

The German Economy in the Spring of 1999

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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In Germany the economic upturn which had begun to shift from exports to domestic demand at the start of 1998 became bogged down in the second half of the year. As in 1995, this prevented a sustained economic expansion developing. Whereas in 1995, however, it had been a combination of the rise in capital market interest rates, real appreciation of the D-Mark and excessive pay increases that initiated the cyclical setback, this time the cause was an external demand shock. As a result of this shock the growth of real GDP has slowed markedly and total capacity utilisation has begun to decline. Employment growth has come to a standstill, while consumer prices remain stable.

The cooling-down of the German economy was caused primarily by external factors, set in train by the crises in Asia, Russia and Latin America. While a marked decline in exports to the crisis-hit regions had been expected, the repercussions of the crisis for other countries were underestimated, even as recently as the Institutes' Joint Report in October 1998. In the event, all the west European economies were increasingly affected by the crises as the second half of the year progressed. This served to weaken German exports to these countries, too. In other words the depressed export trend is the result of cumulative restrictive effects.

Up until the summer of last year, the deterioration on the export side that began to make itself felt in the first half of 1998 was more than compensated by strong domestic demand, which had been stimulated by the monetary conditions; in particular, capital market rates had fallen significantly, partly reflecting the transfer of capital back to Europe. In addition, Germany, along with most of the other European countries, benefited from a significant improvement in its terms of trade as import prices fell. However, since the autumn of last

year the weakening of export growth gradually worked through to domestic demand. Investment in plant and machinery lost momentum because of the marked deterioration in sales and profitability expectations in the export sector. Private consumption, though, continued to expand rapidly into the winter months.

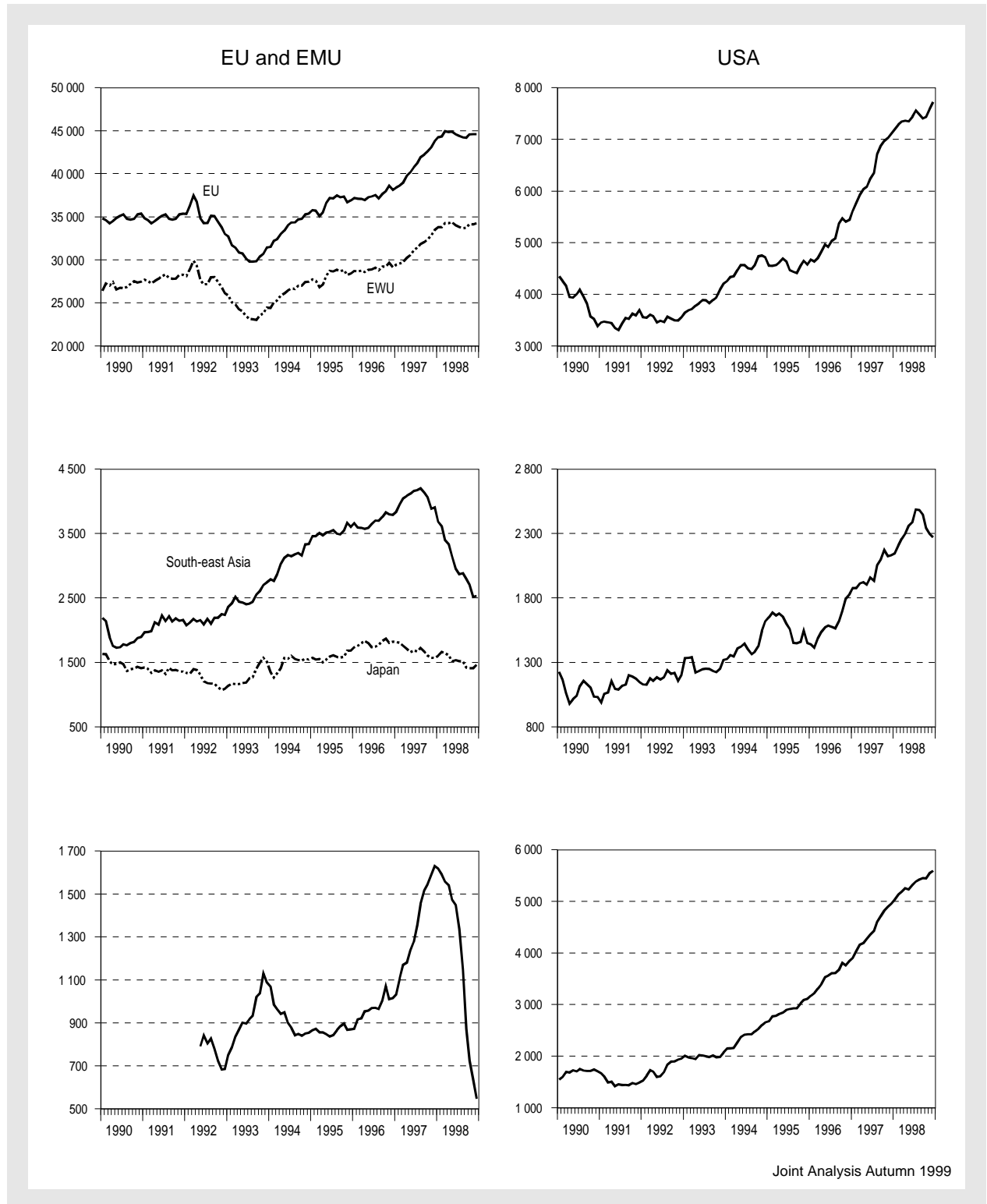
Significant differences emerged between western and eastern Germany. In eastern Germany macroeconomic trends continued to be dominated by the weakness of construction activity: here construction investment fell to a far greater extent in 1998 than in west Germany, in the face of large numbers of empty houses and commercial properties, and this was the prime reason why in 1998 east Germany once again recorded a significantly lower rate of real GDP growth than in west Germany. On the other hand, the immediate effects of the external crises affected the east German economy less severely, as exports and trade with the crisis-hit countries account for a smaller proportion of output; restrictive effects nonetheless applied via production linkages with the west German economy. Although the situation on the east German labour market had improved in the course of last year, this was due exclusively to the expansion of active labour market policy measures; the number of people in unsubsidised employment, on the other hand, has continued to decline.

Effects of the negative external shock subsiding

The prospects for German exports can be expected to improve gradually. As indicated in the report on the world economy, the situation in the developing and newly industrialising countries of south-east Asia is beginning to stabilise, and recovery seems to have already begun in a number of cases. Although the economic trend in Latin America does not appear to have bottomed out yet, there is no sign of a serious recession such as hit south-east Asia. In Russia, on the other hand, the economic trend is still one of sustained contraction. Even so, the overall restrictive effects emanating from the crisis-hit regions on the global economy will gradually attenuate in the course of this year, giving way to a slightly expansionary trend. As the upturn takes hold once again in the west European economies during the course of the summer months, sales opportunities to the region will also improve.

A positive factor in this context is the still relatively favourable international competitive position of the German economy. Although German exporters have suffered considerable losses to competitors from the crisis-hit countries, whose currencies have depreciated sub-

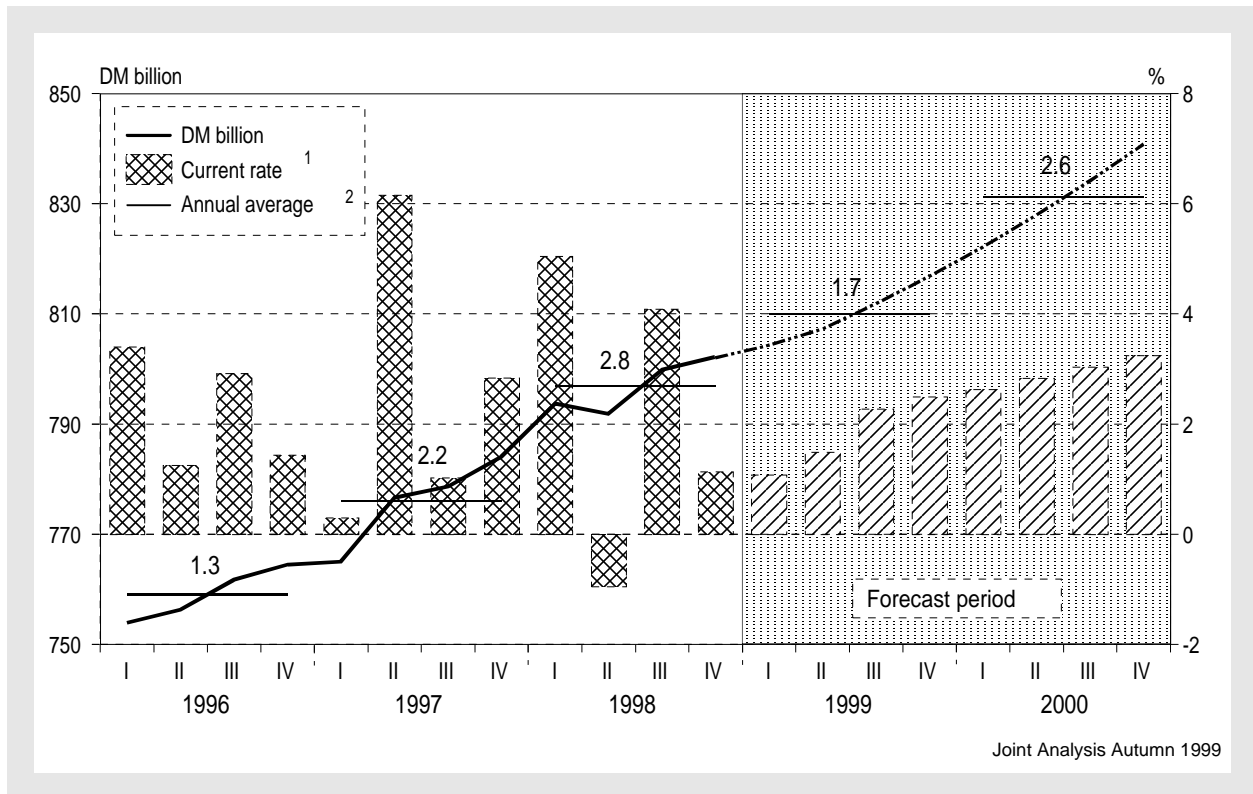
Figure 1
German Exports by Countries and Regions¹
 in DM billion



¹ Seasonally adjusted monthly figures. — 2 Hong Kong, Singapore, South Korea, Taiwan, Indonesia, Malaysia, Philippines, Thailand. — 3 Poland, Hungary, Czech Republic, Slovak Republic.

Sources: Federal Statistical Office; calculations by the Institutes.

Figure 2
Real GDP in Germany
 Adjusted for seasonal deviations and working days



1 Change on previous quarter, expressed as an annual rate, right-hand scale. — 2 % change on previous year.
 Sources: Federal Statistical Office; calculations by the participating Institutes; 1999 and 2000: prognoses by the Institutes.

stantially, since the autumn of last year the price competitiveness of German firms has improved once more, given the strong US-dollar and the stabilisation of currencies in south-east Asia. Although unit labour costs will rise once again, following a three-year decline, Germany's price competitiveness will not suffer, as unit labour costs in its leading competitors will increase to a similar extent.

Economic policy framework remains favourable

The monetary parameters will continue to exert a stimulatory effect on the German economy. Monetary policy has become significantly more expansionary following the recent cut in interest rates. The European Central Bank (ECB) is not expected to tighten the monetary-policy reins until economic growth accelerates in the coming year, in order to prevent inflationary expectations arising; the restrictive effects of this shift in policy are not expected to become apparent during the prognosis

period. Long-term interest rates, too, will remain low, firming only slightly in the coming year.

This year fiscal policy will not exert a significant expansionary effect on economic activity. On balance private households will benefit from only a slight reduction in the tax burden, whereas the burden of business taxes will increase slightly. It is currently very difficult to chart out the course to be taken by fiscal policy in the coming year, as decisions are still outstanding on important programmes, such as the restructuring of fiscal support for families and the reform of business taxation. Based on status quo assumptions, fiscal policy would remain more or less neutral in cyclical terms in the year 2000. This picture does not change if it is assumed, as described in greater detail below, that in the year 2000 tax reductions for families and business are financed in broadly revenue-neutral fashion, i.e. by reducing tax rates and cutting spending.

Following successive years of wage moderation, this year's pay round has seen significantly higher wage settlements. Collectively agreed wages will increase by around 3% in the current year. Given the still high level of unemployment and low inflation, wage growth in the

Table 1

Federal Republic of Germany: Key Forecast Figures for Germany

	Federal Republic of Germany			West Germany			East Germany		
	1998	1999	2000	1998	1999	2000	1998	1999	2000
Gross Domestic Product ¹ (% change on the previous year)	2.8	1.7	2.6	2.8	1.7	2.6	2.0	2.0	2.6
Employment ² (in 000s)	33 970	34 045	34 160	27 915	27 980	28 105	6 055	6 065	6 055
Unemployment (in 000s)	4 279	4 025	3 755	2 904	2 740	2 520	1 375	1 285	1 235
Unemployment rate ³ (in %)	11.2	10.6	9.9	9.4	8.9	8.2	18.5	17.5	16.9
Consumer prices ⁴ (% change on the previous year)	1.0	0.7	1.5	0.9	0.7	1.5	1.1	0.7	1.5
Unit labour costs ⁵ (% change on the previous year)	-1.3	1.2	0.3	-1.2	1.3	0.5	-2.0	0.6	-0.6
Public sector financial balance ⁶ (DM billion)	-79	-69	-61	-	-	-	-	-	-
memo item: in % of nominal GDP									
National definition	-2.1	-1.8	-1.5	-	-	-	-	-	-
EU definition	-2.0	-1.7	-1.4	-	-	-	-	-	-
Balance of payments ⁷ (DM billion)	-6.2	-10	-7	-	-	-	-	-	-

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; Federal Labour Office; calculations by the Institutes; 1999 and 2000: prognoses by the Institutes.

coming year is expected to be somewhat lower than in 1999.

Improved economic prospects

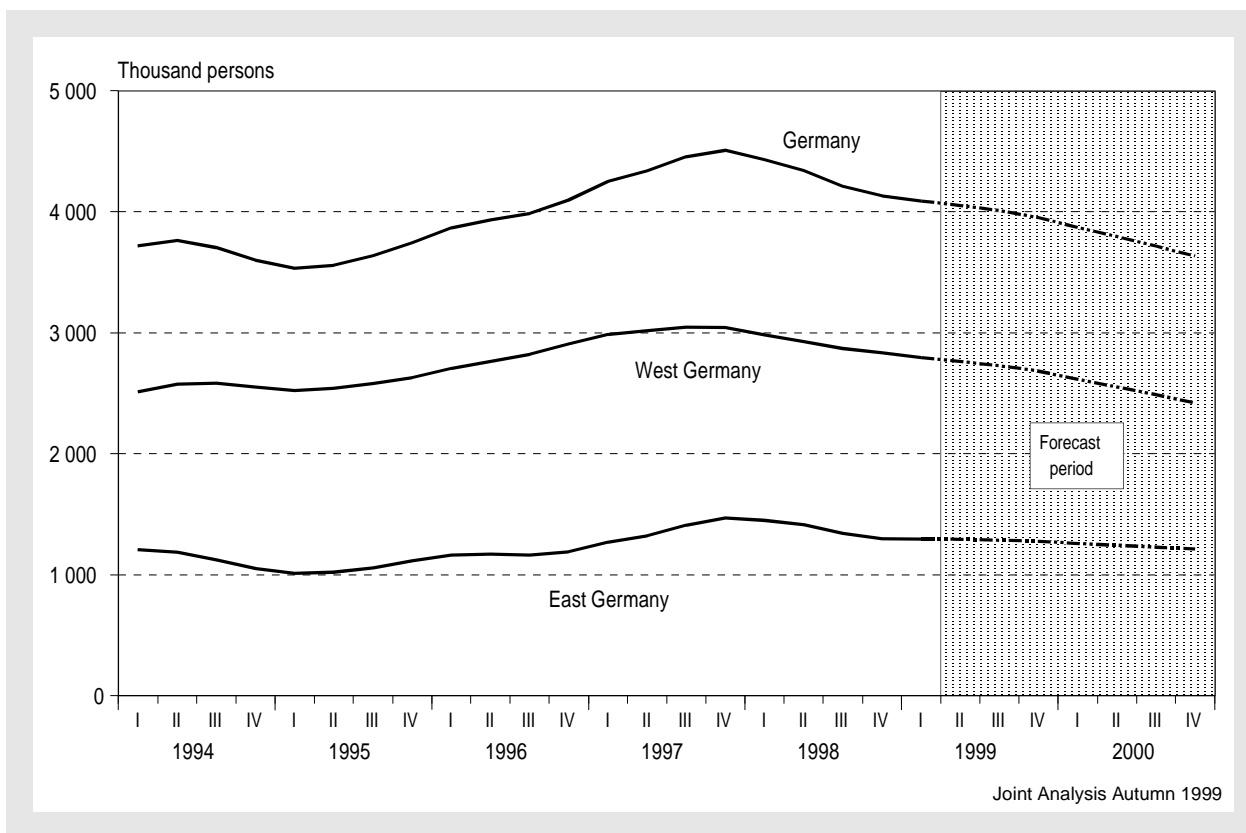
The current situation exhibits similarities to that in 1996. In that year, a temporary weakening of economic growth was followed by a marked surge, as the negative impact of the shocks subsided and the expansionary monetary parameters gained the upper hand. This year, too, conditions are favourable for the economy to gain momentum. The restrictive influences on exports will ease perceptibly in the coming months, although it will take some time for the knock-on effects of weaker export growth on domestic demand to be overcome; this is particularly true of investment. Even so, domestic demand will gather steam in the course of the second half of the year. The cyclical recovery will intensify in the coming year, leading to an improvement on the labour market. Inflation will accelerate slightly, partly due to a slight rise in import prices.

Expectations of stronger economic growth during the summer months are based on the likely impact of the favourable parameters. The early-warning cyclical indicators only offer some initial signs of a turnaround, however. Given the uncertainty on the duration of the repercussions of the external shocks and the crisis in the emerging markets, and the inherent difficulties in forecasting turning points, a considerable degree of uncertainty surrounds the prognosis presented here for 1999. If the turnaround were to occur slightly later than assumed here, even if its course were subsequently the same, the rate of growth of real GDP in 1999, estimated here at 1.7%, would prove significantly lower.

Employment growth sluggish

The improvement on the labour market that began in the spring of 1998 was not maintained during the winter months. Employment actually declined in the goods-producing sector, which was particularly hard hit by declin-

Figure 3
Unemployment in Germany
 Seasonally adjusted figures



Sources: Federal Labour Office; calculations by the participating Institutes; from 2nd quarter 1999 onwards: prognosis by the Institutes.

ing exports, although service employment continued to rise. Overall the employment level more or less stagnated during the six months to April.

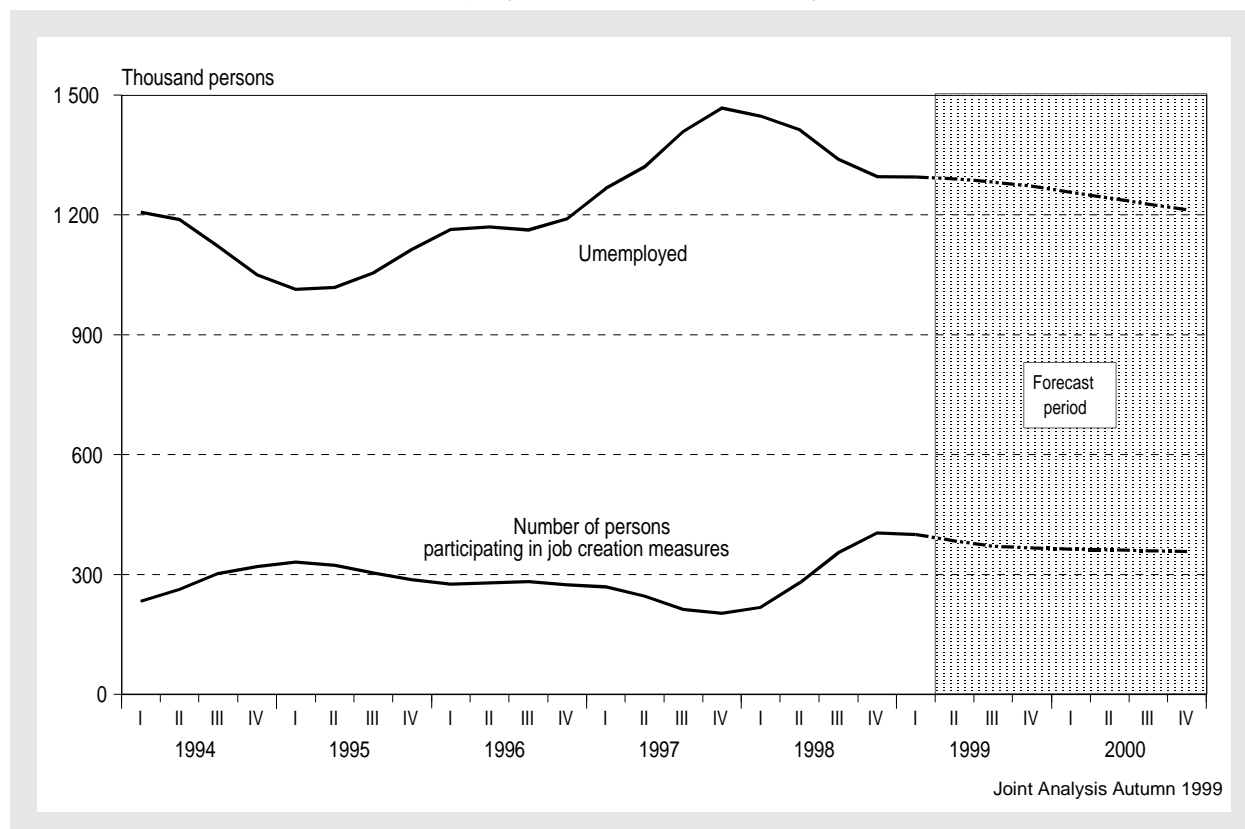
In west Germany net job losses came to an end, while in eastern Germany employment trends were largely determined by labour market policy. Indeed, in the first quarter of 1999 employment probably declined, as the number of workers in subsidised employment was cut.

The situation on the German labour market will improve only gradually. In western Germany the acceleration of economic growth over the prognosis period will begin to make its effects felt on the labour market. The decline in employment in the secondary sector will tail off, while tertiary sector employment continues to rise. In the coming year slightly higher employment levels are expected in both construction and industry. In east Germany, on the other hand, employment will continue to decline slightly in the course of 1999. Although manufacturing companies will take on additional labour, employment will continue to fall in the construction industry as overcapacity in this area is reduced. Job

losses will also continue in the civil service. Not until the year 2000 will employment in east Germany begin to rise once more in the wake of economic recovery, despite a slight reduction in public job creation measures in the year 2000 compared with the current year; on average, employment will stagnate at around the 1998 level in both years. In Germany as a whole, an employment growth of 75 000 is expected for 1999 and of 115 000 for the coming year.

In spite of the relatively weak employment growth, unemployment in Germany will sink perceptibly in the forecasting period. The decisive factor here is an extraordinarily sharp decline in labour supply. In the current and the coming year a decline in the active population totalling almost half a million people is expected (1999: 220 000; 2000: 250 000). Factors behind this trend include, alongside a negative migration balance for foreign nationals, in particular, age-structure effects, the reduced immigration of ethnic Germans from eastern Europe, longer periods spent in education, and greater use of early retirement. In 1999 unemployment will also be reduced by the government's immediate action pro-

Figure 4
Job Creation Measures¹ and Unemployment² in East Germany



1 General job-creation programme and structural adjustment programme. — 2 Seasonally adjusted figures.
Sources: Federal Labour Office; calculations by the participating Institutes; from 2nd quarter 1999 onwards: prognosis by the Institutes.

programme to reduce youth unemployment; according to the data available so far, around two-thirds of the young people participating in this programme were previously registered unemployed. Overall a decline in unemployment of 255 000 is expected for 1999, and a further 270 000 in the year 2000. Even so, at the end of 1999 almost four million people will be unemployed in Germany, and 3.6 million at the end of the year 2000.

Decline in the budget deficit

Fiscal policy in 1998 was once again oriented towards reducing the budget deficit. The total government deficit narrowed by more than DM 20 billion to DM 79 billion, cutting the size of the deficit, according to the definitions used by the European System of National Accounts, from 2.7% to 2.0% of nominal GDP. This reduction reflects both more moderate spending growth and the economic upturn; labour market-related spending was reduced, and tax revenues rose, particularly from taxes on profits. In addition, the tax revenue losses resulting

from government support for investment in east Germany and the effect of firms offsetting losses incurred in earlier years against tax declined substantially. Moreover, government entrepreneurial revenues rose by more than 5%, largely because of an increase of DM 5 billion in the profits transferred to central government by the Bundesbank (according to national accounts definitions).

In the current year government spending will grow more strongly than last year, at 3% compared with 1.5%. Public sector wage growth will be significantly higher, and additional spending will be incurred in the health sector. Moreover, spending on so-called active labour market policy is once again to be stepped up substantially (by DM 6 billion). Central government must also cover the deficit accumulated by the post office support funds (*Postunterstützungskassen*), totalling DM 8 billion.

Next year government spending growth is expected to be somewhat reduced once more. The planned tax cuts will probably be financed by reducing spending; the prognosis is based on an assumed total of DM 12 billion in spending cuts, primarily in the areas of subsidies

Table 2

Labour Market Data

Annual averages, in thousand persons

	1995	1996	1997	1998	1999	2000
Germany						
Employment (domestic concept)	34 860	34 423	33 962	33 970	34 045	34 160
Self-employed	3 614	3 622	3 648	3 687	3 730	3 770
Employees	31 246	30 801	30 314	30 283	30 315	30 390
of which:						
on short-time working	199	277	183	115	125	110
Unemployment	3 612	3 965	4 384	4 279	4 025	3 755
Unemployment rate ¹	9.4	10.3	11.4	11.2	10.6	9.9
Net 'commuters'	-43	-51	-53	-54	-55	-60
Employment (national concept)	34 817	34 372	33 909	33 916	33 990	34 100
West Germany						
Employment (domestic concept)	28 464	28 156	27 884	27 915	27 980	28 105
Self-employed	3 099	3 104	3 114	3 130	3 150	3 165
Employees	25 365	25 052	24 770	24 785	24 830	24 940
of which:						
on short-time working	128	206	133	81	95	80
Unemployment	2 565	2 796	3 021	2 904	2 740	2 520
Unemployment rate ²	8.3	9.0	9.8	9.4	8.9	8.2
East Germany						
Employment (domestic concept)	6 396	6 267	6 078	6 055	6 065	6 055
Self-employed	515	518	534	557	580	605
Employees	5 881	5 749	5 544	5 498	5 485	5 450
of which:						
in job-creation schemes	312	278	235	314	380	360
on short-time working	71	71	49	34	30	30
Unemployment	1 047	1 169	1 364	1 375	1 285	1 235
Unemployment rate ²	14.1	15.7	18.3	18.5	17.5	16.9
Further training	243	230	147	149	170	180

¹ Unemployed as a % of the domestic labour force (residence concept). — ² Unemployment as a % of the labour force in the region (place of work concept).

Sources: Federal Statistical Office; Federal Labour Office; calculations by the participating Institutes; 1999 and 2000: prognoses by the Institutes; figures rounded.

and government consumption. The continued decline in unemployment will also reduce spending requirements. All in all, the growth of government spending in the coming year, at under 2%, will remain below the growth of nominal GDP (4%), reducing public spending as a share of output, following the slight rise in the current year.

A different view

The Rheinisch-Westfälische Institut für Wirtschaftsforschung (RWI) takes a more optimistic view of economic trends in Germany, particularly in 1999, than the other

Institutes. Economic activity will recover earlier and more strongly than forecast by the majority of the Institutes, following a weak fourth quarter in which foreign demand, in particular, was more seriously affected by the various financial crisis than had been generally expected last autumn. The RWI expects more dynamic growth of exports and, as a result, to some extent also of investment.

Consequently, the RWI expects the economic expansion in Germany to be stronger than forecast by the majority of the Institutes. It forecasts real GDP to grow by 2.4% in the current year and by 3% in the year 2000. This will lead to a significant expansion of employment; the RWI expects employment growth of 130 000 for 1999 and 240 000 for the year 2000.

Economic policy considerations

Last year the cyclical recovery in Germany and the rest of Europe became bogged down in the wake of unfavourable global economic trends. However, the Institutes see no danger of the phase of growth weakness proving prolonged, nor mention of the economy drifting into recession. On the contrary, evidence of stabilisation in some of the countries hit by the crisis and, not least, the monetary and fiscal policy stance lead them to expect the German economy to return to a higher growth trajectory. Monetary policy, in particular, is highly expansionary now that the European Central Bank has significantly slackened the monetary reins in the face of lower economic growth in Europe.

Yet even given these favourable economic prospects, the fundamental problems facing the German economy remain. In particular, greater efforts are required to solve the employment problem. It is now up to the other areas of economic policy to remove the obstacles to investment and to make it more attractive to recruit labour. In eastern Germany economic development can only be promoted by improving supply side conditions. Although real GDP growth will no longer lag behind that in west Germany, this does not primarily reflect a return to a 'catching-up process', but rather the fact that the decline in construction activity is coming to an end.

On taking office the new German government emphasised the fiscal policy aim of bolstering demand, with a focus on redistributive measures. In the first stage of taxation reform, the tax burden on private households was reduced, while that on firms was on balance increased. Such measures cannot generate a significant impulse for growth and employment. The government is now seeking to reduce taxes on the business sector, too, an approach that is to be welcomed. The aim of reducing marginal tax rates while at the same time broadening the tax base is a step in the right direction, as it increases the net return on investment and is conducive to new business start-ups. Generally speaking, this can be expected to stimulate medium-term economic growth, to the extent that it involves a net reduction in the overall tax burden. With this in mind, in their joint report last autumn the Institutes called for a bold reform in which the overall tax burden would be reduced significantly, and tax cuts would not be completely offset by higher taxes in other areas. Rather, they should be financed by cuts on the spending side.

Although it is generally true that measures to promote growth should be implemented as quickly as possible, it is nevertheless advisable to proceed with taxation reform in stages. As regards the distribution of the

reform steps over time, the impact on the overall budget deficits is initially of secondary importance, provided at the same time government spending policy, that is changes in the level of spending as a share of output, is set out in advance in the form of a binding medium-term commitment. This would indicate that deficits will remain on a path that it is compatible with the desired reduction in the structural deficit.

Before implementing a number of reform projects, the government has adopted a strategy that has problematic implications for governance. Concrete proposals, such as cuts in corporation tax or the abolition of tax concessions or subsidies, should not be the subject of negotiations with the companies 'affected'. While it is always advisable to exchange information on such matters, there must be no bargaining process. All such proposals should be designed with macroeconomic considerations in mind, and with a focus on efficiency. Because interest groups and associations naturally represent specific economic interests, their incorporation in decision-making is likely to lead to the wrong measures being selected. It is macroeconomic criteria that should be decisive regarding not only the overall strategy, but also the concrete measures. The same principle applies, for instance, to attempts to reduce subsidies. Bargaining with individual interest groups on cutting subsidies is contrary to sound governance principles. It cannot be expected that this will lead to an efficient approach to subsidy reduction, because by no means all recipients of subsidies will be heard, so that particularly influential groups will probably fare better. To this extent such a procedure neglects the interests of taxpayers, who, after all, must provide the resources needed to pay subsidies.

As far as the savings that the government wishes to implement on the spending side are concerned, the greatest scope lies in reducing subsidies. Irrespective of the precise definition used in calculating subsidies, the extent of subsidisation in Germany is so great that it significantly distorts resource allocation and is thus harmful to economic growth, because economic agents orient their behaviour more towards government influences and less towards economic criteria. And, of course, the burden of taxation on the economy is correspondingly higher. It is difficult to realise cutbacks in subsidies in the short term, however, as many tax concessions and financial support programmes cannot be modified in the short run. Consequently, a strategy should be considered in which it is announced that the various measures are to expire, and in which the principle applies that the 'burden of proof' for the necessity of continued payment of a given subsidy lies with its recipients (or with those calling for new forms of support). Irrespective of the method used, it will almost certainly be easier to reduce subsidies if, at the same time, house-

holds and firms benefit from a marked reduction in their tax burden.

The transition to the third stage of European Economic and Monetary Union has been accomplished virtually without problems. Following the introduction of the euro, responsibility for monetary policy in the euro zone now lies with the European Central Bank. Its monetary policy strategy – with the primary aim of ensuring price stability rests on two pillars: the growth of the money supply and forecasts of inflationary trends. During the transition phase, however, the ECB faces substantial problems. Firstly, there is still a lack of reliable data for the euro currency area as a whole. This makes it more difficult to determine the monetary policy course, as this must be based on knowledge of past macroeconomic relationships. Secondly, the monetary policy indicators are not as reliable as they were for individual countries. This is true of interest rates for the currency area, which previously had been influenced by, amongst other things, differences in risk premiums. Even the money supply aggregates themselves are affected; the demand for money may prove unstable, particularly in the initial phase, whereby this may be difficult to identify or quantify in time. The possibility of instabilities in important monetary relationships, in particular the demand for money, exacerbate the task of pursuing a stability-oriented monetary policy. Against this background the information policy pursued by the ECB must be accorded considerable importance. The central bank must seek to promote communication with the public by presenting its strategy in detail in its monthly reports, at press conferences and on other occasions.

There is scope for improving the transparency surrounding important decisions taken by the ECB. For instance, for some time there was considerable uncertainty regarding the quantification of the inflation target. In forecasting inflation the ECB bases its decisions on a number of indicators. Yet it is difficult for the public to determine the relative importance accorded to the various variables; the ECB mentions, among other things, wages, the exchange rate, bond rates and real economic activity. In cutting interest rates at the start of April, it apparently paid particular attention to real economic developments in the euro zone. Observers could gain the impression that the ECB is adopting a discretionary approach in weighing up the various influential factors.

This year collective wage bargainers have deviated from the course of wage moderation adhered to in recent years. Significantly higher collective wage rates were agreed, not least in the light of last year's improvement in the labour market situation, the first for some time. In this the trade unions received support not least from representatives of the German government, who had

called for strong wage growth in the interest of raising purchasing power. This has revealed a political contradiction, for at the same time the government is seeking to promote employment by reducing indirect labour costs. Yet if it is correct that labour costs are important for employment trends – which the Institutes are convinced is the case – then a rise in labour costs caused by a sharp increase in collectively agreed wages is in contradiction to this objective.

The Institutes forecast a perceptible decline in unemployment in Germany in the current year, with an even greater improvement expected next year. To some extent this was cyclically induced, as capacity utilisation in the economy as a whole will gradually begin to rise once more. However, to a significant extent the decline reflects a marked reduction in labour supply. Moreover, it must be recalled that the east German labour market is still receiving substantial support in the form of job creation measures. This means that neither the decline in unemployment recorded to date nor that expected in the near future reflects dynamic employment growth.

Consequently, both the public and the economic-policy debate should focus on employment promotion to a greater extent than has been the case recently. Although it is possible to reduce the number registered as unemployed by a variety of administrative measures, for example by promoting early retirement, this has no beneficial effects on employment; indeed, the volume of working hours would actually decline and national income would be reduced. Rather, the aim must be to make firms more willing to recruit additional labour. Collective wage bargainers must be mobilised behind the aim of achieving a sustained increase in employment. If a consensus could be reached on an employment-oriented incomes policy during negotiations in the context of the proposed 'Alliance for Jobs', this would constitute an important step towards a sustained increase in the employment level.

Monetary policy

At the start of April the European Central Bank cut its base rates to 2.5%, providing a significant monetary impulse and intensifying the expansionary stance of monetary policy in the euro zone. In view of the now more favourable economic prospects, the relaxation of monetary policy poses the question whether it is compatible with the prime task of the ECB, namely to ensure price stability, all the more so as base rates had been cut to 3% in December, ensuring that the monetary parameters were already slightly expansionary.

The ECB bases its judgment of a potential threat to price stability on two pillars: the first is the growth of M3, the second consists of medium-term inflation forecasts. The average year-on growth of M3¹ in the three months to February 1999 was 5.1%, exceeding the reference value of 4½% set by the ECB.² However, current money supply trends may well overstate the growth of demand-relevant liquidity to some extent. The ECB put the particularly strong growth of M3 in January of this year down to various factors linked to the start of monetary union, although it did not specify them further. It may be that the demand for money is not stable in the transition phase to monetary union. The fundamental orientation of monetary policy towards the medium term suggests that the ECB should not allow itself to be guided by the increase in the money supply at the start of the year. On the other hand, this entails a risk that the monetary expansion could subsequently prove to constitute advance warning of an excessive provision of liquidity, and thus the seed of a subsequent acceleration of inflation.

The ECB's inflation forecasts are based on a set of macroeconomic data for the euro zone as a whole. It may be, however, that in the transition phase to monetary union the relationship between the variables used for the prognosis and inflationary trends in the future is subject to instability because of the introduction of the euro. Because, on top of this, neither the ECB's inflation prognoses nor their determining factors are known, it is currently difficult to evaluate the bases for the decisions taken by the ECB.

The cut in interest rates was clearly a reaction to the marked weakening of economic growth, against the background of forecasts for a subdued medium-term inflationary trend. This decision remains justified even allowing for the fact that the underlying inflation rate, which does not contain temporary or one-off factors, is currently probably around half a percentage point higher than the rate of change of the Harmonised Consumer Price Index. Even if commodity prices begin to rise slightly, the rate of inflation will remain significantly below the ceiling of 2% considered by the ECB to be compatible with price stability, and there are little

¹ The definition of M3 used by the ECB is slightly different to that used by the German Bundesbank: it encompasses cash in circulation, sight deposits, deposits with an agreed maturity period of up to 2 years, deposits with an agreed notice period of up to 3 months, repo transactions, shares in money market funds and money market paper and bonds with a maturity of up to 2 years.

² The ECB calculates the reference value of 4½% for the growth of M3 as follows: the growth of potential output amounts to between 2 and 2½%; the decline in the velocity of circulation of money is allowed for to the tune of between ½ and 1%; and inflation is to be limited to a maximum of 2%.

signs at present of a significant acceleration of underlying inflation. In particular, unit labour costs are increasing moderately, if at all, in the euro zone, and indeed they have recently been falling. In addition, macroeconomic capacity utilisation will rise only slightly during the prognosis period. Consequently, the scope for companies to raise prices will remain extremely limited in the current year, although it will increase slightly in the course of next year.

An overall evaluation of the two pillars of monetary policy, money supply trends and the inflation prognosis, currently shows scarcely any signs of an acceleration of inflation that would endanger the stability target. In all probability the goal of price stability will be met during the prognosis period, even allowing for the cut in interest rates. If, however, the signs of an acceleration of the underlying inflation rate were to increase in the near future, the ECB would have to tighten the monetary policy reins. It should do so at an early stage, in order to ensure that the stability target is met. Wage trends in the euro zone will be an important factor in inflation forecasts. If the money supply trend were to deviate further from the reference value, an increase in base rates would be required to the extent that the ECB was unable to show that the money supply overstates demand-relevant liquidity. Taken by itself, the acceleration of economic growth forecast in this report is no argument for tightening monetary policy. If wage trends remain moderate during the upturn, more workers could be integrated into the production process, and both GDP and potential output could grow faster without threatening price stability.

Fiscal policy

There are two main items on the fiscal policy agenda: firstly, the concrete measures that are to be implemented to consolidate the budget over the medium term, and secondly, the ways in which to adjust the taxation system to meet the challenges of the future.

The Institutes take the view that the prospects for government finances are not as unfavourable as is often suggested in the public debate; at least, this is true of the government budget as a whole. Last year the fiscal position improved, thanks to spending cuts and the economic recovery. This year the deficit will again decline slightly as a proportion of output, despite the weaker economic growth trend, falling from 2% in 1998 to 1¾% in the current year (1997: 2.7%). A further decline in the deficit-to-output ratio is expected next year (1½%). This assumes that any new cuts in taxation do not serve to widen the deficit, i.e. that the corresponding

Table 3
Effects of Taxation Reform on Government Revenues
 DM millions

	1999	2000	2001	2002
1 Increase in child benefit	-6 400	-5 800	-5 800	-5 800
2 Cut in lowest rate of tax	-1 370	-1 310	-1 330	-1 360
3 Cut in highest rate of tax for business income	-930	-1 120	-1 380	-1 500
4 Cut in rate of corporation tax	-1 365	-2 868	-3 815	-3 885
5 Increase in basic tax free allowance	-	-4 060	-3 870	-3 900
6 Cut in the lowest rate of tax	-	-620	-570	-600
7 Correction to tax progression	-	-6 280	-6 280	-6 420
8 Cut in the top rate of tax	-	-1 490	-1 630	-1 840
9 Cut in the top rate of tax for business income	-	-1 100	-1 340	-1 550
10 Increase in the basic tax free allowance	-	-	-	-5 220
11 Cut in the lowest rate of tax	-	-	-	-1 860
12 Correction to tax progression	-	-	-	-18 900
13 Cut in the top rate of tax	-	-	-	-2 170
14 Increase in child benefit	-	-	-	-1 900
15 Total revenue losses (1 to 14)	-10 065	-24 648	-26 015	-56 905
16 Tightening of the conditions on calculating taxable profits (provisions, partial depreciation etc.)	2 985	4 620	4 600	6 748
17 Abolition of the reduced tax rate for extraordinary income	1 326	3 820	6 858	6 686
18 Halving of the tax free allowance for income from savings and extension of the 'speculation period' for exemption from tax on private capital gains	166	2 411	3 575	4 035
19 Other measures	5 592	11 716	10 387	18 924
20 Total revenue gains (16 to 19)	10 069	22 567	25 420	36 393
21 Net revenue effect (15 plus 20)	4	-2 081	-595	-20 512

Sources: Federal Ministry of Finance; calculations by the participating Institutes.

loss of revenue is financed by spending cuts and reductions in tax concessions. These figures show that progress is being made in reducing the deficit. The deficit ratios forecast here for 1999 and 2000 are 0.3 and 0.6 percentage points respectively below the figure of 2% envisaged by the government for these years in its stability programme of January 1999. The target of 1% set for the year 2002 consequently appears realistic.

Given that the reduction of the deficit is to be associated with a decline in spending as a share of output, it is necessary to restrain the growth of public spending significantly below that of nominal GDP in the coming years. This will almost certainly not be achieved in the current year, unlike in the two previous years. While the growth of government spending will rise to 3%, nominal GDP growth will be just 2.6%; consequently, public spending will rise as a share of output for the first time in four years, namely from 48% to 48¼%. Given that a substantial proportion of spending is predetermined, not least due to the faster pace of wage growth in the public sector, any attempt to achieve the planned cuts in spending as a share of output would primarily hit public capital spending, and thus damage economic growth; in the event the government budget deficit would rise, benefit-

ing nobody. Specifically, this means that no attempt should be made to reduce spending growth by cutting public investment. If the economy does not recover in the manner forecast here, the higher deficit resulting from the impact of the built-in-stabilisers should be accepted. In other words, the Institutes are in favour of a fiscal policy course that keeps an eye on medium-term budget targets, but at the same time does not block economic recovery.

For the year 2000 the Institutes expect that spending growth will decline once more, reducing public spending as a share of output by one percentage point to 47¼%. If this course is maintained, the goal of a ratio of 45% envisaged by the government for the year 2002 appears attainable. It is also important to consider where and how cutbacks are made, however. Moreover, it must be recognised that substantial productivity reserves still exist in the public sector that could be exploited by simultaneously realising improvements in efficiency, e.g. with the help of new incentive systems.

Given the fact that the Institutes' prognosis for the government deficit as a share of output in the coming year is half a percentage point lower than that envisaged by the government, this scope could be used to

Table 4

Public Spending, Taxes and Contributions, Budget Deficit/Surplus and Government Debt
as a % of GDP

	Spending ¹	Taxes/ contributions ¹	of which:		Other revenue ¹	Budget deficit/surplus ¹	Government debt ²
			Taxes	Social contributions			
West Germany							
1960	32.9	33.4	23.0	10.3	2.6	3.0	17.4
1970	39.1	36.6	24.0	12.6	2.7	0.2	18.6
1980	49.0	42.8	25.9	16.9	3.3	-2.9	31.8
1985	48.0	42.8	25.2	17.6	4.0	-1.2	41.7
1990	46.1	40.5	23.6	16.9	3.5	-2.1	45.6
Germany							
1991	48.9	42.1	24.2	18.0	3.3	-3.3	45.5
1992	49.5	42.8	24.5	18.3	3.9	-2.8	50.4
1993	50.6	42.3	24.4	18.8	3.7	-3.5	56.7
1994	50.1	43.7	24.4	19.3	3.7	-2.6	57.4
1995	50.9 ³	43.9	24.4	19.5	3.7	-3.5 ³	58.3
1996	50.3 ⁴	43.3 ⁴	23.2 ⁴	20.0	3.4	-3.5	60.8
1997	49.0	42.8	22.7	20.1	3.4	-2.8	61.5
1998	48.0	42.5	22.9	19.6	3.3	-2.1	61.1
1999	48.2	43.1	23.6	19.5	3.2	-1.8	61.5
2000	47.2	42.6	23.5	19.2	3.0	-1.5	61.0
Target 2002	45.0	40.5	.	.	.	-1.0	59.5

1 On national accounting definitions. — 2 Government budgets (excluding social insurance; from 1991 including servicing of debts incurred by the German railways, the Treuhandanstalt (state privatisation agency), the former state housing sector of the GDR and special assets such as the fund to service former GDR debt (Erblastentilgungsfonds); from 1995 according to the definition set out in the Maastricht Treaty); figure at year's end as a % of the GDP of the year in question. — 3 Excl. asset transfers resulting from the assumption of the debts of the Treuhandanstalt (state privatisation agency) and the east German housing sector by central government. — 4 From 1996 change in the mode of payment of child benefit.

Sources: Federal Statistical Office; German Bundesbank; Federal Ministry of Finance; calculations by the participating Institutes.

reduce the spending-to-output ratio in the year 2000 by half a percentage point of GDP more than forecast here; this represents around DM 20 billion. The government would still meet its deficit target. The other possibility would be to reduce the deficit ratio faster than planned in order to achieve a completely, or almost completely balanced budget by 2002, which is the medium-term aim under the Stability and Growth Pact. The former strategy offers a chance of initiating more dynamic economic growth by reducing the burden of taxation, enabling faster progress to be made in reducing unemployment. The problem, on the other hand, is that further reductions in the structural budget deficit would be postponed by one year. In the second strategy the budget deficit declines faster. This would benefit not least the central government budget, whose deficit is currently only just below the ceiling set by Article 115 of the German Constitution. Given the continued uncertainty surrounding budget trends (not least in the wake of the Kosovo conflict), it seems less likely that the former strategy will be implemented than the latter. Yet in

doing so Germany would rob itself of the chance of significantly reducing the tax burden in the coming year, and thus of promoting more dynamic economic growth.

The taxation reform measures passed by the government will reduce marginal tax rates in stages, while broadening the tax base. This is a step in the right direction. In their Joint Report last autumn, the Institutes had recommended significant cuts in marginal rates and reductions in the gross and net burdens on taxpayers. They therefore welcome the decision by the government to prepare further reform measures with the aim, in particular, of reducing the tax burden on companies. Following the seemingly never-ending discussion on tax reforms, what is now important is to clearly set out the medium-term course of fiscal and taxation policy. The reform should also be decided upon quickly, so that the debates on taxation policy can finally quieten down. It is also necessary to objectivise the current discussion. For instance, the debate on the tax reduction law has focused exclusively on the financing measures, whereas the cuts in marginal rates were almost entirely over-

Table 5

International Comparison of Corporation Tax Rates and Top Rates of Income Tax

as of 1998, in %

	Corporation tax rate ¹		Top rate of income tax ²	
	Federal level	All levels	Federal level	All levels
Germany	48 ³	56.2 ^{3, 4}	55.9 ³	55.9 ³
France	41.7	.	54	61.3
Italy	37	41.3	50.5 ⁵	50.5 ⁵
Great Britain	31	31	40	40
USA	35	40.8 ⁶	39.6	45.8 ⁶
Japan	34	40.5	50	65
Canada	28	44.6	31.3 ⁵	49.6
Austria	34	.	50	50
Denmark	34	.	23.8	58
Finland	28	.	38	55.5
Ireland	32	32	48	48
The Netherlands	35	35	60	60
Portugal	34	34	40	40
Switzerland	8	17 to 34	11.5	42.4
Australia	36	36	47	47
New Zealand	33	33	33	33

1 Normal rate on retained profits. — 2 Top marginal rate of tax on income from dependent employment. — 3 Incl. solidarity surcharge. — 4 Incl. trade tax. — 5 Incl. surcharges. — 6 New York State.

Source: Comparison by the Institutes on the basis of figures from the OECD and the Federal Ministry of Finance.

looked. In the debate on green taxes, too, calculations were frequently made of the additional burdens without considering the simultaneous cut in social insurance contributions. As a result, the public gained the impression that these reforms would lead to a sharp rise in the overall tax burden. In actual fact, these measures will not increase the overall burden of taxes and contributions as a proportion of output in the current year, and in the year 2002 the burden will actually fall by half a percentage point. What is true, however, is that on balance the business sector faces higher taxes and contributions on the basis of the reforms introduced so far. Private households, on the other hand, will see a decline in their tax burden, although not until 2002 will this be to an appreciable extent.³

For a given volume of tax revenue, the fewer tax concessions there are, the less the taxation system distorts the allocation of resources, so that marginal tax rates could be correspondingly lower. This applies not only to corporate taxation, but to the taxation system as a whole. Such a taxation system is also more transparent, and thus less complicated, reducing the administrative costs to taxpayers and the state. Even after the most recent tax reform, income tax rates remain relatively high and the tax laws have become significantly more complicated.

The significant reduction in tax rates for companies has widened the gap between corporate tax rates and the top rate of income tax. If a uniform tax on a company's earnings (corporation tax or income tax on business earnings and trading tax) amounting to a maximum of 35% were introduced, then the gap on the top rate of income tax – from 2002 this will be 48.5% – would amount to 13.5 percentage points. Private incomes are discriminated against vis-à-vis business incomes, potentially infringing constitutional requirements. It would also increase the incentive to set up postbox companies, in order to declare income as business income. One solution would be to significantly

³ The business sector benefits from the cuts in income tax rates (the top rate of tax on business income will fall to 45% in 1999 and 43% in 2000, and corporation tax on retained profits will be reduced from 45% to 40% in 1999). At the same time companies will pay higher taxes thanks to the broadening of the tax base for income and corporation tax. It is difficult to estimate the overall impact of these tax changes on the business sector with any precision, because of the lack of appropriate statistics and because simplifying assumptions must be made regarding the way the impact of the various measures is divided between the business sector and private households. Estimates by the Institutes suggest that, including the new green taxes, companies face an additional burden of between DM 1 and 2 billion in 1999, while private households will benefit from a tax reduction of between DM 2 and 3 billion.

reduce the top rate of income tax for all types of income, for instance to 40% or even 35%. Such a sharp reduction in tax rates would, however, have substantial financial implications. It could not be financed solely by reducing tax concessions and cutting spending. Rather, a significant increase in indirect taxes would be necessary. On the other hand, a comprehensive taxation reform of this type, involving a marked reduction in tax rates in income and corporation tax, a reduction in the net tax burden, and a shift from direct to indirect taxes, would render the taxation system more conducive to economic growth.

Even a less ambitious reform, relating merely to corporate taxation, can only be introduced in successive stages. The gross reduction in corporate taxes of DM 7 billion assumed in the prognosis for the year 2000 is to be seen merely as a first step towards the planned reduction in the overall rate of business tax to 35%. Together with the necessary reform of the family support system, for which a figure of DM 5 billion has been set for the coming year, this requires, if it is to be financed in a revenue-neutral way, additional cuts in tax concessions and/or spending cuts totalling DM 12 billion.

Wages and salaries

During the past three years collective pay bargainers have sought to improve the conditions for raising the employment level by exercising wage restraint. Wage increases remained relatively moderate, and indeed lagged behind productivity growth, enabling unit labour costs to be reduced. This helped to raise employment last year; to this extent the policy has been successful. Yet this course was abandoned in this year's pay round; the trade unions demanded and got substantially higher wage increases, which were justified with reference to a strategy of bolstering domestic demand. As a result, the rate of growth of collectively agreed wages has risen significantly; at 3% in 1999 it will be almost twice the rate recorded last year.

The majority of the Institutes are concerned about the outcome of the 1999 pay round. It has significantly increased uncertainty over the medium-term course of wage growth. It is currently difficult to tell whether this year's pay settlement marks merely a one-off deviation from the policy of wage restraint. The majority are convinced that it is wrong to depart from the course pursued in recent years. Persistent real wage increases that fully exploit productivity growth would reduce firms' willingness to recruit additional labour and their propensity to invest. Employment would be lower than if the policy of wage restraint were maintained. Conse-

quently, the majority of the Institutes considers a continuation of the policy of wage restraint to be necessary, as argued in greater detail in the 1997 and 1998 Joint Reports, in order to improve the labour market situation.

The new government continues to put its faith in an 'Alliance for Jobs' as a way of raising employment. Experiences so far have not been particularly encouraging, however. This is partly because the topics to be discussed have been very broadly defined, encompassing virtually all areas of economic and social policy. Yet if the framework is too broad, an Alliance for Jobs is in danger of getting bogged down. It should therefore concentrate on two points, namely reducing uncertainty on the course of labour costs in the future, and seeking a consensus on the medium-term orientation of collective pay bargaining.

Consequently, it makes little sense to exclude collective bargaining over pay and conditions from such negotiations, as has been the case so far. Although in principle this is a matter for trade unions and employers' organisations, it may well prove advantageous to bring in the government. For it, too, could help to reduce uncertainty, for instance by presenting a credible strategy regarding the medium-term evolution of indirect labour costs, which are influenced by the state, the extent to which government intends to lay claim to the additional economic resources generated by productivity growth, or more generally by creating greater transparency in economic policy. This may well help to increase acceptance of the reforms necessary in areas such as pension insurance or the health system.

An Alliance for Jobs cannot be expected to bring about a rapid improvement on the employment front. Employers' federations cannot make concrete employment-creation commitments in return for wage concessions, as it cannot be guaranteed that they will be honoured, given that it is individual firms that take the relevant decisions. Similar considerations apply to the state, which should not be tempted to offer an employment guarantee. An Alliance for Jobs could, however, contribute indirectly to improving the employment situation, for instance by establishing more favourable conditions on the labour market and reducing uncertainty. Yet such a 'corporatist' policy also involves risks. There is the danger, for instance, that wage determination will become even more highly centralised than it already is, further reducing the scope for taking branch or firm-specific factors into consideration. Moreover, the tendency that manifests itself in such alliances towards making economic policy increasingly dependent on the outcome of bargaining between interest groups, giving an ever greater say to representatives lacking a political mandate, must give cause for concern.

A different view on wages and salaries

The Deutsche Institut für Wirtschaftsforschung (DIW) does not share the concern of the other Institutes about collective bargaining and current pay trends.

The opposing views of pay trends in 1999 rest, at heart, on a difference of opinion regarding the relationship between wages and employment. The majority postulates that the wage growth forecast for 1999 will prevent stronger employment growth than would have occurred given a greater degree of wage restraint. According to the DIW, wage restraint only makes sense in situations in which prior excessive wage growth has squeezed corporate profitability. This has not been the case in west Germany, however, for many years. On the contrary, according to calculations by the Council of Economic Experts, corporate profitability is currently as high as in the boom phase at the end of the 1980s. Moreover, the extreme form of wage restraint practised in recent years has meant that consumer demand in Germany has expanded only very weakly in comparison with earlier cycles. In this way the severe wage restraint of the past three years has damaged, rather than promoted, employment generation and investment activity. A collective bargaining strategy that seeks to exert pressure neither on supply-side nor demand-side conditions

must be oriented towards medium-term productivity growth. In such a strategy the scope for wage growth is set by the medium-term rate of productivity growth plus the inflation rate tolerated by the central bank.

The scope for wage increases within the parameters of such a strategy is currently of the order of 4%. This is the sum of medium-term productivity growth of around 2½% and an inflation rate of around 1½%. According to the joint forecast by the Institutes, gross wage and salary income per working hour will increase by 3.1% in 1999. Thus wage growth is below the rate compatible with a productivity-oriented pay policy. Even if current productivity growth – which is lagging perceptibly behind its medium-term trajectory, reflecting the impact of the global weakening of economic growth – is taken as a basis, this year's pay settlements do not give cause for concern. Unit labour costs are rising at a rate of 1.2%. They consequently do not pose a threat to price stability, nor will German companies suffer a loss of price competitiveness within the euro zone, as unit labour costs in the other participating countries are increasing at similar rates. This is all the more so given that the expected ending of one-off payments in the coming year means that labour costs will grow slightly more slowly next year, even if collectively agreed pay settlements are at the same rate as in 1999.