German Economic Trends

The economic situation in Germany improved perceptibly in the course of last year. Following subdued growth in the first half of 1999, the pace of economic activity picked up from mid-year on. On annual average figures, however, the rate of economic growth remains very low. The decline in exports was overcome in the summer of 1999, and exports have since recovered strongly. Thus, as in 1994 and 1997, the cyclical recovery has been largely on the back of sales abroad. There has been a slight recovery of domestic demand, however, beginning in the autumn, and incoming domestic orders have expanded. As a result, import growth has also been strong. The strong competitive position of firms operating in Germany, which reflects not least the moderate wage settlements of recent years, suggests that they will gain market shares during the current year. The expansion of domestic demand, on the other hand, will remain subdued, as the growth of disposable income will be sluggish.

The cyclical recovery will all but completely bypass eastern Germany. Economic activity there will continue to be depressed by the contraction in the construction sector. Yet industry, too, particularly the investment-good sector, will also exhibit little sign of recovery. Under these conditions, economic growth in eastern Germany will once again be below that in western Germany; there is no sign of a resumption of the catching-up process.

Brisk export growth

In the second half of 1999, goods exports expanded rapidly, recovering surprisingly quickly from the sharp contraction during the winter of 1998/99. The global demand shortfall resulting from the Asian crisis proved to be of short duration. The average rate of export growth of 4% for 1999 is the outcome of very different trends in the two halves of that year. The decline in sales to east Asia had come to an end as early as the end of 1998; in the first quarter of 1999 exports to the region expanded slightly once more. The decisive factor for German exports, however, was that the crisis in east Asia did not seriously affect sales markets in western Europe and North America – where Germany sells three-quarters of all its export goods (cf. table 1). Exports to central and eastern Europe, on the other hand, stagnated at the depressed level achieved at the start of the year until well into the second half of 1999. Sales to Russia fell particularly sharply.

Exports seem likely to continue to grow strongly in the year 2000. Of the factors conducive to this, the expected cyclical recovery in Europe is the most important. German exporters will benefit to a more than proportional extent from the pick-up in demand, thanks to their favourable competitive position, and they will gain market shares. The depreciation of the euro against the dollar and the yen will also benefit exporters. On top of this comes the fact that rising primary goods prices will bolster demand in those countries whose demand consists largely of investment goods for infrastructural development. Attractive sales opportunities will open up for German exporters here. In 2000 exports are therefore expected to grow at 9%, providing a strong impulse to economic activity.

Slight rise in employment

The expansion of employment came to a standstill in the spring of 1999, as economic growth weakened, and seasonally adjusted employment subsequently declined markedly to the year's end. The contraction of labour market policy measures, particularly in eastern Germany, intensified this trend further.

Assumptions on which the prognosis is based

- The price of primary goods, including crude oil, on world markets rises no further during 2000.
- The real external value of the euro increases slightly due to depreciation of the US-dollar in the course of 2000.
- The ECB tightens its monetary policy stance slightly. Capital market interest rates continue to rise marginally.
- Collectively agreed wages increase by around 2.5% in Germany as a whole, whereby increases in eastern Germany will be no higher than in the west of the country.
- Fiscal policy adheres to its consolidation-oriented stance. The federal government's austerity package is implemented more or less in full. There will only be marginal effects, if any, in the year 2000 from the planned reform of business taxation and the bringing forward of the cuts in income tax rates from 2002 to 2001.

Table 1

Changes in Destination of German Exports (Special Trade) by Region, 1997 to 1999

Country group	1997	1998	1st half 1999	3rd quarter 1999	1997	1998	1st half 1999	3rd quarter 1999	1997	1998	1st half 1999	3rd quarter 1999
	DM billion				As %				As % of GDP			
Total	889	950	474	244	100.0	100.0	100.0	100.0	24.2	25.0	25.2	24.8
EU	494	535	274	136	55.6	56.3	57.8	55.7	13.4	14.1	14.6	13.8
EFTA[1]	48	52	26	13	5.4	5.5	9.5	9.6	1.3	1.4	1.4	1.3
NAFTA[2]	89	103	54	30	10.0	10.8	11.4	12.3	2.4	2.7	2.9	3.0
East Asia[3]	79	67	33	18	8.9	7.1	7.0	7.4	2.1	1.8	1.8	1.8
CEE[4]	78	88	39	21	8.8	9.3	8.2	8.6	2.1	2.3	2.1	2.1
Mercosur[5]	14	15	6	3	1.6	1.6	1.2	1.4	0.4	0.4	0.3	0.3
Others[6]	87	90	42	23	9.7	9.4	8.9	9.3	2.4	2.4	2.2	2.3

1 Switzerland, Norway, Iceland, Liechtenstein. — 2 USA, Canada, Mexico. — 3 Japan, China, Hong Kong, Taiwan, Singapore, Thailand, Indonesia, Malaysia, Philippines, South Korea. — 4 Poland, Hungary, Czech Republic, Slovakia, Bulgaria, Romania, Russia, Ukraine, Belarus. — 5 Brazil, Argentina, Uruguay, Paraguay, and Bolivia and Chile (associate members). — 6 Africa, Australia and Oceania, other Asian and Latin American countries.
Sources: Federal Statistical Office; DIW calculations.

Given that a high level had been reached by the end of 1998, on annual averages the level of employment in 1999 was still more than 100 000 higher than in the previous year. The unemployment rate fell, partly for demographic reasons, from 10.6% in 1998 to 10.2% in 1999. The decline in unemployment was restricted to western Germany, however.

In the wake of the cyclical recovery, employment will rise significantly in the course of this year; on annual averages it will be around 60 000 higher in 2000 than in 1999. Because, for demographic reasons, supply-side pressure on the labour market will ease, unemployment will fall to a greater extent than employment rises. On annual averages around 200 000 fewer people will be registered unemployed than last year. As a result the unemployment rate will fall to 9.8%.

Government budgets

For many years fiscal policy makers have sought, as their prime aim, to bring about a sustained reduction in government budget deficits. In this they have been successful, in spite of the unfavourable macroeconomic environment. Between 1996 and 1998 the overall government deficit, on national accounting definitions, fell by almost half, from DM 121 to 54 billion. This primarily reflected cuts on the spending side, affecting public capital spending, public sector labour costs and social benefits.

Contrary to the forecast made a year ago, government deficits did not rise in the course of last year, but continued to fall, to DM 54 billion; this was in spite of the fact that the new German government had relaxed the consolidatory stance slightly, raising child benefit, boosting spending on active labour market policy, and reversing social security cuts implemented by its predecessor. In other areas additional spending, such as the grant to cover the deficits in the pension funds in the successor firms to the German Post Office, were financed by selling state assets.[1] The reduction in the deficit was considerably facilitated by the relatively positive tax-revenue trend, in which the termination of tax allowances and changes in tax laws played an important role. Whereas the budgets of central, state and local

1 Unlike in the fiscal statistics, in the national accounts such sales are not recorded as a revenue-generating transaction, as government is covered solely in its function as consumer, producer or investor.

Table 2

Federal Republic of Germany: Key Forecast Figures for Germany

	1995	1996	1997	1998	1999	2000
Gross Domestic Product[1] (% change on the previous year)	1.7	0.8	1.5	2.2	1.3	2.4
Employment[2] (in 000s)	36 428	36 158	35 866	35 994	36 109	36 170
Unemployment (in 000s)	3 612	3 965	4 385	4 279	4 106	3 909
Unemployment rate[3] (in %)	9.0	9.9	10.9	10.6	10.2	9.8
Unemployment[4] (in 000s)	3 198	3 498	3 907	3 710	3 542	3 345
Unemployment rate[5] (in %)	8.1	8.8	9.8	9.4	8.9	8.5
Consumer prices[6] (% change on the previous year)	1.7	1.4	1.9	0.9	0.9	1.1
Unit labour costs (% change on the previous year)						
Based on the number of occupied persons[7]	2.0	0.6	-0.8	-0.4	0.8	-0.7
Based on hours worked[8]	1.3	0.4	-0.2	0.1	1.1	-1.3
Public sector financial balance[9]						
in (DM billion)	–104.9	–121.2	–96.5	–64.5	–53.7	–44.6
in % of nominal GDP	–3.0	–3.4	–2.6	–1.7	–1.4	–1.1
Balance of payments[10] (DM billion)	–27.2	–8.4	–2.4	–6.5	–22.0	3.0

1 At 1995 prices. — 2 Domestic employment (average of quarterly figures. — 3 Unemployed as % of domestic employment (national definition). — 4 According to the convention of ILO. — 5 Unemployed as a % of employment (standardised definition). — 6 Price index of the cost of living of all private households. — 7 Wage costs (wages and salaries per employee) in relation to labour productivity (GDP at 1995 per employee). — 8 Wage costs (wages and salaries per working hour) in relation to labour productivity (GDP at 1995 prices per employee working hour). — 9 On national accounting definitions. 1995: excl. revenue of DM 5.6 billion from the takeover of the Deutsche Kreditbank; excl. the debts of the Treuhandanstalt (DM 204.6 billion) and the east German housing sector (DM 28.5 billion) transferred to the Erblastentilgungsfonds. — 10 On balance of payments definitions.
Sources: Federal Statistical Office; German Bundesbank; DIW calculations; 1999 and 2000: DIW estimate and prognoses.

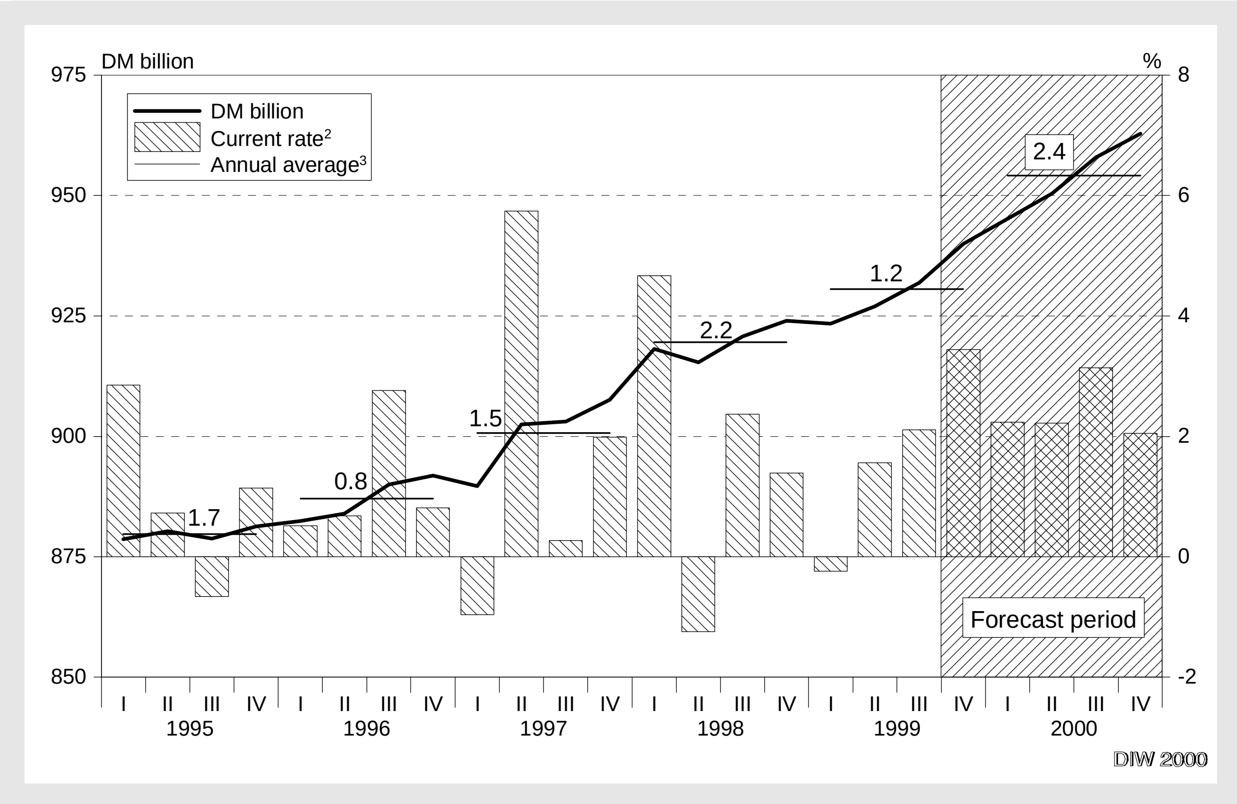
government posted a deficit of DM 66 billion, the social insurance funds recorded a surplus of DM 12 billion, of which DM 10 billion occurred in the pension insurance fund.

This year a further reduction in government deficits can be expected, to DM 45 billion. The deficits of central, state and local government will come down to DM 53 billion, but the surpluses recorded by the social insurance funds will probably also be somewhat lower (DM 8 billion). This would mean that the figure of 1% of GDP set as a deficit target by the federal government for 2003 will almost be achieved this year. Both revenue and spending will increase significantly more slowly than last year, at rates of 2.0% and 1.4% respectively. Tax revenues are expected to expand slightly faster than the size of the macroeconomic tax base. On balance the various changes in tax laws will ease, rather than increase, the pressure on government budgets. Cuts in income tax (DM 15 billion) and measures to reduce the fiscal burden on families (DM 5.4 billion) will be more than offset by the implementation of the next stage of ecological tax reform (DM 10 billion) and measures to broaden the tax base (DM 13.5 billion). The revenue-reducing effect of the tax concessions granted, in particular, in the context of support for the east German economy will also continue to decline in importance. Revenue from social insurance contributions, on the other hand, will increase only slightly, as the contribution rate to the pension insurance scheme is expected to be cut to 19.3%. The social insurance funds will also suffer a loss of revenue from the fact that the federal government has substan-

Figure 1

Real GDP in Germany

Adjusted for seasonal deviations and working days[1]



1 Using the Berlin Method (BV4). — 2 Change on previous quarter in %, extrapolated to an annual rate (right-hand scale). — 3 Change on previous year in %.
Sources: Federal Statistical Office; DIW calculations.

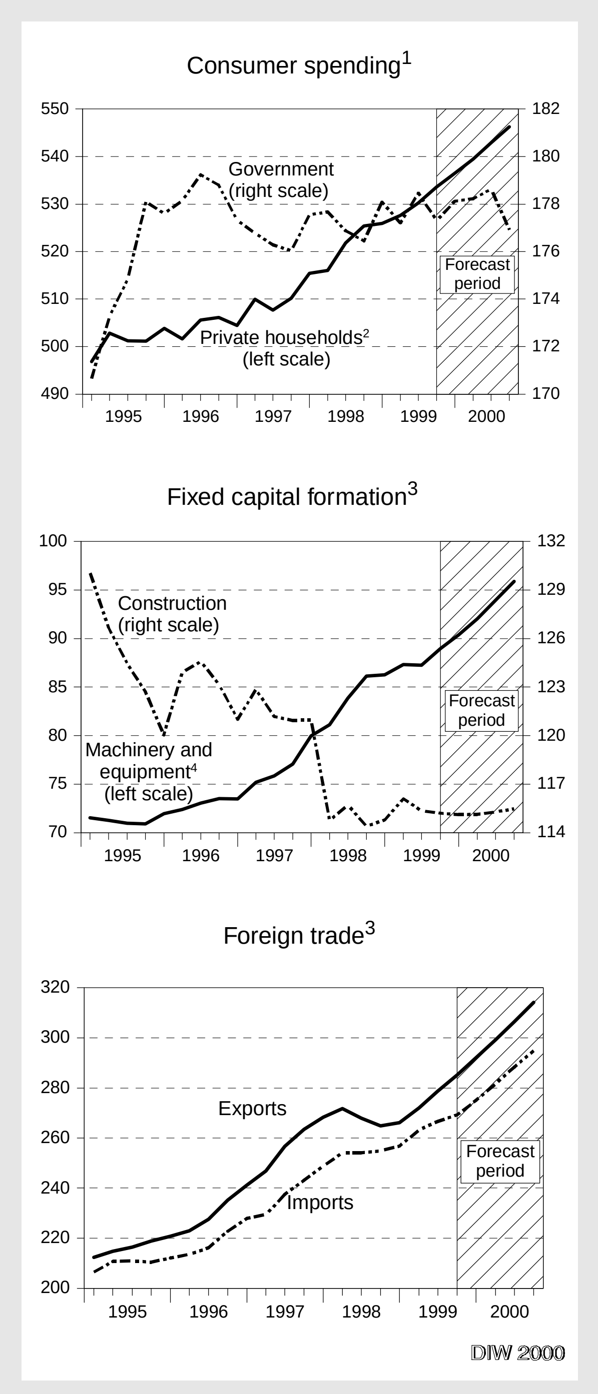
tially reduced the contributions it pays on behalf of recipients of unemployment assistance. The Bundesbank will also transfer a smaller profit to central government; last year the Bundesbank's surplus was inflated by windfall effects. The prognosis assumes that profits of DM 10 billion will be distributed, compared with DM 13.8 billion in 1999.

Developments on the spending side will be dominated by the government's austerity package (*Sparpaket*). It is to be implemented with a financial volume of DM 28 billion; those measures that shift the burden of spending onto state and local governments have been suspended. The package of savings is expected to reduce the burden on the central government budget by only DM 15 billion. More than DM 4 billion of this does not represent genuine savings, and just under DM 9 billion involves passing on the burden of expenditure to the social insurance funds; they, in turn, will benefit to the tune of DM 4.5 billion from the suspension of the formula for increasing pensions in line with net wages (pensions are to rise only in line with inflation). Pensioners are affected doubly by the suspension of pension increases, as they also have to pay the additional ecological taxes used to finance the reduction in contributions to the pension insurance system.

The impact of the austerity package will be felt most in government purchases of inputs and in monetary social benefits to private households; both items will increase by just 1.5%. This figure understates the impact of the austerity package on social benefits, however, as at the same time child benefit is being increased by almost DM 4 billion. Public-sector labour costs will also expand only very moderately. Not only will, as in previous years, rises in public sector wage rates be partially compensated by falling public sector employment; this year wage increases will be limited by the fact that civil servants' salaries are to be increased only in line with inflation, and blue- and white-collar settlements in the public sector are also expected to be below those reached last year.

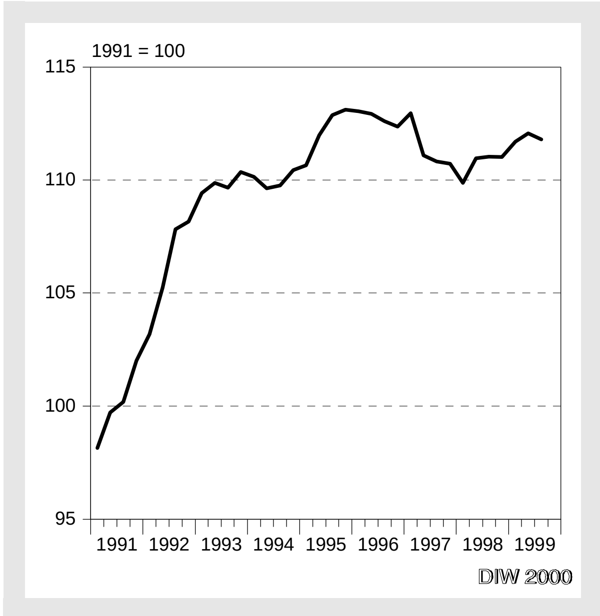
There is still no sign of a recovery in public capital spending. Although its previous dramatic decline came to a standstill last year, the financial position of local government, the main public-sector investor, has not yet

Figure 2
Components of GDP for Germany
in DM billions



1 Seasonally adjusted using the Berlin Method (BV4). — 2 Incl. private households and private non-profit organisations. — 3 Adjusted for seasonal influences and number of working days using the Berlin Method (BV4), — 4 Incl. other plant.
Sources: OECD; DIW.

Figure 3
Germany
Unit labour costs[1]



1 Gross income from employment in relation to real GDP. Seasonally adjusted using the Berlin method (BV4).
Sources: Federal Statistical Office; DIW.

improved to such an extent that it is finally in a position to commit more resources to investment. Local authorities in eastern Germany, especially, are suffering from a chronic lack of finance, though this is precisely the region in which the need for investment tends to be greatest. Thus, central and state governments are called upon to create the conditions under which local authorities are able to boost their capital spending once more.

All in all, German fiscal policy will once again exert a restrictive impact on the economy as a whole.[2] At DM 12 billion the restrictive impulse will be of the same order of magnitude as last year; this represents 0.3% of GDP. Allowing for multiplier effects, the negative impact is estimated at around half of one percentage point of nominal GDP. In their Autumn Report, the six leading German economic research institutes estimated the restrictive impulse of the austerity package alone to be around 0.4%. This effect will be mitigated, however, by factors such as the rise in child benefit and, although to a minor degree, cuts in tax rates.

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[2] The DIW's impulse concept is based on a comparison with the previous year. It is founded on the idea that government gives neither negative nor positive impulses to aggregate demand if its revenue and spending ratios, in each case with respect to nominal potential output, remain constant. Impulses are defined as those deviations in revenue and spending (to the extent that they affect domestic demand) from the actual outcomes of the previous year, extrapolated using the growth of nominal potential output. Thus it is not only discretionary changes in fiscal policy that are relevant to demand, but also, and indeed especially, the built-in stabilisers.

The need for a more offensive economic policy

The imminent cyclical recovery does not alter the fact that Germany's labour market problems will remain unresolved for the foreseeable future, especially in eastern Germany. Following the repeated cyclical setbacks during the 1990s, a sustained improvement in the employment situation can only be achieved if, above all else, it proves possible to achieve economic growth of a sufficiently high level and with sufficient stability to induce firms in large numbers substantially to increase their labour deployment. The example set by other countries shows that this is possible and that modern economies are not simply running out of work. While this is particularly true of the USA, in Europe, too, a number of countries, such as France, have managed to increase the volume of work – the total number of hours worked – during the 1990s (cf. figure 4). Particularly in the USA, but to a certain degree also in France, the growth dynamic has in recent years been higher and more stable than in Germany (cf. figure 5).

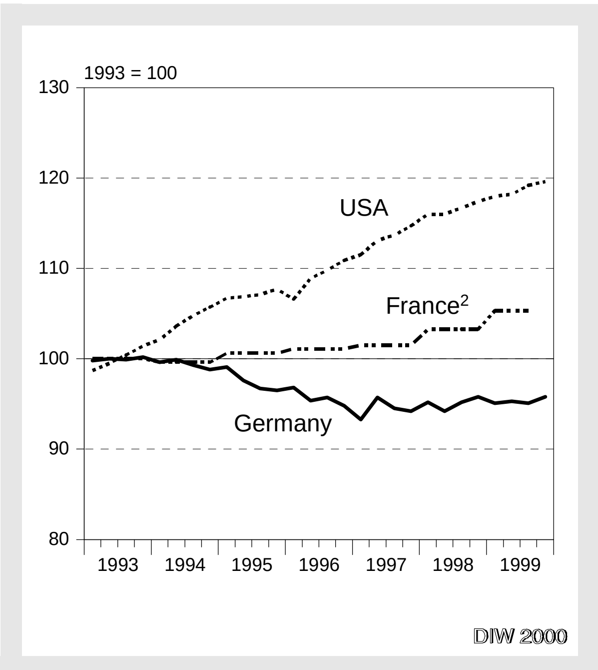
It is here that the central challenge to economic policy makers lies. It must chart out a course for a growth trajectory that, unlike that in 1994/95 and 1997/98, is not brought to a premature end before the problems on the labour market can be defused. Raising the demand for labour by way of a sustained and dynamic upturn is the best way to achieve higher employment. Such an offensive strategy requires, however, that all policy areas be oriented towards economic growth. It is an illusion to hope that isolated measures in specific policy areas, such as the reform of business taxation, will solve Germany's employment problem. Economic policy makers should adopt a course that is geared to the scope for economic growth and should stick to that course. In recent years this has been the case neither in monetary and fiscal policy, nor in collective wage bargaining.

In principle the conditions for an offensive strategy are currently rather favourable, as they were in 1994. The marked acceleration of export growth is sending out positive impulses. It ought now to be the task of economic policy to set the policy parameters in such a way that the export dynamic leads on to a lasting upturn, one that is founded on domestic demand. It is important, in this, that their sights are not set too low. Germany, too, can attain growth rates of 3% and higher over a period of many years. If this were achieved, the situation on the labour market would improve perceptibly.

Currently the stance of economic policy is ambiguous. Last autumn monetary policy abandoned the expansionary course it had charted until then. The intention was to take preventive action to counter inflation-fuelling developments. Yet no leading indicator has so far suggested that the higher prices of imported goods are in fact feeding their way through to a lastingly higher rate of inflation. The ECB's decision to raise interest rates could, therefore, be interpreted as meaning that it considers a growth trajectory of over 3% to be inflation-prone. Given that the EMU is a newly created currency area, it cannot ultimately be determined whether this fear is justified. Yet the empirical test of whether this is the case cannot occur if the cyclical recovery is choked off at an early stage. The costs of such an 'experiment' would be minor, for it would be possible to counter such inflation as may subsequently arise at a later date – namely when leading indicators, such as unit labour cost trends, actually point to such a danger – without the need for a stabilising recession. In view of the current monetary policy stance, therefore, the economy in the euro zone cannot be expected to move up to a growth trajectory of over 3%.

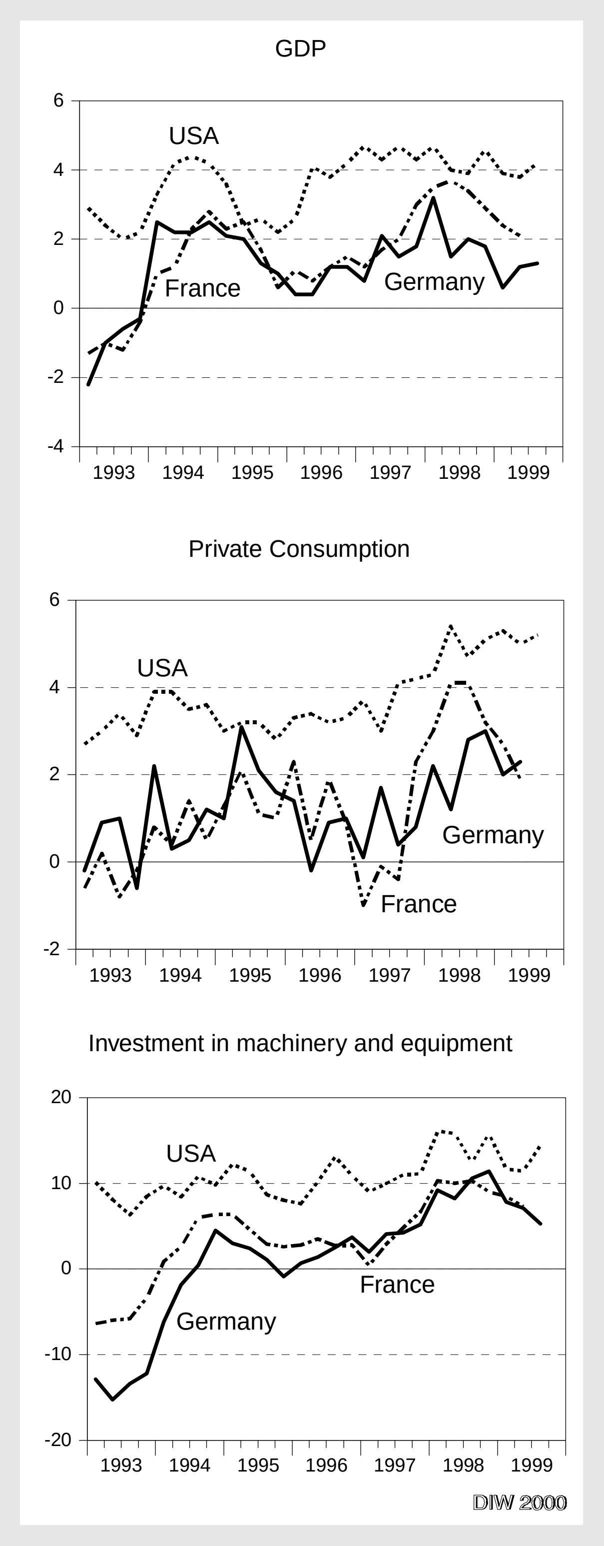
It must be recognised, however, that the scope for monetary policy to stimulate economic activity in Germany is limited. In a common currency area it must be geared exclusively to the EMU average. Currently economic activity in the euro zone is, on average, more favourable than in Germany. Countries such as Spain, Portugal and Ireland have embarked on a growth-inten-

Figure 4
Labour volume[1]



1 Seasonally adjusted. — 2 Only yearly figures available.
Sources: OECD; DIW.

Figure 5
GDP and Important Components[1]
in Germany, France and USA
% change on the previous year



1 Seasonally adjusted, at constant prices.
Sources: OECD; DIW.

sive catching-up process, in which the rate of growth of potential output tends to be very high. It must be noted, though, that in other core countries of the EMU, too, even in France, significantly higher growth rates have been recorded than in Germany since 1997. An important explanatory factor is that domestic demand, and in particular private consumption, has expanded far more strongly there than in Germany. It is the lack of these domestic expansionary forces that explains the unsatisfactory state of the German economy. Consequently, it is largely with the help of policy instruments located in Germany itself that the situation can be improved.

Fiscal policy is also constrained in its activities, not least as a result of the Stability and Growth Pact. Under its provisions Germany has committed itself to balancing public budgets in the medium term. Recently the German government has created the impression that it intended to meet its fiscal targets irrespective of the state of the economy. Surprisingly, it has now not only brought forward the tax cuts planned for 2002 by one year, but has announced further cuts to be implemented in subsequent years. To some extent these are to be financed by selling public assets, partly by 'returning' additional tax revenues to the taxpayers, and partly by borrowing. The less government uses the 'spending brake pedal', the greater the extent to which fiscal policy, at least, will bolster the upswing.

In the years 1996 to 1998 collective wage bargainers pursued a policy of strict wage moderation; nominal wage increases lagged substantially behind productivity growth and thus behind the growth of potential output. Not until last year did the stance shift slightly, and wage increases once again approximated to the trend rate of productivity growth. The employment effects of such a bargaining strategy result primarily via an improvement in international competitiveness. Yet clearly they are not sufficient to stimulate domestic demand. This is particularly the case when, as occurred in 1997/98, the export dynamic is disturbed by turbulences outside Germany's control.

Taking these three policy areas together, it appears questionable whether economic policy in Germany has set its sights high enough to permit economic growth at a rate that would enable a perceptible contribution to be made to reducing the country's employment problems. The one hope at present is that export growth will be so dynamic as to at least partially offset this conceptual weakness. And indeed, this hope is justified for as long as economic growth in the other EMU countries and the USA remains so strong. The current depreciation of the euro is also helpful in this regard. Yet the global economic turbulence of 1997/98 and its aftermath should have made it clear how risky such a strategy is. Each set-back on export markets prevents a further reduction in unemployment. A more reliable strategy would be to pursue, as France has done, a coherent economic policy that relies on strengthening domestic demand. If the nascent upturn is to be maintained over an extended period – similar to the period in the USA – it is vital that domestic demand be strengthened. Otherwise there is a danger that in 2001 economic growth will once again prove too moderate to have sustained effects on employment. What is needed is for Europe to assume the role of global economic locomotive currently played by the USA, with sustained and rapid economic growth.

Monetary policy

With its decision to raise interest rates in the autumn of last year, the ECB tightened its monetary policy stance for the first time since assuming responsibility for monetary policy at the start of 1999; six months earlier, in April, it had cut its base rates by half a percentage point. Was this rate hike really necessary to maintain the inflation rate within the target corridor? In answering this question it needs to be recalled that the ECB's aim is to restrain inflation below 2% over the medium term; thus, it takes the view that the current rate might at times exceed this reference value, provided it was clear that this state of affairs would be only temporary, without this compromising its stability concept.

The indicators chosen by the ECB itself offer no indication that the target is in danger of being missed. In particular, the uncertainties that influenced money supply trends last year in connection with the Y2K problem suggest that such a step should not have been taken so soon, but rather, at the very least, it should first have been established to what extent such uncertainty had distorted the figures.

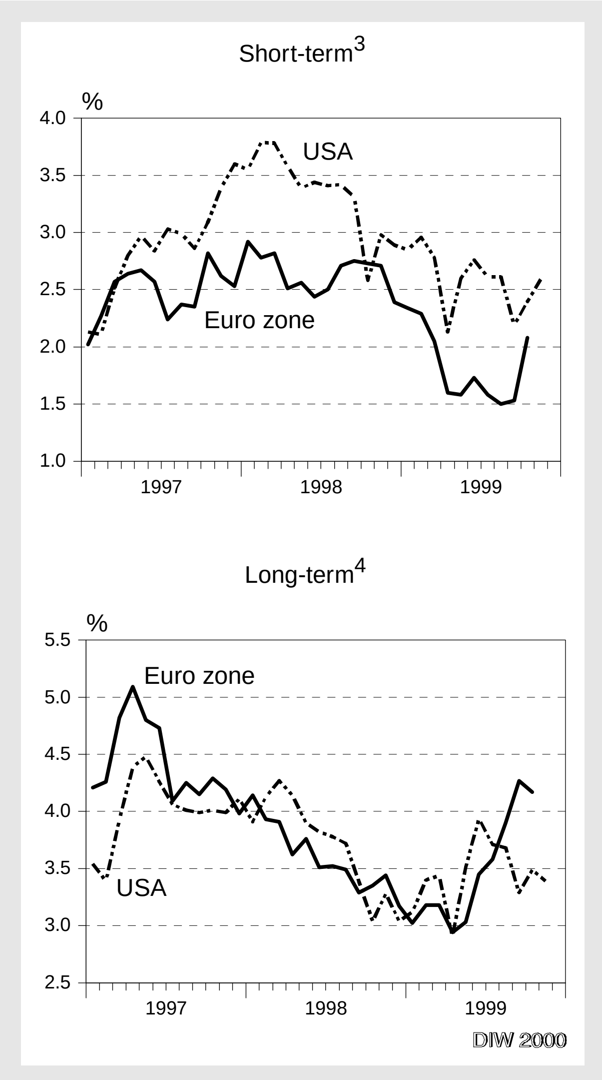
Yet the way in which the ECB evaluates the risk of inflation, too, poses questions. Although it is certainly true that at present, in Europe at least, there is no danger of a deflation, it is hard to see why, within the space of half a year, the economy has shifted from a deflationary to an inflationary risk, inducing the ECB to change the direction of its interest-rate policy. In fact, apart from the rise in the price of oil and the depreciation of the euro, there have been no new indications of inflation accelerating. Taken by themselves, the rise in the price of oil and the depreciation of the euro do not cause inflation to accelerate. It is only when they feed into markedly higher producer prices and, especially, into higher wage settlements that there is a danger of inflation taking hold, to the extent that the stability target might be exceeded. Yet there is no sign of such a trend at present – as was shown in the section of the report on the EMU – and it is only when such a trend is identified that the time has come for an interest-rate hike.

More plausible at first sight is the argument that the rise in base rates is justified because the economic prospects for the euro zone have now brightened to such an extent that a rise in rates is necessary to counter, at an early stage, the inflationary impulse arising out of strong economic growth. Of course, a more favourable economic situation increases the scope for producers to raise prices, particularly for as long as the depreciation of the euro is blunting the price competitiveness of producers from outside the euro zone. It must be questioned, however, whether this gives rise to a potential for inflation. Firstly, it is to be expected that the euro will not continue to depreciate during the current year, but rather will actually appreciate against the dollar, increasing competitive pressure from this direction once more. Secondly, competitive pressure within the euro zone itself remains high, as productive capacity remains under-utilised and wage rises moderate, as shown in the Autumn Report of the six leading German economic research institutes.[3] Under such conditions it is unlikely that the forecast pick-up in economic growth will pose an inflationary threat. Incidentally, almost all the current predictions for economic developments in the euro zone are broadly in line with those made in the spring of 1999, when the ECB cut its base rates. To that extent inflationary fears should have been relevant at that time, too.

The less convincing the justification for the rise in base rates in terms of the need to counter the seeds of future inflation, the more important the decision becomes in another, more fundamental, aspect. It is symptomatic of the restrictive bias of the ECB's policy stance, which, in this respect, appears to be following in the footsteps of the Bundesbank. It seems that monetary policy in Europe is guided by a rather restrictive mindset, one that, if in doubt, automatically attaches greater importance to inflationary risks than to those for growth and employment. This can be seen by comparing the reactions by the ECB to the turbulence in emerging markets with those of the US Federal Reserve. The negative demand impulses were roughly equally strong for both economic areas. Yet in 1997/98 the two regions found themselves in a very different cyclical situation. Whereas the US economy had for many years been on a growth trajectory in which output was growing at more than 3% a year, the European economy was just recovering from a cyclical setback, and had just regained growth of slightly under 3%.

[3] Cf. 'The world and the German economy in the autumn of 1998', The 'Six Institutes Forecast', in: *Economic Bulletin,* vol. 35, no. 11, November 1998.

Figure 6
Real Interest[1] in the Euro Zone[2] and the USA



1 Real interest = nominal interest minus increase of consumer price index. — 2 Up to 1998 national, with GDP-shares weighted rates. — 3 Short-term interest = 3-month interest. — 4 Long-term interest = yield of 10-year government bond.
Sources: OECD; DIW.

Comparison of interest rates between 1997 and 1999 makes it evident that short-term real interest rates in the USA were higher than in Europe throughout virtually the entire period (cf. figure 6). This indicates the slightly more restrictive stance of US monetary policy, which can be explained by the far more favourable state of the US economy. What are astonishing, however, are the changes in interest rates over the period in question. At initially unchanged nominal base rates, real interest rates on the American money markets firmed until the start of 1998, and then, helped by a cut in base rates in the summer of 1998, declined once more until the start of last year. It is only since then that they have been rising slightly, a trend once again brought on by a change (rise) in base rates. At the end of 1999 short-term real interest rates in the USA were roughly as high as at the start of 1997, i.e. before the turbulence on emerging markets, in spite of the still high rates of growth and the still favourable state of the labour market, both of which constitute favourable conditions for significantly higher inflation.

Europe was also characterised by rising interest rates until the start of 1998, in this case induced by an increase in base rates by the Bundesbank in the autumn of 1997. Not until almost the end of 1998, when the EMU central banks jointly cut base rates slightly, did a perceptible fall in money market rates occur, around six months later than in the USA. The interest-rate cut of December 1998 was, at heart, merely a reversal of the hike a year earlier. That increase was not in fact justified, as at no time did the then prevailing fears of accelerating inflation have an empirical basis. Thus the sole reaction of European monetary policy makers to the crisis consists in the base-rate cut in the spring of 1999, which came far later than in the USA. By contrast, it was only just after the USA that the ECB raised the base rate once again. In spite of the much less favourable state of the economy, the relaxation of monetary policy in response to the crisis was substantially shorter. Thus, in this difficult phase monetary policy in Europe provided significantly fewer impulses than in the USA.

This was reflected on the capital market. The turbulence in emerging markets led to a marked fall in capital market rates via the expectation, to which it gave rise, of a serious fall in economic growth, and thanks to the flow of capital it induced out of the crisis-hit countries to both the USA and Europe. It had been expected that subsequently, as the crises were gradually overcome and capital began to return to the emerging markets, capital market rates would rise once more in both continents. What is striking, though, is that in real terms capital market rates are currently higher in Europe than in the USA. Yet economic prospects, and thus expectations of the rate of return on real capital, will at best be only just as favourable in Europe as in the USA during the course of this year. It has to be concluded from this that real interest rates in Europe should not be higher, but rather lower – i.e. the conditions for financing investment more, not less, favourable – than in the USA. On top of this comes the fact that further rises in interest rates are expected in Europe; at least this seems likely on the basis of signs emerging from the ECB. The emerging monetary constellation is such as to place a millstone around the neck of the economic upturn in Europe. It is likely that this drag will initially be overridden by the expansionary impulse coming from export markets, so that this year the prospects for growth will not be seriously tarnished by them. In the longer run, however, this all-too-cautious approach will make its effects felt.

The ECB should have stuck to its expansionary stance even though the crises in the world economy have been overcome. This would have enabled real interest rates in Europe to be maintained at lower levels, improving the conditions for a sustained and dynamic upturn. This chance has been seriously reduced by the change of course in November 1999. With this, the ECB continues the tradition established by the Bundesbank in the 1990s of tightening the monetary reins 'if in doubt'. While there can be no doubt that this approach avoids inflation, it does so at the price of inadequate growth.

Depreciation of the euro no cause for concern

Last year the euro was among the currencies with the highest domestic price stability. Even so, its external value has fallen with only brief interruptions. In December its value was down by one-tenth against a basket of 13 currencies and by as much as 13% against the US-dollar, compared with a year earlier. The D-Mark, for many years the anchor currency in Europe, is probably currently undervalued – on the basis of consumer price parities – by about one-tenth against the dollar (cf. figure 7). The depreciation has often been explained with reference to Germany's pursuit of economic policies that have been detrimental to the euro's image. The dubious government intervention to rescue the bankrupt Holzmann construction company, for instance, has been put forward as a reason, not least by the ECB itself, which does not explicitly pursue an exchange-rate policy, but whose comments have in fact, contrary to its declared abstinence in this area, been grist to the mill of the currency speculators.

This explanation for the deprecation of the euro cannot be proved either way. It appears equally valid to argue that immediately after the Holzmann rescue German share prices shot up, and in the first half of the 1990s the D-Mark was highly overvalued, in spite of vehement criticism of Germany's lack of competitiveness as a result of inappropriate government policies. Less speculative and with a better empirical basis is the view that the gradual depreciation of the D-Mark since the summer of 1995 has been largely due to the gradual narrowing of the bond-rate differential between the USA and Germany (cf. figure 8). More generally, exchange-rate movements, which are often of a very speculative nature, are rarely a close reflection of economic fundamentals.

It is often pointed out, as an argument against the concentration on the exchange rate between the D-Mark or euro and the US-dollar, that since the start of 1999 the euro has also lost ground against other currencies, especially the Japanese yen. This objection loses force, however, when it is recalled that since the start of 1999 the dollar, too, has depreciated against the yen. No-one would consider this to indicate a fundamental loss of competitiveness on the part of the USA. Surely this should give food for thought to those who equate each and every depreciation of the euro with a decline in European competitiveness, but do not apply the same analogy in the case of an appreciation.

The depreciation of the euro is a double-edged sword. It stimulates exports, but it tends to fuel inflation. For this reason exchange-rate trends are being closely watched by the ECB. Depreciation does not offer, by itself, a justification for raising base rates, however. Imports represent around 15% of euro-zone GDP. Even if the euro depreciated by one-tenth, this would per se raise the price level in the currency area by just 0.2%. This effect would only pose a threat to price stability if it were to induce a cost-price spiral; there is no real evidence of this at present, though.

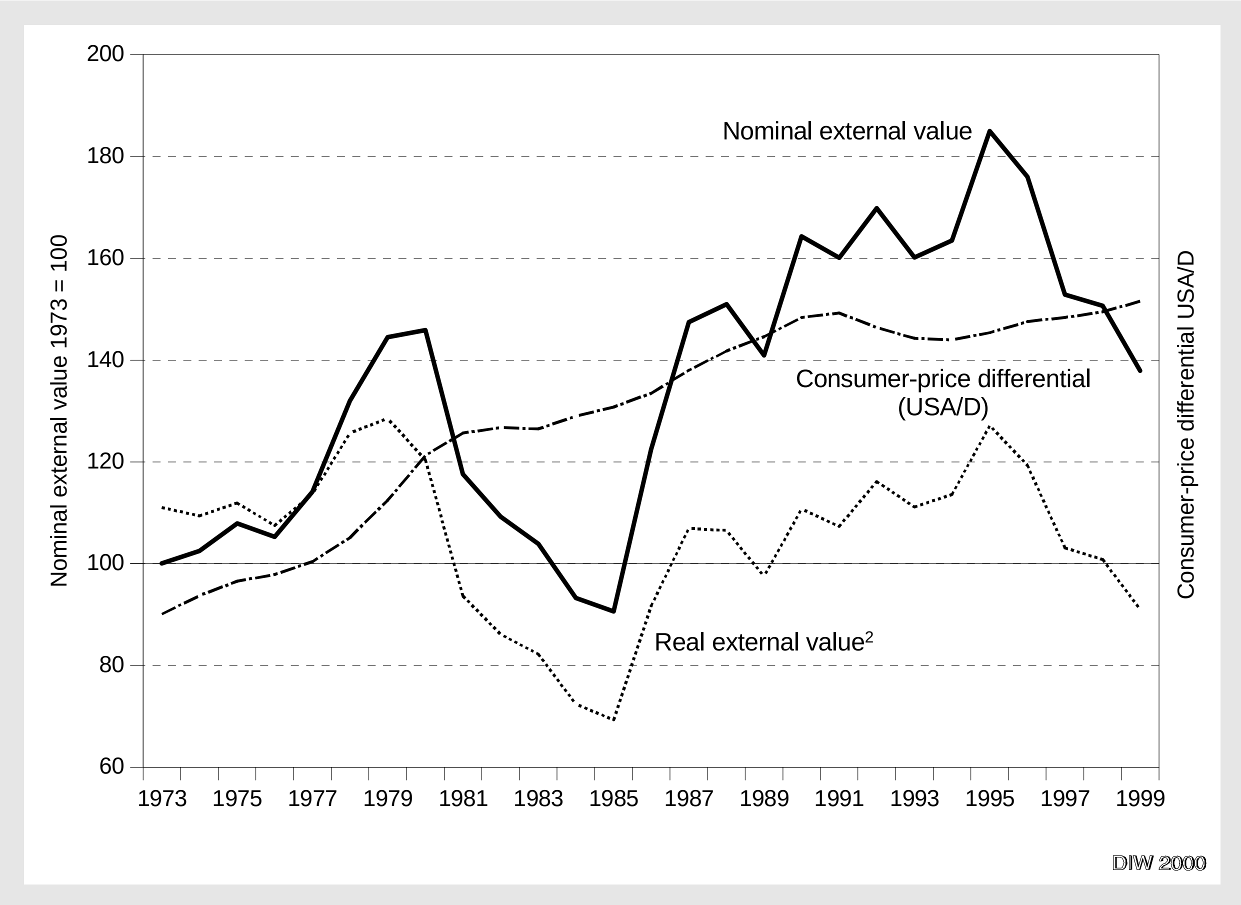
Fiscal policy

According to the prognosis presented above, German government deficits will come down faster than had initially been expected by the federal government. In its Stability Programme, presented to the European Commission at the start of 1999, it assumed a deficit ratio of 2% for the year 2000. The government has, however, recently revised its deficit target by planning to limit the combined deficits of central, state and local government and the social insurance funds to 1% of GDP by the year 2001. At the present juncture such a target does not appear particularly ambitious. Yet given the current state of the German economy, it must be asked whether it is in fact desirable to pursue such a target within this time-frame.

The government has consistently defended its austerity policies with its desire to regain the room for fiscal-policy manoeuvre. And indeed, although there were good reasons for the rise in government debt – and there can be no doubt that German unification and the sustained weakness of economic growth were good reasons – the rise was clearly much too steep, and it is indeed necessary to reduce the size of budget deficits. However, and this is a point the DIW has repeatedly emphasised, when this is done the macroeconomic environment must be taken into account. Timing is all-important.

Figure 7

External Value of the D-Mark Against the US-Dollar[1]



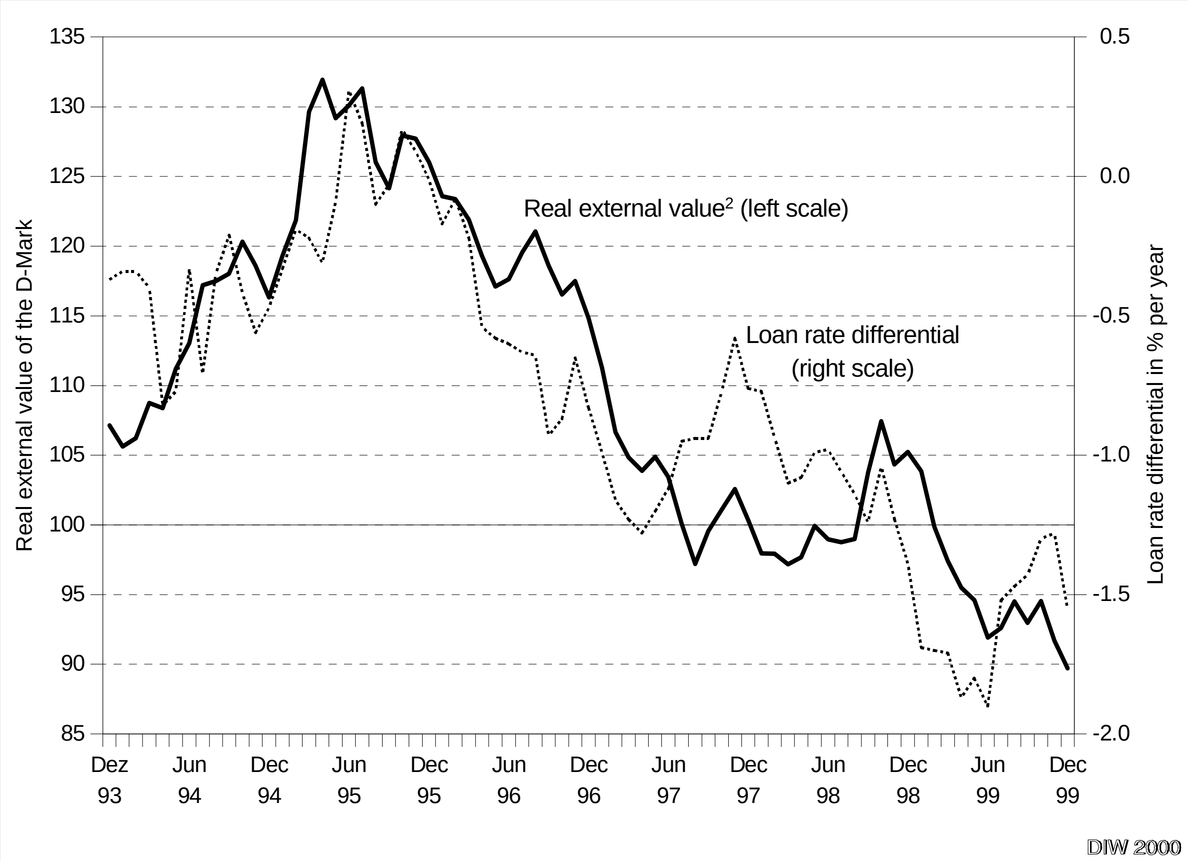
1 Last value (estimated): December 1999. — 2 Nominal external value of the D-Mark divided by the consumer-price differential USA/D; at a value of 100 the DM-dollar exchange rate corresponds to consumer price parity.
Sources: OECD; Federal Statistical Office; DIW.

In agreement with the other leading German research institutes, the DIW argued in favour of bringing forward the tax cuts planned for 2002, in order to provide the economy with the necessary impulses to bring economic growth onto a trajectory that would lastingly raise the level of employment. Surprisingly, shortly before Christmas the German government accepted these proposals to the extent that the tax cuts, alongside the reform of business taxation, are to take effect from 2001 onwards. In addition, further tax cuts to the value of DM 34 billion have been announced, which are to come into force by the year 2005: by that time the initial rate of income tax is to have been reduced to 15% and the top rate to 45%, and the basic tax free allowance to have been raised to DM 15 000. This decision was taken against the background of the favourable deficit trends.

These plans are to be welcomed unreservedly. Although the tax cuts will not offset the restrictive effects of the austerity package in the current year, they do assuage the fears that the cyclical upturn could grind to a halt for a lack of expansionary impulses by economic policy. The planned tax cuts are certain to have a positive influence on the expectations of investors and consumers. The greater the boost given to economic growth, the more likely are additional fiscal revenues in the longer term; deficits will come down more or less automatically during an upturn. If, during this phase, spending discipline is maintained, the German government is likely to record budget surpluses in the near future.

As is always the case with tax cuts, it must be decided which tier of government should initially waive the revenue. Clearly, central and state governments must cooperate in such fiscal policy decisions, and each tier must make an 'appropriate' contribution. The obligation on state governments to support the federal government is derived from their responsibility for the state

Figure 8
Real External Value of the D-Mark Against the US-Dollar and Bond-rate Differential[1] Germany Minus USA



1 10-year government bonds, German figure minus US figure. — 2 Nominal external value of the D-Mark divided by the consumer-price differential USA/D; at a value of 100 the DM-dollar exchange rate corresponds to consumer price parity.
Sources: OECD; Federal Statistical Office; DIW.

as a whole; this is reflected, for instance, in the fact that the actions of the federal states have to take account of considerations of macroeconomic equilibrium. Both central and state government budgets are expected to evolve in such a way during the coming years that, in spite of the tax cuts, they will no longer be in danger of infringing constitutional limits on their borrowing.

Yet in the context of this division of burdens and of the planned reform of business taxation,[4] it must also be considered whether local authorities should suffer a loss of revenue (compared to a situation without tax cuts). For it is planned that those non-incorporated companies that do not profit from the reform, because their profits (and thus their tax rates) are too low, will be allowed to offset their trading tax dues against their income tax dues. Steps must be taken to at least ensure that local governments do not suffer revenue losses. First, they perform tasks that are tightly circumscribed spatially; fiscal measures to stimulate growth, on the other hand, are primarily the task of central government, which, in Germany, also encompasses the federal states, as central and state governments perform their tasks 'as a community' *(gemeinschaftsgemäß)*. Second, the argument that local government finances are relatively healthy does not hold much water. In the case of local authorities it is not their financial balance at the end of the year that is the criterion that should be used to evaluate their financial situation, but rather changes in their capital spending; in recent years such spending has fallen substantially.

4 On a number of occasions the DIW has expressed its views on the reform of business taxation. It considers particularly problematic the introduction of a gap between the tax rates on retained profits by incorporated companies and the top rate of income tax, as this may lead to capital misallocation.

Collective pay bargaining in the year 2000

Following several years of pay restraint, last year collectively agreed wages and salaries increased slightly faster. However, in a number of leading sectors one-off payments were agreed upon which were conditional on the economic well-being of the branch in question. Payment of these one-off sums was possible thanks to the extremely favourable profit trends of companies in a number of sectors, particularly the export-oriented branches. As a result, collectively agreed wages rose by a total of 4.2% in the metalworking sector on annual averages, although new pay settlements were worth only just over 3%. One-off payments were not agreed upon in all bargaining areas, however, and the new settlements outside the metalworking sector were lower, so that the increase in collectively agreed wages in the economy as a whole last year amounted to 2.8% compared with the previous year.

In the past the DIW has repeatedly argued in favour of orienting pay settlements towards the medium-term productivity trend plus the target inflation rate set by the central bank. Such a strategy would stabilise wage trends and avoid both inflationary and deflationary tendencies. The long-term annual rate of productivity growth is of the order of 2.5%. Given an inflation rate of 1.5% considered tolerable by the ECB, a wage-growth trajectory of around 4% would conform to stability requirements. Increases in hourly wages that do not exceed this limit would ensure that collective bargaining did not come into conflict with the stability-oriented policies of the central bank. Unit labour costs – which are a leading indicator of inflationary trends – would then rise at a rate of 1.5%. Such a rate of growth is unproblematic in terms of international competitiveness provided unit labour costs in other countries increase by at least the same rate. This framework for wage trends at the macro level does not preclude sectoral differentiation.

With new settlements worth around 3%, last year's wage increases moved somewhat closer to the trend growth of productivity once more. Further careful progress down this path should be made in future. This year collective pay settlements are again expected to be of the order of 3%, which would be broadly in line with this recommendation. Settlements of this order of magnitude would raise hourly wages in the year 2000 (annual averages) by only just over 2%, as last year's one-off payments have not led to a permanent increase in the collectively agreed wage level.

What is vital above all else is to avoid sudden changes in pay trends; as with monetary and fiscal policy, wage trends should follow a medium-term path. The nominal-wage rigidity of such a strategy would help to smooth out the business cycle. During the upturn the demand dynamic does not receive a further boost, and stable unit labour costs restrain the upward pressure on prices. Both serve to counter an acceleration of inflation and avoid a stabilisation recession set off by the central bank. Equally, in the downswing the orientation towards medium-term productivity, by steadying private consumption, effectively works as a built-in stabiliser and prevents the deflationary trends resulting from falling unit labour costs. Moreover, sudden changes in relative prices, such as oil-price shocks or a rise in value-added tax, which, given rigid prices, tend to raise the price level, are also prevented from influencing subsequent wage trends under such a strategy. In this case an upward jump in the price level does not lead to a lasting acceleration of inflation.

Yet in recent years wage trends have certainly not been characterised by a steady, medium-term orientation towards productivity. Following several years of pronounced wage restraint at the end of the 1980s, hourly wages rose by annual rates of up to 8% between 1990 and 1993, in the wake of the unification-induced boom. In reaction to the subsequent recession, wage increases fell to just over 2.5% in 1994. In the 1995 wage round, however, hourly wage rises once again shot up to over 5%. The years 1996 to 1998, by contrast, were once again characterised by pronounced wage restraint. This is the decisive difference from wage trends in the USA. The overall increase in wage costs during the 1990s, once the recession had been overcome, was broadly the same in both countries, averaging 3%.[5] The degree of variation, on the other hand, was several times as wide in Germany.[6]

It is therefore vital that German wage trends be stabilised. The tripartite Alliance for Jobs offers a suitable forum for reaching agreement on a medium-term wage-growth trajectory. If the demands raised by the trade unions and the offers made by employers were to be geared towards this trajectory from the outset, the extreme fluctuations in wage settlements that have occurred in past years could be avoided.

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

5 USA: 1992 to 1999; Germany 1993 to 1999.

6 The standard deviation of the rates of growth during this period was 0.4 in the USA, compared with 1.3 in Germany.