the fact that a substantial increase in funds for east Germany is highly unlikely to be made available in the coming years, it is vital that the “disposable transfers”, i.e. those that are not, as it is the case with wage compensation benefits, tied to specific consumptive ends, are focused on a small number of central areas. In the area of investment support, a step has been taken in this direction: as from 1999 onwards, investment support will largely be restricted to manufacturing industry – which faces supra-regional competition and whose share of value added is only just over half as high as in west Germany – and producer services. It is vital that the pace of the modernisation of public infrastructure is not allowed to slacken. Although considerable progress has been made here in the eight years since unification, many areas of east Germany are still a long way away from an infrastructural endowment corresponding to modern requirements. This is particularly true of transport infrastructure, for example the construction of bypasses, steps to ease the burden on nodal points etc. Although public construction investment is still far higher on a per capita basis in east than in west Germany, it has been falling for a number of years. In view of the immense need to catch up here, this cannot be justified. Concentrating funding in this area would provide support for the construction industry and stimulate private investment, without the risk of major misallocations of investment resources or of generating substantial temporary overcapacity, such as has occurred in housing construction.

Any new measures must, however, be subject to a strict time limit, and funding must be on a downward sliding scale. It is also vital that the trade unions refrain from seeking wage adjustment to western levels over a period of several years. If this proves possible, productivity in east Germany may be permitted to rise substantially, creating the conditions for higher employment. This would enable the especially high levels of support to be discontinued. The structurally stronger regions in east Germany would then be at a comparable level to structurally weaker regions in the west, and the structurally weaker east German regions would be scarcely

| Table 4 |
| Indicators of the Economic Catching Up Process in East Germany |
| West Germany = 100 |

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<tbody>
<tr>
<td>GDP at current prices per inhabitant</td>
<td>31.3</td>
<td>38.9</td>
<td>47.7</td>
<td>52.3</td>
<td>55.4</td>
<td>56.8</td>
<td>56.8</td>
<td>56.6</td>
<td>56.6</td>
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<tr>
<td>Investment in machinery and equipment at current prices per inhabitant</td>
<td>63.6</td>
<td>75.3</td>
<td>99.5</td>
<td>111.5</td>
<td>12.9</td>
<td>13.4</td>
<td>13.4</td>
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<tr>
<td>Investment in buildings at current prices per inhabitant</td>
<td>67.2</td>
<td>100.8</td>
<td>130.8</td>
<td>163.7</td>
<td>180.2</td>
<td>178.1</td>
<td>168.2</td>
<td>160.9</td>
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<tr>
<td>Housing construction</td>
<td>44.5</td>
<td>61.3</td>
<td>82.4</td>
<td>112.1</td>
<td>132.7</td>
<td>144.9</td>
<td>146.3</td>
<td>138.1</td>
<td>131.4</td>
</tr>
<tr>
<td>Commercial construction</td>
<td>89.4</td>
<td>141.5</td>
<td>193.1</td>
<td>229.9</td>
<td>237.0</td>
<td>227.3</td>
<td>219.2</td>
<td>202.6</td>
<td>190.6</td>
</tr>
<tr>
<td>Government building</td>
<td>92.3</td>
<td>147.6</td>
<td>179.6</td>
<td>237.4</td>
<td>226.9</td>
<td>239.4</td>
<td>240.9</td>
<td>240.9</td>
<td>242.2</td>
</tr>
<tr>
<td>Gross wage and salary income per employee</td>
<td>46.7</td>
<td>60.7</td>
<td>67.9</td>
<td>70.5</td>
<td>72.5</td>
<td>73.6</td>
<td>74.3</td>
<td>74.8</td>
<td>74.7</td>
</tr>
<tr>
<td>Labour productivity</td>
<td>31.0</td>
<td>43.5</td>
<td>53.1</td>
<td>56.0</td>
<td>57.8</td>
<td>59.4</td>
<td>60.4</td>
<td>61.0</td>
<td>61.2</td>
</tr>
<tr>
<td>Unit labour costs</td>
<td>150.6</td>
<td>139.4</td>
<td>128.0</td>
<td>126.0</td>
<td>125.6</td>
<td>123.9</td>
<td>123.1</td>
<td>122.7</td>
<td>122.2</td>
</tr>
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</table>

1) GDP at current prices per employee. — 2) Gross domestic income per wage/salary-earner divided by nominal GDP per gainfully employed.

further behind both groups than are currently the weaker west German regions behind the stronger regions there.

**Monetary policy**

The provisions of the Maastricht Treaty require the European Central Bank to maintain stable prices within the European Monetary Union. It is probable that the ECB, like the Bundesbank before it, will consider an annual rate of inflation of the order of 2% as acceptable. A higher rate would create the impression on the markets that in future the value of the euro will be less stable than the D-Mark has been. In 1998 inflation in the countries participating in monetary union will average at around 1.5%.

The ECB may choose one of two monetary policy strategies. Either it takes the money supply as an intermediate target, or it sets and seeks to meet a direct inflation target. The Bundesbank has implicitly pursued an inflation target within the framework of its targeting of monetary growth: it has set the corridor for the growth of the money supply in such a way that, allowing for the secular decline in the velocity of circulation, the medium-term rate of inflation was to be limited to 2%. This approach was based on the relatively stable relationship between changes in the money supply and in prices. Empirical studies – by, among others, the European Monetary Institute – have obtained similar results for the aggregate demand for money in various groups of countries within EMU. Such studies have not yet been conducted for the eleven countries forming monetary union from 1 January 1999 onwards as a whole, however. The reason for this is that harmonised monetary aggregates are not available for all countries over an extended period. An additional obstacle in the way of a pure policy of monetary control is that it cannot be precluded, particularly during the transitional phase, that the introduction of the euro will lead to changes in cash-balance behaviour and to portfolio restructuring. Firms and private households may, for instance, reduce their cash holdings because the new currency is valid in a larger area. It is also unclear to what extent the euro will play a role as a means of payment outside the EMU.

For these reasons the ECB will probably initially announce both a money supply target and a direct inflation target. Alongside money supply trends, it will also incorporate other indicators which experience has shown to be closely related to future price trends into its decision-making procedure. Yet here, too, if the central bank is to achieve the inflation targets announced, it requires reliable information on the impact of a change in the various real and monetary variables on the future price level in the EMU, or on the degree to which the ECB must change its base rates in order to prevent deviations from the target. Thus, just as with money supply targets, it is also important in the case of a direct inflation target that the relationships between monetary and real-economic variables are stable and can thus be forecast. Pursuit of an explicit inflation target thus differs from a strategy based on money supply targets merely in that, given the short-term instability of the demand for money, additional indicators of future inflationary trends are consulted, alongside the money supply, in order to evaluate current monetary policy.

Even if the demand for money in the EMU proves insufficiently stable over the short term following the introduction of the euro to permit a pure monetary targeting strategy, changes in the money supply are certain to be a central monetary indicator for the ECB. It is to be expected that the factors mentioned will affect the stability of the demand for money only temporarily. It would therefore be advisable for the ECB to formulate a concrete opinion on the desired rates of monetary growth, whereby it should focus primarily on M1 until financial investment behaviour within the euro region has come into line. Given the prevailing uncertainties, deviations from the target path should not damage the credibility of the ECB, provided the reasons for the deviations are set out in detail.

Other monetary aggregates, such as the volume of lending, which play an important role in the process of monetary creation, are also usually used as an indicator alongside the money supply aggregates. The demand for credit can, however, be expected to change substantively in the wake of the process of the convergence of financing structures. Changes in the volume of lending are therefore subject to similar uncertainties and structural discontinuities as the money supply. Interest rates are also usually considered to be an important monetary indicator. What is decisive here is the level of real interest rates compared with the level considered "normal". Given that real interest rates can only be calculated with the help of an estimation of the expected inflation rate, and there is no means of unequivocally deriving a precise conception of the "normal" level, analysis tends to focus on the differential between long-term and short-term interest rates and on deviations in this differential from its long-term average. However, the interest-rate differential that might be considered neutral for the EMU area as a whole cannot easily be derived from past trends. This is because it was previously distorted in a number of countries by specific inflation and exchange-rate risks; these risks will cease to exist in future. As a first approximation, the situation in Germany might be
trends in the euro region will play an important role in
determining the future course of the business cycle. In the USA the figure was significantly higher.

In addition to the monetary indicators, real-economic trends in the euro region will play an important role in evaluating the monetary stance adopted by the ECB. In particular, the central bank must determine whether cyclical trends contain tensions which could lead to higher inflation. As yet there are still gaps in the database on economic developments in the future EMU as a whole. It would therefore be helpful if the necessary harmonised business-cycle data were provided for the entire currency area as soon as possible.

According to the prognosis presented in the preceding report on the global economy, inflation is likely to remain under the target rate of 2% in 1999. Unit labour cost trends in the euro region as a whole do not indicate a significant intensification of cost pressure. Nor does the slight increase in average rates of capacity utilisation pose a threat of a significant increase in the scope for firms to raise prices. The only marginal rise in primary goods prices will also scarcely serve to accelerate inflation. Against this background an increase in base rates would only be justified in terms of ensuring price stability if the rate of monetary growth in the EMU countries exceeded that appropriate to the growth of potential output, allowing for portfolio restructuring, or if signs emerged of wage increases that could not be reconciled with the inflationary target of 2%.

Fiscal policy

Fiscal policy in Germany and most of the other Member States of the EMU has in recent years been oriented towards meeting the conditions of participation in monetary union set out in the Maastricht Treaty. In the event, 11 of the 12 countries wishing to participate met the reference value for the budget deficit – 3% of GDP – in 1997, the decisive year; Greece was the only country to miss the target. In some countries the deficit could only be forced under the reference value with the "help" of temporary measures, however. This gave a renewed impetus to the debate on the sustainability of budgetary consolidation and on the stability of the euro, all the more so because the reference value for outstanding government debt – 60% of GDP – was considerably exceeded by a number of countries. In particular, the debt ratios in Italy and Belgium are still twice as high as the reference value, and although they have begun to decline, the pace is still relatively sluggish.

This poses the following questions. Does the recently decided participation of Italy and Belgium threaten the stability of the euro? More generally, just how sustainable is the process of budgetary consolidation in the euro region? And what role should be played by fiscal policy within the Union in stabilising the business cycle?

The European Commission and the European Monetary Institute recommended that Italy and Belgium should participate in monetary union from the outset. This decision was based, alongside political considerations, on the great efforts towards budgetary consolidation made by the two countries in recent years. Belgium managed to reduce its budget deficit from around 7% in 1992/93 to just over 2% last year. Italy reduced its deficit from an average of 10% of GDP during the first half of the 1990s to 2.7% in 1997, primarily by means of severe cuts in public spending; most recently, however, also with the help of temporary measures such as the introduction of a "euro tax" for a limited period; the European Monetary Institute put a figure of one percentage point on the cuts in the Italian deficit achieved by such temporary measures. The task of reducing the deficit was also facilitated by the fall in interest rates; the lower interest rates reflected, in addition to low inflation and the narrowing of the budget deficit, not least the expectation of accession to monetary union.

Even so, Italy and Belgium were evaluated very critically in the EMI's convergence report and even more so in the statement by the Bundesbank. The Bundesbank takes the view that serious doubts surround the long-term sustainability of the fiscal position in both countries. It expressed "serious concern" which could only be put aside "if additional, substantial and binding commitments are entered into." From this one could draw the conclusion that the participation of Italy and Belgium poses a substantial risk to EMU. According to calculations by the EMI and the Bundesbank, both countries would have to earn budget surpluses in excess of 2% in the coming years in order to reduce the debt ratio to the Maastricht reference value of 60% within a period of around 10 years. Although there are examples that confirm that a marked reduction in outstanding government debt is possible within a decade, this is conditional not only on a rigorous consolidation policy, but also on a lastingly favourable economic growth trend. There is certainly no sign at present of debt reduction achieving such a pace in either Belgium or Italy. Rather, medium-term fiscal planning and prognoses suggest that without further decisive measures Italy and Belgium will not reach the

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reduce the real value of their debts through higher inflation. Prices in Belgium have increased slightly more slowly than in most other countries. In the past, Belgium has clearly rejected this form of debt reduction; indeed, during the 1990s consumer price increases were only short duration. Given that in countries with a heavy burden of government debt governments, faced with the pressure of interest payments, have not infrequently tended to induce their central banks to expand the money supply excessively. The higher rate of inflation had the same effect as a tax (inflation tax), because it devalued private monetary assets and reduced government debt in real terms. This was only possible, however, for as long as savers suffered from money illusion, that is for as long as the high rates of inflation did not lead to correspondingly higher interest rates. Yet this cannot be assumed to hold in the modern world.

In any case, it is improbable that these two countries (or other EMU Member States) will be willing or able to reduce the real value of their debts through higher inflation. In the past, Belgium has clearly rejected this form of debt reduction; indeed, during the 1990s consumer prices in Belgium have increased slightly more slowly than in Germany (2½% as opposed to 3%). Italy, too, has returned to a greater degree of price stability; last year consumer prices rose by less than 2%. Given that this phase of price stability in Italy has so far been of only short duration – previously price increases had ranged between 4 and nearly 7% – one may remain sceptical as to whether there has been a fundamental change in the inflationary mentality there. Yet the fact that Italy has now placed monetary policy control in the hands of the politically independent ECB is a clear indication of the fact that in Italy, too, government wishes to take its leave of the “inflation tax” as a means of government financing. Moreover, even if individual governments were to attempt to persuade the European Central Bank to expand the money supply excessively, and thus to permit a higher rate of inflation, they are unlikely to be successful. After all, such behaviour by individual countries would lead to criticism and opposition by the others, as they would then also have to bear a higher risk premium in their interest rates. What is important is that governments as a whole support the stability-oriented policy of the ECB. They have unequivocally set the ECB the goal of price stability, and, at the present juncture, the risk that it will fail to honour this commitment is to be seen as slight.

It is undisputed that those countries whose government debt lies above the Maastricht reference value bear a particular responsibility with regard to deficit reduction. Indeed, in future further deficit reduction in these countries will require a particular effort, as they cannot count on a further decline in interest rates: the risk premiums built into national interest rates have already fallen sharply in anticipation of membership in EMU. Given that within monetary union interest rates will not depend on national specificities – or will do so only to a marginal extent – in future even intensive efforts by governments in these countries will scarcely be "rewarded" with lower interest rates by way of a lower risk premium. This means that in future care must be taken to ensure that the pace of budgetary consolidation is sufficient to bolster confidence in a sustained consolidation, but that, on the other hand, cuts are not so abrupt as to strangle economic recovery.

Both the convergence reports of the European Monetary Institute and the statement by the Bundesbank contain marked references to the need for further action in other countries, too, regarding the criterion of achieving a lasting sustainable fiscal position. This refers to those countries whose deficit as a proportion of GDP was only slightly, or no lower than the reference value stipulated in the Maastricht Treaty. Of the future Member States of the EMU, this affects – alongside Italy – Austria, France, Germany, Portugal and Spain. According to estimates by the EMI, not only Italy, but also France only managed to meet the reference value for the budget deficit with the help of so-called one-off measures. Having said this, in none of the future Member States will the end of these temporary effects mean that deficits will rise once again above 3% of GDP, as some commentators have feared. There are several reasons for
this. Generally speaking the fiscal policy stance remains oriented towards consolidation, even if the degree of restriction has eased slightly. On top of this, the budgetary position in all the participating countries is now benefiting from the improved economic trend, whereby interest rates will remain low. The fact that the impact of the one-off measures will come to an end does mean, however, that – unless additional consolidation measures are implemented – budget deficits will narrow only slightly on the previous year. In 1997 the (weighted) average deficit of the participating countries fell by around 1¾ percentage points of GDP to 2¼%. In the current and the coming year the decline in the deficit as a proportion of GDP is expected to be only between a quarter and one half of a percentage point in each case. Given consolidation at this pace, in 1999 the deficit in half of the EMU countries (Italy, France, Germany, Austria, Portugal and Spain) will be around 2% or higher. Yet under the Stability and Growth Pact the medium-term goal – given a normal state of the business cycle – is a balanced budget or even a slight surplus. This suggests that in many EMU countries, including Germany, further efforts will be necessary to reach this target.

If, finally, it is recalled that the deterioration in the demographic structure will, if social policy legislation remains unchanged, impose a considerable additional burden on public sector budgets over the longer term – in other words that future pension entitlements constitute a sort of "invisible government debt" – it must be doubted whether the fiscal position of governments in the EMU area can be considered lastingly consolidated. Some countries, including Germany, have taken steps to ensure the long-term sustainability of the statutory pension system. The steps taken are as yet insufficient, however.

Because public finances have not yet been lastingly consolidated, European Monetary Union commences with a mortgage around its neck. Yet the governments of the EMU countries have an opportunity to "pay off" this mortgage, namely by rigorously pursuing medium-term fiscal consolidation, while at the same time fundamentally reforming their systems of provision for the elderly.

If, following accession to monetary union, countries ease back in their efforts at consolidation, in spite of the Stability Pact, they run the risk of their budget deficits rising over the 3% ceiling once more in a future cyclical downturn. The built-in stabilisers of the public finan-

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10 The EMI put the quantitative effect of these so-called one-off measures on the deficit ratio in 1997 at 1% of GDP in Italy, 0.6% in France and Finland, 0.5% in Austria, 0.3% in Belgium, 0.2% in Germany and Portugal and 0.1% in Spain.

11 See also the Institutes' Autumn Report, 1997.
Wage policy

During the past two years collective bargainers in Germany and other European countries, faced with the sharp rise in unemployment, have made considerable efforts to improve the labour market situation. Following the “wage shock” in 1995 – when German wages were increased by almost 5%, coinciding with strong appreciation of the D-Mark – which led to a marked intensification of rationalisation efforts on the part of companies, the pace of wage growth has moderated perceptibly. During the current year collectively agreed wage rates in Germany will increase by just 1.7%. In addition, progress has been made in rendering labour markets more flexible and collective agreements covering entire industries and regions more open for individual solutions, particularly in east Germany.

Even so, the situation on the German labour market remains unfavourable; employment continued to fall until the autumn of 1997. This has raised doubts as to whether wage moderation is the appropriate way to achieve higher employment, and has led to increasingly vocal calls from within the trade unions for an “end to restraint”: instead of practising wage moderation, the scope for income redistribution should be fully exploited, thus bolstering purchasing power. This, it is argued, would improve sales prospects and induce firms to invest more and take on additional workers.

However, the unfavourable employment trends of recent years do not constitute proof of the ineffectiveness of wage restraint; without such moderation, the situation on the labour market would probably have been even worse. Experience suggests that following a "wage shock", such as that in 1995, it takes time to regain lost confidence. On top of this, a number of specific factors have contributed to the sluggish reaction by employment to the economic recovery: for instance the flexibility of working time and the associated agreements to maintain employment levels have initially reduced the short-term necessity for additional recruitment, as more can be produced with the same number of employees and the same capital stock. Moreover, the impact of the restraint exerted in collectively agreed wage rates was reduced by further increases in indirect labour costs, resulting, in particular, from the increase in social insurance contributions.

The call for full exploitation of the scope for income distribution is based on the concept of productivity bargaining, i.e. the general view that real wage increases that match the growth of labour productivity are neutral in employment terms. This concept was originally developed as a "pay guideline" for a wage growth that conforms to the requirement of price stability in a situation of full employment. Accordingly it cannot be directly applied to phases characterised by underemployment. In periods of persistent underemployment, the scope for redistribution is substantially smaller than is the case when full employment prevails. In particular, substantial differences exist with respect to the rate of productivity growth to be applied in the two situations. Some components of productivity growth, particularly those resulting from past productivity gains achieved by shedding labour, should not be taken into account when calculating the current scope for distribution,
although this would be perfectly conceivable in a situation of full employment and a shortage of labour. Otherwise the higher degree of underemployment will become more and more entrenched. Thus in periods of underemployment changes in macroeconomic unit labour costs or the "real scope for distribution" calculated on the basis of productivity increases cannot constitute appropriate yardsticks for determining future wage growth.

The current unit labour cost trend is an important indicator for other issues, however. If unit labour costs increase in line with the inflation target or slightly below it, this indicates that current wage trends cannot pose a threat of cost-push price increases which could force the central bank to intervene. In this sense, such a moderate wage growth is indeed currently to be observed, and for this reason a degree of optimism is justified that the economic recovery will proceed largely without tensions. If unit labour costs, calculated in a common currency, rise more slowly than in a country's trading partners, this is also an indicator that the price-competitive position of the domestic economy is improving against the rest of the world, and that gains in market share can be expected. This has recently been the case in Germany, whereby both a more moderate pace of wage growth and a nominal depreciation of the D-Mark, particularly against the dollar, have contributed to this real depreciation. This improvement in price competitiveness probably explains around one-third of last year's export growth; the remaining two-thirds are due to faster growth of world trade.

Comparisons of macroeconomic unit labour costs, as presented in official statistics, cannot be used to answer the question whether, in the past, wage trends have led to an increase in structural unemployment – i.e. that proportion of unemployment that remains at normal levels of potential capacity utilisation – or what rate of wage growth is appropriate to reduce this type of unemployment. This is true of both comparisons over time and cross-national comparisons. If, for example, the collectively agreed wage rates of low-skill workers rise faster than their productivity, their employment would be reduced. In such a case both the average wage and the average productivity of the economy increase. Average unit labour costs remain constant. Conversely, if, due to wider wage differentials, more jobs are created in low-pay areas, the average wage and the average productivity of the economy decline, while unit labour costs remain constant. In this latter case no one has become poorer, despite the lower average wage. In fact, everyone has gained: because the former unemployed are now contributing to total output, this is higher both in absolute and per capita terms.

Numerous studies have shown that a substantial proportion of unemployment in Germany and in Europe is structural in nature. To a significant extent this is likely to be due to inadequate wage differentiation compared with productivity differentials. In addition, the incentives to take up employment in low-paid jobs are significantly reduced by high overall marginal "tax" rates: on the one hand such employees have to pay taxes and social insurance contributions, on the other, they lose entitlement to social transfers. The fact that in Germany large numbers of jobs are currently being created at wage levels below the threshold for social insurance contributions is clear evidence that the demand curve of employers for labour is negatively price elastic, just like other demand curves. Thus the chances are good that a generalised policy of wage restraint, in conjunction with greater pay flexibility and reforms of the taxation and social security systems, will enable more jobs to be created. Recently the call for full exploitation of the scope for income distribution has also been justified by the necessity of "harmonising" wage trends within European Economic and Monetary Union. Given that within the EMU differences in cost trends can no longer be offset by changes in exchange rates, shifts in relative costs between the participating countries would lead to job losses in those countries in which wage growth was less moderate. Consequently, wage moderation in a leading country such as Germany would, it is argued, inevitably lead to a general "race" to cut wages within the monetary union; this raises the danger of a deflationary spiral with serious negative consequences for growth and employment throughout the EMU area. Yet the danger of a deflationary process in the monetary union appears marginal, provided monetary policy adheres strictly to its orientation towards potential output. Although friction cannot be precluded in the short term, a counter-weight will rapidly develop in the form of a rise in the real money supply. This does require, however, that the ECB retains its monetary policy orientation towards its medium-term price norm, even in situations when current inflation is below the norm. If, on the other hand, the ECB were to adjust its "target inflation rate" downwards, the "built-in stabiliser" of monetary policy would be prevented from functioning.

Finally, it has also been objected that moderate wage increases, which lag behind current productivity growth, amount to a "beggar-thy-neighbour" policy vis-

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13 See the arguments presented by the majority of the Institutes in the Autumn Report 1997.

14 Empirical micro- and macroeconomic studies confirm that age restraint and great pay flexibility are associated with the creation of positive employment effects.
employment throughout the entire currency area. Yet this line of argument negates the positive effects of competition. It is correct to observe that within the EMU differences in cost and price trends between the countries can no longer be offset by means of exchange rates. Just as in the past, shifts in cost and price relations between the countries may occur in future; this means a change in real exchange rates, which clearly can also occur with respect to countries outside the EMU. Yet if one were to attempt to prevent changes in real exchange rates within the Union, that is to bring about uniform unit labour cost trends, one would once again have to address the question as to the appropriate rate of productivity growth to be imputed in each case. In view of the very high average level of unemployment in the EMU area and the differences in the degree of underemployment between the countries, this poses serious problems.

There can be no doubt that the EMU sets new parameters for collective pay bargaining. The transfer of responsibility for monetary policy to a supranational institution, the European Central Bank, and the irrevocable fixing of exchange rates remove a means of shock absorption previously used by a number of countries. Inappropriate behaviour by collective pay bargainers, for instance, can no longer be corrected by inflation, whose impact on employment is then offset by means of currency depreciation. This approach has not played an important role in Germany, however, where, on the contrary, in some years the positive impact of a relatively moderate pay trend was nullified by abrupt revaluation of the D-Mark. In some years, most recently in 1995, excessive wage growth coincided with currency revaluation, leading to a sharp fall in employment. Seen in this light, the common currency will make it easier for German pay bargainers to orient wage growth towards employment-policy considerations.

It is to be concluded from the above that the strategy of wage restraint should be continued in both Germany and in those EMU countries in which unemployment is high. The greater the extent to which wages are differentiated by skill level, sector and region, and the more they are susceptible to the impact of asymmetric shocks, the greater will be the success in reducing unemployment throughout the entire currency area.

A different view

From its analysis of economic developments over recent years, the German Institute for Economic Research (DIW, Berlin) arrives at different conclusions than the other Institutes regarding the division of tasks between economic policymakers, both in Germany and in the European Monetary Union. 1996 saw a fundamental turnaround in wage trends in west Germany. Following the excessive pay rise in the metal-working sector and the appreciation shock that had occurred a year earlier, collective pay bargainers were forced to step forcefully on the brakes in the light of the renewed sharp rise in unemployment. Whereas in 1995 gross wage and salary income per working hour, i.e. the nominal gross hourly wage including indirect labour costs, had risen by almost 5%, the rate of growth fell in 1996 to 2.5% and in 1997 to as low as 1.5%. These represented by far the lowest rates of nominal wage growth recorded in the history of the Federal Republic.

Moreover, this led to the smallest growth of real wages in west Germany since the end of the Second World War. In gross terms, real wages remained constant over the two years; in net terms, i.e. allowing for statutory deductions, they actually declined. This was in response to a call, expressed in many quarters, one that is frequently seen as a necessary condition for more employment, namely that real wage growth should lag perceptibly behind the growth of labour productivity, in order to reduce the relative price of labour with respect to capital, thus making more jobs profitable. During the two previous years real wages in west Germany have lagged almost six percentage points behind productivity growth. This is far more than had been called for by serious proponents of the hypothesis that it is the relative price of labour compared to capital that is responsible for the level of employment. Although actually measured productivity growth was usually adjusted for an "employment component" or "redundancy productivity", this was not to such a degree that the recommendation for real wage restraint derived from it would come close to the actual figure achieved in the past two years. This marks the continuation, at a high level, of a trend that had begun in west Germany as early as the start of the 1980s: since then real wages have almost consistently lagged behind the growth of productivity; earned income and adjusted wages as a share of national income have fallen to their lowest values in post-war history.

Despite the extreme real wage restraint in the past two years, the fall in employment had merely been arrested by the end of 1997, with no increase in the number in paid employment. The volume of working hours, too, declined by more than 2% in the two-year period. The fact that the number of jobs has not yet risen in the wake of real wage moderation is generally explained by the majority of the Institutes by arguing that short-term successes are not to be expected, because such a policy requires a "steady hand". Employ-
whereas gross real wages fell "merely" by half a percentage point, after allowing for taxes and contributions the decline amounted to almost 2.5%.

In other words, the delay in expanding the level of employment in the wake of real wage moderation leads to a deterioration in the conditions for the creation of additional jobs. Firms, whose productive plant is already operating under capacity, are confronted with an additional decline in demand and profitability, precisely because they themselves have not immediately opted to recruit additional labour. This, in turn, serves to confirm them in their wait-and-see attitude. The level of employment cannot be expected to rise without a cyclical recovery, that is without rising demand and profitability; this is the upshot of the analysis of economic trends in 1996 and 1997.

The analysis given above only applies, however, to a largely closed economy. In an open economy, that is one in which exports account for a substantial proportion of output, the situation, at least in the short term, is rather different. If the increase in nominal hourly wages lags behind the rate of growth of labour productivity, because, despite wage moderation, employers do not react to a sufficient extent in rendering production more labour intensive, unit labour costs fall. This is what happened in 1996 and 1997. A decline in unit labour costs – or a smaller increase than in a country's trading partners – improves the international competitive position of an economy because firms, due to the decline in their relative costs, can offer their products on world markets at comparatively favourable prices and thus expand their market shares, or, at unchanged prices, can earn higher profits.

However, such "real depreciations" of national currencies have in the past only ever led to higher market shares on world markets or to higher profits in the short run. From a medium- to long-term perspective, the advantages of a smaller increase in the costs of labour, which is an immobile factor of production, have repeatedly been offset by appreciation of the domestic currency or depreciation of foreign currencies. The empirical evidence for this can be readily produced. However, this compensation was in no way "perfect". Frequently, an "overshooting" of currency appreciation actually more than offsets the advantage enjoyed by the country, i.e. reversed it, while on the other hand more than offsetting the disadvantages. This was one of the main reasons why central banks began, shortly after the transition to floating exchange rates at the start of the 1970s, to intervene repeatedly in the processes of exchange-rate determination on the foreign-exchange markets.

The exchange-rate crises of 1992 and 1995, for instance, were characterised by such an overshooting of D-Mark appreciation. Only after the gradual normalisation of the D-Mark exchange-rate in 1996 was Germany once again able to take advantage of its lower unit labour costs. In addition to the nominal appreciation of the currency, unit labour costs measured in domestic currency declined both in absolute terms and vis-à-vis its trading partners, leading to an extremely sharp real depreciation of the D-Mark. All observers are agreed that this real depreciation is the main reason for the export boom that Germany has experienced since the start of 1996. This boom has taken the sting out of the demand weakness resulting from domestic trends. Because the additional foreign demand means that the profits of exporting companies and those competing with importers are growing strongly, domestic demand, too, has been bolstered; either by way of firms' distributed profits, and thus by way of a component of private consumption, or by a recovery in investment by the firms that have benefited most. Yet this has been insufficient to compensate for the weakness of private consumption as a whole. Consequently, investment in plant and equipment has expanded far more weakly than in comparable cyclical phases in the past, despite the extraordinary export boom. Only in the course of the current year has the export boom gradually begun to exert a stimulatory effect on domestic demand and investment. It was real wage moderation that fundamen-
tally distorted the pattern, expected by many to occur at an early stage, of a rapid recovery of domestic demand in the immediate wake of the export boom, one that would make its effects felt on the labour market.

The experiences with floating exchange rates show that an improvement in the international competitiveness of an economy cannot be relied upon to bring about a lasting stimulation of employment growth. The same applies within a monetary union. In this case, though, there are no exchange rates between the member countries to offset divergent cost and price trends. Consequently, the rates of growth of unit labour costs must be brought into line, if foreign-trade imbalances between the participating countries are to be avoided. Such imbalances can occur between countries participating in a monetary union just as between countries exercising monetary sovereignty; the symptoms of the external imbalances are different, however. Given flexible exchange rates, or a system of fixed but adjustable exchange rates, countries whose competitiveness is relatively low experience a depreciation spiral or the loss of foreign-exchange reserves; in a monetary union, by contrast, external imbalances, i.e. sustained competitive advantages of one partner compared with the others, manifest themselves in persistent balance of payments deficits, loss of market shares and higher unemployment in the disadvantaged countries. If no attempt is made to correct the competitive advantages, that is the real exchange rate is not constant over the longer term, government transfers will sooner or later be necessary in order to finance the current account deficits, as private investors will no longer be willing to perform this task to the required extent. If such transfers are not forthcoming, the disadvantaged regions will become impoverished. The consequences of German unification, which the Institutes have consistently characterised as the result of excessive wage growth in east Germany, and thus a divergence of unit labour costs, clearly show that a monetary union offers no protection against such disequilibria.

Those European countries which for many years had pegged their currency at a fixed exchange-rate to the D-Mark were well aware of the necessity of adjusting to the conditions of the reserve-currency country; this they did by orientating wage growth strictly to productivity, allowing for the target inflation rate of the reserve-currency country. The figure entitled "Unit labour costs under fixed exchange rates" shows that, following the transition to a fixed exchange rate, all of the core countries of the European Monetary Union oriented policies strictly to the D-Mark "anchor" in this way. The only exception to this is the Netherlands, which at times pursued a strategy of undervaluation vis-à-vis the D-Mark. During the 1980s the rate of growth of unit labour costs that had to be achieved within the fixed-rate block was around 2%. In other words, in all these countries nominal wage increases were permitted to exceed domestic productivity growth by just 2%, if disequilibria between the domestic currency and the D-Mark "anchor" were to be avoided. The actual rate of growth of unit labour costs of around 2% within this currency area was compatible with the inflation target pursued by the Bundesbank of 2%.

In recent years unit labour costs in Germany have been far below the former "anchor rate" of 2%, and even the countries in the fixed-rate block were unable or unwilling to follow it. This has already led to a marked undervaluation of the D-Mark, one that will be maintained when, on 1 January 1999, exchange rates within the euro area are irrevocably fixed. This can be concluded from the figure "Unit labour costs in Europe", coupled with the assumption that nominal exchange rates will not change between now and the start of the monetary union. If the other countries cannot adjust to the new norm of the declining or at least constant unit labour costs set by Germany, they will lose market shares to German firms over the medium term. In such a case similar consequences are to the expected as was occurred following German monetary union. If, on the other hand, the other countries of the euro area follow the German example, the inflation target of the European Central Bank is in danger of not being met, namely of being undercut.

In the extensive, largely closed economy that is the euro currency area, prices will follow unit labour costs very soon, as has been the case in Europe in the past. The price norm of 2% cannot be maintained given constant, not to mention declining unit labour costs. If the European Central Bank pursues a policy of monetary targeting, short-term interest rates will automatically be lowered if the inflation target is undercut; this would stimulate the economy and thus constitute a counter-weight to cost inflation, just as conversely, according to the same concept, interest rates are increased if the inflation target is exceeded. Yet it is a moot point whether such a symmetric monetary policy would be sufficient to avoid a deflationary trend. In any case, monetary policy is certain to have an asymmetric effect when short-term interest rates, as in Japan, approach the value of zero. In such a case, a deflationary impulse from wages can no longer be countered by the monetary authorities with interest-rate cuts, because nominal interest rates cannot be negative in a market economy. In such a situation the only possibility of establishing a counter-weight is for fiscal policy to stimulate demand; again, this is currently occurring in Japan. On top of this comes the fact that, as has been the case with the Bundesbank, the European Central Bank will not pursue a pure con-
cept of monetary targeting. Yet, it remains doubtful whether, even given an interest-rate-oriented policy or direct inflation targeting, monetary policy will in fact meet the need to react symmetrically to inflation and deflation. In 1997, for example, a year in which unit labour costs in Germany fell by almost 2%, the Bundesbank raised interest rates instead of cutting them.

In exactly the same way as competitive currency devaluation in the context of floating or adjustable exchange rates, a race between countries for real devaluation, i.e. to cut costs furthest, is at best a zero-sum game in which, at the end of the day, not everyone can win. All countries cannot simultaneously devalue in real terms. A reduction in the rates of growth of unit labour costs is appropriate for all countries for as long as the target rate of inflation has not been met. Absolute cuts in unit labour costs, on the other hand, are dangerous, because they threaten to lead on to deflation. The attempt by wage bargainers to increase "purchasing-power" by means of wage increases that exceed the growth of productivity plus the target rate of inflation is just as hopeless, with a view to a lasting improvement in the labour market situation, as the attempt to raise profits by means of wage increases below the sum of productivity growth and target inflation. Finally, international comparative studies on the relationship between skill structures and unemployment show that in those countries in which overall unemployment has risen sharply the increase in low-skill unemployment as a proportion of total unemployment is small in comparison to countries that have experienced only a small rise in overall unemployment or even a decline. This means that skill structures clearly do not make a decisive contribution to explaining the rise in overall unemployment.  

Similar considerations to those applying to competitive wage cuts apply in the case of competitive tax cuts or to the race between countries to achieve the lowest level of social benefits. At the end of the day nobody can win such races. Rather, such forms of competition bring with them the danger that governments abandon their responsibility for ensuring a satisfactory – defined in terms of growth opportunities – provision of public goods; it would also prevent them reacting appropriately to unique historical events, such as German unification. Because in many cases the tasks performed by government consist of creating and maintaining a "capital stock" that generates yields only over the longer-term – examples include investment in infrastructure and education – the negative repercussions of competitive tax reductions emerge to their full extent only in the medium to long term. The consequences can then only be corrected at high cost. It is just as necessary to remove inefficiencies in the provision of goods, and thus reduce costs, in the public sector as in the private sector. Moreover, it is necessary to reflect constantly on the optimal mixture of the public and private provision of goods and services, because the solution that may have been "correct" at one time may not remain optimal in the wake of technical progress. However, in weighing up such questions, the consequences of a reduced provision of public services must be taken into account, not merely passed over with a mere reference to the possibility of an increase in the supply of private services that may follow cuts in taxation. Consequently, an international regulatory framework is required to limit competition to implement the biggest tax cuts, just as in the case of competition to provide the highest subsidies, if national governments are to remain in a position to perform their central tasks.

Competition between countries to cut costs is frequently seen as analogous to competition between companies, and therefore as something to be welcomed. This view ignores the fact, however, that competition between companies is a competition to achieve the highest productivity in the context of – for each individual company – constant prices for inputs and for labour and capital. Such competition is constructive and innovative, as it aims to raise efficiency and, where successful, generates higher overall incomes. Competition between countries to cut costs is not innovative, because it does not occur within a framework of conditions that is same for all, such as a uniform price for labour of equal scarcity; consequently it is not focused on raising productivity. In the final analysis, competition in the area of wages or taxes merely makes everybody poorer if it is based not on innovation, but purely on cost cutting.

15 Nickell, Bell (1996), Would cutting payroll taxes on the unskilled have a significant impact on unemployment? Snower, Dechesa (eds), Unemployment Policy, Government Options for the Labour Market, CEPR, 1996, pp. 309-312.
Figure 4
Unit Labour Costs\(^1\) at Fixed Exchange Rates

1) Gross wage and salary income with respect to real GDP, in respective national currency; rate of change on previous year. — 2) High degree of exchange-rate stability against the D-Mark in Austria since 1981, the Netherlands since 1984, in Belgium since 1986, in France since 1988.

Sources: OECD; Federal Statistical Office; German Bundesbank; calculated by the participating institutes; 1998 and 1999: prognosis by the Institutes.

Figure 5
Unit Labour Costs in Europe

1) France, the Netherlands, Belgium and Austria; weighted using real GDP expressed in US-dollars. — 2) Italy, Great Britain, Spain, Portugal, Greece, Denmark, Sweden, Finland, Ireland; weighted using real GDP expressed in US-dollars.

Sources: OECD; Federal Statistical Office; German Bundesbank; calculated by the participating institutes; 1998 and 1999: prognosis by the Institutes.