German Economic Trends: Cyclical Setback

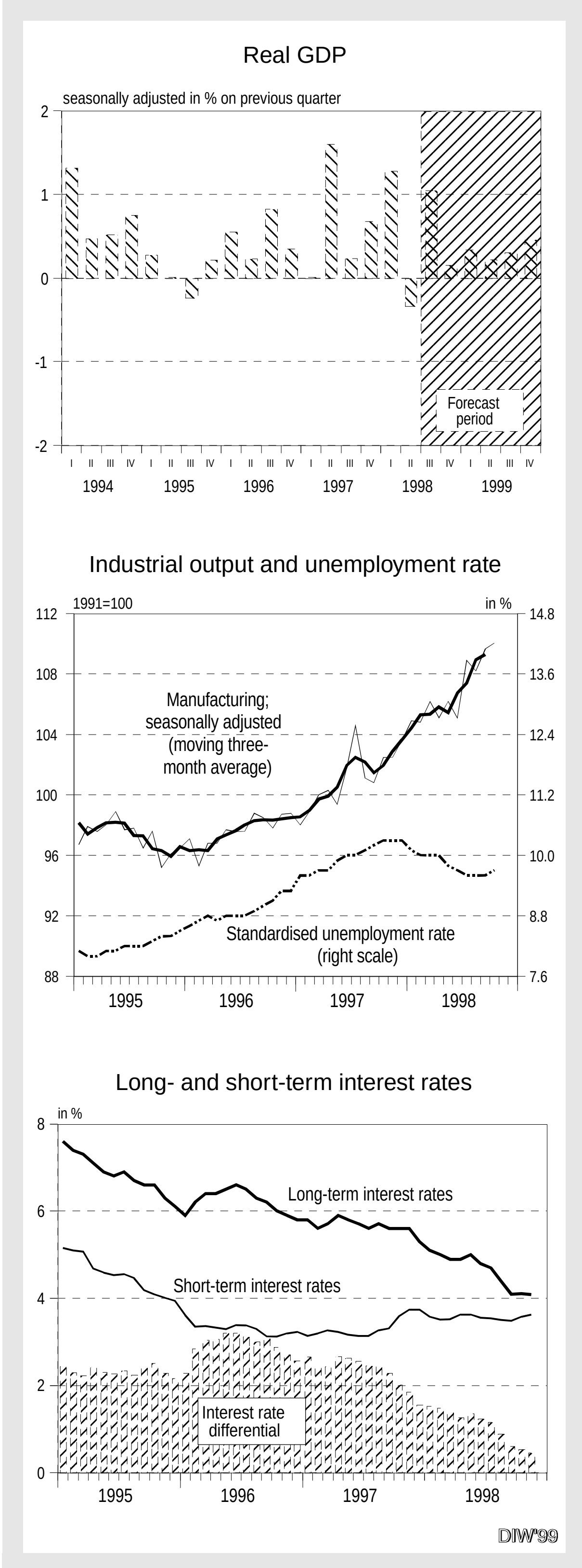
Over a period of more than two years, macroeconomic developments in Germany were characterised by rapid export growth. A central factor behind this trend was the steady fall in the real external value of the D-Mark to the spring of last year; the decline amounted to around 11% on the mid-1995 level. Low unit labour costs, reflecting a policy of wage restraint, have contributed to the improvement in international competitiveness; they have fallen by 3½% since their most recent peak at the end of 1995. However, in the wake of the crises in Asia, Russia and Latin America, which have led to a renewed slight increase in the real external value of the D-Mark, goods exports began to show significant signs of a weakening in the first half of last year; in the second half of the year – earlier than had been widely expected – they fell sharply.

According to calculations by the Federal Statistical Office, in the course of 1998 domestic demand offset the loss of foreign demand to a considerable extent. However, according to the same source, around two-thirds of economic growth in 1998 was due to a rise in inventories. According to preliminary calculations by the DIW, domestic expenditure on goods rose by 2.5% and real GDP by 2.7%. At 1.9%, GDP growth in eastern Germany was once again significantly lower than in west Germany (2.8%). East Germany is thus falling behind even further.

In terms of annual average, the economic figures for 1998 were highly satisfactory (cf. figure 1). Yet analysis of the evolution of current figures clearly indicates the cyclical setback suffered by the German economy in the second half of the year as a result of external economic trends. Moreover, the most recent indicators suggest that exports cannot be expected to recover in the near future. Nor will this trend be offset by a corresponding rise in domestic demand. According to the ifo Institutes's business cycle test (cf. figure 2), business expectations have deteriorated perceptibly. Incoming orders to manufacturing industry from abroad have been declining since the summer of 1998; during the past two months domestic incoming orders, particularly for investment goods, have also declined (cf. figures 3 and 4). The first signs of an impact on the labour market are already visible; at the end of 1998 unemployment ceased falling, even allowing for the effect of the wintry conditions.

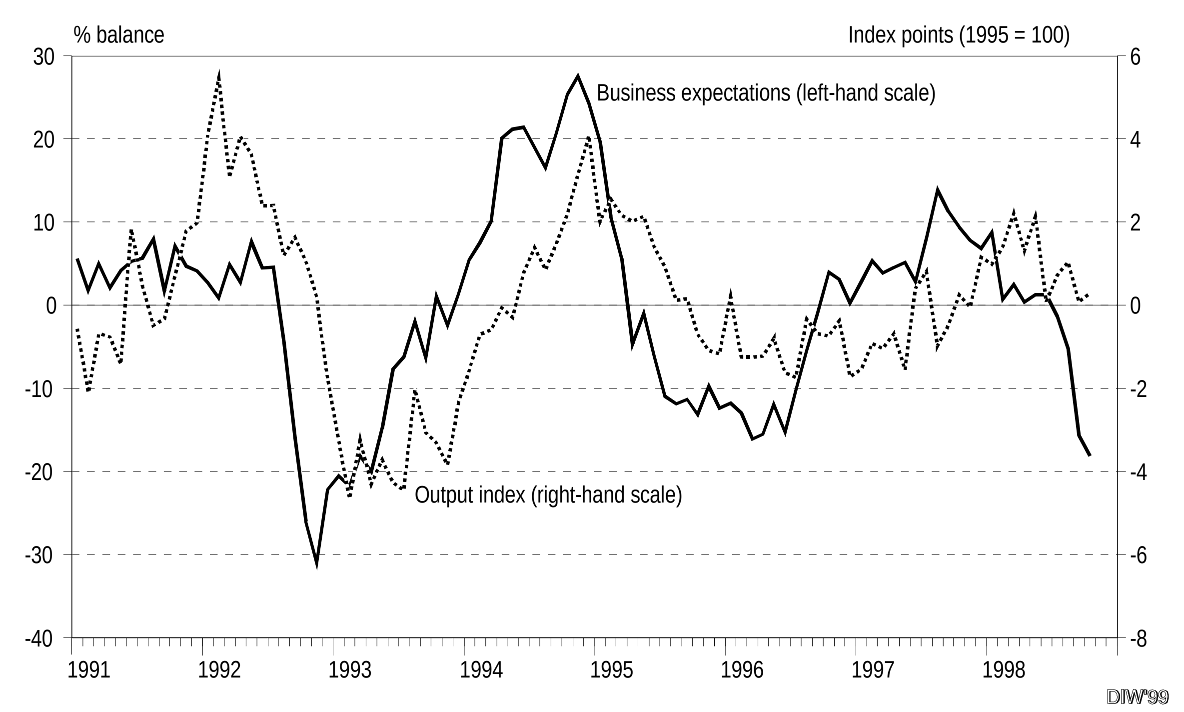
Indeed, given the global weakening of economic growth, a further decline in exports must initially be

Figure 1
Germany



Sources: OECD, DIW calculations and forecast.

Figure 2
Business Expectations[1)] and Output[2)]



1) ifo Institute's business cycle test for west Germany, expectation of business prospects for manufacturing industry; deviation from Hodrick-Prescott (14400) trend. — 2) Output index of manufacturing industry in west Germany; adjusted for seasonal influences and number of working days using the Berlin Method (BV4); deviation from Hodrick-Prescott (14400) trend.
Sources: Federal Statistical Office; ifo Institute Business cycle test; DIW calculations.

expected. This year will reveal the disadvantages of the fact that in recent years the cyclical recovery in Germany has been almost exclusively on the back of exports, whereas little attention has been paid to domestic demand. Although 1999 will see a significantly more rapid increase in real disposable income and in private consumption – 2½% compared to 1½% in 1998 – this increase will be insufficient to offset the losses on export markets to any considerable degree. At 1.4%, real GDP growth in 1999 will be only around half that in 1998. Output growth in eastern Germany (0.8%) will again be weaker than in west Germany (1.5%). There is thus still no sign of a renewed catching-up process.

Weaker demand and the decline in industrial capacity utilisation that has already set in will induce business to revise its investment plans downwards in 1999 (cf. table 1). The industrial sector, which during the past two years had been the motor behind the economic upturn in Germany, will no longer exert an expansionary impulse this year, with the investment goods sector suffering most, given its heavy export dependence.

This year, too, inflation will be very subdued. Although in the latter course of the year the decline in import prices is likely to come to an end, and unit labour costs will rise once more for the first time since 1995, their increase will remain moderate, at less than 1%.

Corporate profitability will again improve this year, although not to the same extent as in recent years. Yet gross wage and salary income as a share of national income, which reached a post-war low in 1998, will decline further. However, in 1999, in contrast to earned income, corporate revenue will be subjected to a slightly higher tax burden, so that business income will be slightly lower than in 1998.

No further improvement on the labour market

Overall, the economic policy pursued by Germany in recent years, which relied one-sidedly on export growth, has borne little fruit on the labour market. Unemployment peaked at the end of 1997 at 4.5 million in Germany as a whole. The fall in unemployment in the course of 1998 by a total of around 400 000 was due pri-

Table 1

Real Investment[1)] in Buildings in Germany

	1997	1998	1999	1997	1998	1999
	DM billion			% change on the previous year		
Housing construction	212.1	202.2	203.1	–0.7	–4.7	0.4
West Germany	162.0	157.7	159.5	–0.9	–2.7	1.2
East Germany	50.1	44.6	43.6	–0.1	–11.0	–2.3
Commercial buildings	120.3	114.0	113.1	–2.4	–5.3	–0.8
West Germany	82.3	80.2	80.4	–1.1	–2.5	0.2
East Germany	38.0	33.8	32.7	–4.9	–11.3	–3.0
Public construction	53.9	52.3	51.8	–9.0	–3.0	–0.9
West Germany	35.3	33.8	33.4	–9.0	–4.1	–1.3
East Germany	18.6	18.4	18.4	–9.0	–0.8	0.0
Total investment in buildings	386.4	368.5	368.0	–2.5	–4.6	–0.1
West Germany	279.6	271.7	273.3	–2.1	–2.8	0.6
East Germany	106.8	96.8	94.7	–3.5	–9.3	–2.1

1) At 1991 prices; on national accounting definitions.
Sources: Federal Statistical Office; 1998 DIW estimate; 1999 DIW forecast.

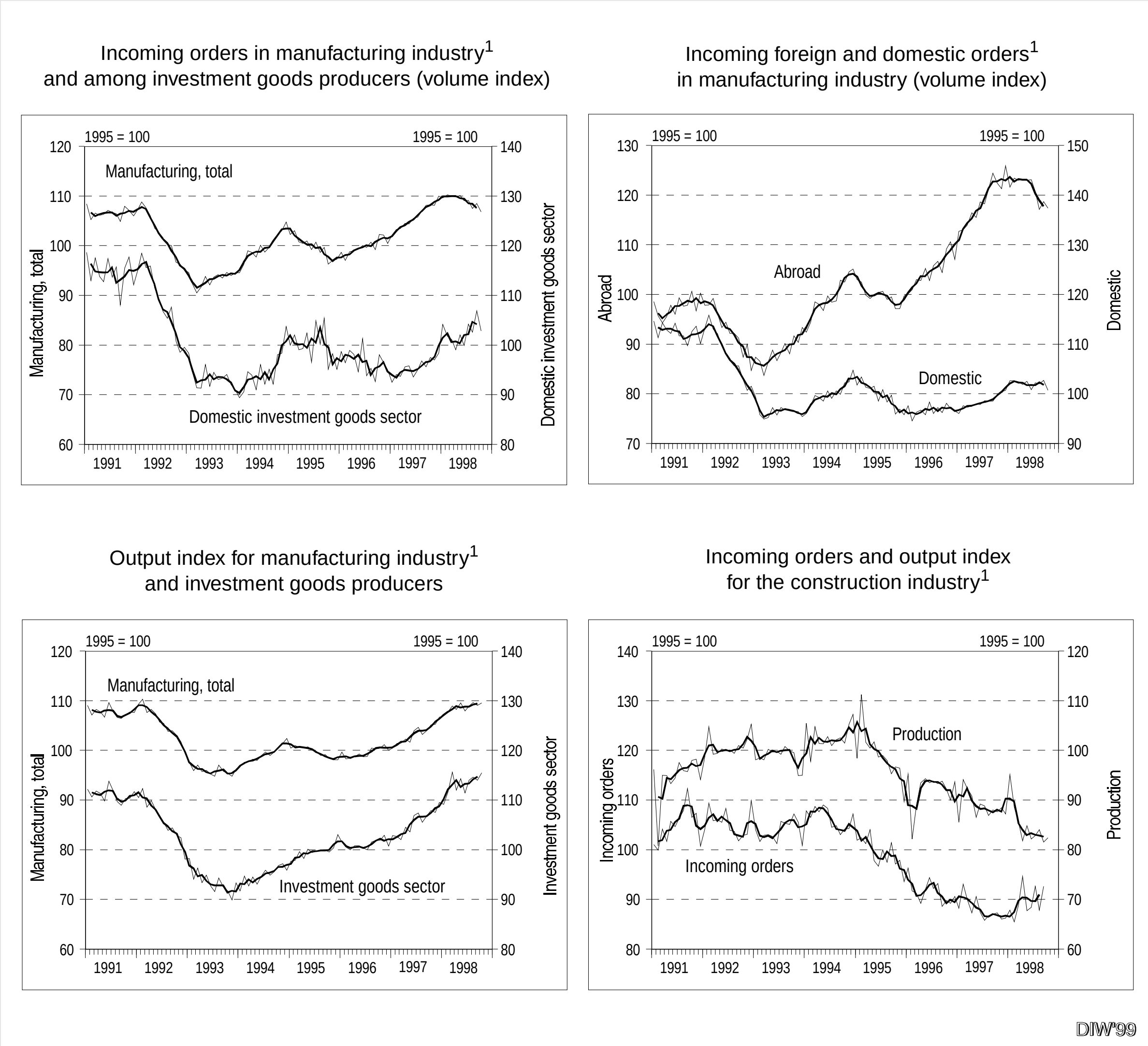
marily to additional labour market policy measures: at the end of the year 100 000 more people were participating in further training and 400 000 in job creation measures than at the start of the year. Not until the middle of 1998 did this also help bring about a rise in employment – for the first time since German monetary union in the summer of 1990. Yet given the cyclical trends expected, a renewed decline in the level of employment must be expected in the coming months. In industry employment began to decline as early as the autumn of last year. It is to be expected, however, that the overall decline in employment will remain limited in view of the lack of labour reserves held by firms: it is more likely that overtime will be cut back and greater use made of collective provisions for a more flexible organisation of weekly working time. Even so, by the end of this year employment is expected to have fallen by around 125 000. Unemployment, though, will rise by only 70 000, due to a decline in labour supply reflecting demographic trends. On annual averages unemployment in Germany will, at 4.2 million, be 100 000 lower than in 1998; the unemployment rate in west Germany will fall to 9.3% (1998: 9.4%) and in east Germany to 17.9% (1998: 18.4%).

Government budgets: renewed rise in budget deficits

Last year fiscal policy was once again dominated by the goal of budgetary consolidation. The total government deficit, including the social insurance system, fell from 2.8% to 1.9% of GDP, substantially below the ceiling imposed by the Stability Pact (3%). The reasons for this development are primarily to be found on the spending side; at 1.5% public spending again rose far more slowly than nominal GDP. At more than 3%, on the other hand, revenue growth lagged only marginally behind that of the macroeconomic tax base.

Unlike in the two previous years, it will not prove possible to further reduce the budget deficit in 1999. According to the estimates presented here, the deficit will rise to DM 75 billion (1998: DM 70 billion), equal to 2.0% of GDP. Spending will grow slightly more rapidly; revenue somewhat more slowly than nominal GDP. The dichotomy between the financial position of German government and that of the social insurance system will continue to widen. While the deficit posted by local, state and central government will climb from DM 90 to DM 103 billion, the social insurance funds will record an

Figure 3
Economic Trends in West Germany

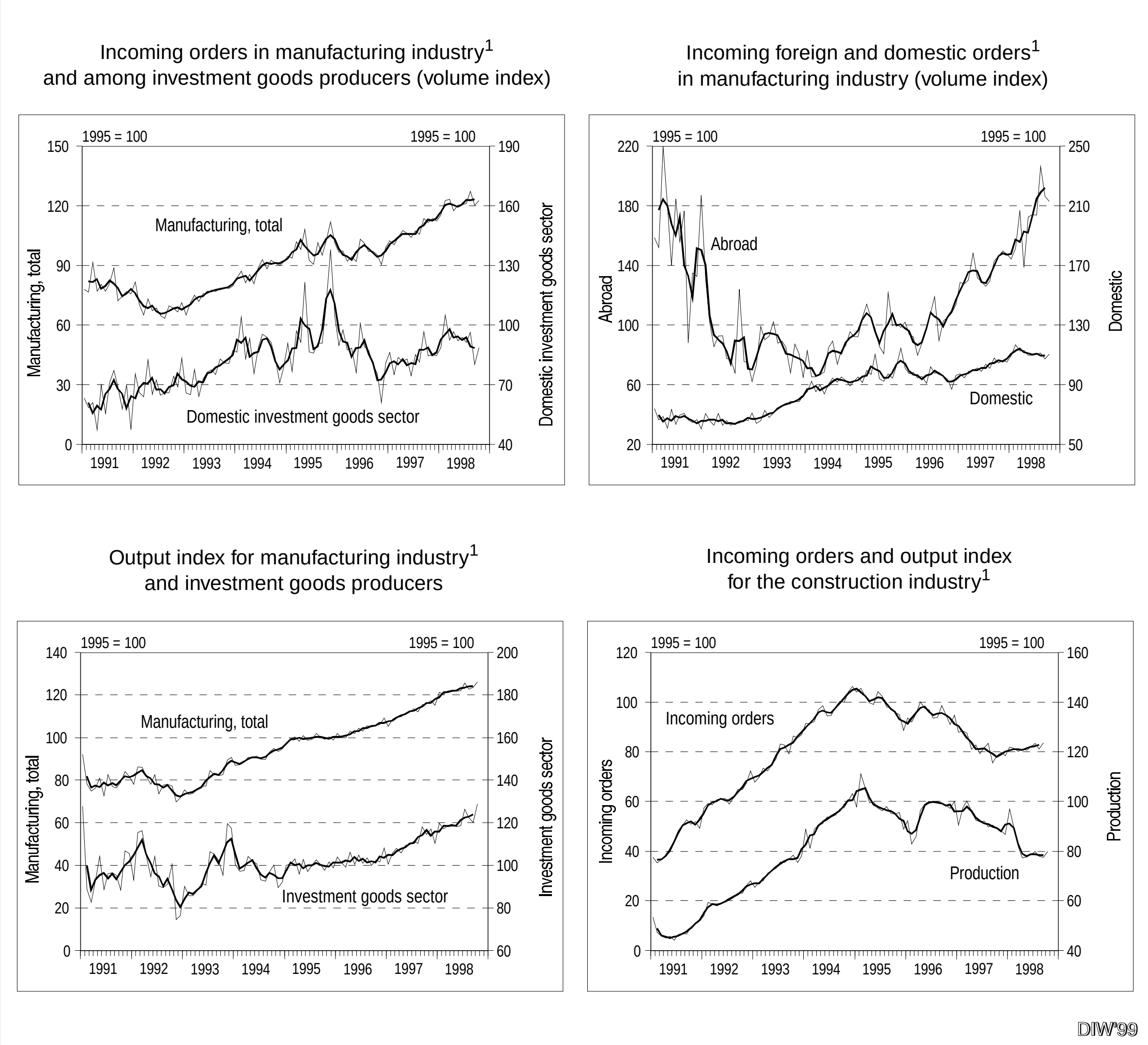


1) Figures adjusted for seasonal deviations and the number of working days using the Berlin Method (BV4) and moving three-month average.
Sources: Federal Statistical Office; DIW calculations.

even higher surplus than last year – DM 28 compared with DM 20 billion. The positive social insurance trend is due in particular to an increase in the central government grant to the pension insurance funds (compensation payments for child-raising periods, compensation for payment of pensions under GDR law, transfer – for a full year for the first time – of the revenue generated by the rise in the rate of VAT on 1 April 1998.

On the revenue side, the two main aggregates, taxes and social insurance contributions, will follow very different trajectories: a more than proportional increase of 3.5% is expected for tax revenue, compared with a growth of just 1.8% in the case of social insurance contributions. The reason behind this difference is primarily to be seen in the impact of the reform planned by the new government. In all, the legal changes implemented in the course of the taxation reform will generate DM 14 billion in additional revenue, according to estimates by the Federal Finance Ministry (cf. table 3). Two factors reducing tax revenue are the increase in the basic tax-free allowance introduced by the previous government (DM 5 billion) and the abolition of the lump-sum tax on 'DM 620 jobs' (marginal employment), representing DM 2.5 billion.

Figure 4
Economic Trends in East Germany



1) Figures adjusted for seasonal deviations and the number of working days using the Berlin Method (BV4) and moving three-month average.
Sources: Federal Statistical Office; DIW calculations.

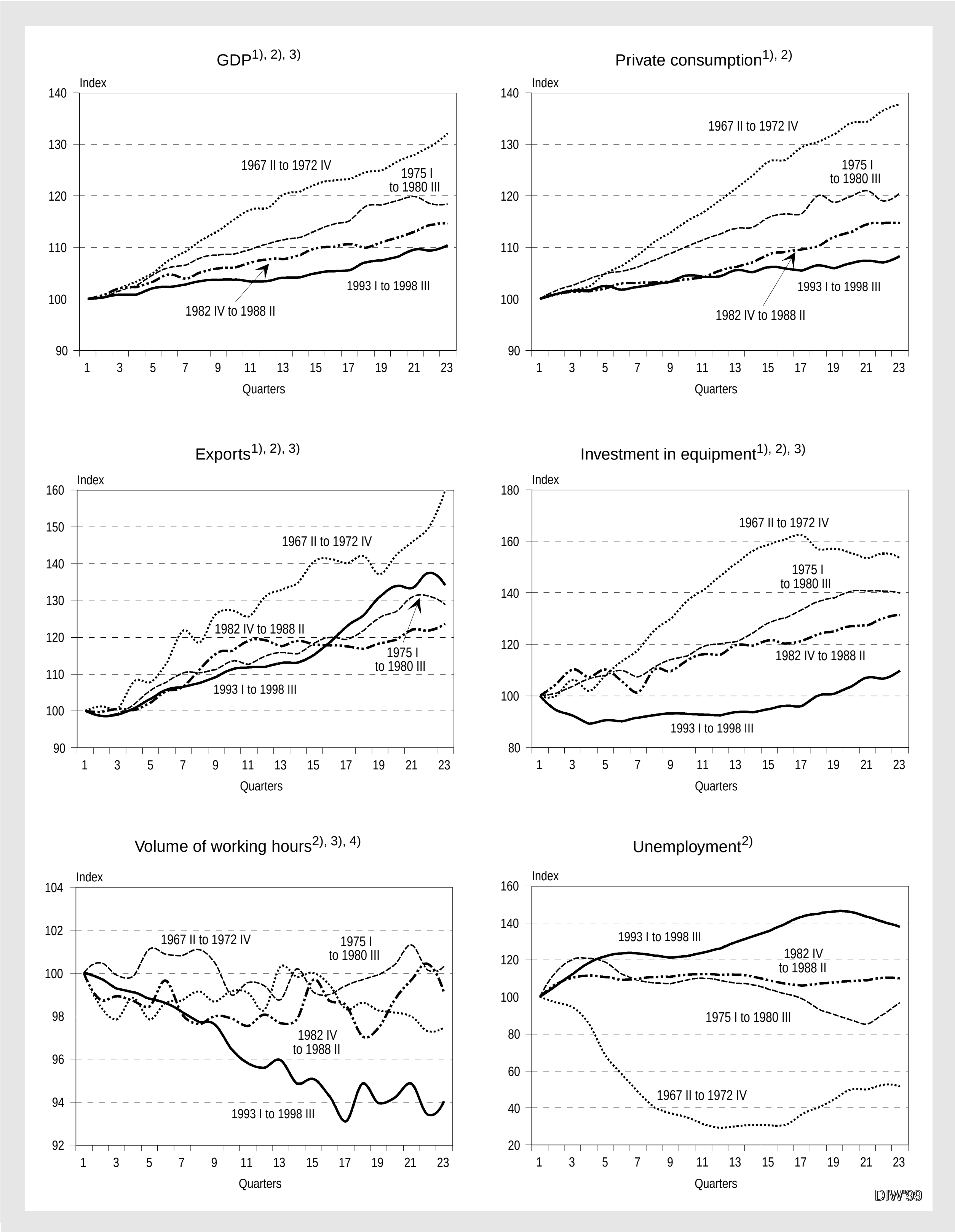
Economic policy faces particularly tough challenges

The precarious monetary and real economic environment places a severe test on economic policy makers in Germany (cf. table 4). As in 1994, an economic upturn in Germany has once again suffered an early and severe setback before it could exert a significant effect on unemployment, although a recession does not currently seem to be on the cards. What is required is an economic policy that takes timely and decisive steps to reverse the contractionary influences.

Following the start of European Monetary Union, German economic policy must be seen in a European context. Monetary policy is now oriented solely to EMU-wide goals. Fiscal policy is tied down by the constraints on the extent of the deficit agreed in the Stability and Growth Pact. As a result, fiscal policy can make only a limited contribution to economic stabilisation. Collective wage bargainers, too, must observe certain restrictions within a common currency area: not only the price stability target pursued by the central bank, but also unit labour cost trends in the other EMU countries. Against this background, the scope for economic policy action in

Figure 5

Comparison of Cyclical Upturns in West Germany



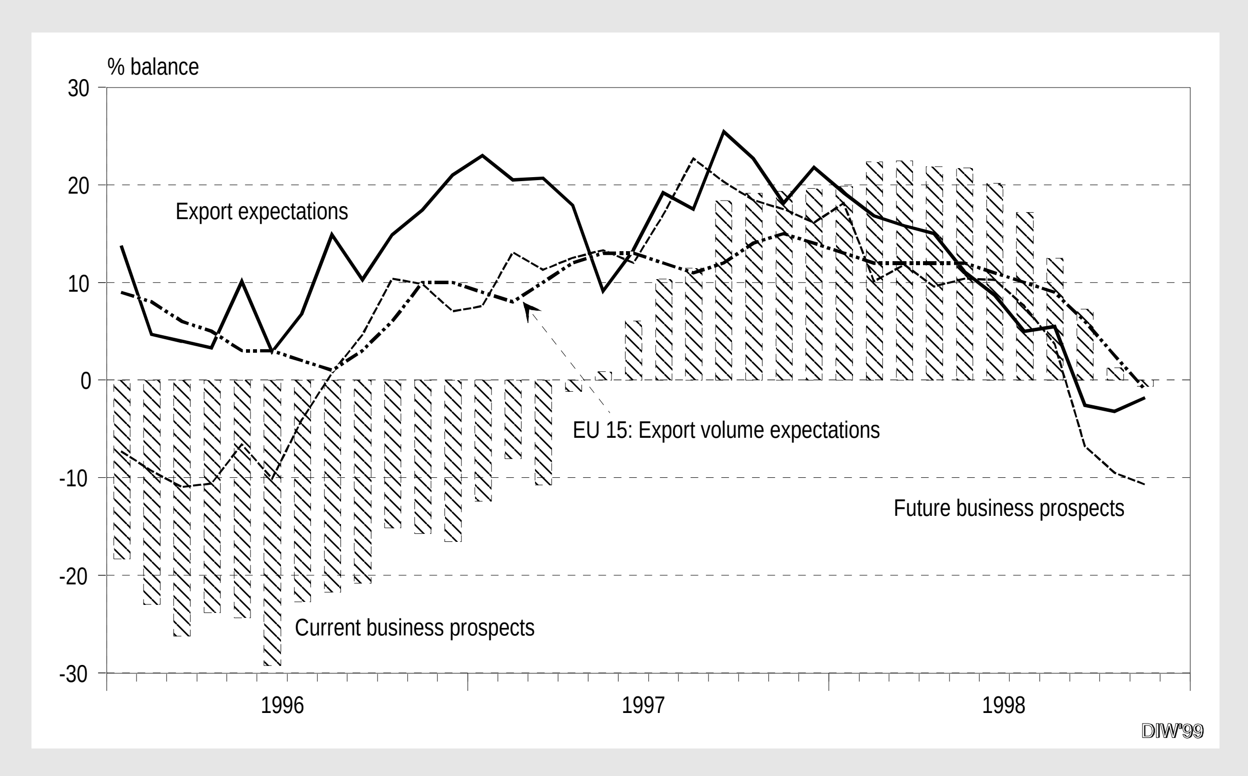
1) At 1991 prices. — 2) Seasonally adjusted using the Berlin Method (BV4); index: quarter marking the GDP-low-point = 100. — 3) Also adjusted for number of working days. — 4) Total working hours performed by the labour force.

Sources: Federal Statistical Office; Federal Labour Office; DIW calculations.

Figure 6

Business Prospects and Export Expectations in Manufacturing Industry

West Germany and EU[1)]



1) Net balance of positive and negative responses as a % of all responses.
Sources: Ifo Institute Business cycle test; EU Commission; DIW calculations

Germany is clearly tightly circumscribed. This makes it all the more important that it is used properly.

What is decisive for the choice of the appropriate economic policy instruments is the nature of the shocks currently being observed. It must also be taken into account that shocks, whatever their origin, influence economic development not only in the short run, but that their effects persist over the longer term.[1] If it proves possible to stabilise aggregate demand and thus counter a negative shock, the growth trajectory will be higher. Conversely, neglect of the demand side can lead to a persistent weakening of economic growth and thus to higher unemployment, which then becomes entrenched and is subsequently considered to be a structural feature. Monetary and fiscal policy can indeed exert a lasting influence on real economic development. It is not the case that their real effects are merely short-term, and their primary effect is not that of accelerating inflation. Demand-side policies, properly understood, amount to more than mere cyclical stabilisation around a given trend.[2] To this extent demand-side policy is also growth policy.

Is the German economy suffering from supply-side problems or a lack of demand?

The importance of a correct analysis of causal factors is illustrated in exemplary fashion by the current situation (cf. figures 6 and 7 and table 2). Does the expected marked weakening of economic growth indicate that the German economy is suffering from supply-side problems, or is it rather a lack of demand?

The key variable on the basis of which a decision must be made on this question is investment. It is undisputed that the dynamic of investment in machinery and equipment[3] has been extremely weak in the course of

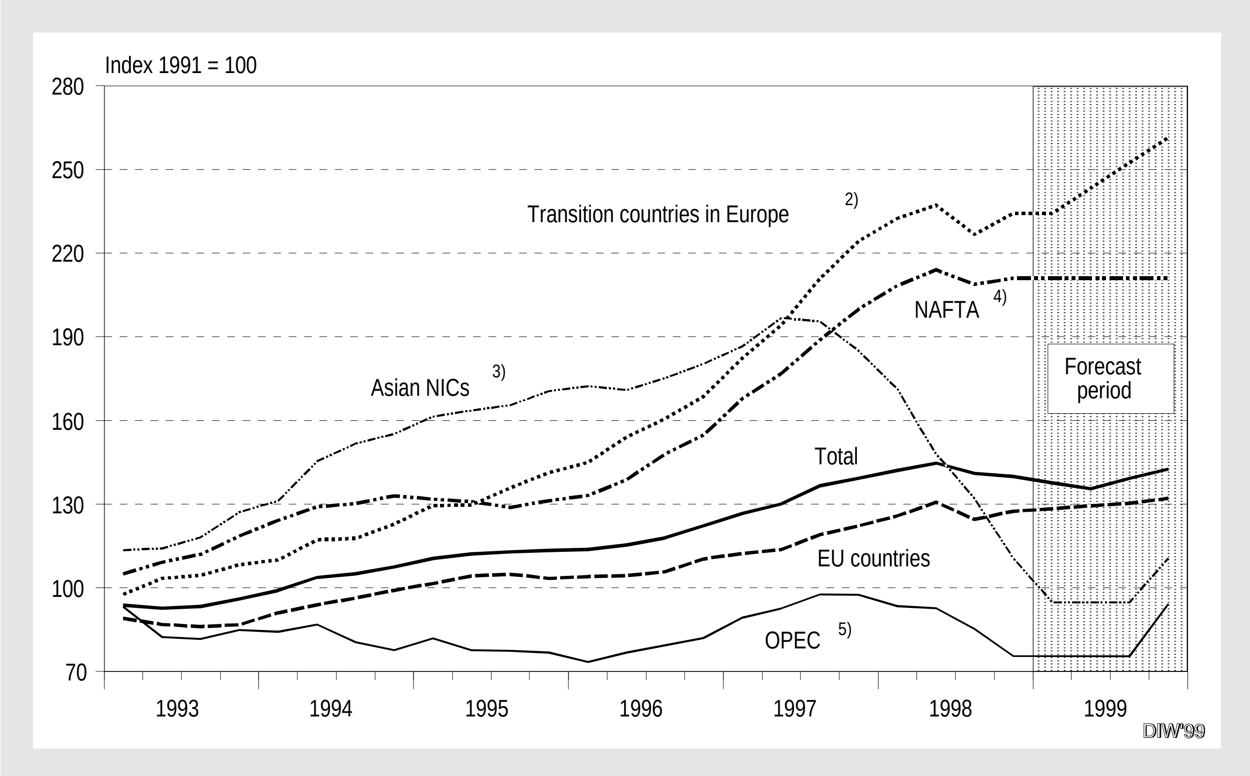
[1] On this see John Y. Campbell and N. Gregory Mankiw, 'International evidence on the persistence of economic fluctuations', *Journal of Monetary Economics*, March 1988, 23/2, pp. 319–333.

[2] This incorporates, as the Council of Economic Experts rightly recognises in its Annual Report (paragraph 339), a restrictive demand-side policy when the economy is overheating.

Figure 7

German Exports by Region[1)]

(Special trade; nominal figures)



1) Adjusted for seasonal influences and number of working days using the Berlin Method (BV4). — 2) Poland, Hungary, Czech Republic, Slovakia, Bulgaria, Romania, Russia, Ukraine, Belarus Estonia, Latvia, Lithuania. — 3) Hong Kong, Indonesia, Malaysia, Philippines, Singapore, Taiwan, Thailand. — 4) USA, Canada, Mexico. — 5) Algeria, Ecuador, Gabon, Iraq, Iran, Qatar, Kuwait, Libya, Nigeria, Saudi Arabia, Venezuela, United Arab Emirates.

Sources: Federal Statistical Office; DIW calculations; from fourth quarter of 1998 DIW prognosis.

this cycle compared with previous cycles (cf. figure 5). This would indicate supply-side problems if at the same time profitability indicators also exhibited signs of weakness. Yet this is precisely not the case. Corporate profitability profit-yield relationship is currently more favourable than at any time since the end of the 1980s, the last time profitability had reached a historically high level (cf. figure 8). At that time higher profitability was achieved at significantly higher rates of wage growth. This alone indicates that the diagnosis of supply-side inadequacies is at best incomplete. It is for this reason that the Council of Economic Experts[4] argues that it is not historical comparison that is decisive, but rather, in the age of globalisation, the profitability realised in other countries. If higher profits can be earned in the USA, for instance, capital will flow across the Atlantic and not be invested in Germany.

Quite apart from the fact that international comparisons of profitability are problematic given in some cases systematic differences in statistical methods, a point recognised by the Council, this begs the decisive question: is higher profitability abroad a consequence of supply-side or demand-side policies? If it were exclusively the result of demand-side policies pursued there, it is difficult to see how a potential divergence in profitability can be used to justify a recommendation for a supply-side policy in Germany. Yet precisely the example of developments in the USA since the mid-1990s used by the Council of Economic Experts supports this view: the USA pursued a successful demand-side policy prior to and during the last recession at the start of the 1990s.[5] The monetary authorities maintained real short-term interest rates close to zero for almost a year and an interest rate differential of more than four percentage points; thus US monetary policy was far more expansionary than in Germany prior to and during the recession of

[3] The weak trend of construction investment is due primarily to specific developments linked to the course taken by German unification.

[4] *Sachverständigenrat* – A group of economists advising the German government. Cf. its Annual Report (*Jahresgutachten*), paragraph 119ff.

[5] G. A. Horn, 'Employment growth in the USA – An explicable miracle', *Economic Bulletin,* vol. 35, no. 4, April 1998.

Table 2

Regional Distribution of German Exports (special trade)

Region	DM billion			% shares			as a % of GDP[1)]		
	1996	1997	1998[2)]	1996	1997	1998[2)]	1996	1997	1998[2)]
Total	789	889	940	100	100	100	22.4	24.45	25.1
EU	454	494	534	57.5	55.6	56.9	12.9	13.6	14.2
EFTA[3)]	45	48	52	5.7	5.4	5.5	1.3	1.3	1.4
NAFTA[4)]	68	89	105	8.6	10.0	11.1	1.9	2.5	2.8
East Asia[5)]	77	79	65	9.8	8.9	6.9	2.2	2.2	1.7
CEE[6)]	61	78	98	7.7	8.8	10.5	1.7	2.1	2.6
Other[7)]	84	101	86	10.7	11.3	9.1	2.4	2.8	2.3

1) Exports as a share of nominal GDP. — 2) January to September, extrapolated to annual basis. — 3) Switzerland, Norway, Island, Liechtenstein. — 4) USA, Canada, Mexico. — 5) Japan, China, Hong Kong, Taiwan, Singapore, Thailand, Indonesia, Malaysia, Philippines, South Korea. — 6) Poland, Hungary, Czech Republic, Slovakia, Bulgaria, Rumania, Russia, Ukraine, Belarus. — 7) Latin America (excl. Mexico), Africa, Australia and Oceania, rest of Asia.
Sources: Federal Statistical Office; DIW calculations.

1993. American fiscal policy, too, was prepared to tolerate cyclically induced deficits to a far greater extent than in Germany. In those years wage trends were oriented closely towards productivity, so that unit labour costs barely rose, but on the other hand never declined (cf. figure 9). This stabilised domestic demand trends without running counter to price-stability goals. The picture was very different in Germany, where wage trends have for many years lagged behind productivity growth, in some cases considerably, weakening in particular private consumption and also, as a result, investment.

Only when the economic upturn in the USA took a firm hold did fiscal policy, followed by monetary policy, tighten the reins, without ever adopting a tightly restrictive stance. At the same time, even in the upturn wage trends never departed from their productivity and stability-oriented path. It was this combination of a potential-oriented and thus anti-cyclical demand-side policy and steady wage growth that has enabled the USA to record one of its longest upturns since the Second World War. Germany, with its more restrictive monetary and fiscal policy and its rather procyclical wage trends, has lagged far behind this dynamic performance. This explains, in particular, why in Germany investment in machinery and equipment and private consumption have developed so weakly in the course of the current cycle. Moreover, the example of the USA illustrates why demand-side policy is also growth policy. For the demand-induced upturn has improved profitability and thus also supply-side conditions. This effect was so strong that it clearly more than offset the effects of the tax increases introduced in 1993 particularly for higher income brackets. By stimulating demand the USA has established the conditions for a sustained upturn, one that continues to this day.

Table 3

Effects of the Planned Reform of the Taxation System on Tax Receipts in 1999

in DM billion

Wage tax	–6 150
Increase in child benefit	–5 800
Cut in rates	–1 270
Abolition of tax concessions	920
Assessed income tax	900
Cut in rates for business income	–880
Abolition of tax concessions	1 780
Non-assessed taxes on profits	500
Corporation tax	850
Cut in tax rates	–1 300
Abolition of tax concessions	2 150
Trading tax	1 160
Turnover taxes	5 000
Abolition of tax concessions	3 200
Imposition of tax on petroleum and electricity	1 800
Petroleum tax	7 100
Electricity tax	4 200
Other	170
Total	13 730

Sources: Federal Ministry of Finance; DIW calculations.

Table 4

Federal Republic of Germany: Key Forecast Figures for Germany

	Federal Republic of Germany			West Germany			East Germany		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
Gross Domestic Product[1)] (% change on the previous year)	2.2	2.7	1.4	2.3	2.8	1.5	1.7	1.9	0.8
Employment[2)] (in 000s)	33 962	33 970	33 950	27 884	27 920	27 915	6 078	6 050	6 035
Unemployment (in 000s)	4 385	4 270	4 175	3 022	2 900	2 860	1 363	1 370	1 315
Unemployment rate[3)] (in %)	11.4	11.2	10.9	9.8	9.4	9.3	18.3	18.4	17.9
Consumer prices[4)] (% change on the previous year)	1.8	1.0	1.2	1.7	0.9	1.2	2.0	1.2	1.4
Unit labour costs[5)] (% change on the previous year)	–1.9	–1.0	0.9	–1.7	–0.9	0.9	–2.7	–1.4	1.2
Public sector financial balance[6)] (DM billion)	–101.5	–69.5	–75	–	–	–	–	–	–
memo item: in % of nominal GDP									
National definition	–2.8	–1.8	–2.0	–	–	–	–	–	–
EU definition	–2.6	–1.7	–1.9	–	–	–	–	–	–
Balance of payments[7)] (DM billion)	–6.9	13	5	–	–	–	–	–	–

1) At 1991 prices. — 2) Domestic employment. — 3) Germany: unemployed as a % of domestic employment (residence concept; employed and unemployed); west and east Germany: unemployed as a % of employment at national concept (place of work concept; employed and unemployed). — 4) Price index of the cost of living of all private households. — 5) Gross wage and salary income created in the domestic economy as a % of real GDP at 1991 prices. — 6) On national accounting definitions. — 7) On balance of payments definitions.
Sources: Federal Statistical Office; German Bundesbank; DIW calculations. fourth quarter 1998 estimate and 1999 prognosis by the DIW.

Economic policy in the face of a global economic slowdown

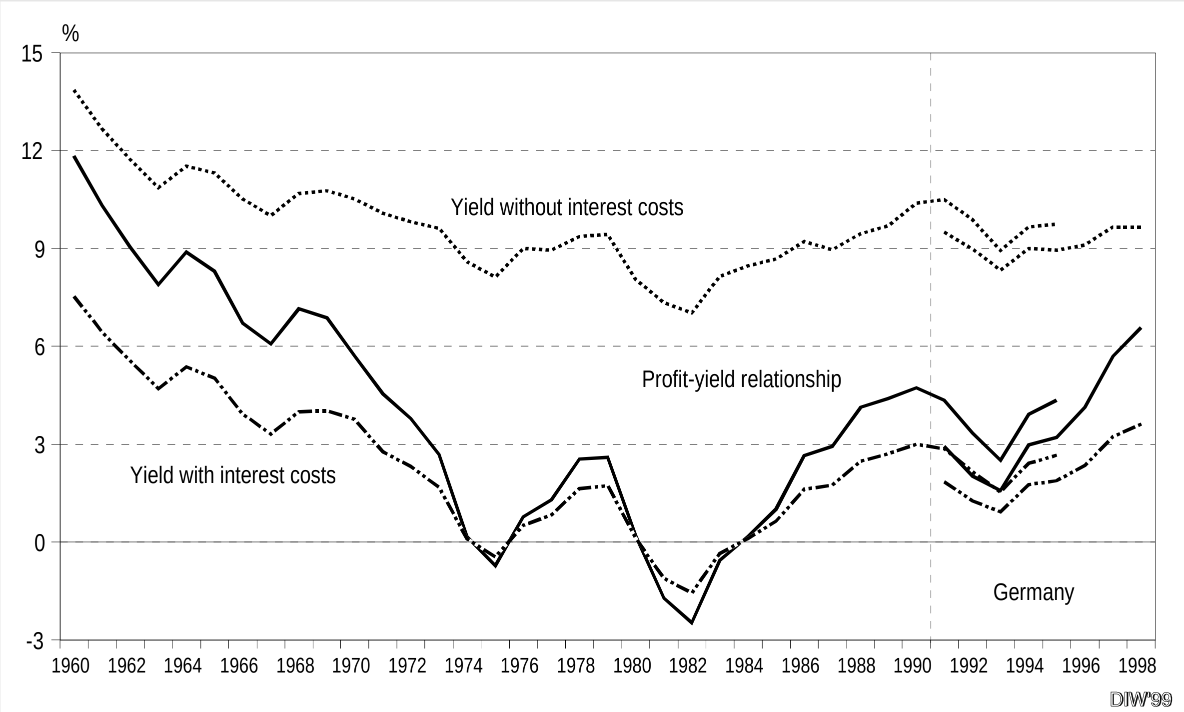
The economic policy strategy pursued in Germany has relied primarily on an export-induced upturn, by improving international competitiveness through wage restraint. That this path is subject to serious uncertainties has now – at the very latest – become all too apparent. Although Germany has succeeded in markedly expanding its exports in recent years, the global economic downturn has placed a constraint on this approach before a sufficient compensatory expansion of domestic demand could occur.

Although the crises in the Asian countries began more than one year ago, economic policy in Europe, and particular in Germany, has scarcely reacted. Alongside the widespread underestimation of the seriousness of the crises, this has been due in large measure to the supply-side orientation of economic policy. If the phase of economic weakness that is now making its effects felt continues to be interpreted in terms of supply-side problems, further distortions in the domestic and world economy are likely. The cyclical setback, which can no longer be entirely avoided thanks to the delayed reaction by economic policy makers, will prove all the more serious the less economic policy makers are willing to take counter measures. It is vital that all the industrialised countries lose global market shares in favour of the crisis-hit Asian countries, while at the same time stimulating their domestic demand, in order to guide the world economy into quieter waters. The USA and the entire NAFTA area have already made a contribution to this, whereas Europe and Japan have failed to do so.

Monetary policy at the start of European Monetary Union

At the start of 1999 responsibility for monetary policy passed to the European Central Bank (ECB). On 1 November 1998 the ECB announced its prime goals and elements of its monetary policy strategy. The maintenance of price stability is its primary goal. It is considered to have been achieved when the rate of growth of the Harmonised Consumer Price Index on the previous

Figure 8
Profit-Yield Relationship in Germany[1)]
Capital yield with and without interest costs



1) Data to 1995 west Germany; 1991 to 1998 Germany.
Source: Council of Economic Experts, Annual Report 1998/99.

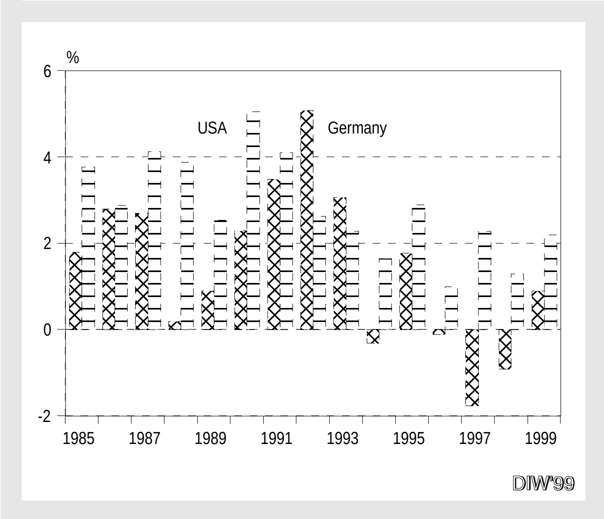
year is under 2%. The money supply plays a prominent role in the monetary policy strategy of these ECB as an indicator and intermediate target variable. Yet the ECB also intends to conduct additional inflation forecasting, which will incorporate a large number of other financial and real indicators.

Following in the tradition of the German Bundesbank, the ECB opted not to choose M1, the narrowest monetary aggregate, as its indicator and intermediate target variable, but rather a relatively broadly defined monetary aggregate: M3 extended, the choice and definitions of which are described in Box 2. Yet given the substantial degree of uncertainty associated with any change in monetary policy regime, it refrained from tying its hands at the outset by announcing a money supply target. In order, nevertheless, to give economic agents an idea of the broad thrust of its planned policy stance, it did, however, announce for 1999 a 'reference value' for a rate of monetary growth considered compatible with price stability. The figure is 4.5%, and if it is met it would imply a continuation of monetary growth at a rate approximating that in 1998, a rate that, given the weakness of economic growth, would appear too low rather than too high.

Unlike the money supply targets announced by the Bundesbank, this rate is not equal to the 'current' rate of expansion on an annual basis. Instead this reference value has been defined as the rate at which the moving three-month averages of the money supply exceed the respective figure one year earlier. The ECB has not announced a target corridor.

The reference value of 4.5% is based on three components estimated or targeted for the EMU: the estimated trend rate of growth of real GDP (2% to 2.5%), as a proxy for the growth of the as yet unknown total potential output of the region; the rate of growth of the consumer price index (under 2%) considered compatible with price stability; and an allowance for the secular decline in the velocity of circulation of money (0.5% to 1%). It is not possible on the basis of these rather vague figures to calculate an exact average value. Depending on whether 'price stability' – an inflation rate of 'less than 2%' – is interpreted as a rate of 1.9% or of just 1.5%, average values of 4.9% and 4.5% are arrived at. This mathematical result would justify, in virtually equal measure, a decision for a reference value of 4.5% or for one of 5%. This suggests that it may well have been advisable to announce a target corridor of, for

Figure 9
Comparison between German and US Unit Labour Costs
in national currencies, change on previous year



Source: DIW calculations.

Box 1

Assumptions on which the prognosis is based

The prognosis is based on a number of assumptions:
- The prices of industrial primary goods on world markets does not start to rise again, if at all, until the latter part of 1999.
- The real external value of the euro rises in the course of 1999 due to the depreciation of the US dollar.
- Short-term interest rates in the EMU countries remain constant at 3% throughout the year. Nor are there significant changes in capital market rates.
- Collective wage increases in Germany remain moderate at around 3%. Wage growth in east German is no higher than in west Germany.
- Fiscal policy pursues a moderately consolidatory course. Cyclically induced increases in deficits are accepted. Income tax reform, the ecological tax reform and the reductions in social insurance contributions come into force in 1999 as announced.

instance, between 3% and 6%, as set by the Bundesbank for the German money supply in 1998, in recognition of the relatively high volatility of the monetary aggregate.

It may be helpful in evaluating the reference value selected by the ECB to conduct a thought experiment that takes account of medium-term aspects; this is illustrated in figure 10. What view should be taken of the development of the actual aggregate money supply if the (subsequent) members of EMU had set a joint money supply target, constant over the medium-term, and with a corridor of three percentage points at the start of 1992? The answer depends on the medium value chosen for this corridor. If a medium value of 4.5% had been chosen, the rate of growth of the aggregate money supply would initially have been excessive, but would have been considered appropriate to the growth of potential output from 1995 onwards. If a medium rate of 5.5% had been chosen, on the other hand, as recommended for Germany by the leading German economic research institutes in their 1996 Autumn Report, the actual growth of the aggregate EMU money supply would have been clearly 'inadequate': in 1995 the money supply would have undershot the target corridor and would subsequently have increasingly moved away from it. This undershooting of the target could have been explained with reference to the efforts made by west European central banks to meet the stability-oriented criteria of the Maastricht Treaty. Yet at the same time one would have to admit that this restrictive stance had clearly been to the detriment of economic growth and that now, the stability goal having been achieved, a revision would be necessary in order to pay greater attention to the economic growth needed to boost employment.

Why did the ECB refrain from announcing a target corridor of, say, between 3% and 6%? The justification offered was the danger that the markets would expect, as soon as monetary growth over or undershot the corridor, an automatic rise or cut in central bank rates, even if this were not justified by other indicators. It is indeed the case that without such a restriction the ECB will retain sufficient flexibility to react to other indicators pointing to a threat to price stability – in either an inflationary or deflationary direction.

Yet on the other hand there are persuasive arguments for setting a target corridor. If deviations from the reference value of more than one and a half points in either direction were possible without any need to justify them, this would amount to immunity from criticism, would reduce the value even of the provisional 'reference value', and cause a loss of credibility. For this reason the ECB would have been well advised to have opted for a corridor. This is all the more the case given that for two of the components making up the reference value the ECB has mentioned a sort of corridor: for the trend growth of output (2% to 2.5%) and for the secular decline in the velocity of circulation of M3 (at a rate

Box 2

Estimating the money supply in the European Monetary Union (EMU)

At the time this report was compiled, official figures on the aggregated money supply of the 11 member states of the EMU chosen by the European Central Bank (ECB) as the intermediary target variable for monetary policy were not yet available. In order to obtain at least a rough idea of the changes in the overall money supply of the EMU countries, the DIW has estimated an EMU money supply that is as close an approximation as possible to the expected official intermediary target variable.

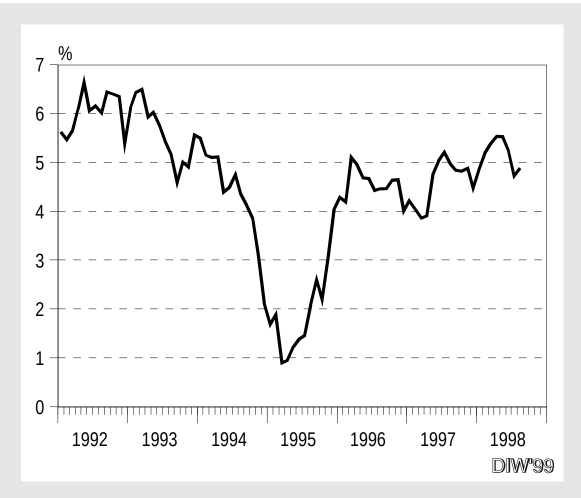
The requirements of such a variable are as follows. Changes in the intermediary target variable should depict as well as possible changes in the monetary policy stance. The central bank must be able to exert a sufficiently strong influence on the variable, and it must exhibit a sufficiently stable relationship to the actual target variables, and in particular inflation. Moreover, fluctuations in the variable should not be excessively volatile.

M1, the narrowest monetary aggregate (encompassing currency in circulation and sight deposits), has the advantage that it reacts sensitively to changes in interest rates, but it is highly volatile, as changes in interest-rate structure and other factors, such as growing uncertainty, induce substantial portfolio restructuring in favour or to the detriment of interest-bearing financial investment. It follows that the broader a monetary aggregate is, the less it is subject to volatility, an advantage that is offset by the fact that broader monetary aggregates contain components that are closer to capital than to money; the rise in such aggregates is an indication more of a rising propensity to save than of additional spending and inflation in the future. In the light of these considerations, the ECB, following the tradition set by the German Bundesbank and other central banks, is likely to have opted for a compromise between a very narrow and an extremely broad monetary aggregate. This amounts to the choice of the aggregate called 'extended M3'[1] as the intermediary target variable for monetary policy.

Given the lack of sufficient information on the components that 'extend' M3 as traditionally defined, such as money market paper, shares in money market funds, deposits with foreign branches and subsidiaries of domestic banks, the DIW has restricted itself to aggregating national money supply as represented by M3 (without extension). For those countries that do not publish statistics on this aggregate, the one was chosen among those on which data is available that comes closest to M3. These are M2 for Italy, M2- for Portugal and M3E for Ireland. The national money supplies selected in this way were converted at the most recent ECU central rates. In the case of Germany the data source was the monthly reports of the German Bundesbank; for all the remaining countries the money supply data were taken from the Main Economic Indicators of the OECD.

[1] Alongside currency in circulation it includes various liabilities of 'monetary financial institutions' in the EMU countries with residents in this zone. These liabilities are: overnight deposits, deposits with an agreed maturity period of up to two years, deposits with a notice period of up to three months, deposits from repurchasing agreements, bonds with a time to maturity of up to two years, shares in money market funds, and money market paper (net).

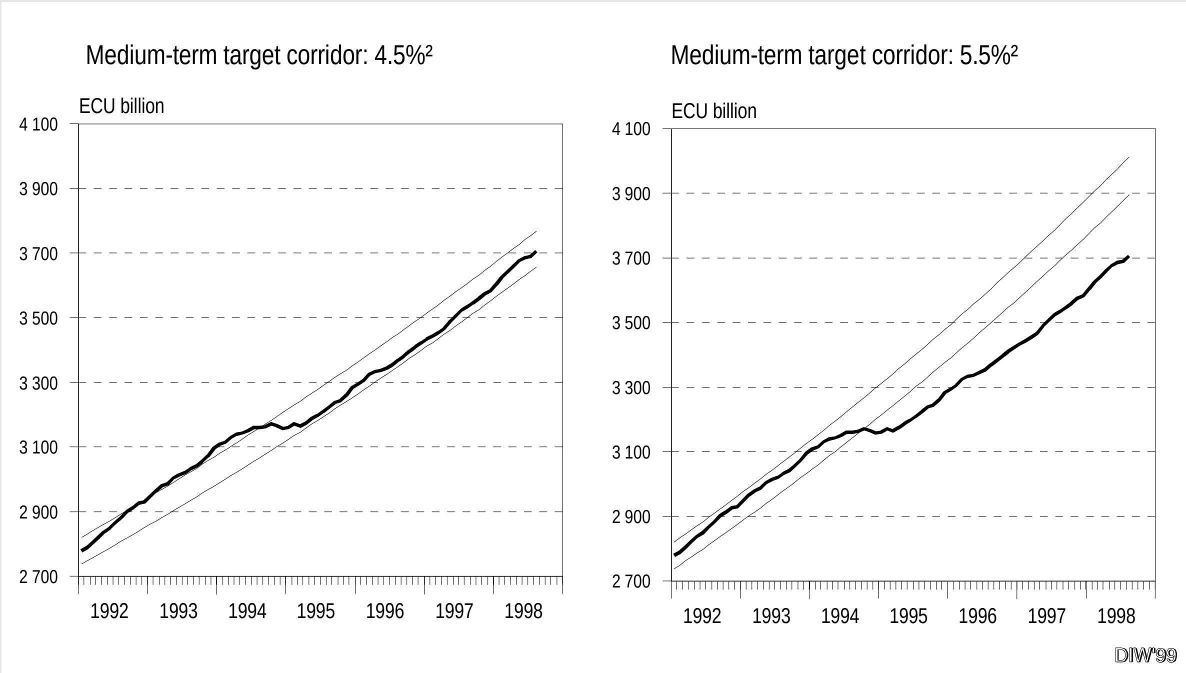
Change in the Supply of M3[1)] in the EMU Countries



1) M3 = cash plus demand, time and savings deposits; for Italy M2; for Portugal M2- and Ireland M3E; calculated on the basis of ECU central rates; monthly data; not seasonally adjusted; change on corresponding month of previous year.
Sources: German Bundesbank; OECD; DIW calculations.

between 0.5% and 1%). Yet if the ECB indicates corridors for these two components, it would be logical to set a corridor for the reference value. A corridor of three percentage points would not have been so narrow as to prevent any account being taken of the likely volatility of the money supply. On the other hand, it would not have been so broad as to free the ECB from the obligation to justify, with sound arguments, why it is prepared, where necessary, to permit money supply growth to depart from the corridor. Supporters of a money sup-

Figure 10
M3[1)] of the EMU Countries



1) Cash in circulation plus demand, time and savings deposits: for Italy M2, for Portugal M2- and for Ireland M3E, calculated on the basis of ECU central rates; monthly data; seasonally adjusted using the Berlin Method (BV4). — 2) Corridor width = 3%.
Sources: German Bundesbank; DIW calculations.

ply corridor can also point to the Bundesbank in this regard: it frequently permitted the money supply to deviate from the announced target corridor, but its reputation for price stability did not suffer because of its ability to defend its position convincingly.

Of course, it is possible to interpret the decision for a pin-point reference value of 4.5% for 1999 very differently from the ECB: both the leading German economic research institutes in their Autumn Report[6] and the Council of Economic Experts in its Annual Report 1998/1999 called for a money supply target of 5%. Given the substantial degree of uncertainty surrounding the relevant forecasts, the difference of one half of a percentage point to the reference value given by the ECB might be considered negligible. Yet the importance of the signal in favour of a restrictive stance that could be given by the choice of the lower rate should not be underestimated. The impression given is that, faced with a choice of giving greater scope to economic growth or doing more for price stability, the ECB would, in case of doubt, opt for a restrictive measure in order to acquire sufficient credibility on price stability.

In retrospect, the choice of a relatively low reference value seems all the more justified as, just a few weeks before the official start of a common monetary policy, the EMU central banks left a 'legacy' by adopting an expansive measure. On 3 December last year they cut the repurchasing rates and, in so doing, set the base rate at which the ECB had to commence its monetary policy activities at the start of this year. Some commentators have seen the fixing of a base rate of 3%, a step taken in agreement with the ECB, as symptomatic of an excessively soft approach by the members of the European Central Bank Council on price stability.

The warnings about the risks of base-rate cuts in the EMU were justified, among other things, with the argument that such a measure would lead to an undesirably strong inflationary impulse in those countries that, for domestic economic reasons (i.e. inflationary pressure), still maintained a relatively high short-term interest rate, when they cut their base rates to the EMU reference level of 3%. Yet this argument is unconvincing. If it were true, Germany, for instance, given its extremely low rate of inflation and sluggish economic growth, would be equally justified in calling for even more pronounced cuts in rates. Yet clearly, regional aspects can

[6] Cf. *Economic Bulletin,* vol. 35, no. 11, November 1998.

no longer be taken into consideration when setting base rates, only European-wide aspects are relevant. Temporary differences in price trends are bound to crop up within EMU, but tougher competition at a 'constant exchange rate' will not permit significant deviations in regional inflation rates, that is longer-term rates of price and cost increases, from the EMU average.

More serious, on the other hand, is the argument put forward against the cuts in rates that both short-term rates and longer-term real rates on the capital markets in Europe are at an unusually low level. Indeed, the statistically computable (i.e. ex post) real rate of interest – the difference between the nominal bond yield of 4% and the current inflation rate of just over 1% – is, at 3%, below the average for the 1990s. Yet this average is unsuited to determining the appropriate rate in the current situation. It also encompasses years in which the interest rate contained an excessive risk premium reflecting higher inflation; this premium can since have been expected to have declined substantially. Instead of historical comparison, therefore, another criterion should be used to determine the appropriateness of the real rate of interest on capital markets: comparison with the rate of return on real capital, or, more precisely, the relationship between the real return that can be expected on investment in real capital and the real rate of interest on the capital market. It may be that this relationship has increased recently, and thus become more conducive to investment, but the long-term interest rate is still not low enough to make a contribution to a sustained and strong upturn, as this prognosis of economic growth in the EMU shows.

Consequently, monetary policy must play its part by cutting short-term interest rates significantly and creating an adequate interest rate differential between the money and the capital market: this would avoid too much savings capital being parked in short-term securities, preventing it reaching the capital market, which is the source of finance for longer-term investment. In the face of the serious risk of the international crisis spreading to Europe and the USA, the European and US central banks are called on to jointly cut interest rates, in order to indicate their willingness to counter the threat of such a crisis from the very outset.

Fiscal policy: the importance of avoiding procyclical effects

The Stability and Growth Pact has significantly narrowed the scope for national fiscal policy by imposing relatively strict limits on borrowing to finance public spending. The guiding model is that of a balanced budget at a 'normal' state of the business cycle. When growth rates are falling, governments may finance up to 3% of their spending by borrowing; borrowing in excess of this limit may lead to the imposition of sanctions. Only in a serious recession – defined as a year in which real GDP contracts by at least 2% on the previous year – may public borrowing exceed this ceiling.

The central problem facing German fiscal policy is that mass unemployment has imposed an enormous burden on government budgets. This burden has, it is true, been eased somewhat by repeated cuts in spending. The cuts that have been achieved in social securities spending, alone, amount to up to DM 100 billion per annum. Significant cutbacks have also been made in government consumption and public capital spending. This has enabled budget deficits to be reduced as a share of output. Yet this process has been associated with substantial macroeconomic adjustment costs. It has not proved possible to return the German economy to a 'normal situation' at a substantially higher level of employment.

In this context it needs to be asked whether the 'normal' state of the economy is in fact a suitable point of reference for determining when the budget should be balanced. This would be the case if such a normal situation was associated with a high level of employment. Yet given that cyclical fluctuations are measured exclusively on the basis of the level of real capacity utilisation, a 'normal situation', so defined, can occur alongside substantial underemployment of the labour force. Last year the German economy was close to such a constellation. Yet if economic activity has been weak for many years and unemployment has become entrenched at a high level, a balanced budget is a fiction. If fiscal policy makers nonetheless seek to attain this goal, every step in this direction weakens the forces for economic growth, and thus contributes to an ossification of unemployment and thus also of the heavy financial burden on government budgets.

Fiscal policy finds itself on a knife edge, as a cyclical setback would quickly push the deficit above the ceiling of 3%. A higher deficit is only permitted when real GDP falls by at least 2% on the previous year and the employment level declines by far in excess of one million.[7] If in the following year unemployment remains at a high level, but total output does not once again contract by at least 2%, fiscal policy would immediately have to return to a policy of strict budgetary consolidation.

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[7] If GDP falls by 2%, the employment volume will fall by 4% – given productivity growth of 2% – that is by 1.2 million persons.

Reform of the taxation system

Last year the postponement of taxation reform was repeatedly identified as a central reason for the persistently weak growth of the German economy. Greater equality of treatment by the tax system and a simpler, more transparent structure were considered urgent requirements. The numerous tax concessions and allowances, it was argued, should be abolished, and in return marginal tax rates cut radically. The package of reforms announced by the new federal government immediately aroused the opposition of business. While many of the planned measures to reduce tax concessions were also contained in the proposal made by the former federal government, there are considerable differences regarding the net reduction in the tax burden planned and the time schedule for implementation. The new government intends to reduce the tax burden by only half as much as the old government had planned, and the reductions are to be spread out over a longer period. In the coming year the burden on small and middle-range incomes is to be reduced, whereas business will on balance pay higher taxes; not until the year 2000 are reductions for business planned.

A central aspect in the current debate is whether a tax reform can really make a decisive contribution to achieving higher growth and employment. It is often not appreciated that in historical terms the overall tax burden as a share of output is currently at a low level. It should be recalled in this context that both the property and the trading capital tax have been abolished, and corporate taxation was reduced substantially in the legislation passed by the last government. Moreover, the German taxation system is characterised by comparatively generous depreciation allowances, substantially reducing the negative impact of the relatively high marginal tax rates on investment activity. In contrast to the 'Petersberg Decisions' of the previous coalition government, the concept presented by the new government contains no measures tightening up the conditions for the general deductibility of depreciation allowances, leading to negative incentive effects for investment.

There can be no doubt that a transparent taxation system improves allocative efficiency. Yet the question is also whether, in the current situation, a policy that removes or reduces special concessions for specific types of income, for example, and in return cuts tax rates, can actually induce the economy to invest more. After all, in the same environment sustained cuts in the burden of wage costs have not induced companies to expand productive capacity. Rather, under the prevailing conditions it is to be expected that reductions in the tax burden will be used to finance, out of firms' own resources, investment projects that would have been conducted anyway. Moreover, a reduction in the tax burden can at best only ever provide temporary impulses.

Those calling for a higher net reduction in the tax burden must indicate how it is to be financed. Hopes that tax cuts will finance themselves are built on sand, as the stimulatory effects are likely to be limited. On the other hand, the various means of financing tax cuts from other sources, for example raising VAT or cutting spending, will inevitably dampen the expansionary effects of the tax cuts, not to mention the question of distributional justice that such measures pose.

The principle of taxation according to ability to pay, as a central pillar of a fair taxation system, has already been increasingly undermined by taxation policy in recent years. This applies even to those cases where, following supply-side policy recommendations, important principles of the German tax system have been abandoned. For instance, the lower tax rates on business income not only call into question the principle of a 'synthetic' income tax,[8] they also work to the disadvantage of lower and medium-range income groups drawing business income.

Against the background of the limits on borrowing imposed by the Stability Pact, the uncertain impact of tax reductions on investment activity, and for reasons of income distribution, the overall package of measures announced by the new government can be seen as balanced, although it would have been better to introduce the reforms in one step rather than in three stages. Cyclical reasons are the main argument in favour of the package, as fiscal-policy stimuli are urgently needed at the present juncture. Due account must be taken, however, of the difficulties of implementing the package in Germany's federal system, as state and local governments have little interest in a tax reform that reduces their revenue. If central government is forced to make compensatory payments, it will encounter constitutional difficulties, as Article 115 of the Constitution bans net government borrowing in excess of public capital spending. This would only be permissible if it could be shown that higher borrowing were necessary to avoid instability to the economy. With this in mind, it is vital that state and local governments contribute to financing the tax reform, particularly given that they will benefit from its positive effects.

Alongside a reform of income taxation, the new government plans to embark on an ecological tax reform. Higher tax rates on petroleum products and the introduction of a tax on electricity aim to make energy con-

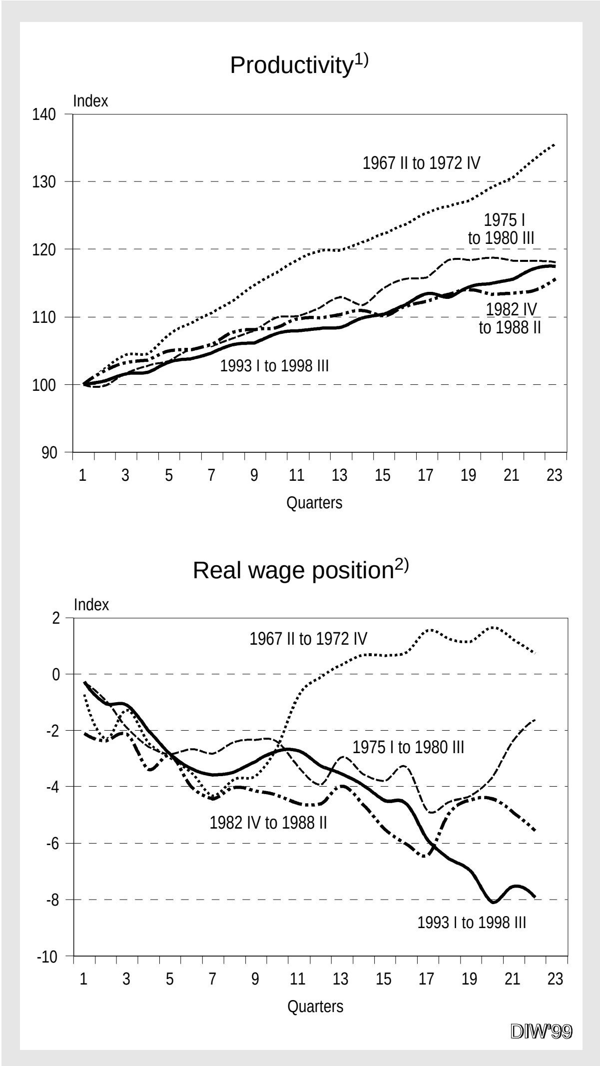
[8] It is argued in justification of the preferential treatment that it offsets the burden of trade tax; but this is a tax on costs and was not conceived as a tax on profits.

sumption more expensive, the additional revenue being used to cut social insurance contributions. Measured against a comprehensive ecological tax reform, as analysed by the DIW, amongst others, in a number of studies, the measures adopted so far appear rather lacking in ambition. The increase in the price of oil products in the first stage by six pfennig per litre is scarcely perceptible; the same applies to the measures for heating oil, gas and electricity. Yet it is less the magnitude of the initial increases than the sustained nature and the predictability of the measures that are important. Indeed, abrupt changes in prices are likely to be damaging on balance, as they generate adjustment friction. A slow and gradual shift in relative prices, on the other hand, creates opportunities to introduce environmentally friendly technology and production processes. What is important, therefore, is to make it clear to business and private households that in the longer run energy prices will rise perceptibly, in order to change economic and social behaviour. To this end the medium-term trajectory of the ecological tax increases should be announced as a guideline.

The planned reductions in and exemptions from the higher rates for energy-intensive branches give cause for concern. They run counter to the aim of achieving across-the-board reductions in environmental damage. In practice, however, for political reasons if for no other, then is no alternative to mitigating real or supposed threats to competitiveness by introducing special provisions for areas of the economy particularly hard hit. These must be seen as concessions to structural changes that place excessive demands on some actors, and that lead to social and regional distortions. Yet if the reform is to be effective, such provisions must apply for a limited period only.

Figure 11

Productivity and Real Wage Position in Cyclical Upturn Phases in West Germany



1) GDP at 1991 prices per working hours adjusted for seasonal effects and the number of working days using the Berlin Method (BV4); index: quarter in which GDP low-point recorded = 100. — 2) Rate of change of the quotient of the index of real hourly wages (gross wage and salary income per employee working hour, deflated using the GDP deflator and seasonally adjusted) and the index of hourly productivity.

Sources: Federal Statistics Office; DIW calculations.

Wages and salaries: return to a productivity-orientation

As in previous years opinions vary widely on the appropriate rate of collectively agreed wage growth. In its most recent report the Council of Economic Experts once again argues for wage increases that lag significantly behind expected productivity growth; the DIW does not consider this an appropriate strategy to bring about a sustained improvement in the labour market situation in Germany (cf. figure 11).

The central problem with the line of argument put forward by the Council of Economic Experts is that it sees the labour market in isolation, and systematically neglects linkages between goods markets and the labour market, and reactions by other market actors. In particular it ignores the fact that the demand for labour depends not only on the price of labour, but also on the demand situation on goods markets. If wage growth lags behind productivity growth, at a given level of employment, wage income and the demand financed by it expand less than aggregate supply. A gap opens up between supply and demand that for firms means a deterioration in sales opportunities on goods markets. The Council hopes that this gap can be closed by rising employment and the associated expansion of private demand. Yet the Council itself writes that employment always reacts only after a certain time lag. Thus a contemporaneous rise in demand cannot occur. Yet the fact that firms' investment decisions depend not only on current profitability, but also on the growth of sales markets is not to be found in the line of argument put forward by the Council of Economic Experts. If sales growth is weak, firms will not invest in expanding productive capacity. Without such investment, no additional jobs will be created.

The demand gap can only be closed if government (public consumption and investment) and/or the rest of the world (exports) step into the breach. In recent years it is only exports, stimulated by wage restraint, that have increased aggregate demand in Germany and thus created incentives for additional investment. Yet this strategy cannot be pursued indefinitely. In the longer run economic agents abroad will not tolerate a deterioration in their competitive position. Rather they will seek to move down a similar path in order to improve their competitiveness once more.

Clearly this is no way to stimulate trade for the long term. An expansion of production possibilities is inextricably linked with competition, but not with just any sort of competition. At the macro level, higher growth is only possible when competition is of an entrepreneurial nature, that is, in the private sector, it must be based primarily on the application of new technologies, the more efficient combination of the factors of production, or the development of new products, so that competitive advantages accrue to firms. This sort of competition generates growth through economic creativity. It also promotes international trade and increases the wealth of all participating countries. The situation is very different with the sort of competition that seeks to create employment by reducing wages, cutting social benefits and lowering taxes. Such an approach promises success only from the perspective of an individual country or an individual firm, that is at the microeconomic level. Yet the resulting competitive advantages are based not on creating the new, but exclusively on devaluing the old. From a macroeconomic perspective this does not create additional production possibilities; at best it is a zero-sum game, in which those that lag behind in the race to cut costs lose out.

In fact the strategy of stimulating growth by raising exports has not been without its costs. Rather, exports successes have been achieved at the costs of a lasting weakness in the domestic components of demand. As can be seen from figure 2, in west Germany last year incoming orders from abroad were around 40% higher than the level prior to be 1992/93 recession, whereas domestic orders have scarcely risen above their low-point during that recession. This weakness of domestic demand is explained primarily by the path taken by collectively agreed wage and salary growth since 1995. The positive effects on markets abroad have been offset by negative effects on domestic markets.

Yet this interdependence is not adequately recognised by the Council of Economic Experts, as is clearly shown by an ex post evaluation of its pay recommendations for 1998. In its 1997 Annual Report (paragraph 273) it calculated, on the basis of its economic forecast, an increase in adjusted marginal productivity of 2¼%. Given the increase in the GDP deflator expected by the Council of 1¾%, the employment-neutral scope for wage increases was of the order of 4%. Seen in terms of this expected potential, the parties to collective bargaining 'did not fully exploit the expected scope, agreeing wage increases of 2%, and so made the deduction that was necessary in view of the still difficult employment situation urgently' (Annual Report 1998, paragraph 169; own translation).

From the current perspective, however, the Council of Economic Experts takes a far less positive view of collectively agreed wage increases in 1998 because the data on which it based its calculations of the scope for wage increases have evolved differently than forecast at the time. According to the new calculations by the Council (Annual Report 1998, paragraph 169) the employment-neutral marginal productivity in the current year is just 1¾%, around half a percentage point lower than assumed last year. The revision of the forecast is due primarily to the somewhat weaker growth of GDP than had been expected. Because the GDP deflator was also lower than expected (below 1% compared with 1¾%), the employment-neutral scope for wage increases fell to just 2%. As a result, last year's collectively agreed wage increases were lower than the 'actually existing scope to a far from adequate extent in order to be able to establish a basis for substantially higher employment' (Annual Report 1998, paragraph 169; own translation).

The Council of Economic Experts makes no attempt at this point to identify a possible connection between its pay recommendations and the change in the economic framework. Yet it was not least due to the weak demand by private households – reflecting the lower rates of income growth – that total output grew more slowly than expected. Of particular importance, however, is the substantially lower rate of inflation, caused by declining unit labour cost over a period of several years. Alongside the demand effects of the substantial difference between the rates of wage and productivity growth, the Council of Economic Experts has also taken too little account of the interdependence of price and wage dynamics. Even if wage increases had been lower still than the 2% actually agreed, the 'deduction' from the rate of productivity growth recommended by the Council would still not have been large enough in ex post terms. An even sharper fall in unit labour costs would, namely, have been passed on by firms, in the tough competitive environment they face, to consumers on goods markets, so that the inflation rate would actually have been even lower.

What would happen if pay bargainers were to follow the Council's advice this year and not fully exploit the scope for wage growth, or indeed were to take account of the fact that the already agreed – and very low – pay increases for 1998 are still – according to the Council's concept and on current data – too high? The resulting gap between wage and productivity growth would again have a negative impact on output and prices. Additional employment would not be created in this way, but the downward slide into deflation would certainly no longer be avoidable.

What guidelines should collective pay bargainers follow in the coming years? In the past the DIW has consistently argued for an orientation towards the trend growth of productivity and the target inflation rate of the central bank. It thus supports a pay strategy based not on current, short-run variables, but on the medium-term trends. This would lead to a rise in unit labour costs that would not come into conflict with the price-stability policies of the central bank and would avoid both inflationary and deflationary tendencies.

In the current situation, however, such a policy is not without its problems. The Council of the European Central Bank has not set a precise target rate for inflation, but has merely announced its intention to keep the rise in the harmonised consumer price index within the EMU below 2%. It cannot be precluded that the ECB would tighten the monetary reins in preventive fashion once inflation began to rise towards the 2% target. In effect this would mean that the effective target rate of inflation is closer to 1½% than to 2%.

Given these facts and the uncertainty surrounding the approach taken by the European Central Bank, for the time being it would seem advisable to call for a pace of wage growth that prevents a further decline in unit labour costs, but that on the other hand does not fully exploit the scope for tolerated inflation. The average rate of productivity growth during the last cycles was around 2½%. Given an inflation rate tolerance of around 1½% by the ECB, the growth of hourly wages that is compatible with stability would be around 4%. In the coming years wage trends should be steadily brought closer to this rate. The prognosis presented here for 1999 assumes collectively agreed wage growth of just under 3%.

Along with other policy areas, following the introduction of European Monetary Union, wage growth can no longer be seen entirely within a national framework. The removal of exchange rates within the EMU countries means that divergent unit labour cost trends can no longer be offset by exchange rate adjustments, and thus have an immediate effect on national labour markets. If unit labour costs are falling in one country, as is currently the case in Germany, whereas they are rising in other countries, a change in competitive relations occurs that only makes economic sense when it serves to correct prior distortions. This was not the case in Germany. Thus not least for this reason, a return to a productivity-oriented path appears an urgent requirement.

An 'Alliance for Jobs'

It is widely hoped that the serious employment problems facing Germany can be solved by means of a cooperative 'Alliance for Jobs' between the two sides of industry and the government. Great expectations have been placed in such a pact.

Although the interest groups involved do not have direct competence to set wage rates, the most important signal that could emerge from the negotiations currently under way relates to medium-term pay trends. If trade unions and employers could agree on the principle of orientating wage growth towards average medium-term productivity growth, there would be a chance of creating employment without inflationary tension. As argued in the previous section, such an incomes policy would of itself promote growth and employment. Above and beyond this, a consensus on this issue could help avoid a destabilising over or undershooting of wages resulting from extreme positions in pay negotiations. In particular, pay determination would be freed of any efforts to redistribute income. At the same time such an agreement would signal that wage growth will not pose a threat to price stability. This would inevitably enter into the inflation forecasts of the ECB and, if it had a European impact, would establish the basis for a monetary policy that sets a broad monetary framework for growth and employment.

Elements of a balanced economic policy

Economic policy in Germany must change course away from a one-sided supply-side orientation in favour of a balanced strategy. To this end decisive steps need to be taken; a hesitant approach merely raises uncertainty and thus promotes destabilisation. Against the background of the weakening of global economic growth, this means that monetary and fiscal policy and collective bargaining must be oriented towards expansion, in order to counter the negative effects of reduced export growth. The ECB must follow the example of the US Federal Reserve and cut interest rates in order to bolster investor confidence in future economic trends. Such an approach serves not merely to stimulate investment demand, and to this extent is not merely a demand-side policy, but rather also improves supply-side conditions, as higher investment leads to a more profitable capital stock. Fiscal policy makers must tolerate deficits induced by the downswing. This will not only stabilise demand, in particular consumer demand, it will also maintain sales and profitability opportunities that would otherwise be lost down the drain of an economic downturn. In addition, cuts in tax burdens should be brought forward in order to promote economic stabilisation. Collective pay bargainers must return to their orientation towards medium-term productivity growth. An Alliance for Jobs could make a valuable contribution in this regard, helping to avoid an unnecessary struggle between unions and employers induced by extreme pay demands or offers. All this should ensure that domestic demand in Germany finally regains its growth dynamic. Sooner or later this will push up capital yields to such an extent that the worries about Germany falling behind in international competition for capital will prove unjustified.

'Arbeitskreis Konjunktur' in the DIW
(Study Group 'Business Cycle')