The German Economy in the Autumn of 2001

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

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Overview

The German economy was already in a phase of weak growth prior to the terrorist attacks of September 11. National output had suffered a significant loss in momentum in the second half of last year and expanded only negligibly this year. Industrial output has even been in decline since spring, while there has been a perceptible decrease in capacity utilisation. The terrorist attacks are initially likely to further exacerbate the economic downturn. Thus, the hopes raised at the end of the summer that the recession had reached its lowest point and that an upswing would set in towards the end of the year have been dashed.

However, the Institutes do not expect this shock to cause a sustained economic decline, but rather only that the recovery will be delayed by a number of months. Nonetheless, given the high degree of uncertainty regarding future political developments and their economic consequences, this forecast is particularly speculative. It is based on the assumption that the terrorist attacks of September 11 were a one-off event, that the shock is only transitory, and that its economic effects will soon subside (cf. box 1). If, however, there were to be renewed massive attacks leading to the destabilisation of individual countries or regions and jeopardising oil supplies, the result would be a significant additional strain on both the world and the German economy. If the situation were to deteriorate into a crisis of this kind, the economy would be likely to sink into a deep recession.

Serious downturn

The economic downturn that began in mid-2000 was caused by the oil-price shock; this year growth was further curbed as the much tighter monetary policy stance adopted last year began to take effect. The end of the IT boom probably played only an insignificant part in Germany, unlike in the USA, for example. Initially the downturn primarily concerned domestic demand. Since the beginning of this year, however, exports have also been hit by the substantial decline in world economic growth.

Domestic demand remained weak this year. While private consumption was strengthened by the tax reform that came into force at the beginning of this year, expanding significantly in the first half of the year, the expansion of investment in machinery and equipment was much slower due to the reduced sales and profit expectations for exports, and it even declined perceptibly in the spring. At the same time, the sharp decrease in building investments continued.

The effects of the economic slowdown also increasingly spilled over into the labour market. After a significant improvement in 2000, employment has been falling since the beginning of this year, while the number of unemployed has risen substantially. The rise in unemployment was higher in western than in eastern Germany.

The perceptible weakening of the world economic climate is also affecting eastern Germany. While exports account for a lower share of eastern German output, the close links between manufacturers in the two parts of the country mean the recession in western German manufacturing industry is also affecting eastern Germany. The weak economy has extremely negative consequences for eastern Germany in as much as the strong growth in industry in recent years to an extent offset the sustained decline in the building trade. Manufacturing industry cannot fulfil this function at present, especially given that the contraction in the building trade has sharpened. Eastern Germany is thus falling further behind western Germany.

Monetary policy reacts to economic risks

If the assumptions concerning the further development of the global political situation prove to be correct, there are many indications for an economic upturn in Germany in the first half of next year. As the US economy grows, in large part thanks to that country's highly expansive monetary and fiscal policies, the global economic climate will improve again. However, export impulses will by no means be as strong as in recent years. On the one hand, the pace of world economic growth will be much slower than in 1999 and 2000. On the other, the stimulating effects resulting from the sharp depreciation of the euro in those years have now

Box 1

Assumptions Underlying the Forecast for Germany

The forecast is based on a range of assumptions, most of which are based in turn on prognostic considerations. However, some of the assumptions are only conjecture. The following are the assumptions made:

- The tense global political situation in the wake of the terrorist attacks in the USA and the resulting military operations will not lead to an escalation.
- Oil supplies will not be impaired. The oil price assumed for this year and next year is US-$ 25 per barrel.
- As described above, world economic growth will remain weak over the coming months. However, it will improve over the further course of the prognosis period. World trade will grow by 3.5% next year, following a 1% increase this year.
- The real effective external value of the euro will increase slightly over the prognosis period.
- The European Central Bank will reduce interest rates by a further quarter of a percentage point in the coming months. Further interest-rate reductions are not expected before the end of 2002. Capital market rates will remain low.
- Collectively agreed hourly wages will rise moderately again in 2002 – on average by 2.5%.
- Fiscal policy will have a restrictive effect next year as the tax burden increases. Government spending will increase roughly at the same rate as nominal GDP.

largely worn off and new export impulses cannot be expected from this quarter. The euro can be expected to strengthen somewhat next year.

Monetary policy is currently following an expansive course. Prior to the terrorist attacks, the ECB had already reduced base rates in two steps by a total of half a percentage point. Subsequently, they were reduced by a further half percentage point. Given the still relatively large degree of uncertainty about future growth prospects, the ECB is likely to reduce base rates again this year by a quarter of a percentage point (to 3.5%). Following a temporary increase around the middle of this year, capital market rates have now once again returned to the low level reached last spring. Overall, then, the monetary policy framework is likely to create impulses that will take effect in the course of the coming year.

Fiscal policy, on the other hand, which supported growth by means of tax cuts this year, will have a restrictive effect next year. In order to dispel doubts about its interest in consolidation and its intentions of adhering to the goals laid down in the stability programme, the German government will be keen to reduce the budget deficit again, which increased sharply this year.

Wages policy has helped to keep inflation within limits in recent years – despite substantial external inflationary pressure – by means of moderate pay settlements. This course is likely to be maintained, especially given the current slack economy and the accompanying perceptible worsening of the situation on the labour market. The marked slowdown in inflation this year will facilitate adherence to moderate pay settlements. Against this background, negotiated wage increases should amount to around 2.5% next year – not much higher than to date. Unit labour costs will rise by 1.5% this year and by over 1% next year. These increases will not exert any inflationary pressure.

Gradual economic recovery next year

The consequences of the terrorist attacks will be evident in the German economy over the coming months. Businesses and private households will be apprehensive and reluctant to make investment and purchase decisions. Against this background, national output is likely to remain stagnant until the end of the year. However, the dampening effects of the events of September 11 will subside perceptibly in the first half of next year. At the same time, the impulses from monetary policy will gradually take greater effect. In addition, the strengthening of purchasing power through subsiding inflation will have a positive effect on private consumption. Exports will be stimulated by the renewed expansion of the world economy, and the investment propensity of enterprises will also increase as sales prospects at home and abroad improve. There will thus be a perceptible rise in national output as early as the first half of 2002. All in all, real GDP can be expected to increase by 1.3% in 2002, as against 0.7% this year. Though capacity utilisation will increase over the course of next year, the annual average will be lower than this year. The labour market situation is unlikely to improve against this

Table 1

German Exports by Region

Country group	Nominal exports (special trade)								
	1999			2000			1st half 2001		
	DM billions	% share	% of GDP[1]	DM billions	% share	% of GDP[1]	DM billions	% share	% of GDP[1]
Total	997.5	100.0	25.8	1 167.3	100.0	29.5	626.4	100.0	31.6
EU	573.8	57.5	14.9	659.9	56.5	16.7	351.5	56.1	17.7
EFTA[2]	53.2	5.3	1.1	59.9	5.1	1.5	32.8	5.2	1.7
NAFTA[3]	115.4	11.6	3.0	137.9	11.8	3.5	76.4	12.2	3.9
East Asia[4]	70.5	7.1	1.8	91.1	7.8	2.3	48.2	7.7	2.4
CEE[5]	84.3	8.4	2.2	103.6	8.9	2.6	57.8	9.2	2.9
Others	100.2	10.0	2.6	114.9	9.8	2.9	59.8	9.5	3.0

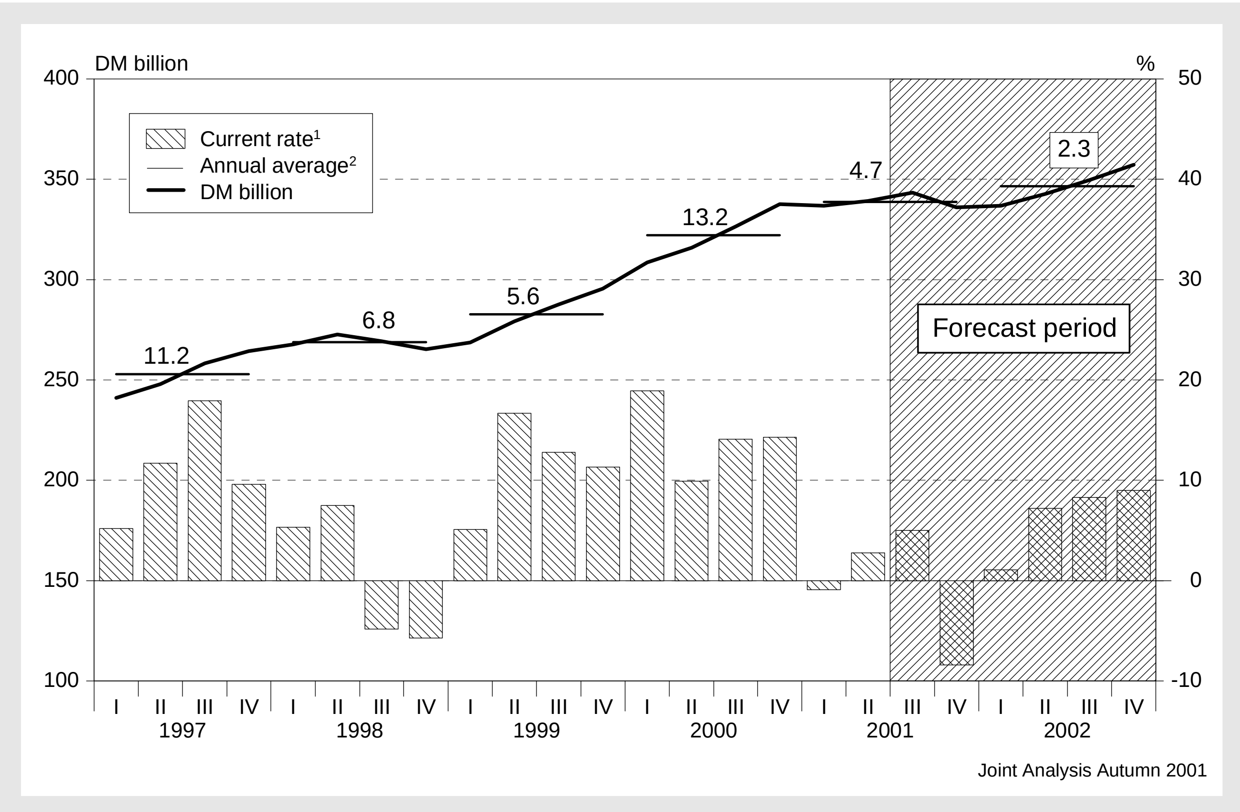
1 As % of nominal GDP. — 2 Switzerland, Norway, Iceland, Liechtenstein. — 3 USA, Canada, Mexico. — 4 Japan, China, Hong Kong, Taiwan, Singapore, Thailand, Indonesia, Malaysia, Philippines, South Korea. — 5 Poland, Hungary, Czech Republic, Slovakia, Bulgaria, Romania, Russia, Ukraine, Belarus.
Sources: Federal Statistical Office; Institutes' calculations.

background; the average number of unemployed in 2002 will be about the same as this year. Inflation, by contrast, will continue to subside, and the inflation rate will amount to 1.5% next year.

Figure 1

Real Exports of Goods and Services

Adjusted for seasonal fluctuations and working days



1 % change on previous quarter, annualised rate. — 2 Figures: % change on previous year.
Sources: Federal Statistical Office; Institutes' calculations; from III/2001: Institutes' forecast.

Forecast

Weak world economy puts a strain on exports

The economic downturn in the world economy hit German exports this year, which expanded only negligibly. While exports of durable and consumer goods, especially cars, were growing until recently owing to relatively robust consumption amongst important trade partners, the quantitatively more important exports of investment goods stagnated.

The foreign markets will initially be influenced by the recession in the USA. Exports will decline in the coming months. Exports to the USA will be hit particularly hard, but those to EU countries will also contract perceptibly. However, exports will expand strongly again from next spring onwards as the world economy recovers. The German economy's price competitiveness is likely to improve slightly over the prognosis period, despite the appreciation of the euro, because the increase in unit labour costs will be weaker than abroad. Real exports of goods and services will increase by only 2.3% on average in 2002 – partly because of their low level at the beginning of the year – as opposed to a 4.7% increase this year (cf. figure 1 and table 2).

Imports have grown only slightly this year owing to the weak economy. This trend will initially continue, but imports will expand more rapidly again next year as the economy grows. Overall, in 2002 imports will increase by 3.6% on 2001, as opposed to a 2.3% increase this year.

Table 2

Foreign Trade Indicators[1]

	1998	1999	2000	2001	2002
	% change on previous year				
Real exports	6.8	5.6	13.2	4.7	2.3
Goods	7.5	5.6	13.5	5.6	2.1
Services	2.3	5.6	11.2	–1.1	3.9
Real imports	10.3	8.0	10.6	2.6	3.6
Goods	3.8	10.3	7.8	1.0	3.7
Services	2.0	0.4	–4.5	0.6	1.4
Terms of trade	7.5	5.6	13.5	5.6	2.1
	DM billion				
Memo item:					
Real net exports	56.3	30.5	69.9	102.8	89.4
Nominal net exports	55.0	32.9	15.5	56.9	60.6
Balance of payments[2]	–11.8	–32.9	–41.1	–14.0	–12.0

1 On national accounting definitions (ESNA 95). — 2 On balance of payments statistics definitions.
Sources: Federal Statistical Office; German Bundesbank; Institutes' calculations; 2001 and 2002: Institutes' forecast.

Table 3

Contribution of Demand Components to Increase in GDP[1]

in percentage points

	1999	2001	2002
Consumer spending	1.1	1.2	1.1
Private households[2]	0.8	0.9	0.9
Government	0.2	0.2	0.3
Fixed capital formation	0.5	–0.6	0.1
Machinery and other investments	0.8	0.0	0.3
Buildings	–0.3	–0.6	–0.2
Change in stocks	0.4	–0.7	0.4
Domestic demand	2.0	–0.1	1.7
External surplus/deficit	1.1	0.9	–0.3
Exports	4.0	1.6	0.8
Imports	–3.0	–0.7	–1.2
GDP[3]	3.0	0.7	1.3

1 The contribution of a demand component to growth is given by the growth rate weighted with the aggregate as a share of the previous year's GDP; at 1995 prices; figures may not sum due to rounding. — 2 Including private non-profit organisations. — 3 % change on previous year.
Sources: Federal Statistical Office; 2001 and 2002: Institutes' forecast.

Following sharp increases in 1999 and 2000, import prices have fallen significantly this year. The decrease was brought about by lower prices for raw materials, especially crude oil. Import prices will initially continue to fall during the prognosis period due to the worldwide decrease in capacity utilisation. But the general economic recovery will gradually expand the scope for price increases so that imports will become slightly more expensive in the course of the coming year. However, inflation will be dampened somewhat by the appreciation of the euro. All in all, a slight fall in import prices can be expected on average next year, following a slight increase in 2001. Export prices will rise moderately in both years. The terms of trade will improve markedly next year, amounting to almost 0.5% of GDP. This will facilitate the recovery in Germany.

Machinery and equipment investments weak

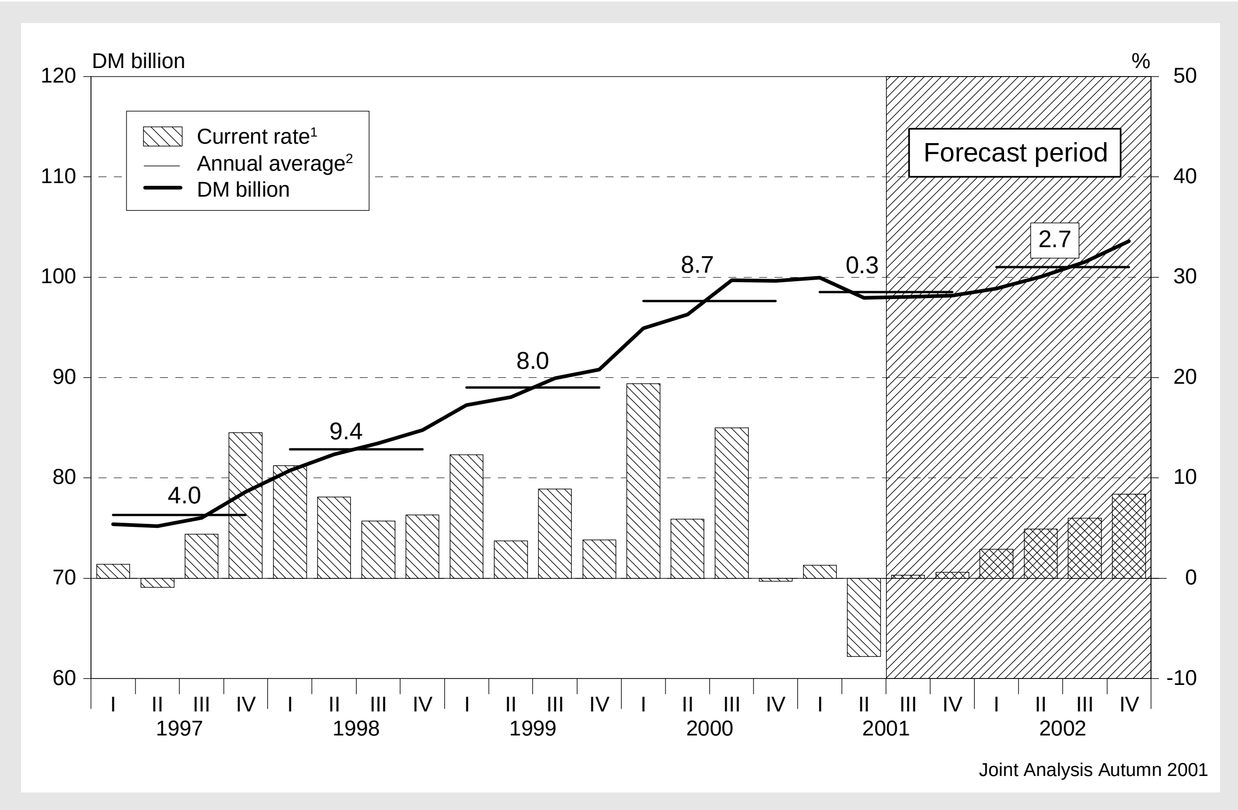
Investments in machinery and equipment declined perceptibly in spring 2001. The decline in capacity utilisation and the gloomy sales prospects in manufacturing industry have been heralding a weaker investment propensity since the end of last year.

Machinery and equipment investments will stagnate in the coming months. The greatly increased uncer-

Figure 2

Real Investment in Machinery and Investment and in Other Equipment

Adjusted for seasonal fluctuations and working days



1 % change on previous quarter, annualised rate. — 2 Figures: % change on previous year.
Sources: Federal Statistical Office; Institutes' calculations; from third quarter 2001 onwards: Institutes' forecast.

tainty about future economic developments at home and abroad will deter enterprises from increasing their investments. In particular, a sharp drop in investment in air transport can be expected owing to the severe losses in this sector. Machinery and equipment investments will only increase as of spring 2002, when exports and domestic demand strengthen. This development will be underpinned by a return to more favourable profit expectations as capital market rates remain low.

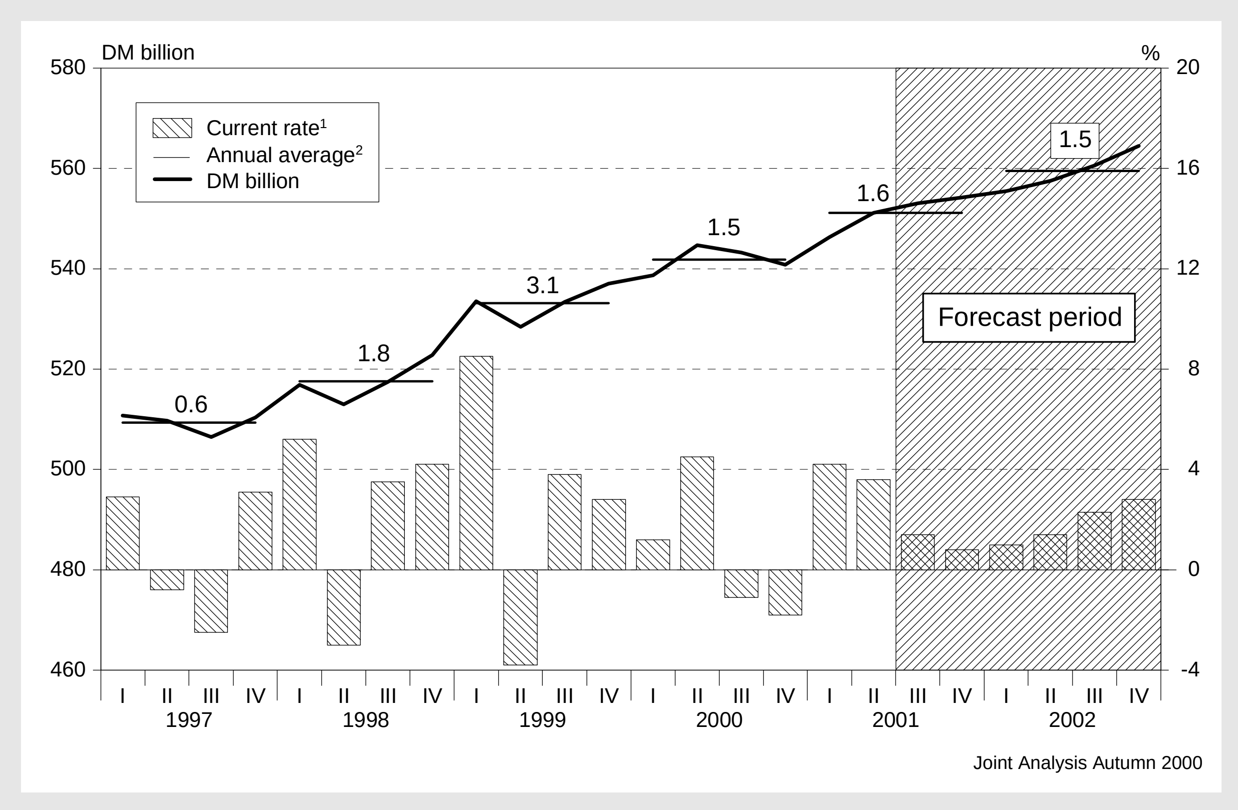
Investment in other equipment, which includes software purchases, has grown at a much slower pace recently, following the end of the boom in the IT sector. A cyclical increase in the demand for software can be expected over the prognosis period, while investment in other equipment will receive an additional stimulus from the increased need for security technology and its software components. Investment in other equipment will thus expand at a higher rate than machinery investments. Overall, investment in machinery and other equipment will increase by 0.3% this year and by 2.7% next year (cf. figure 2).

Consumption growth slow

Private consumer spending expanded strongly during the first half of 2001, in large part as a result of the tax cuts that came into force at the beginning of the year. Net wages and salaries increased in the first half of the year at an annual rate of 4.4% and thus exceeded the increase in gross wages by almost 1.5 percentage points. There was an even higher overall increase in disposable income, probably in part because income from profits was moved forward into this year by the tax reform. However, a substantial share of the income growth flowed into savings; the savings rate increased by almost half a percentage point.

Consumption growth will cool down considerably as this year progresses. While inflation will fall significantly, the dampening effect will now come from the decline in employment. The propensity to consume is also likely to be negatively affected by the terrorist attacks and the general uncertainty about future economic developments. Overall, however, private consumption will increase in real terms by 1.6% this year.

Figure 3
Real Private Consumer Spending[1]
Adjusted for seasonal fluctuations and working days



1 Including non-profit organisations. — 2 % change on previous quarter, annualised rate. — 3 Figures: % change on previous year.
Sources: Federal Statistical Office; Institutes' calculations; from III/2001: Institutes' forecast.

Consumption prospects will brighten again over the course of next year. Gross earnings will rise because pay increases will be somewhat higher than this year and there will be a cyclical increase in employment. However, net wage and salary growth will be dampened somewhat by the increase in contribution rates to statutory health insurance and because the progressive income tax rate will take full effect again. Income from self-employment, investments and monetary welfare benefits (child allowance will be increased at the beginning of the year) is likely to expand significantly. All in all, the disposable income of private households will expand at an accelerated rate in the course of 2002. At the end of the year, real consumption will have increased at roughly the same rate as this year, also as a result of moderate inflation (cf. figure 3).

Inflation eases

Following a temporary acceleration in the spring, when prices for foodstuffs and mineral-oil products had soared, consumer price inflation has now cooled down perceptibly. This was largely the result of the sharp decline in oil prices, which are now even lower than at the beginning of this year. In addition, there are signs that food prices will subside now that the sharp increases due to the livestock epidemics have come to a halt. The cost of living index remained practically constant between June and September of this year. Since reaching its highest value in May (3.5%), the inflation rate has fallen significantly compared with last year. Inflation was only barely over 2% in September.

The price climate can be expected to remain calm over the prognosis period, both because of another small increase in unit wage costs and because of restrained growth, which leaves little scope for price increases. This trend will be interrupted by tax increases in the first half of 2002: in addition to the next step of the ecological tax reform, the recently announced increases in tobacco and insurance tax alone will lead to an increase of 0.5 percentage points in the cost of living. However, as the year progresses, the favourable basic trend will

Table 4

Key Forecast Figures for Germany

	1998	1999	2000	2001	2002
Gross Domestic Product[1] (% change on the previous year)	2.0	1.8	3.0	0.7	1.3
Western Germany[2, 3]	2.2	1.6	3.2	0.7	1.3
Eastern Germany[3]	1.0	1.4	1.1	0.0	1.0
Labour force[4] (in 000s)	37 611	38 081	38 706	38 740	38 754
Unemployed (in 000s)	4 279	4 099	3 889	3 845	3 860
Unemployment rate[5]	10.2	9.7	9.1	9.0	9.1
Consumer prices[6] (% change on previous year)	1.0	0.6	1.9	2.5	1.5
Unit labour costs[7] (% change on previous year)	0.2	0.6	–0.1	1.5	1.2
Public sector financial balance[8] DM billions	–83.5	–60.0	46.7[9]	–101.1	–82.0
as % of nominal GDP	–2.2	–1.6	1.2[10]	–2.5	–2.0
Memo item: Local authorities' financial balance as defined by ESNA 95 (DM billions)	–88.4	–70.5	45.6[9]	–102.8	–84.9
Balance of payments (DM billions)	–11.8	–32.9	–41.1	–14.0	–12.0

1 At 1995 prices. — 2 Including Berlin. — 3 Figures as at March 2001. — 4 Domestic. — 5 Unemployed as % of domestic labour force (place of residence concept). — 6 Cost of living index for all private households. — 7 Gross wages and salaries per employee created in the domestic economy as % of GDP at 1995 prices per member of labour force. — 8 On national accounting definitions (ESNA 95). — 9 Including profits of DM 99.4 billion from the sale of UMTS licences booked as net expenditure on intangible assets. — 10 Excluding profits from the sale of UMTS licences: –1.3%.
Sources: Federal Statistical Office; Federal Labour Office; Federal States' Working Group on ESNA; German Bundesbank; 2001 and 2002: Institutes' forecast.

increasingly take hold. In early summer, the inflation rate is likely to decrease temporarily on this year to 1% – owing to the statistical base effect – but then to increase slightly again. Overall, consumer prices will rise by an average 1.5% in 2002, following a 2.5% increase this year (cf. table 4).

No output growth until next year

The downturn in national output that began in the middle of last year has continued this year. Output stagnated in the second quarter of the year. The substantial contraction in the building sector, in particular, had a dampening effect. In the first half of the year, output in the construction industry fell by 13.5% compared with the same period last year. Industrial production, which – thanks to a cushion of orders – had increased in the first quarter of 2001, has since been in decline. In the tertiary sector, trade and private-sector services were particularly affected by weak demand.

There will be practically no increase in national output for the rest of this year. While the decline in the construction industry will be smaller than in the first half of the year, domestic and foreign demand for industrial goods will decrease. Industrial output will rise only slightly this year – by around 1% – as opposed to 6.3% last year. Moreover, the increase in value-added in the service sector will be curbed, in particular by falling demand in the tourist and air transport sectors. The average annual increase in GDP will amount to only 0.7%.

However, expansive impulses will gradually gain the upper hand again in 2002. Foreign demand will recover, and domestic demand will become more vibrant. Industrial production will thus gain momentum again. The decline in the construction sector will be less severe than this year. In the tertiary sector, stronger growth can be expected in enterprise services and in transport and communications. In private-sector services and in the retail trade, by contrast, value-added will initially rise only slightly. All in all, GDP will increase by almost 2.5% over the course of the year. However, the annual average increase will be only 1.3% owing to the low level at the end of this year.

Box 2

The Cost of Transition to the Euro for the German Public

The euro will be introduced as legal tender at the beginning of 2002. As the date approaches, fears have been expressed in Germany that the conversion to the euro will be accompanied by 'hidden price increases'. However, the fierce competition in the retail trade, which has been squeezing profit margins for years, and the generally weak economy mean significant price increases are unlikely. In addition, prices that for technical reasons can only be exchanged at the rate of two to one (e.g. in the vending machine trade) will be decreased by 2.2%.
In the public sector a range of 'representative amounts', such as tax-free allowances and fee scales, will have to be converted from what are usually round DM sums to euros. The means of conversion will be regulated by several laws, in particular the 'tax law on euro rounding'. The new definition of the representative amounts essentially favours the tax payer. In itself, this has no effect on the consumer price level, but it reduces the tax burden, which acts like a price decrease on real disposable income. The approach taken by the Länder was to use a mixture of cuts and burdens to arrive at cost-neutral regulations. The local authorities followed the same principle.
All in all, the Institutes do not expect to see noteworthy burdens arising from the conversion to the euro. At most, price increases were only likely during recent months as company accounting systems were adjusted to accommodate the euro. A price thrust at the beginning of next year is thus not considered in this prognosis.

According to provisional calculations, GDP in eastern Germany was 0.6% lower in the first half of this year than in the first half of last year. The main cause was the severe decline in building activities: the decline amounted to 19.5% in the construction industry. In addition, industrial production was also sucked into the economic recession.

The economy in eastern Germany is unlikely to improve for the rest of this year. While the decline in the construction industry will not be quite as severe, there is still little sign of improvement in most of the other sectors. Stagnation can be expected on average for 2001. Overall output will increase again in eastern Germany in 2002 because the dampening effect of the decline in the construction sector will subside and because industrial production will gain momentum again as the economy recovers.

Fiscal policy to curb growth

Fiscal policy, which is still providing considerable impulses in 2001 thanks to the 'Tax Reform 2000' as the government pursues its course of consolidation, will have a restrictive effect in 2002, especially because the tax burden will be increased.

Government spending will increase by 2% in 2001 (2000: 1.5%) if the profits from the sale of UMTS licences are excluded from spending in 2000. The increase is primarily caused by monetary social welfare benefits. The decisive elements are the sharp increase in pensions and the increase in certain transfers (housing allowance, student grants, parental allowance, heating subsidy); in addition, labour market spending will increase as a result of the weak economy. Spending on statutory health insurance will also expand strongly. Personnel expenditure will increase slightly – following a slight decrease in 2000 – while personnel reductions will continue because the pay increase in the public service was higher this year than last year. Government interest spending will fall again in 2001 because most of the profits from the sale of UMTS licences were not used to pay off debts until this year.

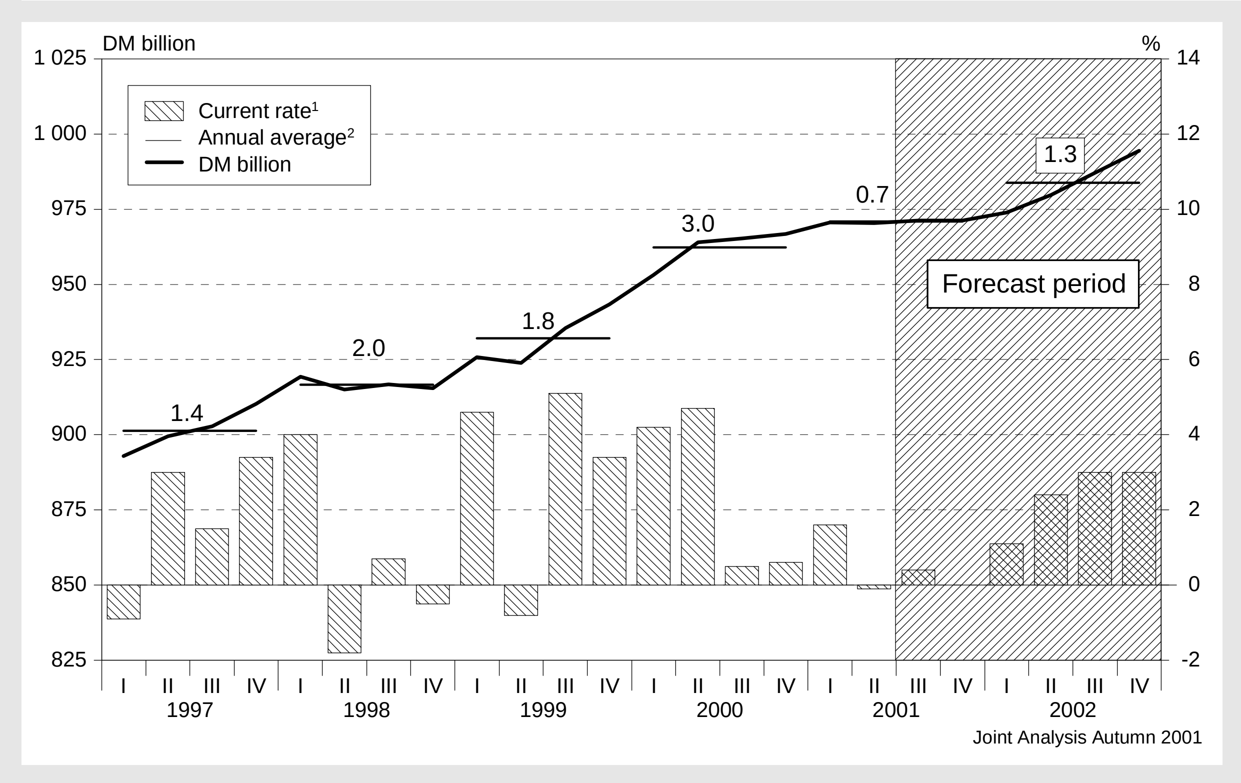
Next year's increase in government spending (3.1%) will be higher than provided for in the federal government's stability programme (2%). Child allowance will be increased and so-called active labour market policy will be expanded. In the area of internal security and in the military sector, spending will be increased by a total of DM 3 billion. In the public health service, by contrast, savings on pharmaceutical expenditure of between DM 2 billion and DM 3 billion are planned. The personnel reductions in the public sector will be smaller than in previous years, while expenditure on personnel will increase somewhat. Interest payments will also increase substantially in the wake of a sharp increase in the new debts assumed by the public budgets in 2001.

Government investments will stagnate this year and next year in view of the tight financial situation of many local authorities and will thus remain entrenched at 1.8% of GDP (cf. table 5), compared with investment rates of 3.9% in the 1970s and 2.7% in the 1980s. How-

Figure 4

Real GDP in Germany

Adjusted for seasonal fluctuations and working days



1 % change on previous quarter, annualised rate. — 2 Figures: % change on previous year.
Sources: Federal Statistical Office; Institutes' calculations; from third quarter 2001 onwards: Institutes' forecast.

ever, the municipalities are now increasingly investing through private companies which they in fact own.

Government revenue will decrease by 0.5% this year, while next year it is likely to increase by 4.3%. The main reason for this year's decline is the Tax Reform 2000; on the one hand, the reform of the income tax rate leads to relief of DM 28.4 billion, while, on the other, the reform of company taxation reduces the tax burden for enterprises by DM 17 billion. This in itself results in a tax-induced impulse of over 1% of nominal GDP. In addition, the weaker growth is now beginning to manifest itself in tax revenue. Thus, stagnating profits are increasingly leading to reduced advance payments. But the situation is also being dampened by the fact that in the case of taxes on profits, the retroactive payments resulting from the assessments of the weak profits of 1999 will be much smaller this year. By contrast, the increase in mineral oil and electricity tax in accordance with the ecological tax reform will increase revenue by DM 5.3 billion. All in all, tax revenue (on national accounting definitions) will fall by 3.7% this year; revenue is likely to be approximately DM 6 billion lower than estimated in May 2001.

Tax revenue will increase sharply next year – by almost 6%. In addition to economic recovery, the increase will also be supported by the fact that the progressive income tax rate will take full effect again, while the changes in the tax law will lead to a net increase in revenue. While the further development of company tax law, which is designed in particular to help small and medium-sized enterprises restructure their companies, and fiscal support for private provision for old age, will lead to reduced revenue, these losses are offset by higher increases in revenue from the third step of the ecological tax reform, the increase in insurance and tobacco tax,[1] and the lower household and educational allowances introduced by the 'second law on family support'. Moreover, increased revenue is also expected from the battle against turnover tax fraud, which is increasing throughout the EU, and against illegal employment in the construction industry.

[1] The federal government estimates that the increase in insurance and tobacco tax will lead to increased revenue of DM 1 billion and around DM 2 billion, respectively, in 2002. The Institutes estimate increased receipts of DM 4.2 billion because they expect more revenue from tobacco tax.

Table 5

Selected Fiscal Policy Indicators[1], 1991 to 2002

as % of nominal GDP

	Government receipts			Government expenditure			Financial balance	Memo item: interest/tax ratio[2]
	Total	of which: Taxes	of which: Social insurance contributions	Total	of which: Interest spending	of which: Gross investment		
1991	44.1	22.4	17.2	47.1	2.8	2.7	–3.0	12.7
1992	45.5	22.8	17.6	48.1	3.3	2.9	–2.5	14.3
1993	46.1	22.9	18.2	49.3	3.4	2.8	–3.1	14.6
1994	46.5	22.9	18.6	49.0	3.3	2.7	–2.4	14.6
1995[3]	45.9	22.5	18.8	49.3	3.7	2.3	–3.3	16.3
1996	46.8	22.9	19.4	50.3	3.7	2.1	–3.4	16.1
1997	46.6	22.6	19.7	49.3	3.6	1.9	–2.7	16.1
1998	46.6	23.1	19.3	48.8	3.6	1.9	–2.2	15.6
1999	47.4	24.2	19.0	48.9	3.5	1.9	–1.6	14.6
2000[4]	47.1	24.6	18.7	48.4	3.4	1.8	–1.3	13.7
2001	45.8	23.2	18.7	48.3	3.2	1.8	–2.5	13.9
2002	46.4	23.9	18.7	48.4	3.2	1.8	–2.0	13.6

1 On national accounting definitions. — 2 Government interest spending as % of tax revenue. — 3 Excluding asset transfers linked to the assumption of the debts of the Treuhandanstalt (privatisation agency) and the housing sector of the former GDR (DM –233.9 billion). — 4 Excluding receipts from the sale of UMTS licences (DM 99.4 billion).
Sources: Federal Statistical Office; Institutes' calculations; 2001 and 2002: Institutes' forecast.

The increase of 2.2% in receipts from social insurance contributions in 2001 will be somewhat lower than the increase in the gross wage and salary bill. The main reason is the fact that the contribution rate for pension insurance was reduced at the beginning of the year from 19.3% to 19.1%. Next year receipts from social insurance contributions will increase at a higher rate – 3% – than the gross wage and salary bill. Given the deficit in the health insurance system, it is assumed that the contribution rates will be increased by an average of 0.2 percentage points to 13.85%. Thus, the total burden of contributions on remuneration that is subject to compulsory insurance will amount to over 41%. The government has thus failed to achieve its goal of reducing the social contributions burden to under 40% in this legislative period.

There will be a substantial increase in received income from assets this year because the Bundesbank profit rose to DM 11.9 billion (2000: DM 2.6 billion) – as entered in the ESNA.[2] Bundesbank profits of DM 13 billion are assumed for next year.

The government's budget deficit is likely to amount to DM 101 billion or 2.5% of GDP this year – much higher than assumed in the stability programme. The main reason for the difference between the actual budget deficit and the government's planning is the fact that the substantial downturn this year – the federal government had expected an increase in GDP of 2 percentage points – will result in economically determined lower revenue from tax and social insurance contributions and increased spending on the labour market. In addition, the most recent revisions of the official statistics led to higher entries for budget deficits – almost DM 12 billion or 0.3 percentage points of GDP for 2000. Next year the deficit will decrease to DM 82 billion or 2% of GDP thanks to the economic recovery and the higher tax burden; the deficit rate estimated in the stability programme is 1%. The social insurance budget will be more balanced both this year and next year; this trend will be helped in 2002 by the increase in health insurance contribution rates.

2 The Federal Statistical Office changed the procedure for entering Bundesbank profits in 1997. Under the new calculation method, all the elements of the profit and loss calculation (including company and interest spending) are included. This means that from 1996 onwards, the public income from assets entered in the balance is much lower than under the previous method. Thus, for 2001, DM 11.9 billion is entered in the national accounts, instead of DM 16.3 billion.

Economic Policy

In the autumn of 2001 the German economy is on the edge of recession. There is great uncertainty over the future development, above all due to the consequences of the terrorist attacks in the United States. This poses considerable challenges for economic policy, not only in Germany but throughout the euro area, for two requirements now have to be met at once. Firstly, economic policy must make a significant contribution to overcoming the weakness in the cycle, and that will only prove possible if it is altogether sufficiently expansive. At the same time, to avoid destabilising expectations, it should not lose sight of its medium-term objectives. There is a field of tension between these two requirements now, and this is particularly affecting fiscal policy in the euro area. If fiscal policy were strongly expansive the consolidation targets governments have set themselves would move to the distant horizon. That applies to Germany in particular, but fiscal policy is also subject to restrictions in the other two major countries in the euro area, France and Italy, owing to the high deficits that still persist there.

Against this background the only stimulus to the cycle can come from monetary policy. The European Central Bank is in a position to provide this stimulus, as are the other central banks, without moving beyond the framework of their monetary policy strategy and without infringing their main objective, which is to maintain stability of the price level.

The objective of price stability is certainly more likely to be achieved if the employers and trade unions observe the scope for distribution in their wage rounds. A moderate wage policy will increase the chances of success for the central bank's stability policy, because inflationary pressure will be kept down from that side. Among other things, this means refraining from demanding 'second helpings' in next year's wage round. Admittedly, prices have risen this year much more strongly than expected, but this was due to external influences and other special factors, so that there is no scope for further distribution here. Advance warnings of a 'tough round of negotiations' should not be implemented. By keeping wage rises moderate in recent years the employers and trade unions have made a big contribution to employment, which has risen again in Germany after many years, while unemployment has been noticeably reduced. The situation has been similar in the rest of the euro area. That course should be maintained in the next few years in the interests of those seeking work.

In fiscal policy the Federal Government's objective of limiting the state budget deficit to 1.5% of GDP this year has clearly not been met. The deficit will be higher, mainly because the cyclical situation has weakened. If the Federal Government were still determined to reach the target for the deficit ratio laid down in its Stability Programme it would now have to cut back expenditure drastically, or drastically increase taxation and charges. That would not only be unrealistic, it would also further weaken the cyclical trend. Conversely, if the economic situation were to improve and the deficit prove lower than expected orientation to the actual deficit would – wrongly – make efforts at consolidation seem less urgent. This shows that European governments' practice of naming targets for the actual deficit in their stability programmes is not economically meaningful. There is broad consensus among economists that budget balances should 'breathe' with the cycle, in order to avoid a procyclical policy, that is, in a good economic situation they can be correspondingly larger, and in a bad one they can be smaller. This is regarded as one of the automatic stabilisers.

This defect in the stability programmes should be removed, for it makes an appropriate assessment of the consolidation measures more difficult, and governments put themselves under unnecessary constraint to justify their policies if the cycle unexpectedly proves worse than forecast. So it should be in the interests of the governments themselves to make the stability programmes more precise. If they fail to reach their target they can lose credibility, even if the deviation is solely due to cyclical causes and not to fiscal policy. As in earlier reports, therefore, the Institutions are in favour of removing cyclical influences from major variables in fiscal policy, such as the ratios for expenditure, revenue and budget balances; accordingly, the targets set in the stability programmes should relate to structural data. That certainly does not mean softening the Stability Pact, but it would take account of the fact that while the cyclical data are largely unaffected by fiscal policy, they can be influenced by other policy areas or external shocks.

The Federal Government also should hold to its target of a balanced budget over the medium term in its next Stability Programme, which is to be published towards the end of this year. In doing so, however, it should concentrate on the structural deficit. The task must be made more stringent by laying down a binding path for expenditure as a complementary measure to the target deficit.

Consolidating the budget is not, however, an end in itself. Rather, the European governments regard consolidation as promoting growth, above all because the stability programmes provide for the state ratio and the burden of taxation and charges to be reduced. The decisive factor here is that the policy of economising must be credible. Otherwise consumers and investors would doubt that they will really be given the tax cuts that have been promised. The growth effects that could result from consolidation would be correspondingly less.

In addition to formulating the objectives in structural data realistic assumptions of the economic growth to be expected over the medium term are essential if the stability programmes are to be credible. Some governments have improved their projections in the past by making over-optimistic assumptions. The Italian Government, for example, based its prognoses on an average growth rate in real GDP of 3% a year, although that had not been achieved in a single year in the past decade and the trend in growth was considerably lower. If assumptions on medium-term growth are too optimistic the governments will repeatedly fail to meet their targets, because they will keep underestimating the level of the structural deficit. This will ultimately harm their reputations.

A transition to target data in the stability programmes adjusted to remove cyclical influences will require consensus on European level. The Institutions regard such agreement as certainly realistic, for the development this year has shown that fixation on actual deficits is not meaningful. Governments can also rely on a broad consensus among economists in this.

Just as the Federal Government should lay down a binding path to deal with the deficit (adjusted for cyclical fluctuations), it should also state that there will be no tax increases beyond the steps already announced (e.g. eco tax). Otherwise the impression could arise that the Government is keeping open the possibility of reducing the budget deficit by raising taxes and charges if there is a risk of not being able to keep to the deficit path. That would be contrary to the objectives of genuine consolidation. There has been a case of precedence this year. After 11 September the Federal Government faced the – admittedly – difficult situation of having to spend more on security and defence at short notice. It would not have been difficult to finance these measures if more progress had been made in consolidating the budget, for under the principles of a fiscal policy oriented to the medium term, expenditure of this kind can certainly be financed by more borrowing. The solution the Federal Government has chosen, namely to raise taxes, looks like the worst solution in this context, particularly as in this case the increases will be permanent and go beyond the level of the additional expenditure planned for 2002. This raises doubts about whether the strict economy course will actually be maintained in the next few years. As a result the promised reductions in taxes and social security contributions may also appear less credible.

The European Central Bank again faced major challenges this year. It responded quickly to the events of 11 September, channelling large amounts of liquidity to the financial markets and taking further steps to ensure that the financial system continued to operate and remained stable. In addition, the ECB, in conjunction with other major central banks, lowered its key interest rates by 50 basis points. The Institutions regard this as justified, for it took account of the deterioration in the cyclical outlook, particularly after 11 September. It is to be expected that the ECB will lower interest rates further before the end of the year. The key rate would then be 3.5%, a level that is appropriate in view of current prospects regarding inflation and the expected cyclical trend.

Monetary policy must follow the signals coming from the two pillars of monetary policy. The expansion of the M3 money stock plays an important part here. The importance of this pillar for inflation in the medium term is repeatedly stressed by the ECB. In their earlier reports the Institutions have always accepted this judgement, as numerous empirical studies have shown that there is a long-term stable relation between the money stock and the price level. However, the money stock is not always taken into account to the same extent in decisions on interest rate policy. One of the reasons given for lowering interest rates in May this year was that M3 had come down close to the reference figure. In the following months the expansion of the money stock accelerated considerably; nevertheless the ECB again lowered its key rate in August, arguing that the money stock was distorted by special factors and was not an indication of higher inflation risks. The Institutions regard this as right, but if factors like this are continuously to be used as reasons for changes in interest rates, the money stock would ultimately be of little use as an indicator.

The development in the money stock is particularly important for the relevance of the first pillar of the monetary policy strategy during this prognosis period. When the special factors cease to play a part the ECB should again take the development in the money stock more into account. What matters is to avoid a liquidity overhang through a rise in M3.

Decisions on interest rates next year should be made dependent on how the two pillars develop. The inflation rate will probably fall back below the 2% mark for the first time for nearly two years – if only slightly – so that the stability target would be met. With the cyclical recovery in the euro area that the Institutions have forecast, there will presumably be no further improvement in the prospects for inflation, and so in today's view it is not appropriate to lower key interest rates beyond the level expected. Should the cyclical situation develop much less favourably than forecast by the Institutions further reductions in interest rates would be appropriate. But should, contrary to expectations, the money stock expand faster than accords with stability, and should the prospects for the price trend deteriorate, higher interest rates would be justified.

Monetary Policy

Monetary policy in the euro area is currently on a tightrope walk. On the one side the signs of a cyclical reversal have been growing at the latest since the early summer, and this, as in the United States, would suggest a rapid relaxation of the course that was still very tight last year. The events of 11 September are putting a further strain on the cyclical situation in the euro area and causing considerable general uncertainty.

On the other side, inflation in the euro area is still too high. Although the inflation rate has clearly fallen since May it is still markedly above the 2% level that the ECB regards as just compatible with the objective of price stability. A rapid easing of monetary policy could therefore awaken the impression that the ECB is orienting too strongly to the cyclical situation and losing sight of its aim of maintaining price stability. Certainly what matters here is not the present rate of price increases or what the rate will be in coming months; the ECB cannot influence these figures now anyway. The danger is rather that the strong rise in prices may gradually penetrate expectations, and consequently become established on the goods markets as producers pass on price increases, and on the labour market in the form of collective agreements for excessive wage rises.

Against that background the ECB has decided on a course of cautious relaxation. Since May this year it has lowered its key interest rates in three stages by altogether one percentage point, and so reacted to the marked deterioration in the cycle in the euro area and falling rates of price increases. The latest reduction by 0.5 percentage points was in step with the response of the US Federal Reserve Bank to the attacks of 11 September. So monetary policy must at present be regarded as stimulating. Whether the ECB's actions are appropriate will be judged here by its own two-pillar strategy. Firstly, it is important to see what signals are coming from the two pillars together. Secondly, in order to show clearly that the ECB is on a tightrope, particular attention will be given to the role of the cycle.

In judging the course of monetary policy it must be remembered that it is by no means as expansive as the figure for the M3 money stock, the first pillar of monetary policy strategy, might suggest. The present rate of increase in M3 is certainly strong, at 6.7% over the same month last year and a current seasonally adjusted annual rate of 10.1%; nevertheless, it cannot be concluded from this that the economy is too richly supplied with liquidity. Temporary influences, special factors and one-off effects are currently preventing an inflationary potential from building up although M3 is growing strongly: 0.75 percentage points of the growth in M3 is due to purchases of money market paper and short-term bonds by euro non-residents. As this is liquidity that, by the nature of the system, cannot have an effect on the domestic market, the ECB intends to publish a series of the M3 money stock adjusted for these amounts towards the end of this year. Uncertainties about the future cyclical trend have also meant that investors are holding more liquid funds, and M3 may be assumed to be inflated by portfolio restructuring that has not led to an increase in demand-effective liquidity. Moreover, the need for transaction funds has risen following the big rises in prices for energy and foodstuffs. The Institutions therefore share the view of the ECB that the latest expansion of the money stock does not imply a risk to price stability.[3]

The relativisation of the current trend in the money stock does not mean abandoning a money-stock-oriented strategy. In presenting its monetary policy strategy the ECB introduced the money stock as an independent pillar of a two-pillar strategy. In doing this it wanted to underline the medium-term connection between the trends in the money stock and prices, and at the same time stress that it was following the stability policy tradition of the Bundesbank. The two-pillar strategy of the ECB does not always meet with understanding, as particular importance is accorded to the first pillar as an indicator of future developments in inflation, while the second pillar consists of a whole bundle of indicators of that very development in inflation. The second pillar is necessary because there is not one indicator, or a single orientation figure, that would give the central bank sufficient information for a monetary policy to maintain stability. Consequently, it must be taken into account that the prognosis properties of the two indicators are very different. The short-term development in inflation can hardly be forecast from the development in the money stock alone – and that also means the trend for the coming year. The second pillar provides better information on this. However, in the longer

[3] At present a clear decline in cash in circulation is evident. There are several reasons for this: the return of the 'coins in the drawer', that is, the reflow of money from the black economy in connection with the conversion to the euro, the reflow of cash from Central and Eastern Europe, both as the currencies there stabilise and in preparation for the currency conversion in the euro area, and the increase in electronic payment transactions. These effects will hardly have affected M3, however, as they will mainly have caused restructuring in sight deposits and so within M3.

term view the connection between the money stock and inflation is stable. Hence protracted excessive expansion of the money stock would create a potential for inflation. In view of the different time horizons of the two indicators the possibility cannot always be excluded that the two pillars may temporarily give divergent signals. By defining the growth in the money stock as a reference figure and not as an intermediate target figure the ECB has taken this possibility into account right from the start.

Nor does the second pillar at present indicate any risk to price stability. Price increases in the euro area have fallen clearly since their peak in May this year, and the trend is still downward. That will continue next year, as wage agreements are moderate and capacity utilisation will remain low. The inflation rate should remain slightly under 2% on average for 2002. Conversion to the euro will not have any notable effect on the price level (cf. box 2).

Reaction to cyclical developments can certainly be reconciled with the ECB's monetary policy strategy. Both the development in the money stock and the analysis of the price climate require careful observation of the cyclical environment. If the cyclical trend is weak there will be less demand for lending and the development in the money stock will in itself be held down. So the ECB must always form a judgement – as is evident from its fixing of the reference figure – on whether the cyclical development implies a growth in the money stock that is reconcilable with a growth process free of tension. The role of the cyclical development is even clearer in the second pillar of the monetary policy strategy. Any weakness in the cycle narrows the scope for companies to pass on cost increases to consumers, and certainly to widen their profit margins, because competition is fiercer. As the economic cycle slows down unemployment rises, and this reduces the possibilities for employees to push through high wage demands, so generally there is no threat of inflationary pressure from that side.

Alternatively, it might be said that the central bank must maintain its credibility in regard to maintaining price stability. Only then will it also have a chance of influencing the cyclical development, as otherwise emergent inflationary or deflationary expectations would restrict the real economic effectiveness of monetary policy. That means that the ECB must show, with reference to its pillars, that the steps it takes serve to maintain price stability, and this must be proven in practice as well. Measured by the reaction of the capital markets, the monetary policy decisions taken by the ECB, including the reduction in interest rates in 1999, have not so far fuelled inflationary expectations beyond the 2% mark. That suggests that the ECB has certainly already built up a reputation in the markets and with the public, although it is a 'young' institution. Hence it does not need to be any more restrictive than other, 'older' central banks in a comparable situation. On the contrary, what matters is that the central bank should give convincing and understandable reasons for its monetary policy measures. It follows from all these considerations that the cautious relaxation of the course is in conformity with the ECB's monetary policy strategy. It would therefore be wrong to accuse the central bank of being overactive in recent months and not keeping to the rules.

The Institutions expect the ECB to lower its key interest rates by a further quarter percentage point in the next few months. This would bring interest rates down to a level that they regard as appropriate for the expected cyclical situation and the low risk of inflation. Should the economic situation prove to be worse than the Institutions are expecting for next year rapid action in monetary policy would be needed. It would be reconcilable with the monetary policy of the ECB to lower interest rates further. The Institutions are expecting the growth in the money stock to slacken noticeably in the course of the prognosis period, as the special factors will lose some of their effect. Should this not happen it could be an indication of a risk of inflation to which the ECB would have to react.

However, should there be renewed danger of panic on the financial markets the ECB should again provide generous amounts of liquidity to calm the markets. Stabilising the financial system is one of the primary tasks of the ECB.

Higher deficits in the public budgets from cyclical causes, as are now appearing in the euro area, do not, in the view of the Institutions, constitute a problem for monetary policy. Allowing the automatic stabilisors to take effect will not jeopardise price stability, as in this case macroeconomic demand will not be increased; the only effect will be to counteract a restriction of private demand.

All in all, the ECB will have to continue its tightrope walk in the next few months. After all, with the greatly restricted scope for fiscal policy owing to cyclical policy in the euro area, monetary policy has the particular task of countering the downslide of the cycle as quickly as possible while maintaining price stability, and also preparing the way for an upswing that is also supported by the domestic economy.

Fiscal Policy

Consolidating the public budgets has high priority in the EMU countries under the Stability Pact. The aim is to achieve balanced budgets in the medium term or earn a surplus. This should reduce the indebtedness ratios and the burden of interest payments for governments, which have risen strongly in the past. The conditions for growth and employment are to be improved, while public expenditure is reduced. In their earlier reports the Institutes basically supported this fiscal policy course, and they still regard it as right. However, unlike a number of smaller EMU countries, Germany (like France and Italy) is still relatively far from a balanced budget. The deficit without the one-off payments from the UMTS receipts was 1.3% of GDP last year. In the current year the deficit ratio will rise to 2.5%, in the estimate of the Institutes, not least owing to the tax reform, but next year it will fall to 2%. In both years, then it will be 1 percentage point higher than envisaged in the Stability Programme. The state ratio (public expenditure in relation to nominal GDP) and the ratio of taxes and charges (taxes and social insurance contributions in relation to nominal GDP) will be clearly above the level announced in the Stability Programme during the prognosis period; next year the state ratio is expected to be 48.4%, and the ratio of taxes and charges 42.5%, that is just under 3 percentage points and about 1.5 percentage points, respectively, higher than planned. There are three main reasons for this failure to meet the targets: firstly, the slacker economic development will mean lower revenue and higher expenditure. The part of the deficit ratio dependent on the cyclical situation should be around 0.5 percentage point in 2001 and around 0.75 of a percentage point in 2002, so that this year the structural deficit ratio will be about 2% and next year 1.25%. Moreover, if public expenditure is shown, not in relation to the lower nominal GDP due to cyclical causes but to the production potential in current prices, which is a better way of measuring state recourse to macroeconomic resources, the state ratio is then 1 percentage point lower than the figure as calculated above.

A second reason for the failure to meet the targets set in the Stability Programme is the stronger rise in cyclically induced public expenditure. This rise is above average in social benefits, especially in the health system and in pensions. Public expenditure on personnel, on the other hand, is rising only slightly, and public investment expenditure is stagnating. The inadequate discipline in expenditure on items not dependent on the cycle is therefore concentrated in social insurance. That will increase the pressure to increase social insurance contributions, or not to lower them as is envisaged in the Stability Programme.

A third, though less important reason for failing to meet the budget targets set in the Stability Programme is that the Federal Statistical Office has changed the data for medium-term planning and so the basis for expenditure. The deficit ratio for the year 2000, for example, has been revised upwards by 0.3 percentage points.

It is evident from all this that the failure to meet the targets set in the Stability Programme is not due to the budget deficit, at any rate not if the target deficit is defined structurally. The decisive reason for the failure to meet the target is the development in expenditure on social insurance, which is reflected in a higher state ratio and a higher ratio of taxes and charges.

In view of the current cyclical downswing and the considerable uncertainty over future development, fiscal policy faces a difficult task. If tough economies are introduced in order to achieve the target for the deficit set in the Stability Programme next year, the downswing will be very considerably accelerated. But if a strong expansionary course is taken next year it will jeopardise the credibility of the consolidation course. In the view of the Institutions what is needed is a fiscal policy that takes due account of the cyclical risk but keeps the medium-term consolidation of the budget in view, thus avoiding negative effects on confidence.

Strict observance of the deficit targets set in the Stability Programme for this and next year would, in the view of the Institutions, lead to a very restrictive fiscal policy. In any case, the deficit planned for the current year cannot now be achieved. But even if the attempt were made to achieve the deficit ratio of 1% set in the Stability Programme for next year extensive additional economy measures would have to be decided and domestic demand would be noticeably weakened. In addition, a further loss of revenue and additional expenditure would be incurred for cyclical reasons, so that despite the cutbacks there would presumably again be failure to meet the target. That policy would be counter-productive.

The question is whether, in view of the constraints, fiscal policy can take any other course. In the opinion of the Institutions it would be wrong, in economic terms, to interpret the Stability Pact as meaning that member states must pursue a strongly restrictive fiscal policy in a weak phase of the cycle. It is precisely the objective of the medium-term consolidation course to create sufficient budgetary scope for fiscal policy.[4] However, the top limit of 3% for the deficit must not be exceeded, unless there is a serious recession. Thus, the Stability Pact concedes that the deficits can fluctuate in the course of the cycle, or indeed should fluctuate, in order to stabilise the economic situation. Rightly interpreted,

[4] Directive F 3 of the Stability Pact (Council Regulation (EC) No. 1466/97, Item 4, states: '... whereas adherence to the medium-term objective of budgetary positions close to balance or in surplus will allow Member States to deal with normal cyclical fluctuations while keeping the government deficit within the 3% of GDP reference value.'

the Stability Pact is not purely a 'consolidation pact': it gives member states the possibility of stabilising the cycle – within the framework set by the upper limit for the deficit.

A distinction must be drawn here between the Stability Pact, which set the framework for fiscal policy for member states, and the national stability programmes, in which the member states have laid down the timescale for their budgetary consolidation. In the German Stability Programme, for example, the target deficits for the individual years are given on the assumption that the cycle will be 'normal' in the next few years, or in other words that economic growth will correspond to trend growth. The deficit figures in last year's Stability Programme do not, therefore, include the influence of any cyclical fluctuations and in this they have the nature of structural target deficits. If one follows the logic of the Stability Pact, the actual deficits may be higher than envisaged in the Stability Programme, in view of the present cyclical downswing. Politicians have neglected to make this clear to the general public, and it is still not clear. By constantly stressing that the deficit targets in the Stability Programme must be met fiscal policy has put constraints upon itself that go beyond the limits of the Stability Pact. If there is now a credibility problem because the target deficit in the Stability Programme has not been achieved, politicians themselves are partly to blame. Target deficits must be credible, but they are only credible insofar as they can be influenced by fiscal policy itself. These are structural deficits, not the actual deficits that are also influenced by cyclical fluctuations.

The Institutions recommend that the medium-term consolidation course should on principle be maintained, but that it should be defined so that the structural deficit is nearly eliminated by the year 2004.[5] However, the target should be regarded as met if the structural deficit ratio is still at 0.5%, particularly as the basis for medium-term planning has changed due to the revisions by the Federal Statistical office. The decisive point is that in this fiscal policy strategy the success in consolidation has to be measured by the reduction in the structural deficit and not by the reduction in the actual deficit.

In the year 2002 fiscal policy, including the automatic stabilisors, should have a roughly neutral effect on the cycle.[6] The state budget deficit would then be nearly as high as in the current year; this conceals a slight rise in the deficit due to cyclical causes (as capacity utilisation in the economy as a whole will fall further) and a slight reduction in the structural deficit. If this strategy is followed – compared with the fiscal policy assumptions in the deficit prognosis by the Institutions for the year 2002, which led to a reduction in the deficit ratio of half a percentage point – further steps could be decided. It would be possible to bring forward to next year the stage of tax reform costing DM 13.5 billion that is earmarked for 2003. The advantage is that the legislation for this further reduction in taxation has already been passed, so that it could be implemented rapidly. Bringing it forward would not only help to stabilise demand. It would also further improve supply conditions.[7] It also accords with the demand put forward earlier by the Institutions that the burden of taxation and charges should be reduced as soon as possible in order to strengthen the forces of growth.

Despite bringing the second stage of tax reform forward to the year 2002 the structural deficit will be nearly eliminated by the year 2004 if it proves possible to keep the growth in expenditure clearly below the rise in nominal GDP over the medium term, as intended in the Stability Programme of last autumn.

However, that strategy will only be efficient if various conditions are met. Above all, there must be no negative effects on confidence in the general public or in the financial markets. That would be the case if the impression were given that in Germany and in the EMU as a whole the Stability Pact were being infringed the first time it was really tested, and that governments were calling the consolidation course in question generally. The loss of public confidence would induce private individuals to save more and invest less, and that would counteract the positive effects on the cycle of the tax reduction. Moreover, the public budgets must absorb the higher deficit caused by the tax reductions; they must not cut back spending further next year, especially their spending on investment. That would not only be harmful to the cycle, but would also restrict medium-term growth. It is therefore essential for the state, and in particular the Länder and local governments, to avoid a procyclical fiscal policy. That also means that the cen-

[5] There are uncertainties in the empirical calculation of the structural deficit. An estimate has to be made of what part of the macroeconomic development can be regarded as cyclical and what part is due to the trend; an estimate also has to be made of how great the gap is between the actual GDP and the trend GDP, that is, the degree of utilisation in the economy as a whole (the output gap). There are also uncertainties in estimating the cyclical influences (i.e. the output gap) on the individual items of state revenues and expenditures, and so on the deficit. For the year 2001 the European Commission has calculated a structural deficit for Germany of 1.6% of GDP, while the OECD calculated 2% (in June).

[6] The Institut für Weltwirtschaft holds a different view on this, which is given at the end of this section.

[7] The second stage of tax reform is intended to flatten the income tax scale further by reducing the lowest rate from 19.9% to 17% and the top rate from 48.5% to 47%. The basic free allowance will also be raised from DM 14 093 to DM 14 525.

tral government and the Länder must not reduce the investment grants to the local authorities; they must increase them.

It is important to make it clear that this fiscal policy course is not an infringement of the Stability Pact. The upper limit of 3% for the deficit ratio will still be observed, and the structural deficit – with the appropriate discipline in spending – will be reduced as intended over the medium term. So it is up to the ECOFIN Council to decide whether or not to criticise the course for German fiscal policy recommended here by the Institutions, which will mean that the deficit ratio will be on a similar level next year to this year.[8] As Germany, as already mentioned, is still relatively far from the medium-term target deficit there could be objections from the ECOFIN Council or even the ECB. But it should be borne in mind in assessing this policy that bringing forward the second stage of tax reform will only have a temporary effect – in the year 2002 – on the timetable for reducing the deficit. It must not be overlooked that at present there are considerable cyclical risks for the European Union as a whole, and the cycle is weakest in Germany. A restrictive fiscal policy in Germany would not only be an additional strain on the cycle here, but would also have a negative effect on neighbouring countries.

The Federal Government's fiscal policy concept, namely to remove both the budget deficit and lower the ratio of taxation and charges over the medium term will, however, fail if it does not prove possible to limit the rise in state expenditure more than hitherto. Any overstepping of the (structural) expenditure path will jeopardise the reduction in the structural deficit or the reduction in the ratio of taxation and charges that is desired. Most recent experience has shown that in health care in particular, discipline on expenditure is relatively low. This creates permanent pressure to raise the contributions and so increase subsidiary wage costs – with correspondingly negative effects on employment. What is gained by reducing taxation is likely to be lost again on contributions to social insurance. The fiscal policy concept of removing the deficit while at the same time reducing the ratio of taxation and charges will therefore require further fundamental reforms, especially in the health system. The faster that can be done the more credible will the medium-term consolidation course be.

In order to make the budget consolidation policy more credible the Institutes argued in the spring of this year that fiscal policy should be oriented more to a medium-term path laid down for expenditure that is independent of the cyclical situation, and that this path should not be overstepped even if the budget situation improves. Any additional expenditure desired could then only be allowed if appropriate cutbacks were made in other payment areas. Expenditure dependent on the cyclical situation, which in the main means the grants to unemployment insurance and the payment of unemployment assistance, should on the other hand be able to 'breathe' with the cycle to avoid a procyclical policy. With the appropriate provisions the state would remain on an economy course even when the cycle was moving up again, so that the additional revenue and lower expenditure due to the cyclical improvement would not be spent but could be used to the full amount to reduce the budget deficits. Binding regulation of this kind was successfully practised in the United States in the 1999s under the Budget Enforcement Act.

A Different View of Fiscal Policy

The Institut für Weltwirtschaft (IfW) holds a different view of fiscal policy from the majority of the Institutes. The differences relate both to the estimate of the effectiveness of fiscal policy and the recommendations for the coming year.

The majority of the Institutes demand that, in response to the cyclical situation, from next year fiscal policy in Germany should deviate from planning to date, with its implication of a clear reduction in the structural deficit. The IfW, on the other hand, recommends that the consolidation course should start next year as planned. The proposal to delay reducing the deficit until the year 2003 risks having the policy of a medium-term balanced budget called in question permanently by the general public. As the structural deficit has already risen, this year and last year, and accordingly has not been consolidated, the announcement that next year would be an exception to the consolidation regulation is hardly credible. Experience has shown that governments are often only willing to pursue an economy course they have decided on in weak phases of the cycle. In upswing phases they often neglect to reduce the structural budget deficit. The year 2000 is a good example of this, when the economic cycle in Germany and the euro area boomed, but the structural deficit was not reduced. It is therefore not very likely that the structural deficit will really be strongly reduced in 2003 and 2004 if the cyclical situation has improved, as the majority of the Institutions assume. The consolidation course must be pursued independently of the cyclical situation, if it is to be credible.

[8] Under the Stability and Growth Pact the medium-term development in the budgets of the Länder must be laid down in the stability programmes that have to be presented to the Council of Finance Ministers (ECOFIN). They can then demand adjustments, should the targets and contents of the stability programmes be too unambitious in their view.

Moreover, if the Government were to deviate from the consolidation course it has announced it would be questionable whether fiscal policy would actually support the cycle, as the majority of the Institutes assume. Failure to implement the consolidation course that has been announced would lead private individuals to expect higher taxes in future, and they would directly cut back their demand, so that nothing would be gained for the cycle. Such non-Keynesian effects of fiscal policy have been increasingly under discussion among economists since the early 1990s,[9] and their relevance is now widely acknowledged.[10] In a number of countries it has been observed that a consistent policy of budget consolidation led to additional private spending in a very short time, which more than compensated for the dampening effects of the action by the state. And the fact that during the current year the growth rate in real GDP fell more noticeably in Germany than in the rest of the euro area, although the stimulus from fiscal policy was strongest here, also shows that a fiscal policy oriented to consolidation does not necessarily harm the cycle. In the view of the IfW, fiscal policy should therefore embark on the announced consolidation course next year. What is decisive is to take action on the expenditure side now and not wait until the year 2003.

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[9] Cf. the survey of the literature in F. Giavazzi, T. Jappelli and M. Pagano (2000): Searching for non-linear effects of fiscal policy, in: *European Economic Review,* vol. 44, no. 7, pp. 1259-1289.

[10] Cf. A.S. Blinder: Is there a core of practical macroeconomics that we should all believe? In: *American Economic Review Papers and Proceedings,* vol. 87, no. 2, pp. 240-243 and O.J. Blanchard: Macroeconomics, 2nd edition, Prentice Hall 2000, here p. 336ff.