

# German Economic Trends 2003/2004

## Stagnation persists

The Germany economy is still expanding only haltingly. Contrary to widespread expectations, an upswing did not set in during the second half of last year. In particular, investment in both machinery and construction remained weak. But private consumption has also only recently begun to show signs of recovery.

The weak pace of growth is largely determined, first, by the sluggish recovery of the world economy. This is evidenced by the only moderate rate of export growth last year, compared with previous upswings. Second, domestic demand, which for years has been the German economy's Achilles heel, has still not taken off (cf. figure 1).

This weakness will not be rapidly overcome, but will persist until well into this year. One of the main reasons is the fact that the German government's most recent resolutions will result in a substantial burden on private households. Tax increases and the significant rise in social insurance contribution rates will mean that, despite the somewhat higher wage rises, there will be practically no increase in disposable income. As a result, a noteworthy expansion of private consumption cannot be expected either this year or next year, when the effects of the additional burden will continue to be felt. Thus, investment demand will receive little stimulation from the domestic economy. The loosening of the monetary policy reins can also be expected to generate only a slight acceleration over the course of this year, while the only gradual expansion of external demand will represent another obstacle to more robust growth. And so Germany's economy will continue to plod along. GDP is likely to increase by 0.6% this year and, under the cur-

rent circumstances, growth of no more than 1% can be expected next year (cf. figure 2 and table 1).

Thus, a constellation has developed in which deflation could emerge. This inherent tendency is currently not discernible in the moderate inflation rate because it is concealed, in particular, by the increase in indirect taxes. However, the fact that inflation rates are still positive should not blind observers to the reality that they are not improving the profitability of enterprises. On the contrary, they are actually an expression of the government's efforts to consolidate the budget and are dampening growth. In addition, the downward pressure on wages in the public sector is increasing. The pressure on prices and wages is aggravating the burden on both enterprises and consumers, and in these circumstances an upswing is impossible.

## Gradual recovery in exports

German goods exports expanded only slightly on average in 2002 (cf. figures 3 and 4). The reasons were the continued weak growth on Germany's most important markets in Europe and the USA and the sharp appreciation of the euro against the US dollar.

As investment growth in the USA and Great Britain livens up again at the beginning of this year, German goods exports to these countries will be stimulated once again. However, the substantial appreciation of the euro against the US dollar will dampen export growth because it will reduce the competitiveness of German suppliers on the US market. But this effect will be attenuated by the fact that prices will rise at a much slower rate in Germany than in the US this year, while exporters will be willing to accept lower profit margins in the interests of defending their market shares.

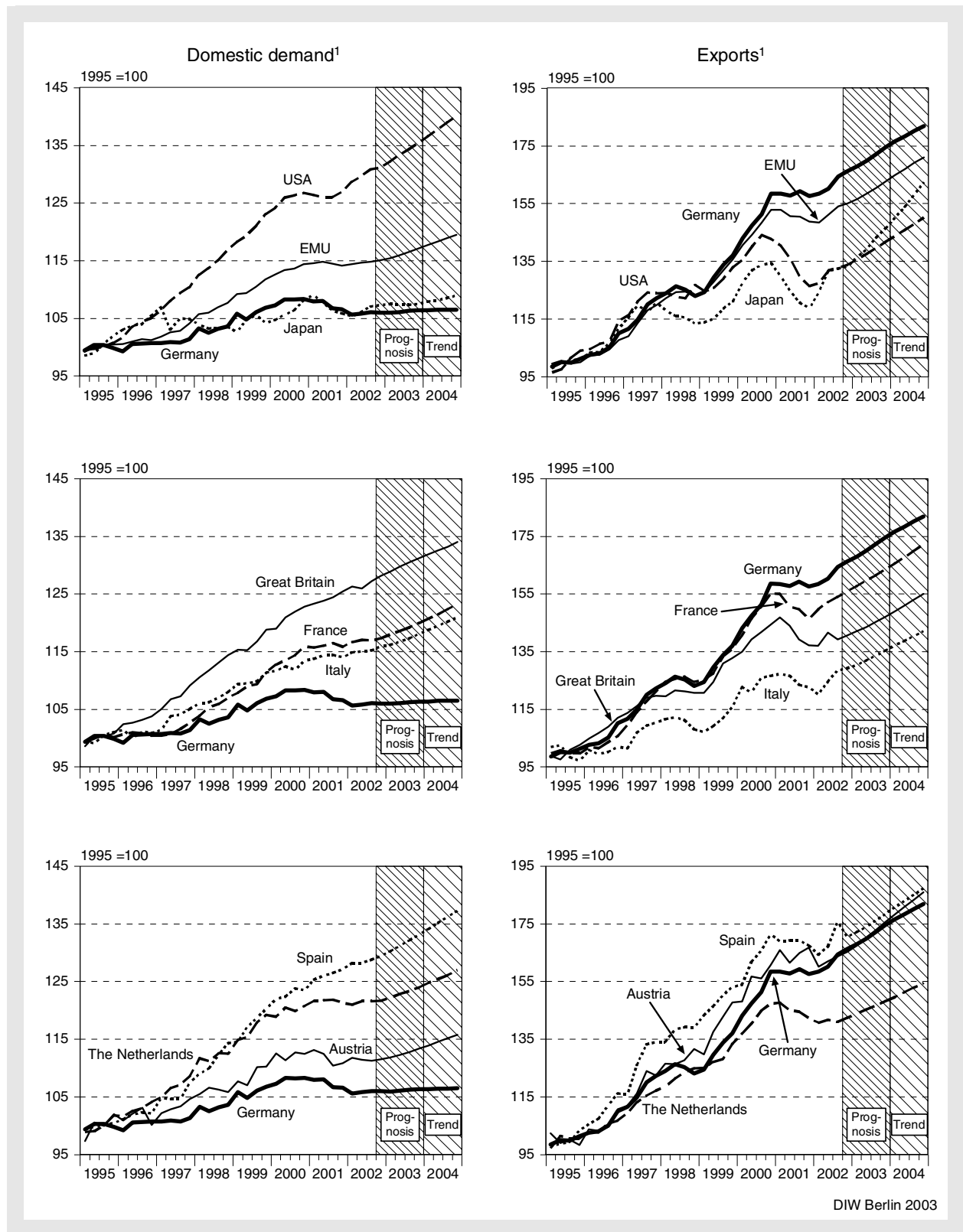
By contrast, the price competitiveness of German exporters has improved further within the euro zone. The demand for investment goods in the euro zone will initially provide little impetus, but will liven up in the

### Box 1

#### Assumptions underlying the forecast

- The price of crude oil will fall slightly and amount to around US-\$ 25 from spring 2003 onwards.
- The euro will initially remain at its current level and then appreciate slightly over the further course of the year. An average rate of exchange of US-\$ 1.05 to the euro is assumed for 2004.
- The European Central Bank will reduce base rates by 0.5 percentage points in the first half of 2003.
- Negotiated wages will increase by around 2.5% this year and by 2.6% next year.
- The increases in taxes and contribution rates incorporated in the forecast are those planned by the German government.

Figure 1  
Domestic Demand and Exports in International Comparison



DIW Berlin 2003

<sup>1</sup> Seasonally adjusted, at constant prices.  
Sources: OECD; Federal Statistical Office; DIW Berlin calculations.

second half of 2003. Overall, goods exports to the euro zone can be expected to expand robustly. The expectations with respect to goods exports to Central and Eastern Europe and to South-east Asia and China remain positive (cf. table 2 and figure 5).

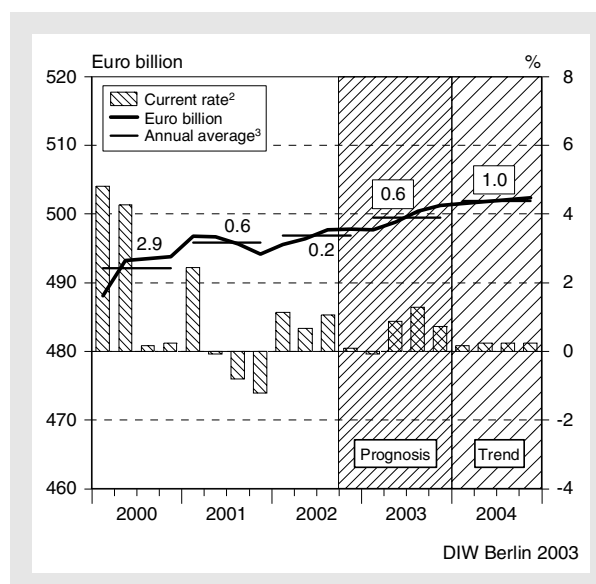
The recovery of German goods exports is likely to continue in 2004, bolstered by robust investment demand from the EU, the US, and Central and Eastern Europe. All in all, exports of goods and services will increase by 5.5% in 2003 and by 5.9% in 2004.

## Burden on income weakens private consumption

Private consumption in Germany was distinctly weak last year. This was mainly a result of the poor growth in disposable income as employment declined; the real value of income actually decreased (-0.2%). Consumption did rise slightly in the summer term following declines in three successive quarters, but a full recovery never materialised. Consumption declined in real terms by a total of 0.6% on average in 2002 (cf. figure 6).

The employment trend will have a negative effect on private consumption this year too, and consumption will be additionally curbed by the increase in the tax and contributions burden. The additional revenue from turnover tax expected on the basis of the proposed law on the abolition of tax concessions will amount to euro 1.5 billion, some of which will be at the cost of private consumption.

Figure 2  
Real GDP in Germany  
Adjusted for seasonal fluctuations and working days<sup>1</sup>



<sup>1</sup> Using X12-ARIMA. — 2% change on the previous quarter, annualised rate (right-hand scale). — 3% change on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

sumption. The contribution rate to statutory pension insurance was raised to 19.5% at the beginning of the year. With the rise in health insurance contribution rates to 14.5% and the increase in the income threshold for the assessment of contributions (for both pension and

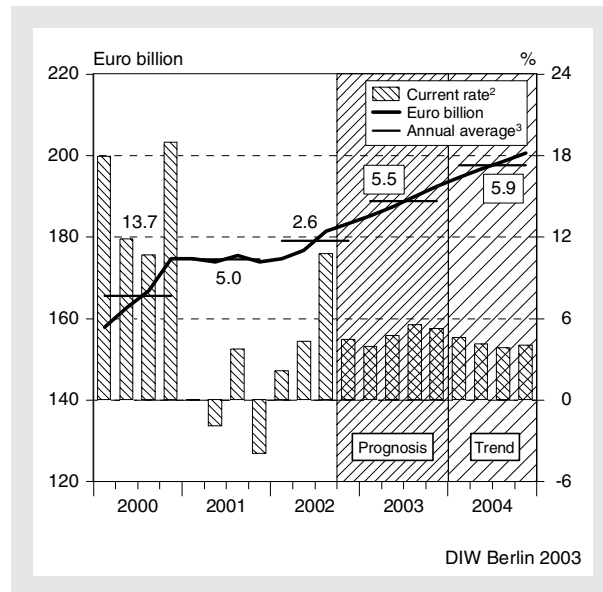
Table 1  
Contribution to Growth in Real GDP  
In percentage points

|                          | DIW estimate July 2002 <sup>1</sup> |      | DIW estimate July 2003 <sup>2</sup> |      | Difference between estimates |      |
|--------------------------|-------------------------------------|------|-------------------------------------|------|------------------------------|------|
|                          | 2002                                | 2003 | 2002                                | 2003 | 2002                         | 2003 |
| Private consumption      | 0.1                                 | 1.0  | -0.3                                | 0.3  | -0.4                         | -0.7 |
| Government consumption   | 0.2                                 | 0.0  | 0.3                                 | 0.1  | 0.1                          | 0.1  |
| Machinery                | -0.5                                | 0.4  | -0.7                                | 0.2  | -0.2                         | -0.2 |
| Other equipment          | 0.1                                 | 0.1  | 0.0                                 | 0.1  | -0.1                         | 0.0  |
| Construction             | -0.3                                | 0.0  | -0.7                                | -0.5 | -0.4                         | -0.5 |
| Investment in stocks     | 0.3                                 | 0.6  | 0.1                                 | 0.1  | -0.2                         | -0.5 |
| Domestic demand          | -0.1                                | 2.1  | -1.3                                | 0.3  | -1.2                         | -1.8 |
| Exports                  | 1.1                                 | 2.6  | 0.9                                 | 2.0  | -0.2                         | -0.6 |
| Imports                  | 0.4                                 | 2.7  | -0.6                                | 1.7  | -1.0                         | -1.0 |
| External surplus/deficit | 0.7                                 | -0.1 | 1.5                                 | 0.3  | 0.8                          | 0.4  |
| GDP                      | 0.6                                 | 2.0  | 0.2                                 | 0.6  | -0.4                         | -1.4 |

<sup>1</sup> Data as at June 2002. — <sup>2</sup> Data as at December 2002.  
Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 2  
Real Exports

Adjusted for seasonal fluctuations and working days<sup>1</sup>



1 Using X12-ARIMA. — 2 % change on the previous quarter, annualised rate (right-hand scale). — 3 % change on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

unemployment insurance), all in all the additional burden on wages and salaries will amount to over euro 7 billion this year, around half of which will be paid by employees. This sum corresponds to around 0.6 percentage points of net wages and salaries. If the additional revenue expected from the increase in turnover tax is included in the equation, the result is a significant drain on purchasing power this year. Moreover, because the second phase of the proposed tax reductions has been postponed to 2004, the income tax progression will continue to apply in full.

Government transfers will be reduced within the context of the austerity measures in the public sector, and this will apply first and foremost to the benefits paid out by the Federal Labour Office. The disposable income of private households will increase by 1.5%, but only because of the renewed rise in income from self-employment and assets. Real consumer spending will then rise again – by around 0.5% – following last year's decline.

The tax burden will have an even stronger effect next year and will further curb income and consumption growth. The introduction of the second phase of tax cuts will have a positive effect, by contrast. As employment rises slightly, real private consumption is likely to increase by over 1% in 2004.

## Inflation remains weak

There has been little increase in prices at the consumer level since April 2002. Prices for heating oil, fuels and services increased substantially, but they actually declined in other areas. The prices for durable consumer goods, for example, have been falling since the beginning of 2002.

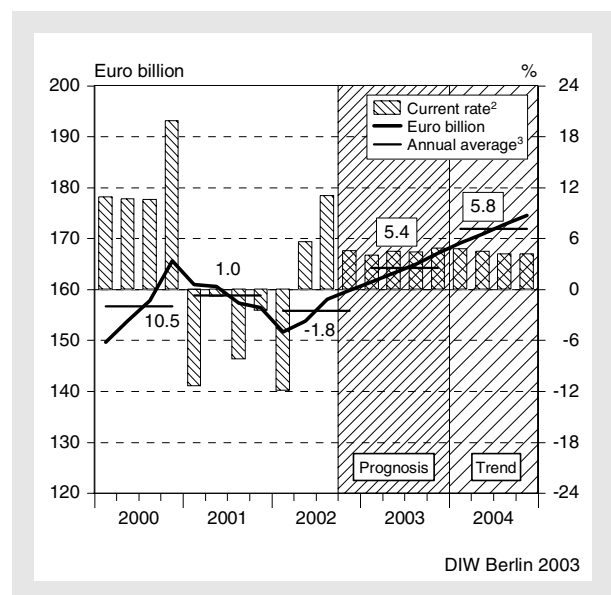
The increase in tobacco and mineral oil tax on 1 January 2003 will create a one-off price thrust of around 0.3 percentage points. In addition, the reduced VAT rate of 7% will no longer be applied to some groups of goods; rather, the normal rate of 16% will be charged. Overall, an annual average increase in consumer prices of over 1% can be expected in 2003. Given weak consumption growth and the moderate increase in unit labour costs, price increases are hardly likely. Thus, the pre-Christmas period actually saw discount campaigns with significant price decreases in many sectors. The trend increase in consumer prices is unlikely to be higher in 2004 than in 2003.

## Machinery investments recover slightly

Real investment in machinery fell by around 8.5% in 2002, and thus even more than in the previous year. As

Figure 3  
Real Imports

Adjusted for seasonal fluctuations and working days<sup>1</sup>



1 Using X12-ARIMA. — 2 % change on the previous quarter, annualised rate (right-hand scale). — 3 % change on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

Table 2

## Regional Trends for German Exports (Special Trade)

| Country group          | 1999         | 2000 | 2001 | 2002 <sup>7</sup> | 1999       | 2000  | 2001  | 2002 <sup>7</sup> | 1999        | 2000 | 2001 | 2002 <sup>7</sup> |
|------------------------|--------------|------|------|-------------------|------------|-------|-------|-------------------|-------------|------|------|-------------------|
|                        | euro billion |      |      |                   | share in % |       |       |                   | as % of GDP |      |      |                   |
| Total                  | 510          | 597  | 637  | 425               | 100.0      | 100.0 | 100.0 | 100.0             | 25.8        | 29.4 | 30.8 | 41.1              |
| EU                     | 293          | 337  | 351  | 233               | 57.5       | 56.5  | 55.2  | 54.8              | 14.8        | 16.6 | 17.0 | 22.5              |
| of which: EMU          | 230          | 265  | 275  | 181               | 45.1       | 44.3  | 43.1  | 42.7              | 11.6        | 13.0 | 13.3 | 17.5              |
| EFTA <sup>1</sup>      | 27           | 31   | 33   | 21                | 5.3        | 5.1   | 5.2   | 4.9               | 1.4         | 1.5  | 1.6  | 2.0               |
| NAFTA <sup>2</sup>     | 59           | 71   | 78   | 51                | 11.6       | 11.9  | 12.2  | 12.1              | 3.0         | 3.5  | 3.8  | 5.0               |
| East Asia <sup>3</sup> | 36           | 47   | 50   | 34                | 7.1        | 7.8   | 7.8   | 7.9               | 1.8         | 2.3  | 2.4  | 3.3               |
| CEE <sup>4</sup>       | 43           | 53   | 62   | 43                | 8.4        | 8.9   | 9.7   | 10.1              | 2.2         | 2.6  | 3.0  | 4.1               |
| Mercosur <sup>5</sup>  | 7            | 7    | 8    | 4                 | 1.3        | 1.2   | 1.2   | 1.0               | 0.3         | 0.4  | 0.4  | 0.4               |
| Others <sup>6</sup>    | 45           | 52   | 56   | 39                | 8.8        | 8.6   | 8.7   | 9.3               | 2.3         | 2.5  | 2.7  | 3.8               |

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 plus Bolivia and Chile (associate members). — 6 Africa, Australia and Oceania, and remaining countries in Asia and Latin America. — 7 January to August.  
Sources: Federal Statistical Office; DIW Berlin calculations.

domestic demand remained weak and exports showed only insubstantial growth, the sales and business expectations of enterprises became gloomy once again. Capacity utilisation in manufacturing industry increased only slightly. Thus, the propensity to invest remained restrained.

In addition, the fall in share prices represented a significant obstacle to those seeking to finance investments on the basis of equity capital.

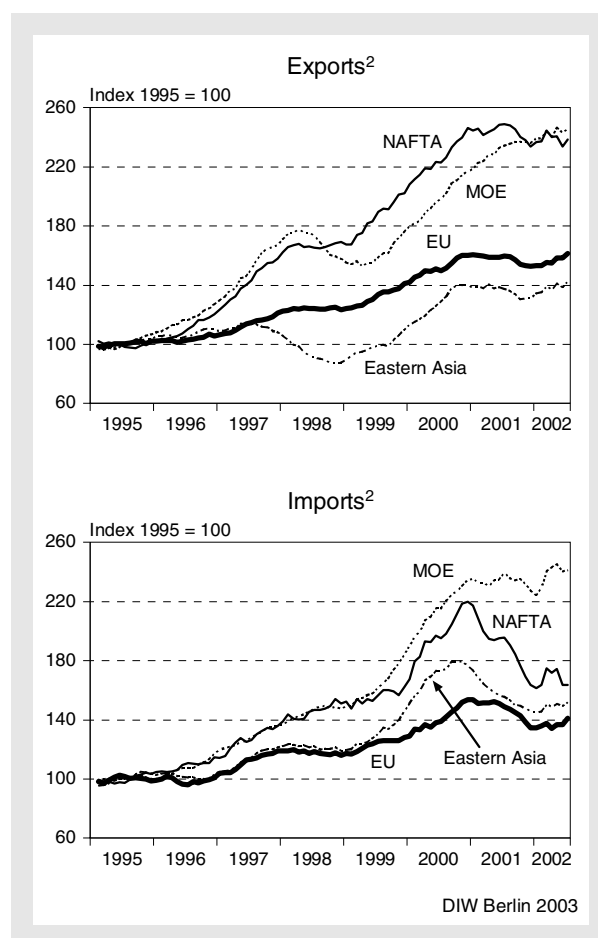
Investments will be initially bolstered somewhat this year by the spending on flood-damage repairs, and they will be further sustained by the renewed upturn in the world economy. As share prices rise steadily and interest rates remain low, investments will then gradually expand.

Investment in other equipment will continue to expand as the demand for software components in the information and telecommunications sector remains stable. Investment in machinery and other equipment will increase by around 3.3% on average in 2003 (cf. figure 7), while the increase will be slightly higher in 2004 (+3.7%).

### Building recession persists

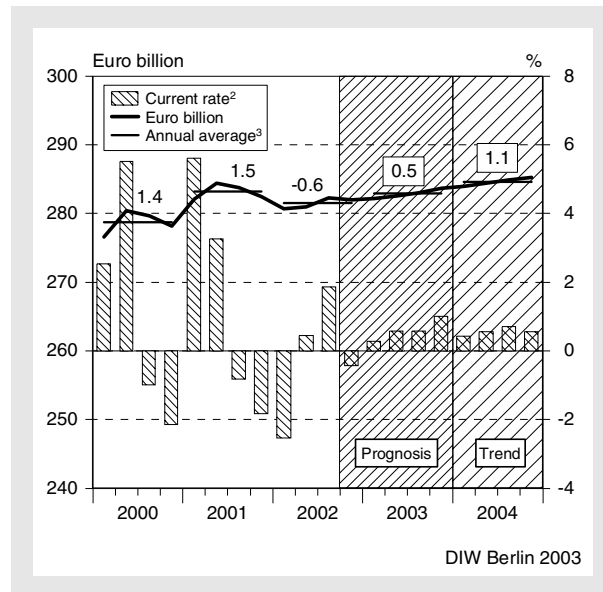
The recession in the building trade has continued. Building investments declined again last year – as in 2001 – by around 6% (cf. table 3 and figure 8). The crisis was evident in both the housing and the commercial construction sectors. The construction industry was particularly hard hit, while the situation was less grim in the allied trades.

Figure 5  
Regional Trends in German Foreign Trade<sup>1</sup>



1 On the classification of countries to regions see table 2. — 2 Special trade, nominal; seasonally adjusted using the Berlin Method (BV4); moving 3-month average.  
Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 6  
**Real Private Consumer Spending**  
 Adjusted for seasonal fluctuations and working days<sup>1</sup>



1 Using X12-ARIMA. — 2 % change on the previous quarter, annualised rate (right-hand scale). — 3 % change on the previous year.  
 Sources: Federal Statistical Office; DIW Berlin calculations.

The decline in commercial construction exceeded the average trend, although the volume of planning permits granted in this segment of the industry had risen slightly in 2001. It appears that the adverse business climate led investors to hold back in implementing their projects.

Investment in housing declined further, especially in eastern Germany. This was mainly due to the continuing high share of vacancies in this region of the country. In western Germany, it was mainly the weak business cycle that caused the decrease in housing investment, although in some conurbations the general conditions – e.g. rising rents for first-time rentals and low interest rates for mortgages – have become relatively favourable for investors.

The flood-damage repairs, which began in September 2002 but will be mostly carried out this year, will provide a temporary boost for building investments.

The building forecast for this year and next year is based on the assumption that the agreements reached in the coalition contract will be given legal form. The new fiscal policy measures will hit the construction industry hard. They include the reduction in subsidies for owner-occupied housing construction, the abolition of degressive tax depreciation for rental housing, the standardisation (at now only 2%) of all depreciation rates for buildings and the taxation of all gains from sales.

Up to now, the subsidy for owner-occupied housing construction has also been considered equity capital by the banks. If this benefit is reduced, numerous private households will find their chances of being granted loans significantly diminished.

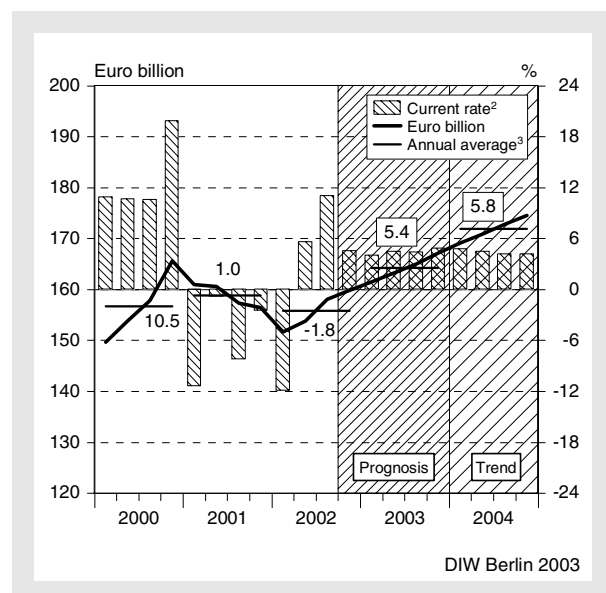
The tax reforms will not only curb owner-occupied housing construction, at least in the short to medium term, but also the construction of rental housing and commercial property. The abolition of degressive depreciation for rental housing will diminish the liquidity of investors and will increase the gap between estimated and actual costs in the initial phase of rental. Profits in the property sector are already modest at present, and if sales profits are taxed in future, imputed gains will decline even further.

All of this is likely to lead to a further sharp decline in building investment – of around 4.6% this year and of 4.9% next year.

## Labour market situation deteriorates

As a consequence of the sustained economic downturn, the number of persons employed fell further over the course of 2002. The decline is likely to have amounted to 220 000 persons (-0.6%) over the entire year. Sectors

Figure 7  
**Real Investment in Machinery and Other Equipment**  
 Adjusted for seasonal fluctuations and working days<sup>1</sup>



1 Using X12-ARIMA. — 2 % change on the previous quarter, annualised rate (right-hand scale). — 3 % change on the previous year.  
 Sources: Federal Statistical Office; DIW Berlin calculations.

Table 3  
Building Investment<sup>1</sup> in Germany

|                               | 2000  | 2001  | 2002  | 2003  |
|-------------------------------|-------|-------|-------|-------|
| Euro billion                  |       |       |       |       |
| Housing                       | 141.1 | 131.1 | 123.4 | 116.4 |
| Non-residential <sup>2</sup>  | 101.0 | 96.6  | 90.9  | 88.1  |
| Government                    | 30.7  | 29.2  | 27.6  | 26.8  |
| Other sectors                 | 70.3  | 67.5  | 63.2  | 61.3  |
| Total                         | 242.1 | 227.7 | 214.3 | 204.5 |
| % change on the previous year |       |       |       |       |
| Housing                       | -2.6  | -7.1  | -5.9  | -5.7  |
| Non-residential <sup>2</sup>  | -2.7  | -4.3  | -5.9  | -3.1  |
| Government                    | -3.4  | -5.0  | -5.3  | -3.1  |
| Other sectors                 | -2.4  | -4.1  | -6.3  | -2.9  |
| Total                         | -2.6  | -6.0  | -5.9  | -4.6  |

<sup>1</sup> At 1995 prices; on national accounting definitions (ESNA 95). — <sup>2</sup> Building construction and civil engineering for the public and private sectors.  
Sources: Federal Statistical Office; 2002 and 2003: DIW Berlin estimate and prognosis.

such as the retail trade, hotels and restaurants, transport, financing, rental and enterprise-related services, which were increasing their personnel up to the beginning of 2002, are now also showing a decrease. Because the share of part-time workers has increased, the volume of work provided by employees declined at an even higher rate than the fall in the number of employed; it is likely to have decreased by 1.1% last year.

The trend will probably be somewhat more favourable next year in view of generally stronger growth, but will remain negative overall. The employment threshold<sup>1</sup> will not be exceeded, so that the number of employed will fall by around 130 000 persons (cf. table 4, figure 9). The decline will not come to a halt until the end of 2003.

Unemployment, which had already begun to rise at the beginning of 2001, increased at a faster pace in 2002 (cf. figure 10). Given an increase of around 200 000 persons compared with 2001, an estimated 4.057 million persons were unemployed on average last year. The cut-back in employment-creation and further-training measures, which affected around 65 000 job-seekers, was largely offset (+63 000 persons) by measures provided under the Job-AQTIV law, which entered into force on 1 January 2002. Other Job-AQTIV measures, such as job rotation and the extension of the Mainz model, have shown little effect to date.<sup>2</sup> This was due not least to the fact that such measures tend to manifest their full

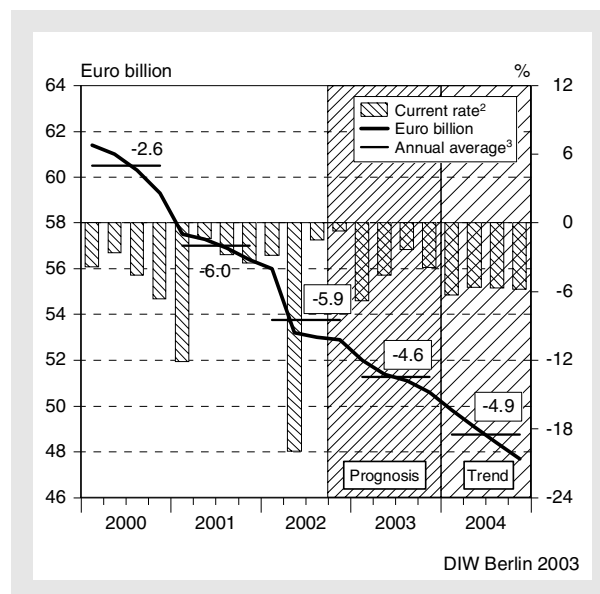
<sup>1</sup> Calculated at real GDP growth of just over 1%. Cf. 'Labour Market in Downturn'. In: *Economic Bulletin*, vol. 38, no. 12, December 2001, p. 393.

strength only when accompanied by robust economic growth. The Hartz proposals,<sup>3</sup> which are based on the same logic – i.e. primarily improving placement services and the labour supply – will thus hardly make themselves felt in 2003. Even if, as a consequence of the most recent new resolutions, the number of employed in the low-wage sector should increase for statistical reasons alone, the total effect of the Hartz proposals on registered unemployment will be minor. Additional employment is likely to emerge primarily from the hidden reserve. Unemployment will thus continue to grow, albeit at a slower rate than last year; over 4.2 million persons can expect to be unemployed on annual average in 2003.

## Eastern Germany

The situation in eastern Germany remained unchanged until summer of last year. Industrial output continued to

Figure 8  
Real Investment in Construction  
Adjusted for seasonal fluctuations and working days<sup>1</sup>



<sup>1</sup> Using X12-ARIMA. — 2% change on the previous quarter, annualised rate (right-hand scale). — 3% change on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

<sup>2</sup> Cf. Working Party of the German Economic Research Institutes (2002): 'The World and the German Economy in the Autumn of 2002'. In: *Economic Bulletin*, vol. 39, no. 11, November 2002, p. 379; German Council of Economic Experts, Report 2002/2003, para. 194 and 195.

<sup>3</sup> Proposals presented by the 'Modern Services on the Labour Market' Commission (Hartz Commission) on 16 August 2002. Some of the draft bills have yet to be passed by the Bundesrat.

Table 4

## Key Forecast Figures for Germany

|  | 2000   | 2001   | 2002   | 2003   |
|--|--------|--------|--------|--------|
| Gross domestic product <sup>1</sup> (percentage change over previous year) | 2.9    | 0.6    | 0.2    | 0.6    |
| Western Germany  | 3.3    | 0.6    | 0.2    | 0.3    |
| Eastern Germany (excluding Berlin)   | 1.0    | -0.1   | 0.1    | 1.4    |
| Gainfully employed <sup>2</sup> (in 000s)                                  | 38 753 | 38 918 | 38 701 | 38 569 |
| Unemployed (in 000s)   | 3 889  | 3 852  | 4 057  | 4 220  |
| Unemployment rate <sup>3</sup> (as a percentage)                           | 9.1    | 9.0    | 9.5    | 9.9    |
| Not gainfully employed <sup>4</sup> (in 000s)                              | 3 066  | 3 074  | 3 256  | 3 423  |
| Percentage not gainfully employed <sup>5</sup>                             | 7.3    | 7.3    | 7.8    | 8.2    |
| Consumer prices <sup>6</sup> (percentage change over previous year)        | 2.0    | 2.5    | 1.3    | 1.2    |
| Unit labour costs <sup>7</sup> (percentage change over previous year)      | 1.0    | 1.5    | 1.2    | 1.7    |
| Public sector financial balance <sup>8</sup>                               |        |        |        |        |
| Euro billion   | 22.8   | -57.5  | -76.2  | -57.4  |
| as % of nominal GDP  | -1.4   | -2.8   | -3.6   | -2.7   |

1 At 1995 prices. — 2 National (annual average based on quarterly figures). — 3 Unemployed as a percentage of the national workforce. — 4 In accordance with the convention of the International Labour Organization (ILO). — 5 Persons not gainfully employed as a percentage of the national workforce. — 6 Price index for the cost of living of all private households. — 7 Labour costs (wages paid per employee) in relation to labour productivity (gross domestic product at 1995 prices per person gainfully employed). — 8 As defined by the national income and expenditure accounts (ESVG95 – Europäisches System volkswirtschaftlicher Gesamtrechnungen – European System of Integrated Economic Accounts); net financial investment 2000 including special receipts from issuing mobile telephony licences (Euro 52.3 billion).  
Sources: Federal Statistical Office; German Bundesbank; DIW Berlin calculations; 2002 to 2003: DIW Berlin estimate and forecast.

rise, though now only slowly because of the economic downturn. The decline in the construction industry also continued, although the trend for incoming orders – with the exception of housing construction – was somewhat more favourable. Output declined in some consumer-oriented sectors, such as the retail trade – a development that was also linked to the continuing fall in population figures.

While the flood disaster of August 2002 led to a fall in output, the necessary repairs will also provide a boost for the economy. The overall losses in output are not likely to have been substantial, although certain sectors, such as tourism and agriculture, were badly affected in the flooded areas.<sup>4</sup> The dimension and timing of the boost for the economy from the flood-damage repairs will essentially depend on the amount of damage sustained. The initial estimations have now been substantially revised downwards. The most recent, though still extremely uncertain, official calculations amount to euro 9.2 billion (including euro 350 million in western Germany). This corresponds to the sum the German government, the local authorities and the EU have earmarked for aid. Going on past experience, the actual damages might still be overestimated, although some repairs which have already been carried out or are due to be car-

<sup>4</sup> These losses must be offset against production increases resulting from efforts to contain the flood and evacuation measures.

ried out on the basis of insurance claims and donations might not be included in the above figure.

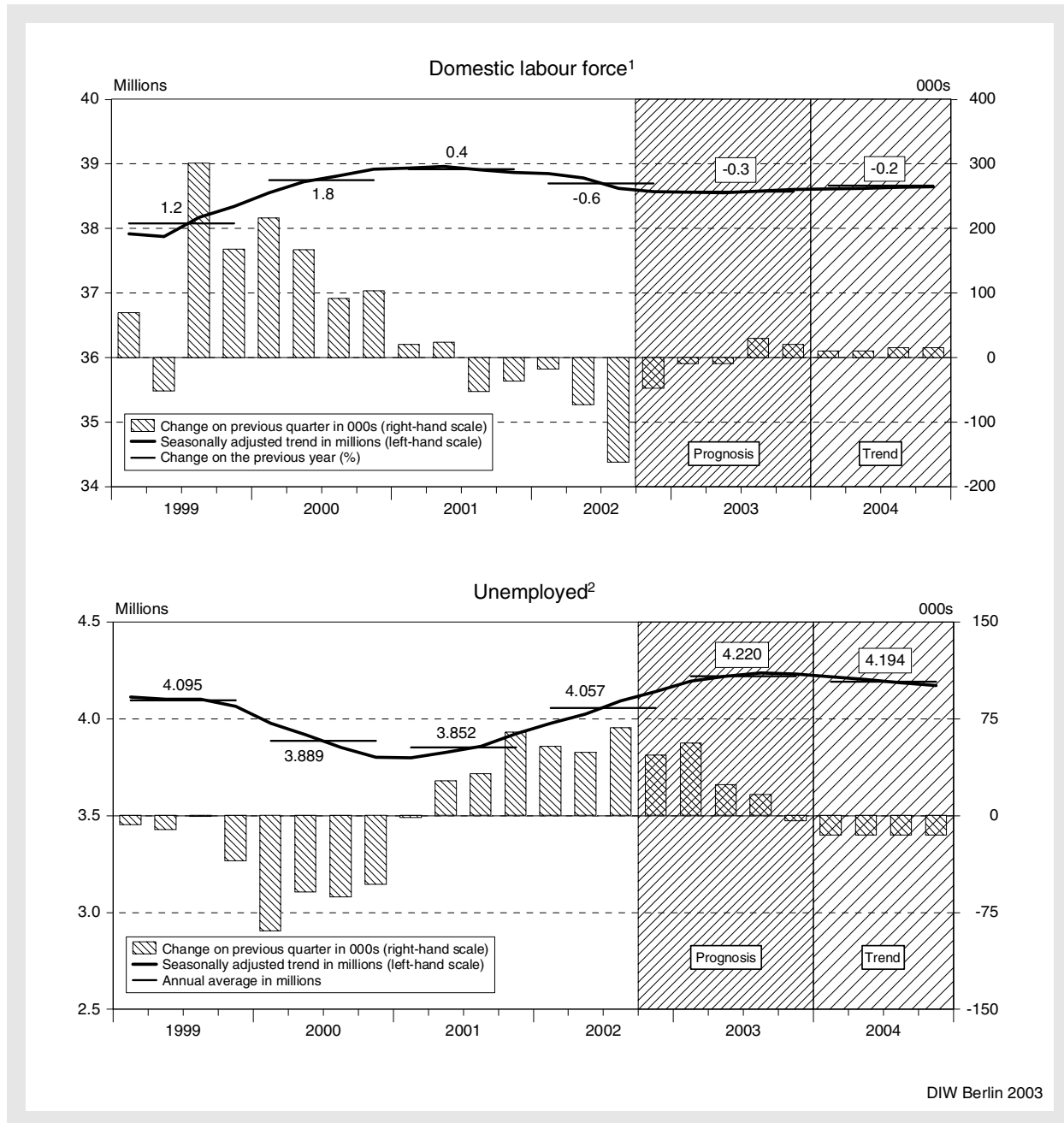
The distribution of the various types of damage is not yet known. Most are probably damages that will require building investments. This will particularly favour the regions which were directly affected, because the work will be carried out on site and a large part of the intermediate input will be acquired on local markets. The construction industry and related economic activities in eastern Germany will thus receive a growth thrust, which will abate again over the course of next year, however. Nonetheless, there is still no sign of a significant expansion in output in the eastern German construction industry.

Despite the positive economic effects of the flood damages, the eastern German economy only managed to stagnate last year. The boost provided by the repairs is likely to be stronger in 2003. Largely as a result of this development, economic performance is expected to show a year-on improvement of almost 1.5%.

### Austerity measures for the public budgets

At 3.6% of nominal GDP this year, the public budget deficits will be somewhat higher than assumed by the Economic Research Institutes in their autumn report

Figure 9  
**Labour Force and Unemployed**  
 Adjusted for seasonal fluctuations



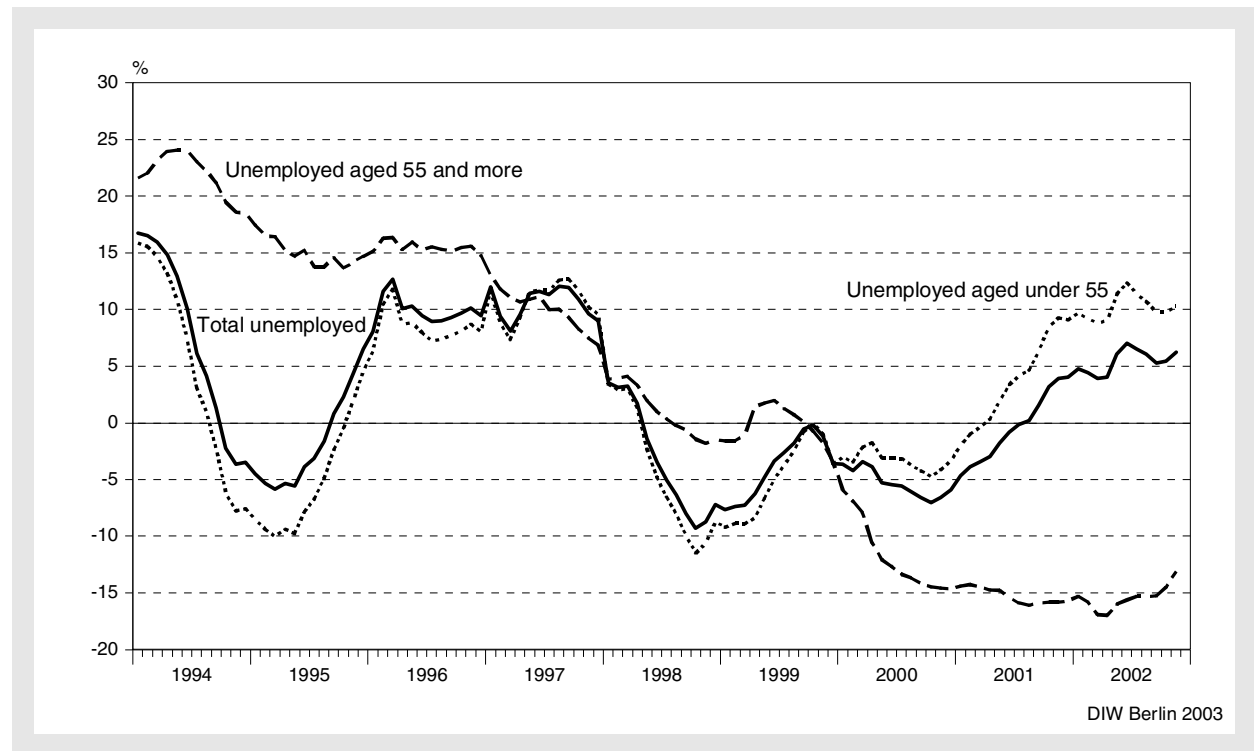
1 Using X12-ARIMA. — 2 Seasonally adjusted using the Berlin Method (BV4).  
 Sources: Federal Statistical Office; Federal Labour Office; DIW Berlin calculations.

(3.2%).<sup>5</sup> This correction is due, on the one hand, to the fact that the Federal Statistical Office has, for example, substantially revised social insurance contributions for

the first half of 2002 downwards (by euro 1.5 billion), with corresponding consequences for the second half of the year. On the other hand, cyclical factors have also played a part. Thus, according to the figures for the third quarter, the gross wage and salary bill is likely to have increased at a much lower rate than assumed to

<sup>5</sup> Cf. Working Party of the German Economic Research Institutes: 'The World and the German Economy in the Autumn of 2002', loc. cit.

Figure 10  
Trend in the Number of Registered Unemployed  
Change on the previous year (%)



Sources: Federal Labour Office; DIW Berlin calculations.

date – with corresponding losses in revenue from tax on wages and salaries and social insurance contributions.

Tax revenue last year again fell below the previous year's level (by 0.3%), although the decline was less substantial than in 2001. Additional revenue from the increase in ecological tax on 1 January 2002 and from the effects of the progressive income-tax rate was more than offset by the cyclical fall in revenue from wage and salary tax, corporation and trade tax, and turnover tax. In addition, in the case of corporation tax, there was an unexpected disbursement of profits, which were taxed in the balance sheets at 40%. This was a surprising development because under the corporate tax reform, legislators had given joint-stock companies time until 2016 to disburse these previously retained earnings.

Social insurance contributions are likely to have increased to a somewhat greater extent last year (1.5%) than the gross wage and salary bill (1.3%). This additional revenue is the result of the 0.4 percentage-point increase in health insurance contributions at the beginning of the year. All in all, government revenue was only 0.4% higher than in 2001.

The slight economic recovery will manifest itself in a return to rising tax revenue this year, given that most of

the burdens affecting taxes on earnings, which curbed revenue in 2001 and 2002, will no longer apply. Revenue will also be boosted by the final phase of the ecological tax reform, the postponement of the second phase of the income-tax reform to 2004 in connection with compensation payments to the flood victims, and the increase in the corporation-tax rate by 1.5 percentage points for just one year. The calculations underlying the forecast also take account of additional revenue (euro 3.5 billion) resulting from the proposed abolition of tax concessions and exemptions provided for in the draft version of the law on abolishing tax concessions (SteVAG). Tax concessions are also to be abolished in the areas of income tax, turnover tax and enterprise taxation. Thus, depreciation on premises will become less favourable, the flat-rate assessment for private car use will be increased, private gains from the sale of securities will be taxed at 15% and the subsidy for owner-occupied housing construction will be restricted to families with children. Certain products and services, which up to now were subject to a favourable tax rate of 7%, will be taxed at the standard rate of 16% from 2003 onwards. In the case of enterprise taxes, a reduction by half of loss deduction and the abolition of the simplification regulation for

depreciations are planned. All in all, tax revenue will increase by 3.9% in 2003. A slightly lower increase is expected in 2004, although the additional revenue resulting from special regulations and the abolition of tax concessions will amount to over thrice the figure for this year (euro 10.7 billion). The reason is that the second phase of the income-tax reform, which was postponed in order to finance damage repairs following the flood disaster, will enter into force in 2004.

Revenue from social insurance contributions will rise sharply this year (4.8%). This is due, on the one hand, to the renewed significant rise in health insurance contribution rates (by 0.5 percentage points) in view of the substantial deficits in the health insurance funds and, on the other, to the 13% increase (to euro 5 100 per month) in the income threshold for the assessment of pension insurance contributions and the increase from 19.1% to 19.5% in the pension contribution rate. Overall, these increases are likely to create additional revenue of euro 7 billion per annum. The increase in 2004 will be largely determined by the rise in the gross wage and salary bill. All in all, government revenue will increase substantially this year (by 3.6%) and by an estimated 3% in 2004.

Following the cyclically determined hefty losses in tax revenue, the government, Länder and municipalities will have to curb spending even further in the future. Numerous Länder have now frozen their budgets in an effort to reduce the deficits. The resulting savings are likely to have been only minimal last year, however. Government spending expanded by a total of 2.2% in 2002, while an increase of 1.5% is expected in 2003. Spending growth is likely to continue to decline substantially in 2004. Public-sector employers have announced that they will be adopting a hard line at the next wage rounds. This forecast assumes that negotiated wage increases in the public sector will be substantially lower than those in the private sector both this year and next year. Wage increases of 1.5% in 2003 and of 2% in 2004 have been assumed. As in previous years, the number of public-sector employees is likely to be further reduced. All in all, this means that wages and salaries will rise only slightly in both years.

Government operating expenditure increased by around 4% in 2002, with the local authorities showing a slightly higher increase in spending compared with the social insurance funds. The decisive factor in this respect was the increase in spending on internal security and military defence necessitated by Germany's involvement in various foreign interventions, while the additional expenditure caused by the flood disaster also played a part. Owing to the austerity measures, the operating expenditure of the local authorities and the social insurance funds will increase at a much lower rate

in 2003 (1.4%), and the rate of increase will probably fall substantially below 1% in 2004. This calculation is based on the assumption that the austerity measures agreed for the health system will lead to a stagnation of operating expenditure.

Monetary social benefits to private households increased by over 4% in 2002, with the rise in spending by the local authorities (6.4%) exceeding social insurance spending growth by almost 3 percentage points. The sharp rise was caused by the increase in children's allowance at the beginning of 2002 and by the high expenditure on unemployment assistance benefits. Spending on pensions, by contrast, only rose by over 3%.

Government investments are often the buffer that reduces the gap between revenue and expenditure, and last year was no different in this respect, as evidenced by the sharp decline in investment spending (-4.6%). The effects of the flood disaster on public investment were probably relatively minor in 2002, but spending on infrastructure repairs will have a positive effect on government investment this year. Nonetheless, the intense pressure to consolidate the budget means that a further decline in government investment spending (-3.6%) must be feared, although the decrease will be less substantial than in the past. In 2004, as the special effect induced by the flood disaster abates again and the second phase of the tax reform enters into force, a continued decline in government investment spending can be expected.

Based on the estimate presented here, the government deficit, which amounted to euro 76 billion or around 3.6% of nominal GDP in 2002, is likely to fall below the magic limit of 3% this year, although - at an estimated 2.7% - less substantially than many observers have been expecting. A deficit ratio of 1.6% can be expected in 2004. However, this will still not be low enough to meet the target laid down in the government's stability programme. While it will be possible to achieve a slight reduction in the local authorities' deficit in 2003, most of the reduction in the deficit ratio will be due to the substantially growing surpluses in the social insurance funds - not least a result of the assumed increases in contribution rates to pension and health insurance. Owing to the austerity measures and the fact that pensions will increase by only 1.4% on 1 July this year (because the pension adjustment formula now takes account of contributions to private pension schemes), the social insurance funds will show only a moderate increase in operating and monetary expenditure.

## Economic policy

### Double jeopardy

The German economy currently faces two dangers. There is already an immediate risk of stagnation becoming entrenched; and, at the same time, an economic situation has developed in which a deflationary trend might even emerge. The urgent task now facing economic policy is to rapidly combat both threats. It is worrying that the economic policy makers currently seem to be oscillating between a state of paralysis and action at all costs, however unconsidered. This applies to monetary policy, which has stood idly by for a year observing the weakness in the economy and only now has effected a long-overdue reduction in base rates. But it applies even more to fiscal policy, which is vacillating between efforts to consolidate the budget and measures to stimulate growth – and achieving neither. Wages policy is divided in the euro zone: only in Germany is it currently perceptibly geared towards stability, if not actually moderate. In most of the other EMU countries, wage increases are excessive – in some cases substantially so – and are thus jeopardising regional competitiveness and at the same time represent an obstacle to a less restrictive monetary policy stance.

The current situation calls for an economic policy stance that is clearly aimed at an upswing. This applies both to the euro zone as a whole and to Germany in particular. In the euro zone, given the weak prospects for growth, this means that both monetary and fiscal policy must be demonstratively expansionary. Otherwise, the timing and the strength of the upswing would largely depend, as on most occasions in the recent past, on the world economic trend – an extremely unpredictable variable. In addition, the global imbalance in the foreign trade balances, specifically the exorbitant current account deficit in the USA, would increase further, as would the risk of drastic exchange rate adjustments. If a stable upswing is to be achieved, the euro zone must create it on the strength of its own economy. This means that monetary policy must react more forcefully and, especially, more rapidly to economic developments, as long as there is no threat to price stability.

Pursuing an upswing based on Europe's own strength also means reconsidering the fiscal policy consolidation strategy pursued to date in the euro zone. The European Commission's most recent recommendations show that it has already departed substantially from a rigid interpretation of the Stability and Growth Pact. However, the basic problem remains: all of the large EMU countries would be forced to adhere to a procyclical fiscal policy in the coming years, which would not help to stabilise growth. If the upswing is to succeed,

what is actually needed is a concept whereby consolidation is achieved with the help of a tailwind of strong growth and is also enforced when growth is robust. A strategy based more on spending goals than on strictly defined deficit goals seems the better option in this respect.

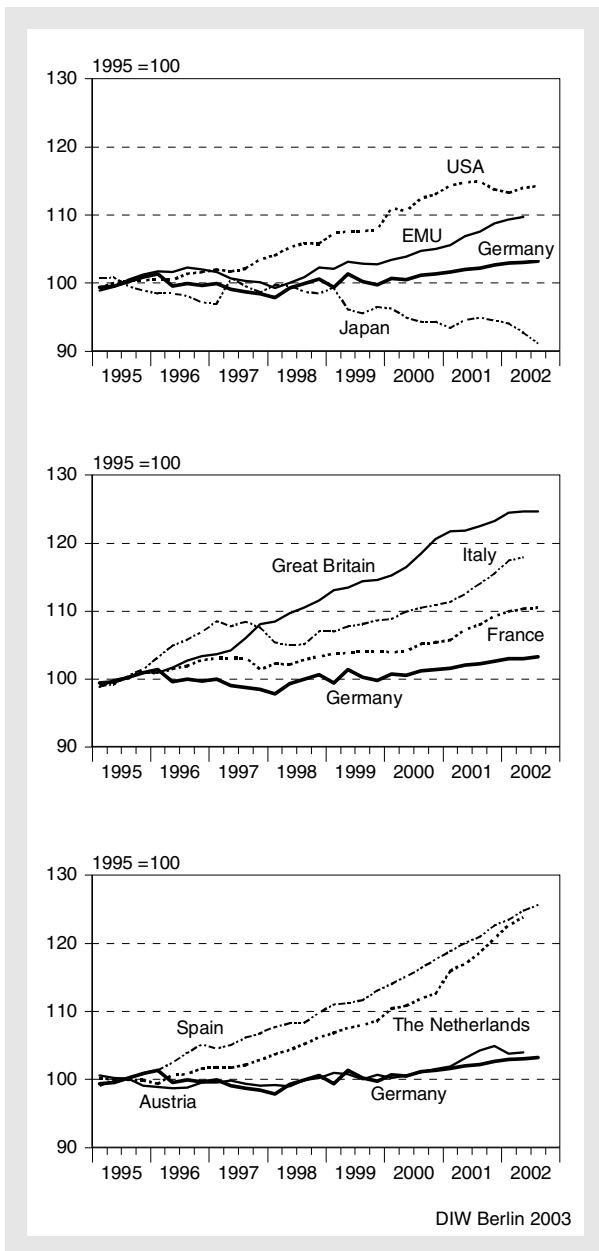
The fact that wage growth in the euro zone is drifting in opposite directions represents a considerable challenge to wages policy. Since the beginning of monetary union, the question of stability-oriented wages policy in each country of the euro zone has never been as urgent as today. If wage growth remains on its current course in each country, the euro zone risks an economic divide, which would prove the critics of monetary union correct in retrospect. Thus, contemplating a concept of wage formation that does not have a destabilising effect in the euro zone represents a contribution to the integration of the European economic area. This would be guaranteed if the wages policy pursued in all countries were based on productivity.

The significance of the macroeconomic factors is often underestimated. An upswing is impossible without sufficiently expansive macroeconomic parameters and without a wages policy that is compatible with the goal of stability. This applies in particular to the current situation in Germany. And yet there is widespread belief in Germany that structural measures such as the reform of the job placement service (Hartz Commission) and the health and pension systems (Rürup Commission), which will not come into effect until 2004 anyway, will kick start an upswing. Regardless of how the practical implementation of the proposals of both commissions turns out, structural reforms of this kind cannot solve the basic problem, namely a lack of demand for labour as a consequence of insufficient domestic demand. What is needed is a macroeconomic strategy. Viewed the other way round, however, improved domestic demand can significantly alleviate the problems of the social insurance system in the short and medium term. Higher demand leads to higher employment and thus to a greater number of persons paying contributions, while the number of benefit recipients declines.

One of the perceived aims of the existing commissions is to significantly reduce ancillary wage costs in the hope of creating substantial employment effects. However, this could only happen if German unemployment were basically the result of excessive ancillary wage costs. In actual fact, Germany's unit labour cost growth is extremely moderate compared with that in other countries (cf. figure 11).<sup>6</sup> This means that the bargaining parties – rightly – took the expected increases in

<sup>6</sup> Cf. Working Party of the German Economic Research Institutes: 'The World and the German Economy in the Autumn of 2002', loc. cit.

Figure 11  
**Unit Labour Costs<sup>1</sup> in  
 International Comparison**



<sup>1</sup> Gross income from dependent employment in relation to real GDP; seasonally adjusted.  
 Sources: OECD; Federal Statistical Office; DIW Berlin calculations.

ancillary wage costs into consideration in their agreements and agreed on accordingly lower wage increases. Thus, enterprises were ultimately not subjected to any additional cost burden that would have led to lower profits on the basis of ancillary wage costs.

Notwithstanding these arguments, the efficiency of the job-placement service must still be improved, and

the incentives to take up employment must be strengthened. There is also no doubt that the social insurance systems need to be thoroughly scrutinised because of the risks posed by the changing demographic trend. Two advantages can be expected from these structural reforms. On the one hand, they will prove their worth once an upswing has set in. If the job-placement service becomes more efficient, then the rising demand for labour should be satisfied more rapidly than to date. In addition, the supply of labour will increase, thus creating the conditions for a more permanent, smoother upswing. If, in addition, the social insurance systems are put on a firm footing once again, the constant and erratic increases in contribution rates would come to an end. This would expand the scope – and this would be the second advantage – for increasing disposable income.

Under these circumstances, the more sensible economic policy strategy would seem to be one which, on the one hand, generally renders the macroeconomic parameters in the euro zone more expansive. On the other, the structural reforms in Germany should not only curtail the increase in burdens via the social insurance systems but also, in the long term especially, create a credible system of social security. This in itself would increase the propensity to expand consumption and investment.

### Is Germany on the brink of deflation?

Fears have been growing recently that the German economy is slipping into deflation and faces the risk of a sustained decline in prices. Until recently – at least in Germany – references to deflation only seemed appropriate within the context of historical observations on the economy; deflation was certainly never the main focus of current analyses. It is true that there is currently no sustained decline in the price level either in the euro zone as a whole or in Germany. On the contrary, the inflation rate in the euro zone still slightly exceeds the 2% benchmark the European Central Bank considers compatible with stability. Moreover, this and all other known forecasts indicate that prices will rise again next year, albeit at a slower pace.

The concern about deflation is based on new insights regarding developments in Japan over the last decade. These show that deflation is not a phenomenon that suddenly appears out of the blue, but a creeping process which is difficult to forecast.<sup>7</sup> This is fatal, because the possibilities open to conventional economic policy are significantly narrowed down in deflationary phases. When prices fall, the influence of monetary pol-

icy on real interest rates diminishes because the central bank cannot reduce the base rate to below zero. Thus, the decisive instrument – stimulating the economy by reducing financing costs – is no longer available. The danger, then, is that stagnation becomes entrenched or even turns into a depression as expectations become ever gloomier. The only fiscal policy weapon available against this kind of situation is a decisively expansionary stance. Half-hearted expansionary steps, which are retracted at the first sign of improvement because of growing deficits and thus end up as a stop-and-go policy, reduce the scope for fiscal policy manoeuvre as debts rise sharply. Consequently, it is all the more important to recognise early on that a national economy is moving in this direction – long before deflation emerges at all. Thus, the important question for Germany is not whether the economy is currently in a deflation, but whether it is manifesting trends and constellations that are capable of creating deflation over the short or long term.

An examination of Germany's price trends shows that the weakening of inflation is particularly evident here compared with other European countries. This applies both to consumer and to producer prices (cf. figure 12), and also to unit labour costs (cf. figure 11). However, these developments are not yet indicative of a particularly dramatic situation in Germany. The current situation could be compared to that during and immediately after the Asian crisis of 1998/99, when there was also little price growth and unit labour costs were actually in decline.

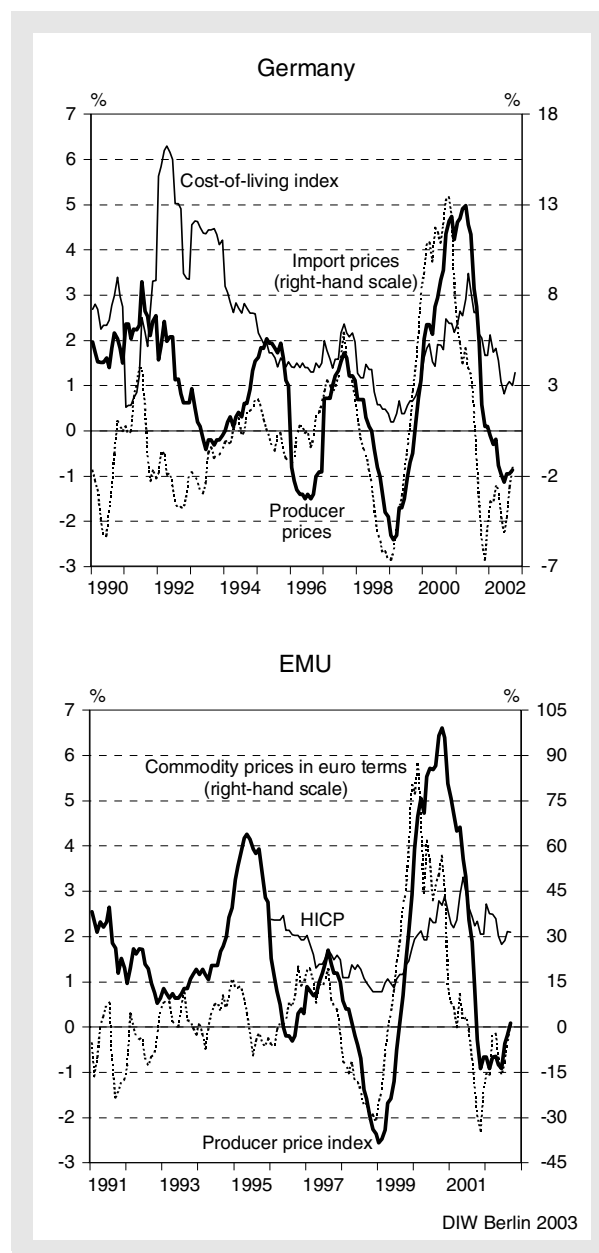
However, one direct result of the comparatively low inflation rate in Germany is the fact that real interest rates (deflated by producer prices) are now higher in Germany than in the other EMU countries (cf. figure 13). Thus, the financing conditions on the German capital market are less favourable than in the remaining countries. In this sense, economic growth in Germany is currently particularly at risk.

The decline on the stock markets is particularly significant in the light of the experience of the Great Depression in the late 1920s and early 1930s.<sup>8</sup> While market values were still rising sharply in 1998 and 1999, share prices began falling in 2000 and have only recently begun to recover to some extent (cf. figure 14). This development has been accompanied by a profound loss in confidence amongst investors, who now have

<sup>7</sup> Cf. Alan Ahearne, Joseph Gagnon, Jane Haltmaier and Steve Kamin: 'Preventing Deflation: Lessons from Japan's experience in the 1990s', Federal Reserve Board, mimeo 2002.

<sup>8</sup> Cf. Charles Kindleberger: 'The World in Depression 1929–1939'. University of California Press, Enlarged edition 1986.

Figure 12  
Price Growth in Germany and the EMU  
Change on the previous year (%)



Sources: Federal Statistical Office; International Monetary Fund; European Central Bank; DIW Berlin calculations.

much less optimistic profit expectations. The result is that investors are finding it extremely difficult to finance their projects via the sale of shares, in other words via the formation of equity capital. While the negative change in the trend on the stock markets was a global phenomenon, German investors seeking capital face an additional burden. On top of the stock market

decline, lending in Germany is also extremely weak (cf. figure 13) – it has now fallen to its lowest level since 1970. However, there has been a perceptible increase in the emission of industrial bonds – albeit at sharply increased yield differentials compared with government bonds. The emission of bonds is clearly being used as substitute for bank loans, but the sharp rise in the yield differential shows that the capital markets assess the risk for industrial bonds much more unfavourably. While the overall picture is one of more difficult financing conditions for investment, this situation is not necessarily related to a credit squeeze. Econometric estimates by the German Council of Economic Experts do not show any evidence of a squeeze.<sup>9</sup> On the contrary, there is much to suggest that the banks and capital markets are less willing to provide funds because the economic setting has deteriorated, which has increased the hazards. There is currently no empirically sustainable evidence that the rationing of funds has any other cause.<sup>10</sup> Another argument in favour of this view is the fact that the banking sector in German is still considered stable. At the end of the day, the current yield differential between bank loans and government securities with the same maturity is not unusually high. Investors are thus not demanding a special risk premium for banks.

All in all, it is evident that the conditions for investors are much less favourable than in 1998/99, and this situation is inevitably significantly reducing both the propensity to invest and economic growth in Germany. Thus, almost all forecasts assume that even in the best case growth will be moderate.<sup>11</sup> In 1998 and 1999, by contrast, the prospects for the future were viewed much more positively. In autumn 1998, when the downturn had already become appreciable, the Economic Research Institutes still predicted a marked upturn for the following year.<sup>12</sup> One year later, on the basis of sustained growth in the USA and the ECB's notably less restrictive monetary policy stance, the forecast was even more favourable.<sup>13</sup> Against this background, the expectations of market participants then, unlike today, were presum-

<sup>9</sup> Cf. Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: 'Zwanzig Punkte für Beschäftigung und Wachstum.' *Annual Report 2002/2003*, para. 161.

<sup>10</sup> Also cf. ECB, *Monthly Bulletin*, November 2002, p. 12 ff.; German Bundesbank, *Monthly Report*, October 2002.

<sup>11</sup> Cf. the majority view in the Institutes' joint report for autumn 2002 and the opinions of the Council of Experts and the OECD.

<sup>12</sup> The Working Party of the German Economic Research Institutes (1998) predicted that German GDP would grow by no less than 2.3% in 1999. Cf. 'The World and the German Economy in the Autumn of 1998'. In: *Economic Bulletin*, vol. 35, no. 11, November 1998.

<sup>13</sup> The joint report of autumn 1999 forecast growth of 2.7% for 2000. Cf. 'The World and the German Economy in the Autumn of 1999'. In: *Economic Bulletin*, vol. 36, no. 11, November 1999.

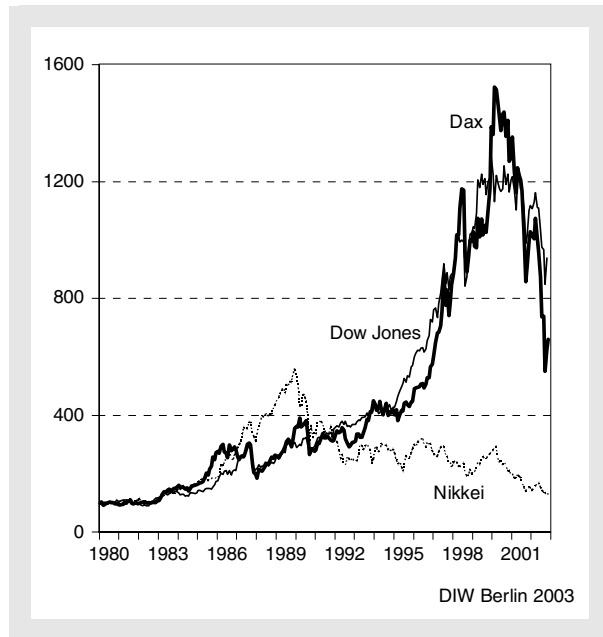
Figure 13  
Short-term Real Interest Rates, Loans and Yield Spreads



1 France, Italy, Spain, Netherlands and Belgium. — 2 Up to 1998: National three-month rates (OECD) aggregated with GDP weights. From 1999 onwards: three-month EURIBOR. Deflated using an aggregated producer price index for the countries concerned. Weights for price index from Eurostat. — 3 Three-month rate on Frankfurt Interbank Market, deflated using producer price index. Sources: European Central Bank; Eurostat; OECD; German Bundesbank; Federal Statistical Office; DIW Berlin calculations.

ably based on the belief that growth would accelerate. Deflationary tendencies cannot indeed emerge in cir-

Figure 14  
Share Price Indices  
1980 = 100



Sources: Bank of Japan; German Bundesbank; DIW Berlin calculations.

cumstances as positive as these. Gloomy expectations, by contrast, are fertile ground for deflation.

Both in Argentina<sup>14</sup> and in Japan, crises of growth – albeit with different causes – were harbingers of deflation. Japan's deflationary phase commenced with a dramatic fall in share prices at the beginning of the 1990s, which signalled the start of a sustained decline in profit expectations. Weak growth, falling producer prices and then consumer prices, and an appreciation of the yen followed. If a deflationary trend is to be recognised in time, it is important to know whether any, and if so which, of these variables are forerunners of falling prices. This was examined for Japan using pair-wise Granger tests within the framework of a VAR model, which test whether the explanatory variables are precursors of the dependent variables. The tests were carried out for all the above variables for the period between 1990 and 2002 and showed that GDP was a forerunner of all the other variables (cf. table 5). GDP was followed by producer prices, the real exchange rate, unit labour costs and consumer prices. The data thus show Japan's path to deflation: first stock exchange prices collapsed, which caused a profound crisis of confidence and resulting considerable losses in growth. The partially recessive and partially stagnant output trend exerted pressure on

<sup>14</sup> Cf. Gustav A. Horn and Ulrich Fritsche: 'Argentina in Crisis'. In: *Economic Bulletin*, vol. 39, no. 4, April 2002.

producer prices. This pressure was ultimately passed on to wages, which reacted flexibly in Japan because of its variable bonus payments and rapidly adjusted downwards. Finally, as input prices fell, consumer prices also declined, and deflation had arrived. The pressure on prices and wages was reinforced in Japan by the repeated appreciation of the yen, which also led to falling import prices.<sup>15</sup>

It is impossible not to see the parallels with Germany, and not only with respect to the stock market crash as the point of departure. The stagnation which is setting in is already exerting pressure on producer prices, and only minor growth rates can be expected from the current round of wage talks. In addition, the euro can be expected to appreciate further in view of the massive current account deficit in the USA, which will exert pressure on import prices. The level of consumer prices has not yet begun to decline in Germany, and so the German economy is currently only in the phase that can precede a deflation. However, if an upturn were to set in within the near future, the spectre of deflation would be rapidly banished.

There are two different arguments against the threat of deflation outlined above. The first, expressed only recently by Milton Friedman,<sup>16</sup> is that deflation is just what Germany needs. Friedman believes that, considering its internal difficulties, Germany entered monetary union with an excessive exchange rate for the D-Mark, which is what has slowed down growth in recent years. Deflation would help Germany to become more competitive with respect to the other EMU countries, he argues. Subsequently, an export boom would set the German economy in motion again. But Friedman's arguments are not convincing. First, Germany can increase its competitiveness without deflation if its positive inflation rate remains lower than that of the other EMU countries. Second, German companies, as their exceptional export performance compared with other countries shows, are already competitive and have no need of depreciation. This is evidenced by the wholly positive and even expanding trade balance between Germany and the rest of the euro zone. Even more importantly, Friedman entirely ignores the negative real economic consequences of deflation.

A second argument against the threat of deflation is that deflation simply cannot arise in Germany as long it does not exist in the other EMU countries. On the one hand, constant import price growth would increase

<sup>15</sup> As Kindleberger demonstrates, falling import prices due to appreciation were also one of the main causes of deflation in the 1930s. Cf. Kindleberger, loc. cit.

<sup>16</sup> Cf. interview with Friedman in the *Süddeutsche Zeitung* of 28.11.2002.

Table 5  
Granger Test<sup>1</sup>

Deflation in Japan

Null hypothesis ( $H_0$ ): The explanatory variable does not forerun the dependent variable

| Dependent variable | Explanatory variable | Probability of rejecting $H_0$ |
|--------------------|----------------------|--------------------------------|
| GDP                | Producer prices      | 0.28                           |
|                    | Real exchange rate   | 0.75                           |
|                    | Unit labour costs    | 0.58                           |
|                    | Consumer prices      | 0.66                           |
|                    | All variables        | 0.78                           |
| Producer prices    | GDP                  | 0.01                           |
|                    | Real exchange rate   | 0.93                           |
|                    | Unit labour costs    | 0.58                           |
|                    | Consumer prices      | 0.19                           |
|                    | All variables        | 0.05                           |
| Real exchange rate | GDP                  | 0.15                           |
|                    | Producer prices      | 0.00                           |
|                    | Unit labour costs    | 0.83                           |
|                    | Consumer prices      | 0.49                           |
|                    | All variables        | 0.02                           |
| Unit labour costs  | GDP                  | 0.12                           |
|                    | Producer prices      | 0.49                           |
|                    | Real exchange rate   | 0.13                           |
|                    | Consumer prices      | 0.31                           |
|                    | All variables        | 0.04                           |
| Consumer prices    | GDP                  | 0.00                           |
|                    | Producer prices      | 0.03                           |
|                    | Real exchange rate   | 0.36                           |
|                    | Unit labour costs    | 0.10                           |
|                    | All variables        | 0.00                           |

<sup>1</sup> Calculated using two lags. The lag length of the VAR was determined using the Akaike information criterion.

Source: DIW Berlin calculations.

prices in Germany again; on the other, falling wages and prices would stimulate exports – and thus the economy – via increased competitiveness to such an extent that higher capacity utilisation and rising employment would raise prices and wages again.

While this argument makes immediate sense for a small, open economy, which exports perhaps the bulk of its output, its viability appears doubtful for a medium-sized, not to mention a large, economy. In the latter cases national output is determined to a much greater extent by domestic demand. In order to investigate the empirical validity of this idea for Germany, the DIW Berlin carried out two simulations using the German module of its European Business Cycle Model (cf. box 2). The first simulation shows the consequences that can be expected from a higher inflation rate in the other EMU countries. It assumes a resulting import price thrust of

1% per annum for three years, which ultimately leads to a higher domestic price level of one percentage point (cf. figure 15). This would be a direct consequence, on the one hand, of higher prices for intermediate goods. On the other, exports and thus output and employment would be stimulated by the implied real depreciation. In the course of this development wages, and thus ultimately prices, too, would rise again. Thus, the idea that an isolated increase in import prices can help to overcome a deflation is certainly correct.

The second simulation illustrates the domestic origins of deflation. The primary impulse assumed here is that nominal wages permanently rise at a rate which is 1% lower than in the status quo scenario (cf. figure 16). This leads directly to lower prices, which result in turn in lower wages again. At the end of the simulation, nominal wages are around 2% lower than the reference level, while prices are around 1% lower. Real wages are thus in decline. As expected, the falling prices boost exports, which at the end of the simulation period are 0.3% higher than in the base scenario. While the lower real wages would in themselves lead to rising employment, this positive impulse would be more than offset by weaker consumer demand resulting from lower real income, so that the effect for the domestic economy would be restrictive. All in all, according to the results of these simulation studies, domestic restriction and external stimulation as a consequence of deflation would have a more or less neutral effect for Germany in real economic terms. National output would be slightly curtailed, but employment would be somewhat higher at the end of the simulation period, though weakening all the time. Under these circumstances, price growth cannot accelerate despite the successful export economy. If wages were to continue to fall, deflation would thus not be overcome. This result is all the more significant given that the simulation does not take account either of the negative consequences of the rising real indebtedness of enterprises during the deflationary phase or of the reaction of the other EMU countries to Germany's improved competitiveness. If these countries were to follow the same path as Germany as a consequence of their loss in growth, the competitive edge – basically the result of a kind of beggar-my-neighbour policy – would gradually diminish, as would the boost from exports; the overall effect would then presumably be negative. For all these reasons, the argument that Germany cannot slip into deflation within a monetary union with overall positive inflation rates must be rejected.

So what should economic policy makers do in such a situation? Normally monetary policy would be primarily called on to combat the risk of deflation early on by means of a less restrictive stance – as appears to be happening at the moment in the USA. But monetary policy

### Econometric simulations

The simulations were carried out using an econometric business-cycle model for Germany (EBC model) recently developed at the DIW Berlin. The results are intended to illustrate the strength and development over time of selected chains of effects. The simulations were carried out for an ex-post period (1995 to 2001); however, the processes can also be applied to the immediate future. The first simulation, 'Gradual increase in import prices by 1% per annum for three years', simulates the effect of a gradual increase in import prices. Import prices, which are exogenous to the German module, increase over a period of three years at a much higher rate than in the comparative scenario, and at the end of this period the import price index is 3% higher than in the comparative scenario. An annual increase in import prices of this dimen-

sion can arise, for example, if the annual increase in prices is greater in the other EMU countries than in Germany. Using this simulation experiment it is possible to illustrate the implications of these varying inflation rates for the general course of the German economy.

In the second simulation, 'Long-term reduction by 1% of increase in hourly wage level', the endogenous explanation of wage growth in Germany is manipulated. The experiment simulates a one-off increase in wages which is one percentage point lower than in the comparative scenario, and no effort is made in the subsequent years to correct this difference. A 'wage lag' of this kind has consequences: prices rise at a lower rate, which in turn influences subsequent wage agreements.

in the euro zone must be suited to the European context and could thus only act accordingly if the entire euro zone were affected by the threat of deflation in Germany. This is currently clearly not the case. The unavoidable reticence of monetary policy is a further cause for worry from the German point of view because it is extremely reminiscent of the – self-imposed – hesitant reaction of the Japanese central bank.

Fiscal policy is committed to the constraints of the Stability and Growth Pact, and so Germany finds itself with absolutely no room for fiscal policy manoeuvre. Given the extremely difficult budget situation, an expansionary impulse cannot be expected from this corner. Thus, fiscal policy is actually having a dampening effect on growth.

In these circumstances, wages policy has a decisive role to play in Germany. While it is not capable of stimulating growth, it can serve as an anchor for stability against deflationary trends. If the national wage level increases in accordance with secular productivity growth and an inflation premium which is in line with price stability, private consumption can be stabilised. The deflationary trend will be counteracted by an upward pressure on costs, which enterprises will eventually pass on to prices. Japanese wages policy, by contrast, contributed to price destabilisation for, given the less favourable economic situation, wages were actually temporarily lowered through the reduction of bonus payments. Thus, they actually reinforced the deflationary pressure. Bearing in mind the usual approach to wage formation in Germany, this is where there is a chance to avoid such a development with the help of stability-oriented wage formation.

The fact that stable nominal exchange rates exist for the bulk of German exports should also have a positive effect overall. Drastic appreciations, which would strengthen the deflationary pressure, are only signifi-

cant with respect to non-European trade relations and thus much less important than for Japan, where several sharp appreciations further reinforced the deflationary pressure. In the 1930s, too, deflation was induced in some countries, including Germany, by currency appreciations.<sup>17</sup>

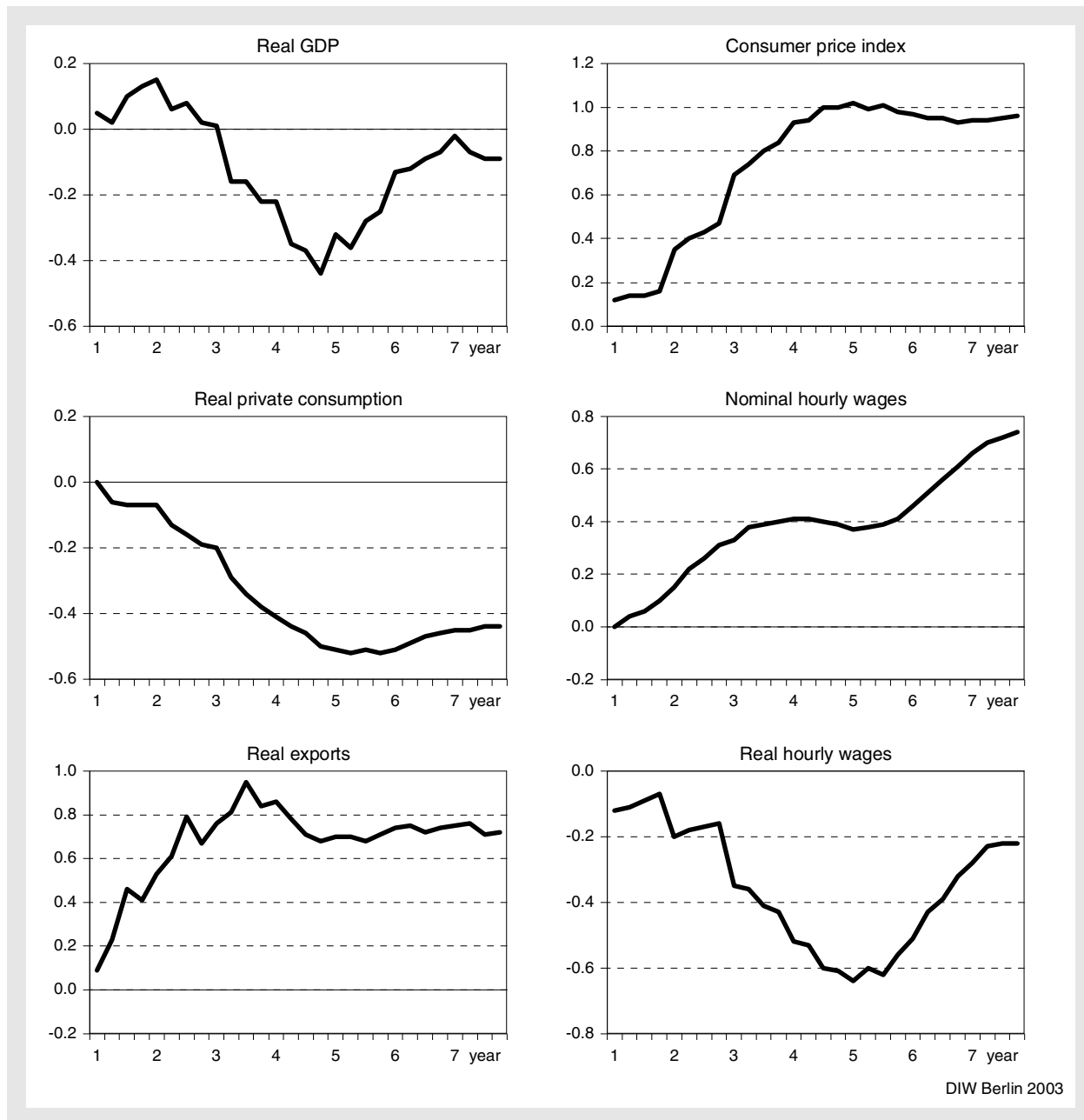
Thus, deflation is not inevitable in Germany. If the growth trend should turn out to be more favourable than predicted here, then the danger will rapidly evaporate. If wages policy adheres to its current course, the risk will at least be reduced. Nonetheless, the current basic constellation in Germany could push the economy towards deflation and fiscal and monetary policy will have to try to rectify this situation.

### Monetary policy overly reticent

The ECB recently reduced its base rates by half a percentage point in reaction to the substantial deterioration in the prospects for economic growth since the middle of 2002. In December 2002, the ECB reduced its projection for real economic growth in 2002 by over half a percentage point compared with its December 2001 forecast, and by almost one percentage point for growth in 2003. There is still no sign of an economic upswing, and so the output gap – the percentage difference between overall output and potential output – is widening further. In the euro zone, GDP has been growing at a much weaker rate than potential output would permit since the beginning of 2001, and domestic demand has not increased at all: it was at the same level in the second quarter of 2002 as in the fourth quarter of 2000. The output gap in the euro zone will amount to an average 1.9% in 2002<sup>18</sup> and will increase by around another percentage point this year.

<sup>17</sup> Cf. Kindleberger, loc. cit.

Figure 15  
**Gradual Increase in Import Prices by 1% Per Annum for Three Years**  
 Deviation from base simulation (%)



Source: Simulation using DIW Berlin's EBC model.

The cooling down of the economy in the euro zone over the course of 2001 had led the ECB to reduce its

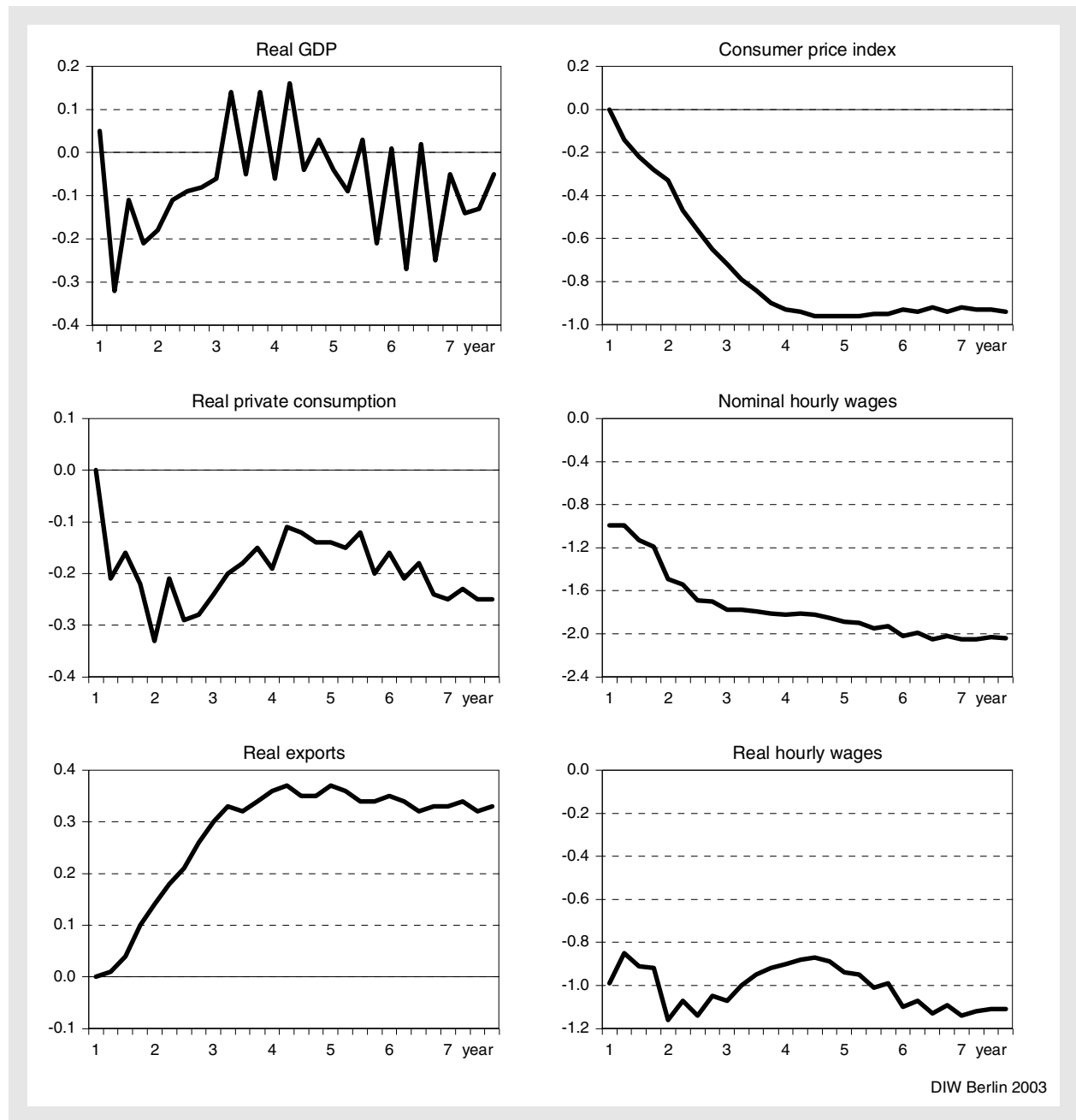
base rates by a total of 1.5 percentage points. This does not seem much compared with the interest-rate reduction of 5.5 percentage points in the USA, even considering the fact that the decline in capacity utilisation was stronger in the USA than in Europe. In view of the strong expansion of the output gap in Europe and the gloomy economic prospects at the time, shortly after the start of 2002 the DIW Berlin had already called for a fur-

<sup>18</sup> This figure is based on the IMF's calculations on potential growth; the OECD believes the output gap in the euro zone will amount to 1.5% in 2003. Cf. International Monetary Fund, *World Economic Outlook*, September 2002, p. 16; OECD, *Economic Outlook*, no. 72, November 2002, p. 20.

Figure 16

### Long-term Reduction by 1% of Increase in Hourly Wage Level

Deviation from base simulation (%)



Source: Simulation using DIW Berlin's EBC model.

ther substantial decrease in interest rates by the ECB.<sup>19</sup> This would also have been justified even if the (cautious) expectations of an economic recovery that arose in the summer had been fulfilled. But even these modest

<sup>19</sup> Cf. 'Economic Trends 2002/2003'. In: *Economic Bulletin*, vol. 39, no. 1, January 2002.

hopes were soon disappointed. A reaction by the ECB in the form of an interest-rate reduction of half a percentage point at the latest in the autumn, and not only at the beginning of December 2002, was thus all the more necessary.

The traditional indicators certainly do not suggest that the euro zone is on the brink of a recession, not to

Table 6

## Forecast of GDP and Inflation (HICP) in the Euro Zone, 2002 to 2004

|   | GDP  |      |      | HICP |      |      |
|---|------|------|------|------|------|------|
|   | 2002 | 2003 | 2004 | 2002 | 2003 | 2004 |
| ECB projection December 2002 <sup>1</sup> | 0.8  | 1.6  | .    | 2.2  | 1.8  | .    |
| ECB projection December 2001 <sup>1</sup> | 1.2  | 2.5  | .    | 1.6  | 1.5  | .    |
| ECB projection June 2002 <sup>1</sup>     | 1.2  | 2.6  | .    | 2.3  | 1.9  | .    |
| OECD November 2002                        | 0.8  | 1.8  | 2.8  | 2.4  | 2.2  | 2.0  |
| Consensus October 2002                    | 0.8  | 1.9  | .    | 2.2  | 1.9  | .    |
| DIW Berlin January 2003                   | 0.8  | 1.4  | 2.0  | 2.2  | 1.8  | 1.6  |

<sup>1</sup> Mean value of spread.

Sources: ECB; OECD; DIW Berlin calculations.

mention deflation. But, as explained above, there is reason to warn against these developments in Germany because sooner or later they will also begin to make themselves felt throughout the entire euro zone. Deflation, recession and stagnation are all easier to prevent than to combat once they have set in.

One could argue that economic forecasts are always highly uncertain and that, in view of the time lag between an adjustment of monetary policy and its effect, the ECB is right to wait for clear signs of economic weakness before taking action to avoid the risk of a procyclical impulse. However, even the results of the ECB's own most recent studies argue against hesitancy in the current situation. These studies show, on the basis of several econometric models, that monetary policy takes effect relatively rapidly in the euro zone.<sup>20</sup> Thus, a reduction in interest rates has a significant positive influence on GDP after only six months. If it should turn out in six months' time that the economy world wide and in the euro zone is in better shape than expected, nothing would have been lost by a reduction in interest rates now; rather, something would actually have been gained because the output gap would be narrowed somewhat more rapidly.

The ECB's monetary policy was made more difficult by the fact that the increase in the HICP last year was once again higher than the maximum ceiling of 2% laid down by the ECB for the medium term; on the latest figures, the increase is still strong at 2.2%. A detailed analysis of the inflation trend shows that, as in 2000 and 2001, special factors are responsible for this high increase in prices compared with the ECB's inflation target.<sup>21</sup> Thus, overall hourly wages rose at a slightly higher rate last year than in the previous year, but in

itself this trend is in line with stability. Moreover, the increase seems to have been weakening again recently. All in all, inflation appears to be slowing down.

While the money supply has been expanding at strength for some time, this increase is due first and foremost to the fact that, in view of the fall in share prices and low capital market interest rates, more investors are opting for shorter-term forms of investment. Another argument against the suggestion that the expansion potential of the money supply is excessive is the fact that, at rates of 5%, the increase in lending has actually been weak for some time.

Short-term interest rates are currently low in both nominal and real terms. But is this level also appropriate in economic terms? One commonly used monetary policy criterion is the so-called Taylor interest rate (cf. box in report 1 of this issue, p. 7).<sup>22</sup> While the Taylor rule can provide an indication of the appropriate rate, it is not possible to clearly determine the real equilibrium interest rate underlying this rule, nor can the weights with which the output gap and deviations between the inflation rate and the target rate are to be included in the determination of the appropriate rate be precisely defined either theoretically or empirically. If a real equilibrium interest rate of 2% is assumed in accordance with medium-term productivity growth and, as in the original Taylor rule, the output and inflation gaps are each weighted at 0.5 then, given an expected output gap of almost 3% and an expected inflation rate of 1.8% in 2003, the result would be a Taylor interest rate of 2.5%, which is somewhat lower than the current rate. If the output gap were weighted with 1 and if the fact that the fall in share prices by almost 30% since the beginning of

<sup>20</sup> Cf. European Central Bank, *Monthly Report*, October 2002, p. 47 ff.

<sup>21</sup> These special factors are described in the ECB's *Monthly Bulletin* of June 2002, p. 38 ff.

<sup>22</sup> On the Taylor interest rate, also cf. J.B. Taylor (ed.): 'A Historical Analysis of Monetary Policy Rules'. In: *Monetary Policy Rules*, Chicago 1999; Silke Tober: 'Europäische Geldpolitik: Expansionskurs beibehalten'. In: *Wochenbericht des DIW Berlin*, no. 12/2002, p. 205.

the year and the appreciation of the euro by 7.5% represent a significant deterioration of the monetary parameters were taken into consideration, then the resulting interest rate would be much lower.<sup>23</sup>

Econometric studies have shown that an interest-rate reduction of one percentage point would lead to an increase in GDP of 0.3% in the year of the reduction and of a further 0.2% the following year.<sup>24</sup> It emerges that the real economic effect becomes significant as early as the second quarter after the reduction. If we now consider that the ECB has reduced its growth forecast for this year and next year by a total of 1.25 percentage points since its last interest-rate reduction, then the most recent reduction appears very low. According to the results of the econometric studies, it will only be able to absorb a quarter of one percentage point of the correction of the forecast and so, despite the interest-rate reduction, the output gap will continue to grow.

## Heterogeneous wages policy in the euro zone

Since the introduction of monetary union, wages policy has never been as disparate in the euro zone as it is now. While in Germany, despite a slight acceleration in wage growth, unit labour costs rose only very moderately – most recently by only 0.4% – they have increased sharply at a rate of 2.6% in most of the remaining large countries (EU8). So while wage growth in Germany dampened inflation growth, this was not the case in the rest of the euro zone.

Thus, a critical situation has emerged in the euro zone, because wage growth which is almost in line with stability is the aggregate result of extremely heterogeneous trends in the various regions. The differences are only partially due to diverging growth and employment trends. But the euro zone as a whole is still some distance from a stability-oriented wages policy with wage growth based on secular productivity growth and an inflation premium that can be tolerated by the ECB. A strategy of this kind would, on the one hand, do justice

to the different growth rates for economic efficiency in the individual countries. Thus, in a country such as Ireland, which is still in the process of catching up and shows high productivity growth, nominal and real wages could increase at a much higher rate than in Germany, for example. A strategy of this kind would not pose a threat to economic stability: neither the supply nor the demand conditions would be affected and, at the same time, wage pressure which could threaten price stability would not emerge.

There has clearly been no success to date in implementing a strategy of this kind in the individual countries. In actual fact, almost the entire burden of adjustment to the stability targets is currently being assumed by German wages policy, a situation that cannot continue in the long term. The competitiveness of the remaining countries of the euro zone relative to Germany and the general supply conditions will deteriorate, which will have a negative effect on export and output growth in the countries concerned and ultimately also on growth and employment. But in Germany, too, the gain in competitiveness on international markets will not offset the decline in domestic demand. What is needed, therefore, is a change in the conceptual approach to wages policy in the euro zone and a switch to a long-term strategy based on productivity. There is now evidence of initial moves in this direction on the part of the European Trade Union Confederation.<sup>25</sup>

Thus, German wages policy should continue to adhere to the course embarked on last year. This means that while wage increases in the public sector should remain below the national average of almost 3%, the deviation should not be too marked, rather maintaining the usual gap of around one percentage point. Higher wage concessions would only make sense if the government were to provide corresponding employment guarantees. Wage growth in most of the remaining EMU countries, by contrast, should be more moderate in order to avoid inflationary risks.

This recommendation implies that wages in Germany would act as an anchor for stability in the current situation. Thus, in the national context they would actually assume the role of monetary policy, which must inevitably be oriented towards the euro zone as a whole.

## Fiscal policy torn between consolidation and growth

In view of a budget deficit of 3.6% of nominal GDP in 2002, the local authorities have agreed to restrict public

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<sup>23</sup> On the other hand, the resulting Taylor interest rate would be much higher if the real equilibrium interest rate were set not at 2% but at 2.5% and the inflation rate not at 1.8% but at 2.2%.

<sup>24</sup> Cf. European Central Bank, *Monthly Report*, October 2002, p. 47 ff. Also cf. Ilian Mihov: 'Monetary policy implementation and transmission in the European Monetary Union'. In: *Economic Policy*, no. 33, October 2001; Rudi Dornbusch, Carlo Favero, Francesco Giavazzi: 'Immediate challenges for the European Central Bank'. In: *Economic Policy*, April 1998, p. 20 ff; Ramana Ramaswamy, Torsten Slok: 'The Real Effects of Monetary Policy in the European Union: What Are the Differences?' IMF Staff Papers, vol. 45, no. 2, June 1998, pp. 374-399.

<sup>25</sup> Cf. Intervention adopted by the ETUC Executive Committee, Brussels, 19-20 November 2002.

spending in 2003 and 2004 in order to bring the deficits back in line with the path laid down in the stability programme.<sup>26</sup> The government efforts towards complete budget consolidation have not manifested a clear direction to date, however. There is still no convincing strategy for limiting public spending in the medium term. Following the motto 'Modernisation and simplification are the leitmotif of fiscal policy', fiscal policy has actually reacted to the public budget 'emergency' with increases in taxes and contributions, which will burden growth.

Because the postponed second phase of the income-tax reform will take effect in 2004, it will probably only be possible to slightly reduce the local authorities' deficit ratio. The fact that the government deficit ratio will nonetheless fall to 1.5% will be primarily due to the increases in contribution rates and the spending cuts in the area of social insurance.

The government's most recent decisions are questionable not only as regards fiscal policy, but also with respect to pension and health insurance. Together with the austerity measures, they will lead to substantial surpluses in the social insurance funds in the coming years, which will make a significant contribution to deficit reduction. Without these surpluses, the overall deficit would probably fall only slightly below the 3% limit this year, too. While most of the social insurance surpluses created in 2003 will be needed to offset the deficits shown in 2002, what is needed in 2004 are reduced contribution rates and not the accumulation of further surpluses.

The government's consolidation strategy finds itself in a serious crisis. Over the last two years, it has failed to meet the deficit goals laid down in the stability programme by a wide margin, and the next two years will not see any improvement. The question is how the government should react to this situation. Given that its consolidation efforts have not sufficed, should the government continue to reduce the deficits in the long term, reduce spending even more than planned, or increase taxes? Or should it fundamentally change its strategy? The DIW Berlin will argue below in favour of the last option because the other alternatives are doomed to failure from the outset.

The aim of the consolidation strategy, which is to reduce the deficits in the public budgets to zero in the medium term and thus to steadily reduce the stock of debt, is not called into question. A high stock of debt implies a permanent burden on fiscal policy via interest and redemption payments, with the result that finances

are permanently tied up and thus not available for other projects. The question, then, is not whether the budgets should be consolidated, but how this should be achieved.

Budget consolidation serves national interests anyway, so that there really should be no need for a European stability pact to this end. The pact only makes sense if external effects in the form of higher inflation and higher interest rates emerge in the entire euro zone because of an excessive national debt. But a situation of this kind can only develop if not enough consolidation is achieved in times of robust growth. It is only then that expansionary government demand leads to inflation and accordingly higher interest rates. When the economy is weak and capacities are under-utilised, inflationary effects cannot be expected from expansive government demand. Thus, external negative effects cannot arise in this situation.

A European stability pact should thus provide for limits on government spending, in periods of strong growth in particular. The strategy pursued to date of stipulating deficit goals for each year meant this was impossible to achieve. In the original interpretation of the pact, the goals referred to current deficits, but because of the resulting inevitable procyclical orientation of fiscal policy, now many observers have suggested switching to structural deficit targets. However, this would not solve the problem either. The differentiation of deficits into cyclical and structural components is anything but straightforward.<sup>27</sup>

In addition, as seen in Germany in 2001, tax cuts, which increase the structural deficit,<sup>28</sup> and discretionary spending increases are believed to be inadequate steps towards budget consolidation, although they serve a fiscal policy goal advocated by many in that they reduce the government share of overall output and thus strengthen the forces for growth.

A glance at the other large countries in the euro zone – Italy and France – shows that the approach followed to date has reached its limits. If the deficit strategy currently pursued were maintained, the result would be a drastic tightening up of fiscal policy's restrictive course, with disastrous effects for the already precarious European economy. The fact that most of the EMU countries have healthy budgets is no help, for these are smaller countries with correspondingly less weight in the European economy. Seen in this light, intentions to proceed along the current course lose all credibility.

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<sup>26</sup> The government intends to reduce spending in the coming years by an average of 0.5% per annum. The Länder and municipalities will reduce annual spending growth to 1%.

<sup>27</sup> Cf. 'A different opinion on the European Stability and Growth Pact' In: 'The World and the German Economy in the Autumn of 2002', loc. cit., p. 393 ff.

<sup>28</sup> The tax cuts carried out in Germany in 2001 increased the structural deficit by over one percentage point.

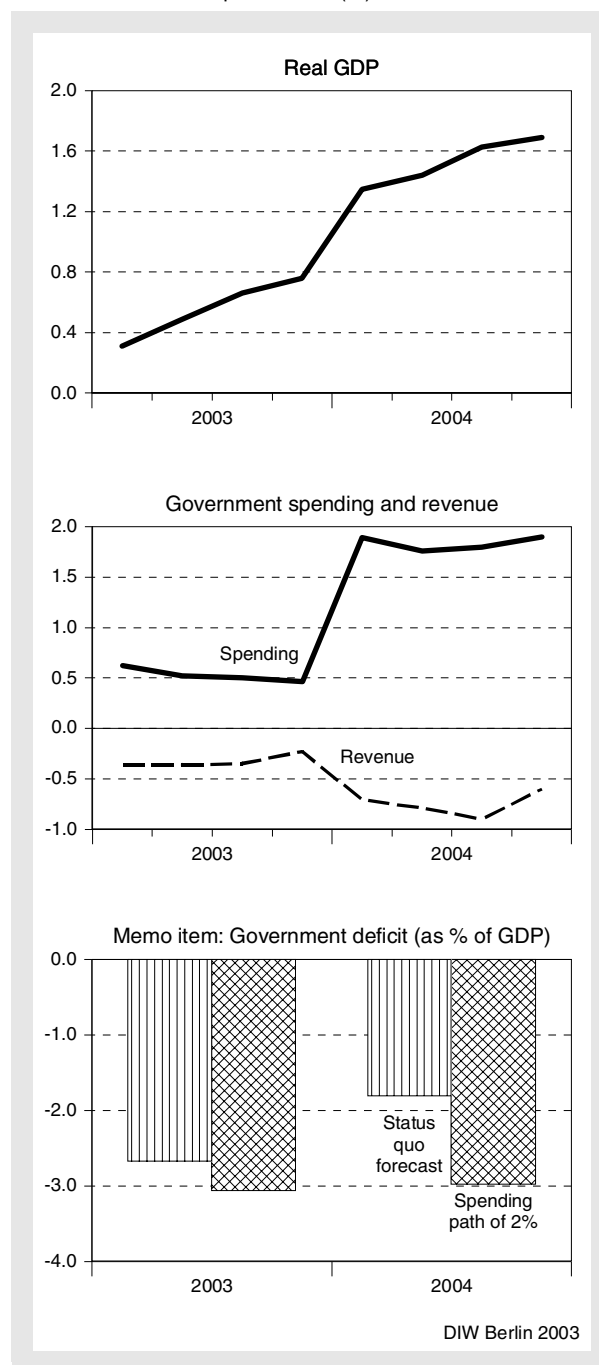
The argument that a credible consolidation strategy based on the reduction of structural deficits would have no negative repercussions for the economy because the increase in the government savings ratio would be offset by a decline in private savings in the hope of future tax cuts is not convincing. Individual households have no certainty that the very taxes that burden their income or spending will be cut. Thus, they will wait to see whether this actually happens and only then change their behaviour. Otherwise they could reduce their savings or even increase their debts without ever being compensated by the desired lower taxes.

For all these reasons, then, the wisest option is a fundamental shift in the consolidation strategy. Deficit goals should no longer be pursued in the short term. Instead, a spending path should be laid down based on the medium-term goal of a balanced budget. If one assumes – very cautiously – that the German economy will show both trend growth and an average inflation rate of 1.5%, then any increase in spending under 3% would in itself be compatible with the goal of medium-term consolidation. If Germany were to pursue a spending path with annual growth of maximum 2% for all local authorities, this would be in line with the medium-term goal of consolidation and would at the same time offer greater scope for public investment. If the economy were to show stronger growth than expected then, with tax revenue flowing abundantly again, a 'hard' maximum ceiling would have been set on the predictable desire to spend.<sup>29</sup>

The effect of a strategy of this kind can be illustrated in a simulation using the DIW Berlin's EBC model (cf. figure 17). Overall output growth would be much more favourable than forecast here. At the end of 2004, GDP would be 1.6% higher than the path presented in the forecast, while the GDP growth rate would amount to 2% instead of 1% in 2004. The price for the higher expenditure would be increased deficits in the short term, which would amount to almost 3% in 2004 because of the generally still weak growth and the entry into force of the third phase of the tax reform. The debt situation would, however, gradually improve towards the end of 2004. The deficit would then primarily fluctuate in accordance with the cyclically determined additional or reduced revenue. Tax cuts would lengthen the road to budget consolidation, while tax increases would shorten it. Given that the government plans to introduce another two phases of tax cuts anyway, no additional tax relief should be agreed, at least in the short term, in

<sup>29</sup> Accounting conventions and regulations in line with the ESNA would also be required for this consolidation strategy. As for the deficit criterion, compliance with these regulations should be overseen by Eurostat.

Figure 17  
**Spending Path of 2% with No Additional Increase in Tax and Contribution Rates**  
 Deviation from status quo forecast (%)



Source: Simulation using DIW Berlin's EBC model.

order not to further delay the consolidation process. But the tax increases envisaged by the government are also ruled out by the weak economy. As long as the consolidation process has not been concluded, the DIW Berlin

recommends imposing a fiscal policy moratorium in which the tax burden would remain unchanged overall.

However, above and beyond the question of consolidation, the tax system should be overhauled anyway. The tax rates in the lower income brackets could be reduced and the VAT rate increased in a revenue-neutral fashion. The DIW Berlin recommends defining income-tax entry rates that follow both a lower and a smoother curve than the current rates.<sup>30</sup> This could be achieved with a fully linear progressive rate, which in particular would relieve the lower and middle income brackets (cf. figure 18). The loss in revenue for the government would amount to euro 25 billion.

One way to finance the loss in income-tax revenue would be to increase VAT, which is still lower in Germany than in the rest of Europe. But in order not to excessively burden low-income households, the reduced rate should remain unchanged. The normal rate would have to be raised by estimated 3.5 percentage points if VAT is to be used to achieve revenue-neutral compensatory funding. With a view to avoiding more severe price shocks and problems with the passing on of costs, the tax measures proposed here should be carried out in gradual steps. All in all, the simultaneous reduction of income tax would above all ease the burden on tax payers with a relatively low income so that the regressive effects of a VAT rise in low income brackets could be absorbed.<sup>31</sup>

In connection with the discussion on reintroducing wealth tax, the government is considering switching to a settlement tax on interest earnings at a standard, definitive rate of 25% (under the current system, interest is subject to a withholding tax of 30%, which is allowable against income tax). Tax evaders who have transferred their money abroad can re-enter the tax system by paying a one-off rate of 25% on the returning capital and also taxing their future earnings at 25%.

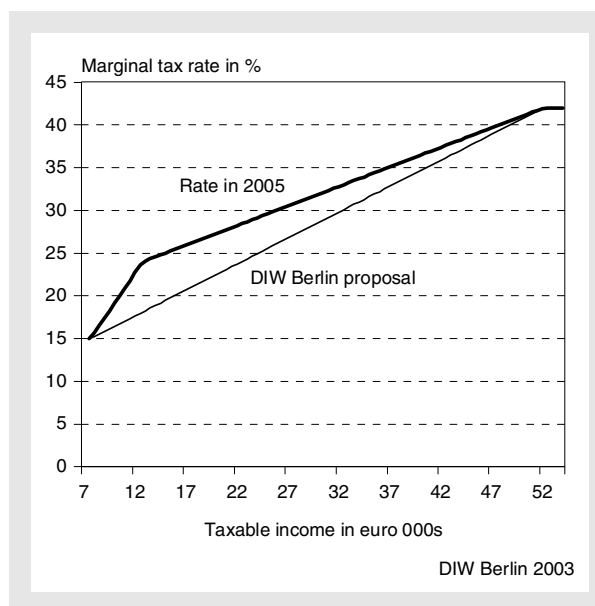
This change is problematic from the point of view of the tax system as a whole because under the German system earnings – from whatever source – have always been taxed on principle at a standard and uniform rate, based on the principle that functional efficiency is achieved via the progressive tax rate. However, the hope is that tax evaders will grasp the opportunity to become honest tax payers and that the system will be rendered fairer in this way. Positive experiences in other EU countries favour the introduction of a settlement tax of

<sup>30</sup> Under the income-tax rate due to take effect in 2005, the marginal tax rate – starting at the tax-free subsistence minimum of euro 7 664 – will rapidly rise from 15% to 23.97% up to an income of euro 12 740.

<sup>31</sup> Cf. Klaus-Dietrich Bedau, Stefan Fahrlander, Bernhard Seidel and Dieter Teichmann: 'The effect of the increase in VAT on private households'. In: *Economic Bulletin*, vol. 35, no. 5, May 1998.

Figure 18  
Income-tax Rate 2005 and  
DIW Berlin's Proposed Rate

Basic table



Sources: Federal Ministry of Finance; DIW Berlin calculations.

this kind. The more countries that decide on taking this step, the greater is the chance that an increasing volume of capital will remain at home and be taxed in accordance with the domestic regulations.

However, there is need for caution against overly optimistic expectations concerning revenue. A switch to a settlement tax would mean losses in revenue could be expected on balance for the foreseeable future. These would result from the lower tax rate – 25% settlement tax compared with 30% withholding tax – and the reduced revenue from income tax, which would not be offset by the additional taxation of capital earnings because these would now be taxed at home. The amount of one-off additional revenue that can be gained from the surcharge on the returning capital is also uncertain. The government expects returning capital of around euro 100 billion, which would result in additional revenue of euro 25 billion. This potential revenue is probably hugely overestimated.

What counts at the end of the day, as explained above, is that the government pursue a fiscal policy strategy that will lead the economy onto a higher growth path. To this end, stabilising government spending is much more important than the tax measures discussed here.

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