The German Economy in the Spring of 2003

An abridged version of the Evaluation of the Economic Situation by the following members of the Association of German Economic Research Institutes, Hamburg, Germany

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Finalised in Hamburg, 11 April 2003

Overview

The German economy has been persistently weak for a number of years now. Since mid-2000, the growth trend has alternated between stagnation and recession, with at best intermittent phases of very modest recovery. Overall capacity utilisation has been in decline throughout the entire period. Real GDP showed only very weak growth in 2002. The lull in activity has had an increasing impact on the labour market: the fall in employment has accelerated perceptibly since the middle of last year, while the number of unemployed recently soared upwards. The price climate remained calm, with the year-on inflation rate amounting to 1.2% in March of this year.

In recent months, the Iraq conflict, in particular, has further burdened the already weak economy. The escalation of the conflict led to a temporary sharp increase in the price of oil and raised fears of a new oil-price shock. These events put paid to the hopes held last autumn that growth would strengthen this year. The dampening influence exerted by the world economy was exacerbated in Germany by increased taxes and social insurance contributions. Finally, Germany's export prospects were subdued by the appreciation of the euro.

The Iraq conflict is just one of a series of shocks that have hit Germany – as indeed most of the industrialised countries – in recent years. The high point of the boom in 2000 was followed by the realisation that there had actually been no real basis for the boom on the stock markets; this was particularly true for the IT sector. After the bubble burst, the consequences were a massive depreciation of assets, much less optimistic profitability expectations and a significant downward correction of growth prospects. At the same time, monetary policy in the industrialised countries had adopted a restrictive stance. The first signs of recovery were abruptly curbed by the terrorist attacks of 11 September 2001. While the mood among investors and consumers subsequently brightened up to an extent, not least because the monetary policy reins were loosened substantially once again, individual sectors such as the airline industry and tourism entered a difficult phase, which still persists today and is impeding growth. Moreover, spending on internal and external security was increased, which reduced the profitability of investments. Finally, it became clear over the course of 2002 that the stock-market correction was not yet over; share prices continued to drop and the situation on the financial markets remained precarious. All these developments affected both the USA and the EMU countries, albeit to differing extents. The euro zone had to contend with an additional negative effect as, following the preceding massive depreciation of the euro, the exchange rate trend was reversed again last year, which put an end to the competitive advantages the euro zone had previously enjoyed. The rate of expansion of the German economy was much slower than in the rest of the euro zone, as it already had been for some years. The German economy is clearly particularly weak, and the causes must be sought in the country's economic policy.

Domestic demand remains weak

Last year, the German economy was mainly sustained by exports, which expanded by around 5% over the course of the year despite only moderate world growth and the appreciation of the euro. By contrast, the weak domestic demand trend, which has been evident for several years now, persisted. Private consumption stagnated over the course of 2002 – largely because there was practically no increase in real disposable income, not least because of the decline in employment. Moreover, the depreciation of assets caused by the fall in share prices and the prospect of higher taxes and contributions both curbed the propensity of private households to spend. The trend for building investments remained negative. This basic trend was obscured by two special effects in the second half of 2002: on the one hand, the flood-damage repairs and, on the other, the government decision to reduce the subsidy for owner-occupied housing construction, which probably created early investment effects. Investment in machinery stabilised over the course of last year.

The longer the lull persisted, the more the labour market was affected. It appears that, faced once again with gloomy growth prospects, many enterprises increasingly shed labour they had been 'hoarding' up to then; at the same time, vacancies were increasingly left unfilled. In addition, job-creation schemes were cut back and training schemes reduced. The result is that the fall in employment has increased substantially since last summer, while unemployment has risen at an accelerated pace.

External effects

The trend for growth over the coming months will depend in particular on further developments in Iraq. If the assumption that the tension in the region will soon ease again turns out to be correct, then the economic climate is likely to improve worldwide in the second half of this year, and the positive impulses provided by economic policy are likely to have a stronger impact on all sectors. A helping hand will be given by the oil price which, having periodically significantly exceeded US $ 30 per barrel in the first quarter of the year, will level off at US $ 25 per barrel. The Institutes also assume that share prices will stabilise and that the US dollar will not depreciate any further (cf. box 1). If these assumptions are correct, then the second half of 2003 should see a global recovery which will be initiated by the USA and will continue in 2004. However, as pointed out in the report dealing with the world economy (see preceding article in this issue), the pace of growth will initially only be moderate, first and foremost because private households, enterprises and financial institutions will still take some time to get over the depreciation of assets caused by the fall in share prices in recent years. The recovery of the world economy will significantly boost the German economy, on the one hand via exports and the economic sectors that are directly or indirectly dependent on them, and on the other via a general improvement in the expectations of enterprises and consumers.

Monetary parameters to remain favourable

Monetary policy in the euro zone is currently decidedly expansionary. However, because of the lower inflation rate, short-term real interest rates are somewhat higher in Germany than in the remainder of the euro zone. Moreover, the banks have passed on little of the reduction in short-term base rates to private borrowers. It is also possible that the transmission of monetary policy impulses is currently being hindered by structural problems in the banking sector and by higher credit standards on the part of banks. This possibility is indicated, for example, by the weak growth of loans to enterprises and private individuals.

Long-term interest rates have again fallen perceptibly in recent months. At just over 4%, the yield on German government bonds with a ten-year maturity is currently 1 percentage point lower than in spring 2002 and is thus low in both nominal and real terms compared with the long-term average. While economic recovery will favour interest-rate increases, the Institutes believe that interest rates will still be relatively low at the long end in 2004 and will boost growth. However, the fall in share prices will make it more difficult for enterprises to obtain financing via the capital market and to collateralise bank loans.

The expansionary monetary stance is counterbalanced by the appreciation of the euro; the German econ-

Box 1

Assumptions underlying the forecast

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

- The tension in Iraq will ease in the spring.
- The price of oil will level off at US-$ 25 per barrel.
- World trade will increase by over 4.5% this year and by 7.5% next year.
- The stock markets will stabilise.
- At US $ 1.08 per euro, the euro/dollar exchange rate will remain roughly the same over the prognosis period as in the first quarter of 2003. Germany's price competitiveness on international markets will improve slightly.
- The European Central Bank will reduce base rates by 25 basis points in the spring. Base rates will be raised again by 25 basis points in the second half of the year. The capital market rate will rise slightly over the prognosis period.
- Negotiated hourly wages will increase by an average of 2.7% this year and by 2.3% next year. At 2.3% and 2.2%, respectively, the increase in actual earnings will be somewhat lower.
- Fiscal policy will be concerned with reducing the budget deficit. The structural deficit (as a share of GDP) will be reduced by 0.75 percentage points in 2003; the forecast assumes that the deficit will be decreased by almost 0.5 percentage points in 2004 (cf. box 4).

omy's price competitiveness was around 5% lower in March 2003 than at the end of 2002. The effects of this decline will be felt for some time. This burden will ease next year, however, and the Institutes do not expect a further appreciation of the euro. All in all, the monetary parameters will promote growth in Germany, too, over the prognosis period.

Fiscal policy efforts to reduce deficit

Fiscal policy is already under considerable pressure to consolidate the budget as a result of the procedures initiated by the European Commission against Germany on the basis of its excessive budget deficit. At the end of 2002, the government agreed on a series of measures intended to push the deficit ratio below 3% again this year. These included substantial increases in social insurance contribution rates, in particular for pension insurance, and – less substantial – spending cuts. Moreover, tax increases that were already on the agenda, as in the case of the ecological tax, entered into force. Finally, the contribution rates for statutory health insurance were raised. Even if not all the measures agreed on by the government are implemented – as assumed in this forecast (cf. box 4) – fiscal policy will still be distinctly restrictive this year. However, owing to the automatic stabilisers the deficit will decrease only slightly. From today's perspective, it seems likely that the deficit will be reduced in 2004 thanks to the somewhat more favourable economic situation, even though the second phase of the tax reform, which was postponed until 2004, will enter into force as planned.

The government also expects an improved labour market situation to ease the burden on the public budgets, and has mainly placed its hopes in this respect on the proposals presented by the Hartz Commission, some of which have already been implemented. However, the Institutes do not expect these measures to have much impact. It is difficult to foresee the effects of the measures due to enter into force at the beginning of 2004, because it is not yet known what exactly they will entail.

Moderate rise in actual wages

The agreements reached in last year's pay round (some of which will not expire until 2005) led to an average increase of 2.6% in negotiated hourly wages in 2002; this year's increase will be of the same magnitude. Enterprises reacted to the higher increase in negotiated wages and the weak business cycle by sharply reducing their non-negotiated payments last year, so that the increase in actual wages was much lower than that in negotiated wages. But these payments will probably not be cut back to the same extent this year, which will thus see a higher increase in actual earnings. Labour costs will rise at an even higher rate owing to the increase in

Table 1

Key Forecast Figures for Germany

	2000	2001	2002	2003	2004
Gross domestic product[1] (Change (%) on the previous year)	2.9	0.6	0.2	0.5	1.8
Western Germany[2, 3]	3.0	0.6	0.2	0.5	1.8
Eastern Germany[3]	1.5	0.0	–0.2	1.0	1.5
Labour force[4] (in 000s)	38 752	38 917	38 688	38 306	38 316
Unemployed (in 000s)	3 889	3 852	4 060	4 450	4 500
Unemployment rate[5] (%)	9.1	9.0	9.5	10.4	10.5
Consumer prices[6] (Change (%) on previous year)	1.4	2.0	1.4	1.3	1.2
Unit labour costs[7] (Change (%) on the previous year)	1.0	1.5	0.8	0.9	0.5
Public sector financial balance[8] Euro billion	22.8	–57.5	–76.2	–73.1	–64.7
as % of nominal GDP	1.1	–2.8	–3.6	–3.4	–2.9
Balance of payments (euro billion)	–28.5	1.0	48.9	45.0	50.0

1 At 1995 prices. — 2 Including Berlin. — 3 As at March 2003. — 4 Domestic. — 5 Unemployed as % of domestic labour force (place of residence concept). — 6 Consumer price index (2000 = 100). — 7 Compensation of employees per employee created in the domestic economy as % of GDP at 1995 prices per member of labour force. — 8 National accounting definitions (ESNA 95).
Sources: Federal Statistical Office; Federal Labour Office; Federal States' Working Group on ESNA; German Bundesbank; 2003 and 2004: Institutes' forecast.

social insurance contribution rates introduced at the beginning of the year. Together with the weak economy, this will probably mean that the willingness of enterprises to recruit new labour will remain subdued.

Slow economic recovery

The German economy is currently characterised by stagnation. However, the end of the war in Iraq will reduce the uncertainty of consumers and enterprises in Germany, too; as the world economy recovers, foreign demand will also accelerate, and the expansionary monetary stance will have a stronger impact. This suggests that the economy will liven up in the second half of this year. However, the recovery will be extremely sluggish, for the world economy will expand at only a moderate pace, the previous appreciation of the euro and the depreciation of assets on the stock markets will still make themselves felt for some time, and fiscal policy will have a slightly restrictive effect. All in all, real GDP will increase by 0.5% in Germany this year. Overall capacity utilisation will continue to decline and the situation on the labour market will deteriorate further.

While the recovery will become more robust next year and domestic demand will thus probably show a slight increase, growth in Germany in 2004 will still not have much momentum overall. In purely economic terms, the annual average increase in real GDP cannot be expected to exceed 1.25%. However, it must be remembered that next year is a leap year and that several public holidays will fall on weekends, making 2004 a year with an extraordinarily high number of working days. The result will be higher output (cf. box 3). The working-day effect will amount to over 0.5 percentage points and so, overall, real GDP will grow by 1.8% in 2004.

Significant forecast risks

Repeated clashes or terrorist attacks cannot be ruled out even after the end of the Iraq war, and the entire region could remain a constant trouble spot. This would mean that the current extreme uncertainty would not abate, while the oil price would rise again. All of this would presumably have a negative impact on the international financial markets and on the behaviour of investors and consumers. The world economy's weak cycle would be prolonged, and Germany would risk slipping into recession. However, the situation may relax more rapidly than expected after the war in Iraq, and then the investment climate would brighten up considerably. The world economy would recover more rapidly and develop a stronger growth dynamic than assumed here. This would also have a positive impact on growth in Germany.

But whatever happens in Iraq, there are also other risks. For instance, the US dollar could depreciate significantly again, for example because of the high balance of payments deficit in the USA. This is all the more likely given that the budget deficit has now increased further, partly because of the cost of the war in Iraq. Another sharp depreciation of the US dollar would also create problems for the German economy and further delay the recovery.

The Institutes carried out a simulation with a macroeconometric multi-country model (cf. box in report 1 of this issue, p. 139) and with their models for Germany in order to quantify the consequences of deviations from the assumed trend for important variables. According to these simulations, if the oil price were US $ 10 per barrel higher this year and next year than assumed, then the increase in real GDP in Germany in both years would be nearly 0.25 percentage points lower than in the base scenario. If the dollar exchange rate against the euro were 10% lower than assumed, the dampening effect would be of similar magnitude. The simulations assume that monetary policy would react accordingly in each case.

Individual trends

Exports to gradually gain momentum

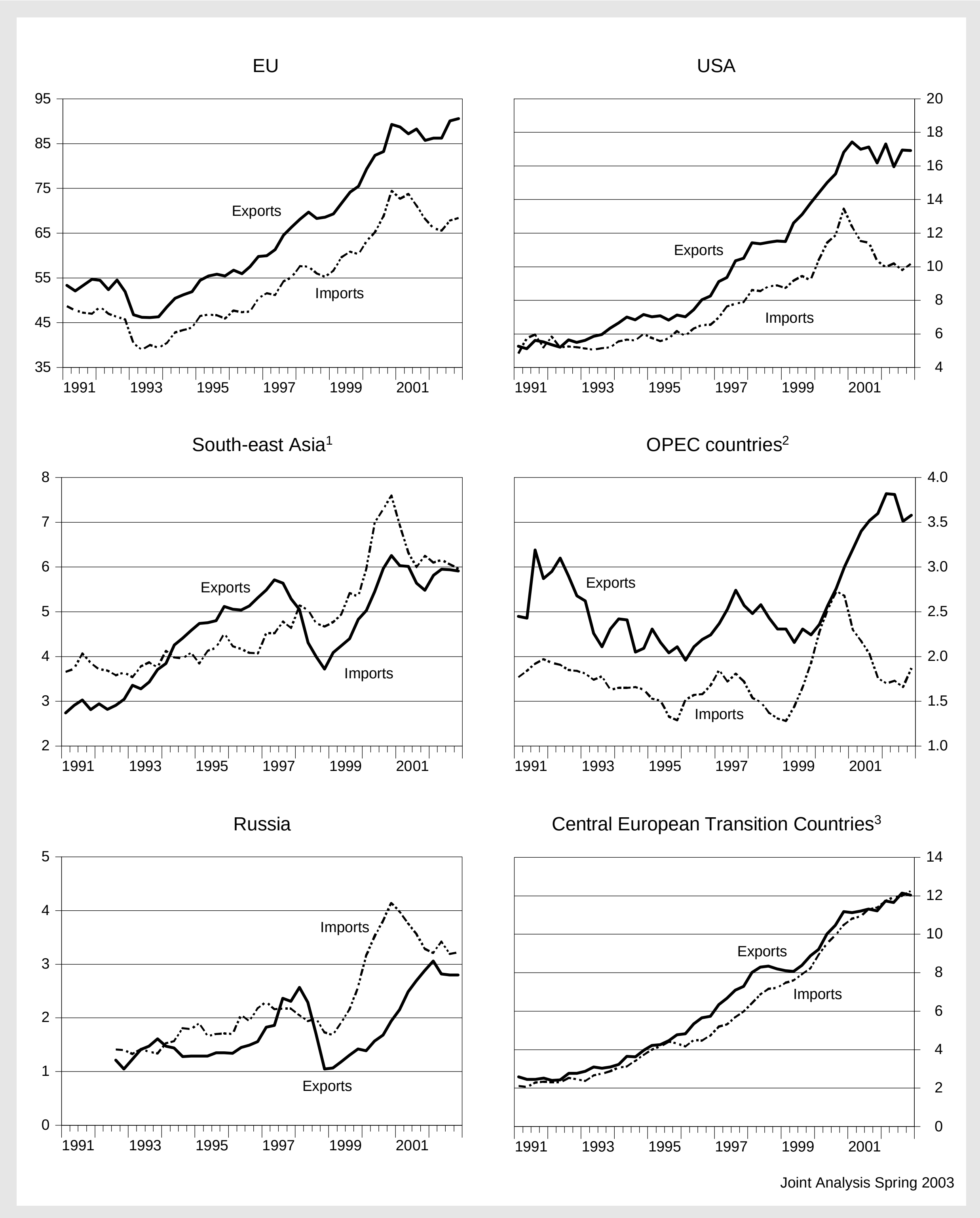
Export growth has been restrained for some time. While goods exports grew rapidly up until autumn 2002, they have expanded only slightly since then (cf. figures 1 and 2). The slow pace of expansion was mainly caused by the decline in price competitiveness (due to the euro's appreciation) and by the weak growth of sales markets.

Following a weak trend in the first half of this year, exports will gain momentum again in the second half of the year as the world economy recovers. The euro's appreciation will continue to curb growth at first, but this effect will gradually ease off. Positive impulses can be expected initially from outside Europe, in particular, but then also increasingly from within the euro zone. The demand for German goods will also increase in the CEE countries as their economies gain strength (cf. table 3). German exporters will benefit from more intensive investment on the part of their trading partners thanks to the range of products they have to offer. In addition, Germany's price competitiveness will improve slightly over the course of the year. Overall export growth of 3% can be expected this year, while exports will increase by 6.3% next year (cf. figure 2).

Figure 1

German Exports by Country and Region

Special trade; seasonally adjusted quarterly values in euro billion



1 Hong Kong, Singapore, South Korea, Taiwan, Indonesia, Malaysia, Philippines, Thailand. — 2 Algeria, Libya, Nigeria, Venezuela, Iraq, Iran, Saudi Arabia, Kuwait, Qatar, United Arab Emirates, Indonesia. — 3 Poland, Hungary, Czech Republic, Slovakia.

Sources: Federal Statistical Office; Institutes' calculations.

Box 2

Assessment of the autumn 2002 forecast

The Institutes' spring 2002 forecast for real GDP in 2002 proved to be too optimistic; instead of the expected increase of 0.9%, real GDP only grew by 0.2%. However, the forecast made in the autumn 2002 report, which was based on data from the first two quarters of the year, was only 0.2 percentage points higher than the increase announced in January 2003 (and also in the first quarterly accounts in February). The external factors – both world trade and the economy in the USA – were predicted relatively accurately. By contrast, the Institutes' expectations regarding the growth of domestic demand were somewhat too bright. The forecast for building investments deviated relatively sharply from actual events. The flood damages turned out to be much less substantial than initially reported and the amount invested in the necessary repairs was lower than assumed by the Institutes in their forecast. Investments in machinery and other equipment were also somewhat less substantial than predicted, partly because the general conditions for enterprises deteriorated in the latter half of the year.

Table 2

Forecast and Deviations from Forecast for 2002

GDP expenditure at 1995 prices

	Autumn report 2002		Federal Statistical Office				Deviations from forecast for 2002	
	Estimated figures for 2002		Actual[1] figures for 2002		Actual[2] figures for 2002			
	Change on previous year (%)	Contribution to growth in percentage points[3]	Change on previous year (%)	Contribution to growth in percentage points[3]	Change on previous year (%)	Contribution to growth in percentage points[3]	Difference between contributions to growth in percentage points	
	(1)	(2)	(3)	(4)	(5)	(6)	(4) minus (2)	(6) minus (2)
Domestic demand	–1.0	–1.0	–1.3	–1.3	–1.5	–1.4	–0.3	–0.4
Private consumption	–0.5	–0.3	–0.5	–0.3	–0.6	–0.4	0.0	–0.1
Government consumption	0.9	0.2	1.5	0.3	1.5	0.3	0.1	0.1
Machinery and other equipment	–5.6	–0.5	–6.9	–0.7	–7.7	–0.8	–0.1	–0.2
Construction	–3.4	–0.4	–5.9	–0.7	–5.9	–0.7	–0.3	–0.3
Change in stocks (euro billion)	–14.3	0.0	–14.3	0.0	–13.9	0.1	0.0	0.0
External balance (euro billion)	89.9	1.4	91.0	1.5	94.0	1.6	0.1	0.2
Exports	1.7	0.6	2.9	1.0	2.6	0.9	0.4	0.3
Imports	–2.5	0.8	–1.3	0.4	–2.1	0.7	–0.4	–0.1
Gross domestic product	0.4	0.4	0.2	0.2	0.2	0.2	–0.2	–0.2
Memo item:								
GDP USA	2.3	–	2.4	–	2.4	–	–	–
World trade	3.0	–	2.8	–	–	–	–	–
Consumer price index[4]	1.4	–	1.3	–	1.4	–	–	–

1 Series 18: National Accounts, Preliminary Results of the Calculation of Domestic Product, January 2003. — 2 Series 18: National Accounts, IV/2002, February 2003. — 3 Contributions of demand components to change in GDP (Lundberg components). A demand component's contribution to growth is given by the growth rate weighted with the aggregate as a share of the previous year's GDP. Figures may not sum due to rounding. GDP: change (%) on previous year. — 4 Formerly 'Cost-of-living index for all private households'.
Sources: Federal Statistical Office; Institutes' calculations.

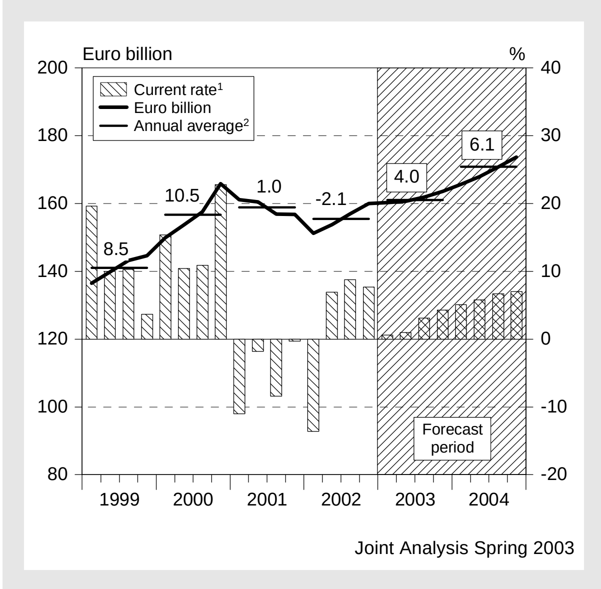
The increase in real GDP forecast for 2003 in this report is almost 1 percentage point lower than predicted by the majority of the Institutes in autumn 2002.[1] A third of the deviation can be explained by the weaker growth in the second half of 2002 now announced by the Federal Statistical Office and in particular by the overestimation of the flood damages. In addition, war did actually break out in Iraq, which was not expected in autumn 2002. There was thus a somewhat higher increase in the price of oil, while share prices fell once again. In particular, and contrary to expectations, the world economic climate has deteriorated in recent months.

[1] The DIW Berlin had predicted real GDP growth of 0.9% in 2003, which is only 0.4 percentage points higher than the current forecast.

Following robust growth up to the end of 2002, goods imports increased only moderately in the initial months of this year, and growth will also remain slow over the coming months. From the second half of 2003 onwards, when exports begin to expand again and domestic demand strengthens, there will be a significant increase in German demand for foreign goods and services. Imports will grow on annual average by 4.0% in 2003 and by 6.1% in 2004 (cf. figure 3).

Import prices have risen again sharply since the end of 2002. The main reason was the rise in the price of crude oil and other raw materials, which more than offset the downward price pressure of the appreciation of the euro. The increase in import prices will initially be curbed by the fall in the oil price and by the continued impact of the euro's appreciation. As these effects ease off and the prices for industrial raw materials increase as a result of the world economic recovery, the increase in import prices will accelerate somewhat over the further course of the prognosis period. The terms of trade will improve only very slightly (cf. table 4).

Figure 3
Real Imports
Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.
Sources: Federal Statistical Office; Institutes' calculations; from 1st quarter 2003 onwards: Institutes' forecast.

Machinery investments to recover hesitantly

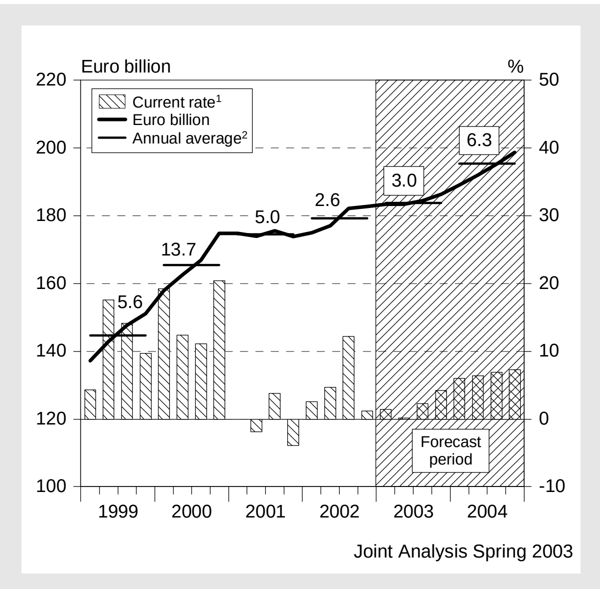
The investment climate appears to have stabilised over the course of last year. Following eight quarters of decline, machinery investments actually expanded slightly in the final quarter of 2002. Domestic orders have been increasing slightly amongst investment goods producers for some time, and the upward trend can thus be expected to continue over the prognosis period. The increase will remain modest, however, because of the uncertainty caused by the war in Iraq and the low level of capacity utilisation. As sales prospects brighten up, investors will increasingly abandon their hesitancy over the course of this year and next year. Moreover, the interest-rate reductions of the last two years will then also bear fruit and unit labour costs will continue to rise only marginally. All in all, earnings prospects will improve.

Investment in other equipment, in particular software for enterprises, will increase at a faster pace again over the prognosis period, albeit by no means as rapidly as during the IT boom. All in all, investment in machinery and other equipment will increase by 1.9% this year and by 5.1% next year (cf. figure 4).

No trend reversal in construction sector

The construction industry is still in decline. Building investments fell last year by 5.9%, which was similar to the decrease in 2001. The decline affected all sectors,

Figure 2
Real Exports
Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.
Sources: Federal Statistical Office; Institutes' calculations; from 1st quarter 2003 onwards: Institutes' forecast.

Table 3

German Exports by Region

Nominal exports (special trade)

Country group	2000			2001			2002		
	Euro billion	Share (%)	% of GDP[1]	Euro billion	Share (%)	% of GDP[1]	Euro billion	Share (%)	% of GDP[1]
EU	337	56.4	16.6	352	55.2	16.9	355	54.8	16.8
EFTA[2]	31	5.2	1.5	33	5.2	1.6	32	4.9	1.5
NAFTA[3]	71	11.9	3.5	78	12.2	3.8	77	11.9	3.7
East Asia[4]	47	7.9	2.3	50	7.8	2.4	52	8.0	2.4
CEE[5]	53	8.9	2.6	62	9.7	3.0	66	10.2	3.1
Others	58	9.7	2.9	63	9.9	3.0	66	10.2	3.1
Total	597	100.0	29.4	638	100.0	30.7	648	100.0	30.7

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

though it was obscured this winter by the activities needed to repair the flood damages and probably also by early investment effects due to the planned reduction of the subsidy for owner-occupied housing construction.

The basically negative trend in housing construction will continue over the prognosis period because there are still substantial excess capacities and because job and income prospects are still uncertain. The decline will be mitigated somewhat by the Housing Modernisation Programme 2003/2004, which provides for loans at reduced interest rates for a maximum credit volume of 8 billion euro. The Institutes expect the programme to have substantial windfall gains effects and to lead to additional investment of only 1 billion euro this year and 3.5 billion euro next year. All in all, investment in housing construction will decrease by 1.2% this year. There will be no decline next year, but only because of the higher number of working days; otherwise the decrease in 2004 would be significant.

Commercial construction will also remain on a downward trend this year because of the slow rate of overall growth and the continuing high number of vacancies. This trend is indicated by the decline in orders for commercial building. While the profitability expectations of enterprises will brighten up as the economy recovers and interest rates will remain low, the under-utilisation of capacities means that investment in commercial construction is not likely to stabilise until next year. Investment in commercial buildings will decline by an average 2.8% this year, while the decline will be minor next year – mainly because of the working-day effect.

Investment in public-sector construction will continue to decline because the pressure to consolidate the public budgets will not let up over the prognosis period. Only the flood-damage repairs will boost public construction to some extent this year. The interest-rate reductions planned under the German Development Bank's infrastructure programme, by contrast, are unlikely to provide significant additional impulses

Table 4

Foreign Trade Indicators[1]

	2000	2001	2002	2003	2004
	Change (%) on the previous year				
Real exports[2]	13.7	5.0	2.6	3.0	6.3
Goods	13.6	5.1	2.4	3.1	6.4
Services	14.0	4.4	4.4	2.0	5.6
Real imports[2]	10.5	1.0	–2.1	4.0	6.1
Goods	10.7	0.0	–1.6	5.3	6.0
Services	9.8	4.5	–3.8	–1.1	6.3
Terms of trade	–4.4	0.4	1.6	0.3	0.2
	Euro billion				
Memo item:					
Real net exports[2]	35.0	62.2	94.0	90.6	98.2
Nominal net exports	7.8	38.6	83.0	81.4	91.2
Balance of payments[3]	–28.5	1.0	48.9	45.0	50.0

1 On national accounting definitions (ESNA 95). — 2 At 1995 prices. — 3 On balance of payments statistics definitions.
Sources: Federal Statistical Office; German Bundesbank; Institutes' calculations; 2003 and 2004: Institutes' forecast.

because the municipal budget law will prevent most local authorities from expanding their borrowing in view of the shortage of funds. Thus, the only result of this programme will be more favourable interest rates for investment projects that were already on the agenda anyway. Nonetheless, slightly higher municipal investment spending can be expected from the law releasing the local authorities from their obligation to contribute 800 million euro to the 'Reconstruction Aid' fund. The Institutes expect that public-sector building investments will decrease by 1% in 2003 and by 5.8% in 2004.

All in all, there is no sign of a change in trend in building investments. These will fall by 1.6% this year and by 0.8% next year (cf. table 5 and figure 5); the decline in 2004, adjusted for working-day effects, will amount to around 2.5%.

Table 5

Real Investment in Construction[1]

	2002	2002	2003	2004
	% Share	Change (%) on previous year		
Residential buildings	57.5	–5.9	–1.2	0.0
Nonresidential buildings	42.5	–5.8	–2.2	–1.9
Commercial construction	29.8	–5.3	–2.8	–0.2
Public-sector construction	12.7	–6.9	–1.0	–5.8
Investment in construction	100.0	–5.9	–1.6	–0.8

1 At 1995 prices.
Sources: Federal Statistical Office; Institutes' calculations; 2003 and 2004: Institutes' forecast.

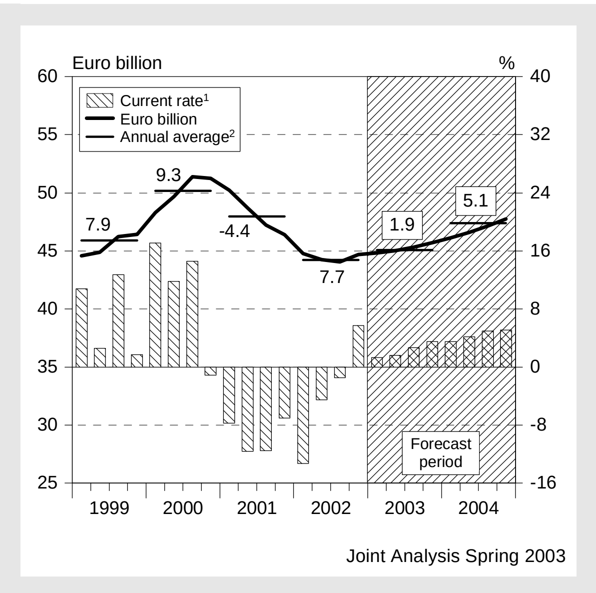
Private consumption sluggish

Private consumption, which almost stagnated over the course of last year, did not liven up in the initial months of this year either (cf. figure 6). This was mainly because the situation on the labour market deteriorated. But consumption was also curbed by the increase in social insurance contributions and indirect taxes.

Figure 4

Real Investment in Machinery and Other Equipment

Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.
Sources: Federal Statistical Office; Institutes' calculations; from 1st quarter 2003 onwards: Institutes' forecast.

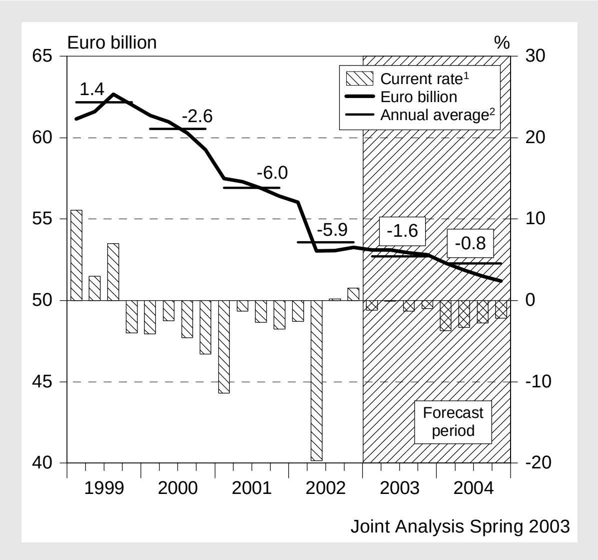
The prospects for private consumption are likely to improve only slightly over the further course of the year. The mood of consumers is being depressed by the recent stock-market losses of private households and the persisting risk of unemployment. Income growth will exert little in the way of positive influence: while the increase in actual wages will be somewhat higher than last year, the decline in employment will persist. At 1.1%, gross wages and salaries will increase at only a slightly faster pace than last year, while net wages and salaries, i.e. after tax and social insurance contributions, will stagnate once again. In addition, monetary social benefits will expand at a much slower rate despite a cyclically determined increase in transfer payments, partly because old-age pensions adjustments will be lower and partly because of benefit cuts – unlike last year, when some benefits, such as children's allowance, were increased. Income from self-employment and assets, by contrast, is likely to increase again following last year's decline. Overall, the disposable income of private households will increase by 1.7% in 2003; the real increase will amount to 0.4%. As the savings ratio declines slightly, real private consumer spending is likely to expand by 0.6%.

Consumption will show a somewhat higher increase again in 2004 as employment rises slightly. At 2.2%, the increase in gross wages and salaries will accelerate, while net wages and salaries will actually increase by 2.9% owing to cuts planned under the second phase of the Tax Reform 2000. Monetary social benefits will only increase by 1.1%, however, because of extensive benefit cuts and a slower increase in labour market spending. All in all, disposable income will increase by 2.7% next year. As the savings ratio remains stable (the lower taxes suggest there will be a temporary increase in the propensity to save, while the abatement of job uncer-

Figure 5

Real Investment in Construction

Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.
Sources: Federal Statistical Office; Institutes' calculations; from 1st quarter 2003 onwards: Institutes' forecast.

tainty suggests the opposite), real private consumption will increase by 1.5% in 2004.

Inflation to remain low

Having eased off significantly in the second half of last year, inflation increased temporarily at the beginning of 2003. This was actually due in large part to several special factors: mineral-oil tax, electricity tax and tobacco tax were all increased. These measures caused a one-off thrust of around 0.3% in consumer prices. In addition, energy prices rose sharply following the increase in the price of crude oil.

Inflation will ease again over the further course of the year. Energy prices are likely to fall again substantially, while the previous appreciation of the euro will also curb price growth. Unit labour costs will not cause additional cost pressure, and competition will remain intense because of the difficult economic situation. Consumer prices are likely to increase by 1.3% in 2003.

Consumer price increases will also remain moderate next year. While the scope for price rises will increase slightly as the economy strengthens, the pressure from unit labour costs will decrease somewhat. There will also be no further increase in the ecological tax. All in all, consumer prices are likely to rise by 1.2% on annual average in 2004.

Moderate output growth

National output has been weak since mid-2000, and seasonally adjusted real GDP did not increase in the final quarter of 2002. Output is likely to remain stagnant in the first half of 2003.

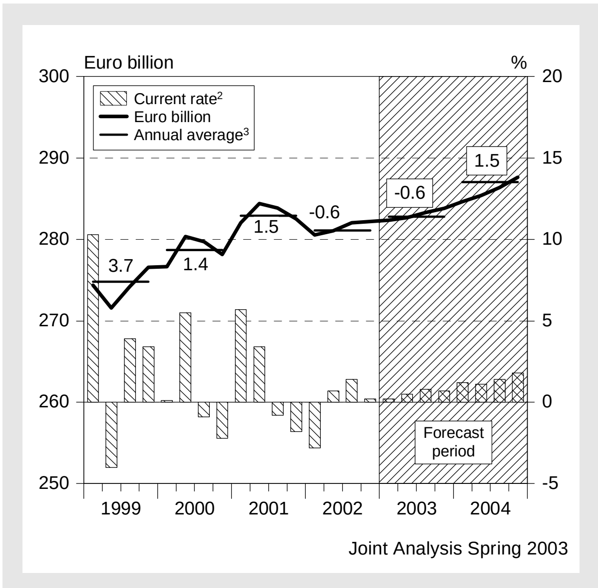
A slightly higher increase in overall output can be expected over the further course of the year as the world economy livens up. Industrial output is likely to expand significantly because many business projects which were postponed because of the widespread uncertainty will now be initiated. This will be particularly noticeable amongst producers of intermediate and investment goods. The consumer-oriented sectors, by contrast, will contribute little to output growth, while building activities will continue to decline. Under these circumstances, GDP will increase by only 0.5% on annual average in 2003 (cf. table 6).

Foreign demand will gain momentum next year and domestic demand will recover slightly (cf. figure 7). This will boost industrial output. The increase in investment activity will lead to an expansion in the manufacture of machinery and its intermediate goods, especially. In the tertiary sector, enterprise-related services and transport and communications, in particular, can be expected to show a higher increase in value added. In the construc-

Figure 6

Real Private Consumer Spending[1]

Adjusted for seasonal fluctuations and working days

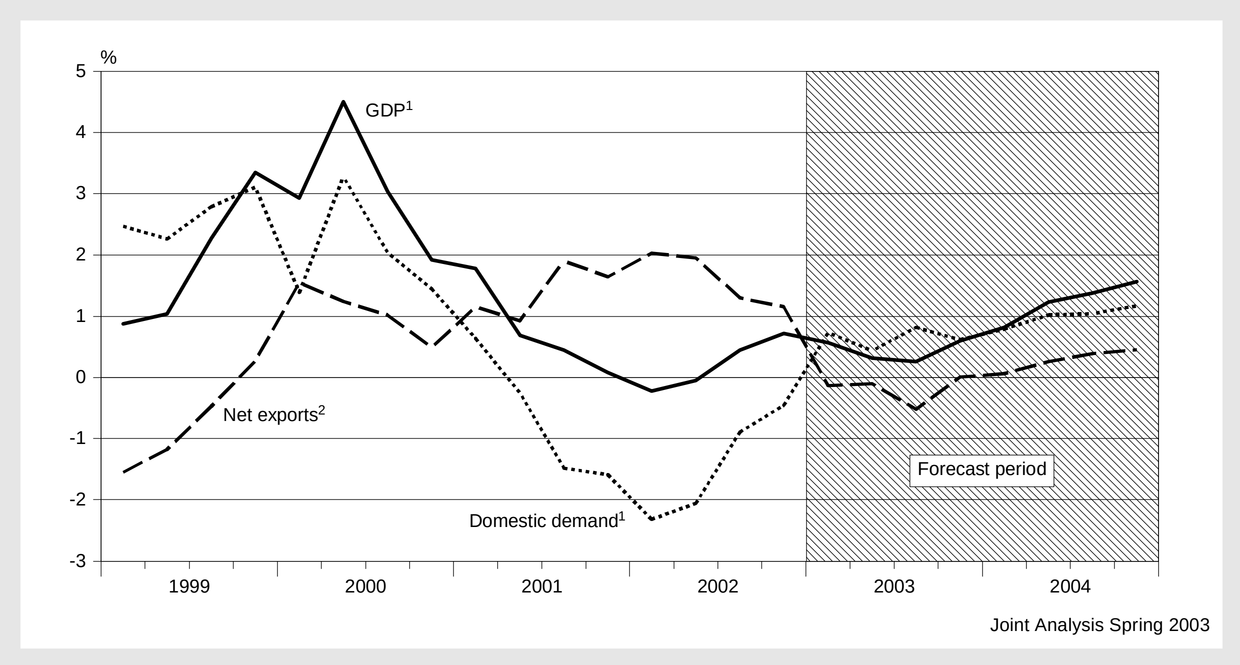


1 Including private non-profit organisations. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Figures: change (%) on the previous year.
Sources: Federal Statistical Office; Institutes' calculations; from 1st quarter 2003 onwards: Institutes' forecast.

Figure 7

GDP, Domestic Demand and Net Exports

Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous year. — 2 Difference between real net exports in current quarter and equivalent quarter one year previously as % of real GDP in equivalent quarter one year previously (contribution to growth).
Sources: Federal Statistical Office; Institutes' calculations; from 1st quarter 2003 onwards: Institutes' forecast.

tion sector, however, the decline in output will persist. Overall, GDP will increase by 1.8% on annual average (cf. figure 8), though over 0.5 percentage points of this increase will be created by the higher number of working days (cf. box 3).

Eastern German industry is also feeling the effects of the persisting weak phase. While industrial output did show an increase, the renewed drastic decline in the building trade and the consequences of the flood disaster on the Elbe and its tributaries dampened overall growth. Thus, GDP in eastern Germany (excluding Berlin) fell below the previous year's level by 0.2%.

Unlike recent years, overall output in eastern Germany is likely to increase at a somewhat higher rate in 2003 than in western Germany. Industrial manufacturing will expand perceptibly as a result of the economic recovery at home and abroad. At the same time, the repairs to the buildings and infrastructure destroyed by the floods will temporarily reduce the dampening effect exerted by the construction sector. All in all, GDP in the eastern German Länder will increase by around 1% and thus at roughly twice the western German rate. As the population in eastern Germany continues to decline, the per capita output gap will narrow (cf. table 9).

The boost provided by the flood-damage repairs will abate next year, with the result that the construction

Table 6

Contribution of Demand Components to Increase in GDP[1]

In percentage points

	2002	2003	2004
Consumer spending	–0.1	0.5	0.9
Private households[2]	–0.4	0.3	0.9
Government	0.3	0.2	0.0
Fixed capital formation	–1.4	0.0	0.4
Machinery and other equipment	–0.8	0.2	0.5
Construction	–0.7	–0.2	–0.1
Change in stocks	0.1	0.1	0.2
Domestic demand	–1.4	0.6	1.5
External surplus/deficit	1.6	–0.2	0.4
Exports	0.9	1.1	2.3
Imports	0.7	–1.2	–2.0
GDP[3]	0.2	0.5	1.8

1 Cf. table 2 for definition; at 1995 prices; figures may not sum due to rounding. — 2 Including private non-profit organisations. — 3 Change (%) on previous year.
Sources: Federal Statistical Office; 2003 and 2004: Institutes' forecast.

Box 3

Calendar effects

Numerous economic variables, for example turnover and output, depend on the length of the period observed, and they also often depend on the number of actual weekdays contained in this period. Thus, enterprises with practically continuous production (e.g. energy producers and the steel and chemical industries) generally produce more in 31-day months than in 30-day months, while many retailers achieve their highest turnover on Saturdays.[1] The influence of the calendar in individual time series can vary considerably, while over one period of time the calendar can actually have contrasting effects on different sectors of the economy. The series-specific calendar effect[2] represents an average value that can be ascribed to the calendar component in the period of time on which a calculation is based.[3] The calendar component filters out the effects of shifting weekday structures and the variations in the number of weekend days or public holidays. The effects of the different lengths of the months of the year are usually attributed to the seasonal effect because the actual number of days in each month is the same every year (except for the leap-day effect in February).

Table 7

Working Days and Calendar Factors

	Working days	Calendar-adjusted GDP[1]	GDP[1]	GDP calendar factor according to X12-ARIMA
	% change on previous year			Percentage points
1992	1.2	1.8	2.2	0.4
1993	0.1	–1.1	–1.1	0.0
1994	–0.3	2.4	2.3	0.0
1995	–0.4	1.8	1.7	–0.1
1996	0.1	0.8	0.8	0.0
1997	–0.3	1.5	1.4	–0.1
1998	0.7	1.7	2.0	0.3
1999	0.4	1.9	2.0	0.2
2000	–0.9	3.1	2.9	–0.2
2001	–0.3	0.8	0.6	–0.2
2002	0.0	0.2	0.2	–0.1
2003	0.1	0.5	0.5	0.0
2004	1.2	1.2	1.8	0.6

1 2003 and 2004: Institutes' forecast.
Sources: Federal Statistical Office; Institutes' calculations.

[1] Cf. W. Strohm: 'Zur Frage der Kalenderbereinigung von Zeitreihen'. *Wirtschaft und Statistik*, no. 6/1986, pp. 422 f.

The year 2004 has a very unusual calendar constellation: four national or regional public holidays fall on a Sunday (the Feast of the Assumption, 3 October, Reformation Day and 26 December), and another two fall on a Saturday (1 May and 25 December), while 2004 will also have a 29 February. According to the Institutes' calculations, 2004 will therefore have 3.3 more working days (1.25%) than 2003.[4] The calculation of the Census X12-ARIMA calendar factors results in an annual effect of almost 0.6 percentage points on GDP (cf. table 7). The effect will be stronger on some and weaker on other expenditure aggregates (cf. table 8).

Table 8

Calendar Effect on Expenditure Components of Real GDP in 2004

Percentage points (rounded)

Private consumption	0.4
Government consumption	0.0
Machinery and other equipment	1.3
Construction	1.8
Domestic demand	0.5
Exports	1.2
Imports	1.1
GDP	0.6

Sources: Federal Statistical Office; Institutes' calculations.

[2] The German Bundesbank and the Federal Statistical Office use appropriate monthly indicator series to identify calendar effects and to quantify calendar factors as part of the Census X12-ARIMA time-series analysis procedure they adopt to calculate the GDP income and expenditure variables. These are weighted and aggregated to form a factor of the relevant component. The series-specific calendar effect is calculated by regressing the preliminary irregular components of the time series (calculated in a first iteration step) with an appropriate explanatory variable (which describes the calendar situation) selected from a larger catalogue. Finally, the calendar factor for the real GDP variable is constructed by weighting and aggregating from the income side (cf. German Bundesbank, *Monthly Report,* April 1991, p. 38). The Institutes also adopt the Census X12-ARIMA procedure and thus use the resulting seasonal and calendar factors to adjust the original values of the GDP expenditure components in order to present the economic trend as adjusted for seasonal and calendar-related variations.

[3] The results are very similar when a structural components-based approach (where all components of a time series are estimated simultaneously) is used. Cf. G. Flaig: 'Arbeitstageeffekt und Bruttoinlandsprodukt.' *ifo Schnelldienst,* no. 22-23/2000. Munich.

[4] The results are very similar when a structural components-based approach (where all components of a time series are estimated simultaneously) is used. Cf. G. Flaig: 'Arbeitstageeffekt und Bruttoinlandsprodukt.' *ifo Schnelldienst,* no. 22-23/2000. Munich.

industry will start shedding excess capacities again. While the expansion of GDP will also accelerate as industrial output rises robustly, the growth rate will again fall below that of western Germany.

Persisting lull frustrates efforts to reduce deficit

The government's financial situation deteriorated noticeably in 2002. The extremely sluggish growth trend resulted in substantial losses in revenue from taxes and social insurance contributions and in higher labour market spending. Special factors related to the reform of company taxation led to additional high revenue losses.[1] The budget deficit rose to 76.2 billion euro, in other words to 3.6% of nominal GDP (cf. table 10). The maximum deficit of 3% stipulated in the Maastricht Treaty was thus significantly exceeded.

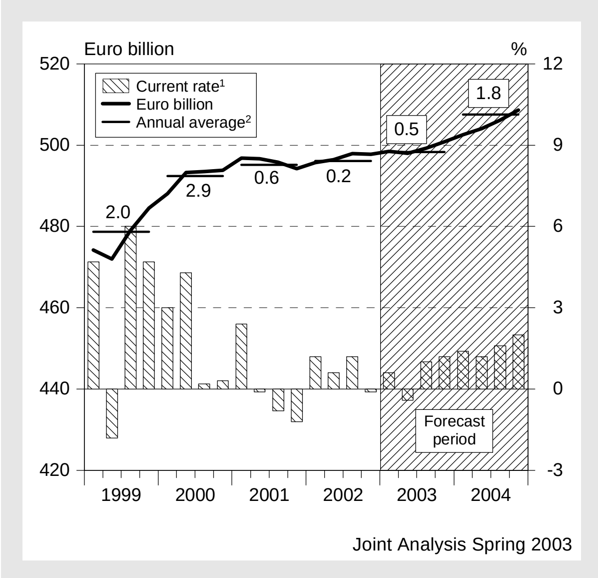
Germany's fiscal policy makers aim to achieve a marked reduction in the deficit in 2003 and have planned tax and contribution increases, in particular,

[1] Cf. Association of German Economic Research Institutes: 'The German Economy in the Autumn of 2002'. *Economic Bulletin,* vol. 39, no. 11, November 2002, p. 380.

Figure 8

Real GDP

Adjusted for seasonal fluctuations and working days



1 Change (%) on the previous quarter, annualised rate (right-hand scale). — 2 Figures: change (%) on the previous year.
Sources: Federal Statistical Office; Institutes' calculations; from 1st quarter 2003 onwards: Institutes' forecast.

Table 9

Indicators for Economic Recovery in Eastern Germany

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
	Western Germany = 100											
Per capita GDP (nominal)[1]	33.4	41.2	50.8	57.2	59.6	61.7	62.2	61.5	62.1	61.4	61.0	62.7
Per capita investment in construction (nominal)[2]	70.2	103.1	131.0	164.1	175.8	180.8	172.8	153.3	137.0	120.6	110.0	105.1
of which:												
Residential building[2]	45.8	61.7	81.1	110.0	131.2	143.2	140.6	121.4	106.9	90.8	78.7	73.1
Nonresidential building[2]	97.0	151.4	195.0	241.7	240.5	237.9	223.2	205.1	186.2	169.3	160.0	156.3
Per capita investment in new machinery and other equipment (nominal)[1]	58.2	67.6	87.2	98.5	101.1	99.8	90.4	88.5	87.2	84.4	84.6	80.6
Compensation of employees per employee[1]	49.3	61.9	69.2	72.6	75.2	75.8	76.1	76.3	77.1	77.2	77.3	77.6
Labour productivity[1,3]	34.9	48.3	59.4	64.2	65.0	67.0	68.0	67.7	68.4	69.2	70.7	71.5
Unit labour costs[1,4]	141.1	128.3	116.3	113.2	115.7	113.1	111.8	112.6	112.7	111.7	109.8	108.5
	Change (%) on the previous year											
Population[1]												
Eastern Germany	x	–1.3	–0.7	–0.6	–0.4	–0.4	–0.3	–0.4	–0.5	–0.6	–0.8	–0.8
Western Germany	x	1.2	1.0	0.5	0.4	0.4	0.3	0.1	0.2	0.3	0.4	0.4
Labour force (domestic)[1]												
Eastern Germany	x	–12.4	–2.5	2.4	1.9	–0.7	–1.2	0.2	0.6	–0.9	–1.6	–1.6
Western Germany	x	0.8	–1.1	–0.6	–0.1	–0.2	0.0	1.3	1.4	2.3	0.8	–0.4

1 Figures for eastern Germany: New Länder excluding Berlin, figures for western Germany: Old Länder including Berlin, as at March 2003. — 2 Figures for eastern Germany: New Länder including East Berlin, figures for western Germany: Old Länder including West Berlin. — 3 GDP per member of labour force at current prices. — 4 Compensation of employees per employee created in the domestic economy as % of GDP at current prices per member of labour force.
Sources: Federal Statistical Office; Federal States' Working Group on ESNA; Federal and States' Working Group on Employment Statistics; ifo Institute; Institutes' calculations.

Table 10

Selected Fiscal Policy Indicators,[1] 1991 to 2004

	Government receipts[2]			Government expenditure[2]			Financial balance[2] Surplus/deficit	Memo item: interest/tax ratio[3]
	Total	Of which: Taxes	Of which: Social insurance contributions	Total	Of which: Interest spending	Of which: Gross investment		
1991	44.1	22.4	17.2	47.1	2.8	2.7	–2.9	12.6
1992	45.5	22.8	17.6	48.1	3.3	2.9	–2.6	14.3
1993	46.2	22.9	18.2	49.3	3.3	2.8	–3.1	14.6
1994	46.6	22.9	18.6	49.0	3.3	2.7	–2.4	14.6
1995[4]	46.0	22.5	18.8	49.3	3.7	2.3	–3.3	16.3
1996	46.9	22.9	19.4	50.3	3.7	2.1	–3.4	16.0
1997	46.6	22.6	19.7	49.3	3.6	1.9	–2.7	16.1
1998	46.6	23.1	19.3	48.8	3.6	1.9	–2.2	15.6
1999	47.3	24.2	19.0	48.8	3.5	1.9	–1.5	14.4
2000[5]	47.0	24.6	18.6	48.4	3.4	1.8	–1.4	13.7
2001	45.5	23.0	18.5	48.3	3.3	1.7	–2.8	14.2
2002	45.0	22.6	18.4	48.6	3.2	1.6	–3.6	14.1
2003	45.5	23.0	18.7	48.9	3.2	1.6	–3.4	14.1
2004	45.1	22.9	18.4	48.0	3.3	1.5	–2.9	14.3

1 On national accounting definitions. — 2 As % of nominal GDP. — 3 Government interest spending as % of tax revenue. — 4 Excluding asset transfers linked to the assumption of the debts of the Treuhandanstalt (privatisation agency) and the housing sector of the former GDR (–119.6 billion euro). — 5 Excluding receipts from the sale of UMTS licences (50.8 billion euro).
Sources: Federal Statistical Office; Institutes' calculations; 2003 and 2004: Institutes' calculations and forecast.

and – to a lesser extent – spending cuts to this end. The resulting budget savings – including the additional revenue from the fifth phase of the ecological tax reform – will amount to around 23 billion euro (or 1.1% of GDP); when other positive net budgetary effects are taken into account, the decrease in the structural deficit will amount to 0.8 percentage points. The fiscal policy course will be less restrictive in 2004, and the structural deficit can be expected to fall by almost 0.5 percentage points.

Tax revenue will expand by 3.4% this year and by 2.4% next year. The additional revenue will be created, on the one hand, by the elimination of the special factors deriving from the new system of taxation for joint-stock companies and, on the other, by the amendments to taxation law this year. The corporate tax rate has been increased by 1.5 percentage points to 26.5% for the year 2003, and mineral oil, electricity and tobacco tax were all raised (leading to additional revenue of 4.6 billion euro). Moreover, tax concessions and special regulations are to be abolished, while the reform of interest taxation will also create temporary additional revenue. Revenue from income tax will also increase on the basis of the progressive income-tax rates. The second phase of the income-tax reform will reduce revenue next year (cf. table 11).

Revenue from social insurance contributions will increase by 2.8% in 2003. This will be due mainly to the significant increase in contribution rates: in particular, the ceiling on income subject to pension and unemployment insurance contributions was raised at the beginning of the year, while the pension insurance contribution rate was increased by 0.4 percentage points. The average contribution rate to statutory health insurance is likely to increase by 0.4 percentage points in 2004 – despite the implementation of cost-cutting measures and the increase of the income limit at which individuals can switch from statutory to private health insurance. Together, these measures will lead to additional social insurance contributions of 8 billion euro. The burden on wages and salaries that are subject to compulsory insurance will increase from 41.3% to 42.1% and thus reach a new record high; were it not for the substantial transfers from the ecological tax revenue and the further reduction of the contingency reserve, the increase in the burden would have been even higher. Next year, the revenue from contributions will increase by 1.6%. A further increase in contribution rates is not expected because a comprehensive reform of the health system is planned; savings of 2.5 billion euro are expected. In addition, savings in pension insurance are likely to be implemented.

Box 4

On the fiscal policy assumptions

It began to become clear in autumn 2002 that the government budget deficit would exceed the 3% of GDP limit in 2002. In addition, there was a risk that the deficit would not decrease significantly in 2003. The government therefore decided to implement consolidation measures, many of which entered into force at the beginning of 2003. Other new regulations, in particular the fifth phase of the ecological tax reform, were introduced at the same time. All of this will lead to additional revenue of 14.2 billion euro in 2003. The discretionary spending cuts in the area of statutory health insurance, labour market policy measures and unemployment assistance will add up to 5 billion euro.

Table 11

Changes in Taxes and Social Insurance Contributions[1]

Budget savings (+) and burdens (–) due to legal amendments in euro billion

	2003	2004
Fifth phase of ecological tax reform	2.8	3.1
'Further development' of ecological tax reform	1.4	1.4
Increase in corporate tax	0.5	–
Second phase of income-tax reform	–	–6.5
Increase in tobacco tax	0.4	0.5
Abolition of tax concessions[2]	1.0	3.0
Reform of interest taxation[2]	2.5	–1.0
Reform of low-wage sector	1.0	1.5
Increase in pension insurance contribution rate from 19.1% to 19.5%	3.6	3.7
Increase in ceiling on income subject to contributions to pension and unemployment insurance	1.6	1.6
Increase in average contribution rate to statutory health insurance from 14% to 14.4%	2.9	3.0
Total	17.7	10.3

1 Excluding macroeconomic consequences; excluding Retirement Savings Act. — 2 Not yet passed, Institutes' conjecture.
Sources: Federal Ministry of Finance; Institutes' calculations.

However, some of the essential elements of the government's consolidation package have not yet been passed. The Institutes assume the following in this regard:

- Only some of the specific measures described in the law on abolishing tax concessions will be passed, for example the limit on the disbursement of reserves in order to reduce corporate tax. The subsidy for owner-occupied housing construction will not be reduced, and the regulations on depreciation for residential construction will not be tightened up. The volume of additional revenue from these measures is estimated at 1 billion euro in 2003 and at 3 billion euro in 2004.
- Interest taxation will be reformed: a settlement tax of 25% will be levied on interest earnings regardless of the taxation of other income, although low interest earnings will remain untaxed on the basis of a tax-free amount which will not change. An amnesty will encourage investors who have not yet declared interest earnings acquired abroad to transfer their assets to Germany. A one-off tax of 25% (if the transfer is concluded in 2003) or 35% (if the transfer is concluded by 30.6.2004) will be levied on untaxed income. Together, the two measures will create additional revenue of 2.5 billion euro in 2003. In 2004, reduced revenue of around 1 billion euro is expected because of the lower tax on interest earnings.
- In its Agenda 2010 programme, the government announced proposals for reforming the social insurance system which will also have an effect on the government deficit. In particular, unemployment assistance and social welfare benefits are to be integrated, while the health system will be reformed. The Institutes forecast total savings of 5 billion euro from these measures in 2004.
- The consolidation measures which are planned or expected will create additional revenue of almost 18 billion euro and savings of 5 billion euro in 2003. The structural budget deficit as a share of GDP will probably be reduced by 0.75 percentage points, which would mean the government's promise to the ECOFIN Council would be almost fulfilled. The measures discussed to date will not suffice to reduce the structural deficit ratio by 0.5 percentage points in 2004 as recommended by the European Commission; the Institutes predict a reduction of less than 0.5 percentage points.

Additional revenue will also be obtained from the distance-based autobahn toll for goods vehicles, which is to be introduced in August 2003 and will replace the duration-based 'vignette' sticker. This additional revenue is estimated at 0.7 billion euro (2003) and 1.5 billion euro (2004). The profits transferred by the German Bundesbank to central government (5.4 billion euro in 2003) are likely to decrease in 2004 because of the lower interest rates.

Government spending will show a higher increase than expected this year (2.2%) because the slack economy will lead to significantly higher labour market spending and because the local authorities will not strictly limit their spending increases as agreed in the Financial Planning Council. A significantly weaker increase in expenditure (0.9%) can be expected only next year when the economy improves and the efforts to reduce spending are intensified.

Personnel spending will expand only moderately over the prognosis period. The negotiated wage increases of 2.1% in 2003 and 1.6% in 2004 will be offset by further job cuts of 1.5% each year, which will be facilitated by the collectively agreed extension of working time. Savings will also be made on purchased materials and services, while social benefits in kind, which had shown an above-average increase in recent years, will expand at a lower rate this year owing to the savings planned in the health system. Thus, pharmacies and pharmaceutical companies will be obliged to offer discounts to the health insurance funds. At the same time, most hospitals and doctors are unlikely to have their budgets increased. Further savings are planned for 2004 in the statutory health insurance funds (cf. box 4).

The increase in monetary social welfare benefits will slow down perceptibly because savings will be made in active labour market policy and because the regulations on calculating unemployment assistance will be tightened up. In addition, pension adjustments will be lower because contributions to private pension schemes will be taken into account in the pension adjustment formula. The reduction of subsidies is likely to continue as in recent years. Other current transfers, by contrast, will be increased sharply in both 2003 and 2004. This will be partly due to the fact that the GNP-based contribution to the EU budget will be increased.

As in previous years, the austerity measures will particularly affect public investment spending, where the political opposition to cuts is least vehement. In addition, the local authorities – the most important public-sector investors – often have no other option when faced with tighter budgets than to reduce their investment spending. Thus, public investment has been in decline for years – a situation that the government's 'Investment for the Future' programme is likely to do little to change. This year the downward trend will be alleviated by the repairs to the public infrastructure damaged by the floods in eastern Germany, with the bill being paid from the 'Reconstruction Aid' fund. Next year, when this special effect wears off, a renewed substantial decline in investment spending can be expected. The government's interest-rate reduction programme will do little to help because most local authorities will be unable to increase their borrowing. Thus, probably the only outcome of this programme will be more favourable rates for financing investment projects that were already on the agenda anyway. Additional municipal investment spending is more likely to be created by the release of the municipalities from their obligation to contribute a total of 800 million euro to the 'Reconstruction Aid' fund. However, the government is considering spreading out its investments over time in order to contain the budget deficit. Overall, investment spending will decline slightly this year and then considerably (–4.5%) next year. Interest spending will increase again because of the hefty increase in the budget deficit. However, the low interest rate will permit substantial savings in the refinancing of due debts.

All of this will mean that the budget situation will improve at a much slower rate than the government would wish.[2] The main reason is that the economy will grow at a much slower rate this year and next year than assumed in the Stability Programme of December 2002. The budget deficit will decrease only slightly in 2003 – to an estimated 73 billion euro, so that the deficit ratio, at 3.4%, will again significantly exceed the maximum limit laid down in the Maastricht Treaty. Next year, the budget deficit is likely to fall to almost 65 billion euro or 2.9% of GDP as a result of the presumably more intense efforts to economise and the livelier economy (cf. table 10). The debt ratio will increase to 63.2% this year and to 64.2% next year.

The increase in contribution rates along with the austerity measures will allow the social insurance fund to almost balance its budget this year and next year. However, the sharp increase in unemployment will result in substantial additional labour market spending, so that the government will probably have to transfer a much higher sum than last year (5.6 billion euro) to the Federal Labour Office in order to offset its budget deficit. Despite more stringent austerity measures, the government will fail by a wide margin to meet its aim of reducing the transfer to zero.

[2] The government assumes in its Stability Programme that the deficit ratio will fall to 2.75% this year and to 1.5% next year. This figure was not revised following the downward correction of the government's growth forecast for this year from 1.5% to 1% on the publication of the annual economic report for 2003.

Economic policy

The German economy is stuck in a phase of weak growth, which began three years ago. Practically all the industrialised countries are affected by the global downturn, and unemployment has also risen in the USA and in other countries whose labour markets are generally considered more flexible than Germany's. In this respect, the downturn cannot be blamed on Germany's economic policy or institutional conditions. However, real GDP is currently growing more slowly in Germany than in the rest of the euro zone, as it has been on average over the past few years, while the difference relative to the USA's growth rate remains even more pronounced.

Trend growth in Germany is also relatively weak. This has been clear for some time now, and there is no shortage of proposals (including some from the Institutes) as to how the problem should be handled. The current efforts to implement reforms that will move Germany onto a higher growth trajectory are basically welcome. However, these efforts must not be abandoned once the economic situation improves, for the need to resolve various serious problems will be no less urgent even when the growth trend is stronger.

Economic policy has failed to pursue a consistent strategy for many years now, while the decisions made by the government following the September 2002 elections actually lead in the wrong direction: it is well known that raising taxes and social insurance contributions is counterproductive in a country seeking economic growth and higher employment. These decisions made it clear once again that Germany's economic policy makers did not have a medium-term strategy. The harm done by such an approach becomes evident when the consequences are described in detail:

1. Trend economic growth, which has already decreased to a meagre 1.5%, would decline even further. Many observers believe a growth rate of 1% is probable. The result would be a decline in the standard of living for large parts of the population.
2. If the claims on social insurance do not decrease and the social security system remains inefficient, contribution rates would continue to rise sharply.
3. If weak growth persists and the labour market remains inflexible, unemployment would remain high in the medium term and employment growth would not set in.

These problems must not be seen as isolated difficulties. Higher growth and increased employment would relieve the burden on the social security system, while lower contribution rates would lead to increased investment and employment. Evidently, what is needed is a comprehensive approach that tackles all the problems and takes the consequences for all the different objectives into account.

There has been no lack of good intentions to date. The government has repeatedly announced significant fiscal policy shifts in its stability programmes, though only a few of these have been carried out. Policy makers have also repeatedly tried to implement reforms on the basis of consensus agreements, for example by establishing commissions representing all the important groups of society. However, the example of the 'Alliance for Jobs' shows that this kind of strategy can lead to a dead end.

The initiative must come from the government, for it is the government and not its commissions that is ultimately responsible for the course of Germany's economic policy. In announcing its 'Agenda 2010' programme, the government has stepped up to the helm again, and its intentions at both the macroeconomic and microeconomic levels point in the right direction. However, these should be considered no more than a first step. If this agenda represents all the changes that are to be made up to 2010, then the conditions for growth will improve only very slightly.

The idea contained in Agenda 2010 of strengthening the investment capacity of the local authorities is basically correct. The decisive move in this respect will be a reform of municipal finances. However, the scheme that offers low-interest loans to the local authorities, which is motivated by a growth-oriented policy, does not promise success because it will entail significant windfall gains.

The chancellor's promise that the tax concessions announced for the next two years will definitely be implemented is to be welcomed. However, the government should also announce that the tax burden will not be increased. What is really needed to promote more rapid growth are even further tax decreases, but in view of today's high budget deficits and the need for extensive consolidation, it was probably unrealistic to promise tax cuts for as early as 2006.

The government still intends to fulfil its commitment to achieve a balanced budget by 2006. Indeed, the stability programme passed in December 2002 is based on this intention. However, Agenda 2010 suggests that Germany plans to interpret the terms of the Stability and Growth Pact 'flexibly'. This stance should probably not be considered a rejection of the Pact. If what it actually means is that the reference value will be the structural (cyclically adjusted) deficit and not the actual deficit, this would correspond to the consensus already reached at European level. The most sensible approach is to allow the actual deficit to fluctuate in accordance with the growth cycle, so that the aim of budget consolidation should be based on the structural balance. Therefore, a higher budget deficit this year can be accepted as an exceptional case because the economy is slacker than assumed in the stability programme. The fact that Germany is permitted to have a deficit ratio in excess of the 3% limit is a concession on the part of the European Commission, for the rules of the Pact actually stipulate that steps be taken to push the deficit below the 3% mark again. Faced with disciplinary proceedings due to an excessive deficit, the government was only able to avoid further steps on the part of the EU by promising measures this year that would reduce the structural deficit ratio by around 1 percentage point. If this is achieved, then the reduction of the deficit will be seen to be proceeding more or less as planned by the government. The regulation defined to date at European level has been that countries with high deficits reduce their structural deficit ratio by 0.5 percentage points per annum. Given a structural deficit of around 3% of GDP in 2002, this would mean that the budget would be practically balanced in 2006.

It is important for the government to now announce the concrete steps with which budget consolidation is to be achieved. In accordance with the recommendation not to increase the burden of contributions, cyclically adjusted spending will have to increase at a slower pace, and even decrease in some areas. Vague intentions will not suffice here, for experience with the stability programmes has ultimately shown higher increases in cyclically adjusted spending than originally planned. What is needed is the formulation of a concrete spending path stipulating the savings that will lead to budget consolidation.

The Institutes agree on the aim of medium-term budget consolidation. They also stress that budget consolidation must be achieved on the expenditure side, for a higher burden of contributions is not compatible with the goal of stronger economic growth. However, the Institutes disagree as to what would be the most appropriate consolidation strategy (cf. section on Fiscal Policy). As pointed out on numerous occasions, the economy drive does not have to lead to a decrease in public investments, which promote growth. On the contrary, such investments should actually be increased. In particular, investment in human capital should be expanded, for the training of human capital represents an important growth factor in that it raises productivity.

The principle of avoiding a further increase in the burden of contributions should also apply to social insurance contributions over the coming years. This principle is also stressed in Agenda 2010. Thus, capital-based provision for old age must be expanded. The government also plans to encourage increased private provision and personal responsibility in the area of health insurance. The reform of the social security system will be basically concerned with halting the rise in ancillary wage costs. In addition, Agenda 2010 intends to abolish or at least relax various regulations that discourage employment creation. This applies to protection against dismissal, the deadlines for the payment of unemployment benefit and the abolition of bureaucratic regulations. In addition, enterprise foundations will become easier in future. As regards wages policy, the adjustment of wages to the circumstances of enterprises will be facilitated. Moreover, social welfare benefits and unemployment assistance are to be merged, though this step will do little to achieve the real aim, which is for more people to find access to the primary labour market. Thus, the second step should also be taken, in other words increasing the gap between earned income and payments to social welfare recipients who are fit for work so as to increase the incentive to enter employment. Under the current system, a beneficiary's social welfare payment is drastically reduced, with the marginal transfer reduction rate amounting to almost 100%. This reduces the incentive to take up work in the very group that is most affected by unemployment: the unemployment rate is around 20% amongst the low-skilled.

The European Central Bank has reacted to the weak economy in the euro zone and further relaxed its monetary policy stance in recent months. Measured against all the available standards, including the Taylor rule, base rates are currently low. They now amount to around 0.5% in real terms – their lowest level since the introduction of monetary union. The Institutes believe the ECB's course is appropriate, for the prospects for growth have now become even gloomier. The 'equilibrium real interest rate' – a highly important variable in macroeconomic models – is probably lower now than its average over many years. It is even likely that the ECB will reduce rates again over the coming weeks. Thus, monetary policy is exerting a strong impulse in favour of economic recovery.

Monetary policy

Monetary policy in the euro zone is currently highly expansive. This is the appropriate course in view of declining inflation and gloomy growth prospects. The high degree of uncertainty among consumers and investors would justify an even more relaxed interest-rate policy.

The ECB is currently reviewing its monetary policy strategy. Since the beginning of monetary union, the bank has managed to keep inflation low in the euro zone and to build up trust in its stability-oriented approach.

Low inflation can also be expected in the future; this is indicated by the current inflation forecasts of various institutes and organisations and by the inflation expectations of financial market participants. Thus, the ECB's strategy has proved itself in this respect.

The ECB must decide whether to maintain its two-pillar strategy, which gives a prominent role to M3 money supply. This aspect of the strategy has come in for growing criticism. For example, academic researchers currently mainly use macroeconomic models where money supply plays no role at all; rather, the central element is rules for interest rates. Moreover, the ECB is the only large central bank that considers money supply to be an important variable. In other countries, the demand for money has recently proved to be unstable in the long term, so that an orientation based on a money supply aggregate did no longer seem appropriate. The euro zone has also seen instabilities in recent years since empirical research on the period prior to monetary union and on the two subsequent years showed a sufficiently close relationship between nominal GDP and prices. Since mid-2001, however, the indicator function of money supply has been considerably impaired by substantial portfolio restructuring in favour of short-term investments, which are a component of M3 and reflect grave uncertainty on the financial markets. The ECB has reacted by relativising the importance of money supply growth for a period of time and basing its policy to a greater extent on other criteria. Otherwise at best only minor interest-rate reductions would have been possible, for the reference value for M3 has been exceeded significantly for some time.

The ECB's strategy expressly defines only a reference value for money supply growth and not a targeted value. An accompanying analysis of monetary capital and loan growth as well as other financial market variables is planned, and this will also examine the extent to which a change in money supply reflects the change in demand-relevant liquidity. An analysis of this kind might possibly help more than an interest-based orientation in the early identification of both inflationary and deflationary risks in phases that are critical for stability.

The Institutes suggest that the ECB continue to attribute importance to M3 money supply, for it is not possible to conclude yet whether the demand for money is unstable in the long term. Instead, the close relationship which has been confirmed between money supply and prices in the medium term is likely to continue. Thus, money supply is an important indicator for medium-term trends.

The ECB has also acted appropriately on the whole with respect to the second pillar (inflation prospects) and has prepared and justified its interest-rate steps in a comprehensible way. The bank certainly cannot be accused of a lack of transparency. With respect to price growth, it also correctly distinguished between variations deriving from special factors and those which were more a reflection of the medium-term trend. The bank has recently published its own forecasts, which is also a useful step because it increases the transparency of the ECB's decisions.

One aspect of the ECB's strategy is its chosen definition of price stability. According to this definition, the bank's aim is to keep the increase in the Harmonised Index of Consumer Prices below 2% in the medium term. Thanks to this quantitative definition, the ECB's policy is more transparent than that of central banks that do not provide a concrete definition of their concept of price stability. However, the failure of the ECB to define a lower limit or a precise target value for inflation means it is unclear whether the ECB is striving for a medium-term inflation rate of 1%, 1.5% or just under 2%. A precise target value would reduce the expectation bias and the resulting losses in efficiency. The flexibility required for the eventuality of supply shocks would still be guaranteed if a precise target value were defined, for this would remain no more than the medium-term aim.

As regards the actual level of the target value, the Institutes would advise the ECB to base its decision on the quantification used to date. The inflation target should not be too low, because then every real interest-rate level would be linked to an only slightly higher nominal interest rate. This would increase the perpetual risk of monetary policy losing its most important instrument when inflation rates are low, because the nominal interest rate would already have reached its lowest level of zero and could not be reduced any further. Moreover, if the target inflation rate were too low, there would be a risk of deflationary tendencies in EMU countries with below-average structural inflation. Conversely, a much higher target value could impair the allocative function of the price system.

The ECB should thus define its medium-term target inflation rate. The above considerations suggest that the choice is between 1.5% and 2%.[3] For example, a goal of

[3] The ifo Institute believes the medium-term inflation rate of 1.5% or 2% recommended by the majority of the institutes is too low. The reason is that given target inflation rates as low as this, EMU countries with below-average structural inflation – due to the Balassa-Samuelson effect – would face the risk of deflationary tendencies. This consideration is particularly significant for Germany, which – given an ECB medium-term target of under 2% – already has the lowest inflation rates in the euro zone. In addition, asymmetrical negative shocks can lead to the desire to rapidly reduce real wages in the countries affected. This would be easier to achieve if the ECB were to seek a higher medium-term inflation target than recommended by the majority of the Institutes. Otherwise, real wage depreciation could only be achieved very slowly because of the prohibitive opposition to nominal wage reductions. For these reasons, the ifo Institute recommends a medium-term inflation target of 2.5%.

2% would be favoured by the fact that it would offer greater short-term real-wage flexibility, which would have a stabilising effect on employment. However, this could send out a negative signal if the only change or specification of the monetary policy strategy were a higher inflation target than defined to date. Thus, a rate of 1.5% is recommended.

Under the current circumstances, difficulties in the banking sector are raising fears that the transmission mechanism of monetary policy impulses is not functioning efficiently. For example, open-account lending to enterprises and private individuals has been weakening for some time in the euro zone. However, loan growth is only very slightly weaker than the average for the last business cycle. In real terms, growth rates have actually risen again slightly since reaching their lowest level in November; the three-month average of the seasonally adjusted month-on comparison was 2.2% (annualised rate) in February 2003, as against 1.6% in November 2002. This confirms the Institutes' conclusion last autumn that there is no explicit evidence for a credit squeeze in the euro zone.

In Germany, by contrast, the growth rates for real open-account loans to enterprises and private households were significantly below the long-term average, and lending has actually been declining since the beginning of last year. Interest rates for current-account loans are also adjusting only very slowly to base-rate reductions.

On the demand side, the differences between loan growth in Germany and the rest of the euro zone can be seen as deriving from the slacker economy in Germany. This would suggest that lending will expand rapidly again in the course of economic recovery. The fall in share prices on the stock markets, which was more evident in Germany than in the rest of the euro zone, could indicate a supply-side reduction in lending. The fall in share prices might have caused an imbalance in the banks' balance-sheet structure, which led them to restrict lending. This is suggested by the fact that large banks, in particular, reduced their volume of loans. However, the reduced volume of securities for bank loans due to the fall in share prices probably also contributed to the decline in lending.

The historically high spreads between industrial and public-sector loans are not, however, necessarily indicative of a higher risk premium for the provision of loan capital. Because the net issuance volume of industrial loans increased very substantially over the same period, a part of the yield differential is probably due to the higher demand on the capital market.[4] In addition, long-term lending rates reacted, as usual, to base-rate reductions.

While, all in all, there is no clear evidence of a credit squeeze in Germany, the risk cannot be ignored given the current situation. A sustained weak growth phase accompanied by high insolvency figures and repeated sharp falls in share prices could trigger a supply-side shortage of this kind.

Wages and labour market policy

Wage growth was more moderate overall last year than could have been expected following the initial pay settlements, some of which were quite high. Negotiated wages increased by an average 2.6% and thus roughly in accordance with the rate based on trend productivity growth plus an inflation premium that the Institutes believe should be the long-term guideline for wages policy.

In view of the economic lull, the negotiated wage increases were often not fully implemented at company level. Actual wages, in other words wages and salaries per hour worked, increased by only 1.8% in 2002 – a much lower increase than in the previous two years. The difference is partly provided for in the collective agreements, which now often contain clauses permitting more flexible wage payments, for example by linking the amount of the Christmas bonus to the economic situation of the individual enterprise. This scope for savings was evidently used more intensively in view of the weak economic climate. However, some of the weaker growth of actual wages can be attributed to the fact that numerous enterprises – especially in eastern Germany – have left the employers' associations and are thus no longer bound by collective agreements. The significant difference between actual wages and negotiated earnings clearly illustrates that 'regressive' wage demands do not necessarily increase the purchasing power of employees as intended.

The stage for this year's wage growth has already largely been set. The term of numerous of last year's agreements runs well into 2004 and in some cases – such as the public service – even into 2005. The increases that have already been agreed are likely to serve as a guiding principle for the remaining wage talks, which suggests that negotiated wages will increase this year at much the same rate as last year. The increase will be somewhat lower in 2004. Actual wages, in view of the situation on the labour market, are likely to increase at a somewhat lower rate than collectively agreed wages.

[4] The fact that there is practically no difference between the yield on bank and government loans suggests that the risk of a banking crisis is considered minor on the capital markets.

The difference will narrow to an extent as the economy improves.

Not only wages and salaries are decisive for employment effects, but rather all labour costs, including ancillary wage costs. The latter rose more rapidly on average in recent years in Germany than gross wages and salaries. This trend will continue this year due to the increase in pension and health insurance contributions. However, the government has announced measures to reduce ancillary wage costs in its Agenda 2010.

The government hopes that the labour market reform will substantially reduce unemployment and has begun to implement the proposals of the Hartz Commission to this end. The Institutes believe that many of the agreed or planned measures point in the right direction; in particular, they are likely to improve the efficiency of labour market policy. However, in the short term, the reforms will have only a minor impact on the labour market. The government estimates the possible reduction of the labour market burden at between 100 000 and 120 000 persons, although the Hartz Commission's report spoke of integrating up to 2 million unemployed into the labour market within three years. Experiences with the Job AQTIV law, which entered into force at the beginning of 2002 and whose instruments have been applied on only a small scale to date, and the low use made so far of the Job Floater scheme, which has been in operation since November 2002, confirm the Institutes' opinion that the reforms will have little effect this year. In addition, the measures will be subject to significant windfall gains and displacement effects, while the new regulations will go hand in hand with the elimination of traditional labour market policy instruments. Moreover, the promotion of the low-wage sector provides only minor incentives for the unemployed to take up regular work. The main beneficiaries of the increase to 400 euro of the earnings limit for marginal employment are probably employees who take on a second job (who now fall under this category again) and 'secondary wage earners', who were counted amongst the hidden reserve up to now. In the extended low-wage sector (income of up to 800 euro a month), the incentive to take up work is already low because of the high burden of marginal taxes.

All in all, the effects of the labour market policy reform will be minor on balance both this year and next year, and only when the economy improves will it become clear to what extent they can help to reduce the employment threshold. However, the main reasons for Germany's high unemployment rate remain the weak growth dynamic, the insufficiently employment-friendly labour market conditions, and the lack of skills at the supply end. As experiences in other European countries have shown, job centres can make a significant contribution to providing more efficient further training. However, these will not be established in Germany before 2004 at the earliest.

In order to increase the employment-friendliness of labour market regulations, the government's Agenda 2010 provides for less rigid dismissal protection in firms with under five employees, the introduction of selective regulations on severance pay and more flexible social criteria for redundancy. The Institutes welcome these proposals because they will make it easier for enterprises to calculate the conditions under which employment relationships can be terminated again.

Fiscal policy

Faced with the sustained weak business cycle, weak growth and the resulting high budget deficit, fiscal policy is still in a difficult situation, and the Institutes see no end in sight within this forecast period. While the budget deficits will decrease over the prognosis period, they will still significantly exceed the target sought by the government. The main reason is that the economy will expand at a much slower pace both this year and next year than assumed in the stability programme (cf. table 12). Moreover, savings will be less substantial than originally expected. The balanced budget sought by 2006 is not guaranteed. On the one hand, the growth path of 2.25% assumed by the government seems too optimistic. On the other, proceeding on the basis of the current forecast and given the intention to avoid further contribution increases, a balanced budget can only be achieved by 2006 if the ambitious plan to reduce the government spending ratio by 4 percentage points to 44.5% over the next four years is actually carried through. Spending would have to decrease by around 0.5% per annum in 2005 and 2006 if nominal GDP were to increase by an average 3.5%.

Against this difficult background, fiscal policy has never demonstrated convincingly how it could recover credibility. This in itself has had detrimental consequences: uncertain investors and consumers are acting reticently and are thus additionally burdening economic growth.

The fiscal policy course must thus be urgently reconsidered. The Institutes agree that the aim of budget consolidation – via the expenditure side – must be maintained. They also agree not only that consolidation should be sought without increasing the tax burden on households and enterprises, but also that the planned tax cuts must be implemented in full. Inaccurate estimations of the fiscal consequences of amendments to taxation law, as in the case of corporate tax, must, however, be corrected on the income side – as currently planned

Table 12
Government Fiscal Policy Planning

		2001	2002	2003	2004	2005	2006
Stability programme scenarios							
Real GDP growth[1]	– Stability Programme 2000	2.8	2.5	2.5	2.5	–	–
	– Stability Programme 2001	0.8	1.3	2.5	2.5	2.5	–
	– Stability Programme 2002	0.6	0.5	1.5	2.3	2.3	2.3
Deficit rate[2]	– Stability Programme 2000	– 1.5	–1	–.5	0	–	–
	– Stability Programme 2001	– 2.5	–2	–1	0	0	–
	– Stability Programme 2002	– 2.8	– 3.8	– 2.8	– 1.5	–1	0
Structural deficit rate	– Stability Programme 2002	– 2.8	–3	–2	–1	–1	–0.5
Government spending rate[3]	– Stability Programme 2000	46.5	45.5	44.5	44	–	–
	– Stability Programme 2001	48	48	46.5	45.5	44.5	–
	– Stability Programme 2002	48.3	48.5	48	46.5	45.5	44.5
Tax ratio[4]	– Stability Programme 2000	41	41	40.5	40.5	–	–
	– Stability Programme 2001	41.5	42	42	41.5	41	–
	– Stability Programme 2002	41.5	41	41.5	41.5	41	41
Risk scenario[5] for Stability Programme 2001							
Real GDP growth[2]		0.6	0.2	1.5	2	2	2
Deficit rate[2]		– 2.8	– 3.8	– 2.8	– 1.5	–1	–0.5
Medium-term fiscal planning	Real GDP growth[1]	0.6	0.8	2.5	2.5	2.5	2.5
Annual economic report 2003	Real GDP growth[1]	0.6	0.2	1	–	–	–
Memo item:							
Institutes' joint report in spring 2003							
Real GDP growth[1]		0.6	0.2	0.5	1.8	–	–
Deficit rate[2]		– 2.8	– 3.6	– 3.4	– 2.9	–	–
Government spending rate[3]		48.3	48.6	48.9	48.0	–	–
Tax ratio[4]		41.5	41.0	41.7	41.4	–	–

1 At 1995 prices; % change on the previous year. — 2 Budget deficit as % of nominal GDP. — 3 Government spending as % of nominal GDP. — 4 Taxes and social contributions as % of nominal GDP. — 5 Scenario assuming lower growth rates.
Sources: Federal Ministry of Finance; Federal Statistical Office; Institutes' calculations and forecast.

for the law on abolishing tax concessions. All the Institutes agree that a strategy of this kind must be flanked by a reform of the social security system that will increase its efficiency and thus permit a reduction in social insurance contributions and curb contribution increases for the foreseeable future.

The opinions of the Institutes diverge as regards the most credible approach to consolidating the public budgets. The majority of the Institutes believe it is essential for reasons of credibility to maintain the aim laid down in the government's stability programme of reducing the structural deficit to almost zero by 2006.[5] The DIW Berlin and the IWH, by contrast, recommend a change in the direction of the consolidation strategy, which would then be based on an a priori spending path for expenditure that is independent of the business cycle (with no relation to the aims for the structural deficit) and would ultimately reduce the budget deficit.[6] Both strategies entail accepting cyclical shifts in the deficits.

Both approaches would see the government gradually withdrawing from economic activity and a decline in the government spending ratio. This would create more scope for private-sector activities, which would also lead to increased efficiency. This goal is also stipulated in the European Commission's 'Broad Economic Policy Guidelines' and has been accepted by all governments.

It is neither necessary nor desirable for a consolidation programme to limit all spending to the same degree. Empirical research shows that consolidation strategies tend to be most successful when they start with government consumption spending. The 'Broad Guidelines' take the same view: they recommend a shift from consumption spending to investment spending in reducing the government's share. Otherwise the consolidation strategy would also reduce investment spending, which would have a negative impact on potential growth. This is why qualitative consolidation should see a redefinition of priorities on the expenditure side. Savings should be made first and foremost in the area of consumption spending, in particular government transfers and outlay on personnel. Spending on infrastructure and on research and education, by contrast, which strengthen

[5] Cf. Association of German Economic Research Institutes: 'The German Economy in the Autumn of 2002'. *Economic Bulletin,* vol. 39, no. 11, November 2002.

[6] Ibid.

the forces for economic growth, should be substantially increased.

Public investment has declined in Germany in recent years, and a change of course is urgently required in this respect. The problem concerns the local authorities, in particular, who are unable to make sufficient investments, and their investment capacity cannot be guaranteed until the municipal finances are reformed. Essentially, the financial power of the local authorities must be strengthened by increasing their taxable capacity; at the same time, municipal tax revenue must be structured in such a way that it is less susceptible to the effects of the business cycle. A rapid improvement could be achieved by allocating a higher share of value-added tax to the local authorities. Another useful solution would be to grant the local authorities greater tax autonomy, which could take the form of the right to levy a supplement on income tax, for example. Reducing the social welfare burden by merging unemployment assistance and social welfare benefit is another possibility. Then a higher share of the cyclically determined burdens on the budget would be shifted to the federal level.

The social security system must also be reformed if the consolidation of the government budget is to succeed. So far the government has reacted to the difficult financial situation in social security only with shortsighted initiatives. Thus, in addition to the substantial increase in social insurance contributions, the contribution rate to the statutory health insurance funds was frozen and the pension insurance contingency reserve, which was already low, was further reduced. On the expenditure side, only gradual changes were introduced in the health system, in particular. These austerity measures will not suffice to limit the spending growth of the social security system in the long term. Thus, the pressure to increase transfers to social security or to raise social insurance contributions (and thus ancillary wage costs) remains.

The reform efforts should be focusing on increasing the efficiency of the social security system, not on cutting benefits. There are clearly efficiency reserves in the health system. Agenda 2010 provides for significantly reducing health insurance contributions to 13% of earnings subject to compulsory insurance by removing certain benefits from statutory health insurance. The Institutes welcome these reforms in so far as inefficiencies in the system are removed or noninsurance benefits which are in the interests of the entire society (such as maternity benefit) are no longer financed by social insurance contributions but by taxes. The Institutes also see possibilities for transferring certain benefits from statutory health insurance to private insurance. The question is whether – as planned by the government – this is a good idea in the case of sickness allowance. If insurance against major life risks is at the discretion of the individual employee then, quite apart from problems of the transition phase, there is a high risk of under-insurance – a risk that would ultimately be borne again by the state, for example via social welfare benefits to those employees who did not invest sufficiently in insurance protection. Those on low incomes, in particular, are also likely to find it difficult to afford adequate insurance, and again the state would have to step in.

A lack of competition, in particular, has now led in many areas to substantial monopoly profits whose elimination would reduce costs without having to cut benefits. Institutions such as the Association of Statutory Health Insurance Physicians, which imposes obligatory membership on doctors and has a monopoly position in the negotiation of fees, and the pharmaceutical industry, which has practically no competitors in some market segments, deserve mention here. Savings are required everywhere where more efficient spending of funds can be achieved through appropriate incentives. In cases where this is not possible, for example in the case of the chronically ill, cuts should be avoided, and not only for social reasons, but also because the health insurance system must provide insurance against the financial risks of serious illnesses that cannot be prevented.

Increased efficiency in the pension insurance system can also be achieved by abolishing false incentives. Thus, it is hard to understand why early entry into retirement currently does not entail the required actuarial reductions in the calculation of the pension. This gives a clear incentive to enter early retirement and thus leads to higher spending and lower revenue.

Similar observations on increased efficiency can also be made with respect to unemployment insurance. A systematic analysis that ultimately leads to greater incentives to take up work is essential here. What must be avoided, in particular, is the situation in which the combination of tax and contribution burdens, on the one hand, and the loss of transfers, on the other, make entry into employment unattractive.

It is to be welcomed that the government's efforts in the planned integration of unemployment assistance and social welfare also give priority to job placement for social welfare beneficiaries. It must be taken into account that a full reduction of unemployment assistance to social welfare benefit level will lead to a loss in income for the long-term unemployed. However, the level to which unemployment assistance should be reduced is a question that must be answered against the background of the income structure that is tolerated by society.