

# Economic Trends 2003/2004

## Stagnation continues in Germany

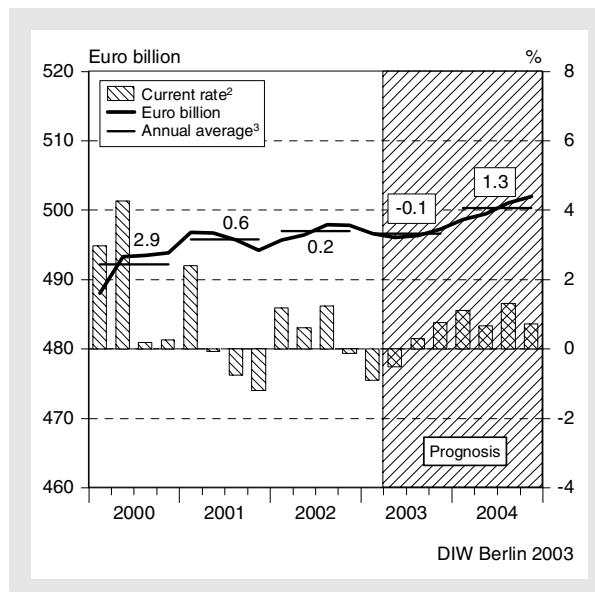
Germany is now in its third year of economic stagnation. Real gross domestic product is expected to fall slightly in 2003, by 0.1%, and a fundamental change in the cyclical trend is not in sight for next year either. Average growth for the year will probably be arithmetically at 1.3%, with 0.6 percentage points due to a working days effect (cf. figure 1). Hence, the cyclical rate will be 0.7%. Beside the weakness in the domestic economy, which is primarily due to unfavourable earnings prospects and investors' uncertainty regarding the development in the world economy, the export trade, which has so far been the most dynamic sector in the German economy, is now under strain (cf. figure 2). The rise in the external value of the euro has been stronger than expected, and this has hindered exports, while imports have increased strongly, necessitating a revision of the prognosis downwards (cf. table 1 and figure 3).

Nor are there signs of improvement in the domestic economy, and in the context of this stagnation the deflationary tendencies continue unbroken. If marked additional stimulus cannot be given to the German economy soon there can be little hope of an upswing, for a change in the trend is not foreseeable in the further course of this year. The foreign trade environment should revive – with corresponding positive effects on German exports – but this stimulus will be dampened by the higher external value of the euro. The domestic economy, on the other hand, is caught in the interplay of unfavourable earnings prospects and continued job reductions. As a result, the employment problem remains unsolved.

## Exports still weak

In the first quarter of 2003 German exports of goods increased only slightly on the whole. Small increases were achieved in exports into the euro zone and to Cen-

Figure 1  
Real Gross Domestic Product in Germany  
Adjusted for seasonal and working days effects<sup>1</sup>



<sup>1</sup> On the basis of X-12-ARIMA. — <sup>2</sup> Change (%) on the previous quarter, annualised rate (right-hand scale). — <sup>3</sup> Change (%) on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

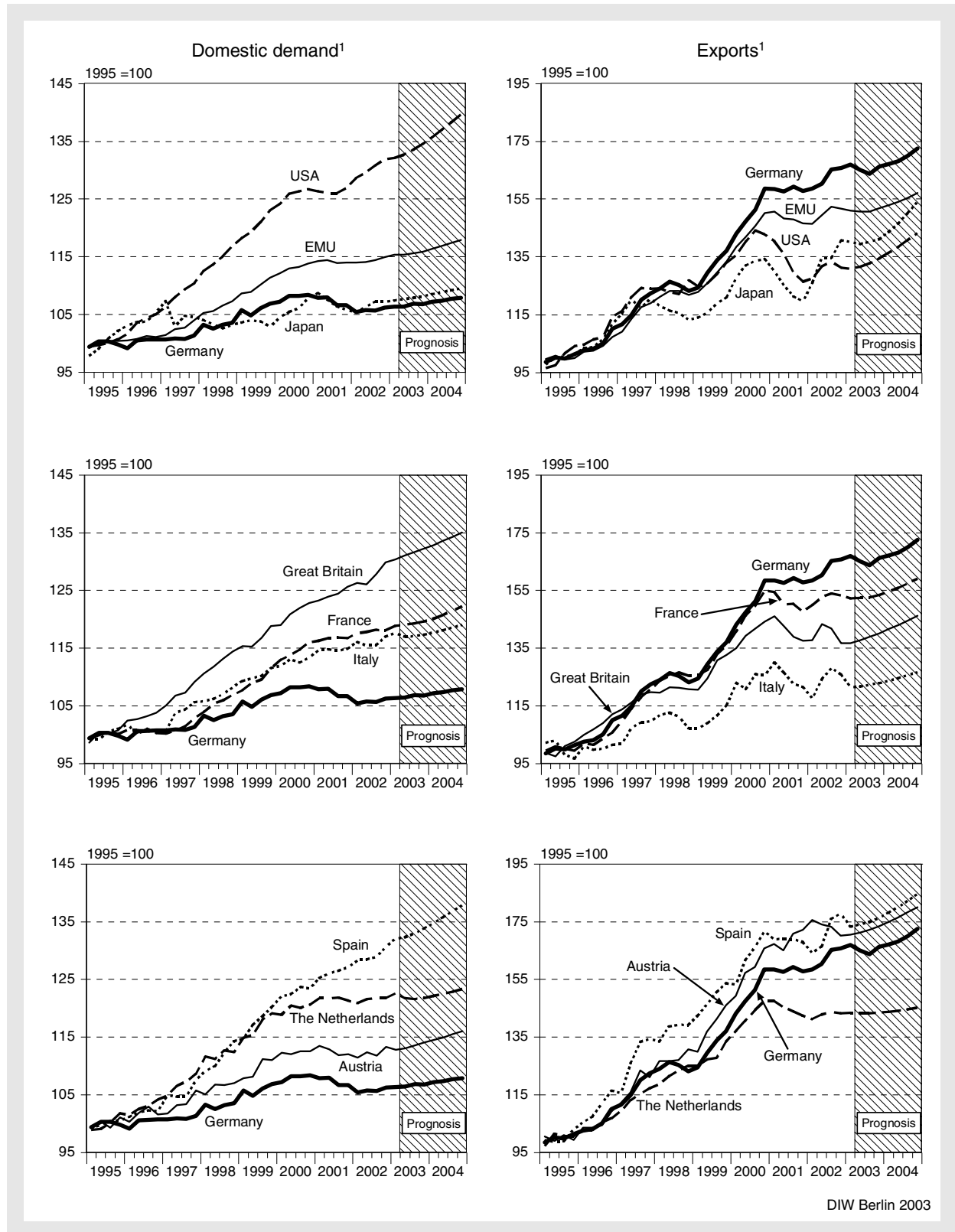
tral and Eastern Europe. Exports to the Far East grew rather more strongly, especially to China, which is now Germany's most important trading partner in Asia. Deliveries of goods to NAFTA, especially the USA, declined markedly (cf. figure 4 and table 2). The lower level of exports this spring was due firstly to the continued weakness of demand in the euro zone, the main sales market for German products, and secondly to the strong appreciation of the euro against the US dollar.

During the prognosis period exports will initially continue on a lower level. Exports into the euro zone will increase only moderately this year. German suppliers will be able to improve their price competitiveness against their European competitors further, as the rise in prices in Germany will be clearly below that in the other euro zone countries. But demand for capital goods from the euro zone will remain weak at first and only revive again slightly in the autumn. For the USA a grad-

### Assumptions

- The price of crude oil will be US \$ 25 a barrel from the third quarter of 2003.
- The exchange rate for the euro will remain at the level of May 2003 (US \$ 1.16 = 1 euro) in the forecast period.
- The European Central Bank will lower its key rate by half a percentage point in the third quarter of this year.
- Collectively agreed wages will rise by about 2.5% this year and presumably by 2.3% next year.
- The second stage of the tax reform 2000 will be carried out as planned in 2004.

Figure 2  
Domestic Demand and Exports by International Comparison



DIW Berlin 2003

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

Table 1  
**Contribution to Growth in Real GDP**  
 In percentage points

	DIW estimate July 2002 <sup>1</sup>		DIW estimate July 2003 <sup>2</sup>		Difference between estimates	
	2002	2003	2002	2003	2002	2003
Private consumption	0.1	1.0	-0.3	0.5	-0.4	-0.5
Government consumption	0.2	0.0	0.3	0.2	0.1	0.2
Machinery	-0.5	0.4	-0.8	0.1	-0.3	-0.3
Other equipment	0.1	0.1	0.0	0.0	-0.1	-0.1
Construction	-0.3	0.0	-0.7	-0.4	-0.4	-0.4
Investment in stocks	0.3	0.6	0.1	0.3	-0.2	-0.3
Domestic demand	-0.1	2.1	-1.4	0.7	-1.3	-1.4
Exports	1.1	2.6	0.9	0.7	-0.2	-1.9
Imports	0.4	2.7	-0.7	1.5	-1.1	-1.2
Trade surplus/deficit	0.7	-0.1	1.6	-0.8	0.9	-0.7
GDP <sup>3</sup>	0.6	2.0	0.2	-0.1	-0.4	-2.1

<sup>1</sup> Data as at June 2002. — <sup>2</sup> Data as at June 2003. — <sup>3</sup> Change (%) on the previous year.  
 Sources: Federal Statistical Office; DIW Berlin calculations.

ual recovery of investment activity is expected as early as this quarter, but the positive stimulus to demand from this will be more than outweighed by the appreciation of the euro against the US dollar. German exports are therefore expected to fall slightly at first and only pick up again towards the end of the year.

The weak trend in exports will gradually be overcome next year if the negative effects of the appreciation of the euro subside and German exports are stimulated again by a recovery in investment activity in the euro zone and cyclical recovery in the USA. The decisive factor in the prognosis of the development in exports in 2004 is the assumption that the euro will not rise further against the US dollar. Altogether exports will grow by 1.9% this year and 3.6% next year (cf. figure 5).

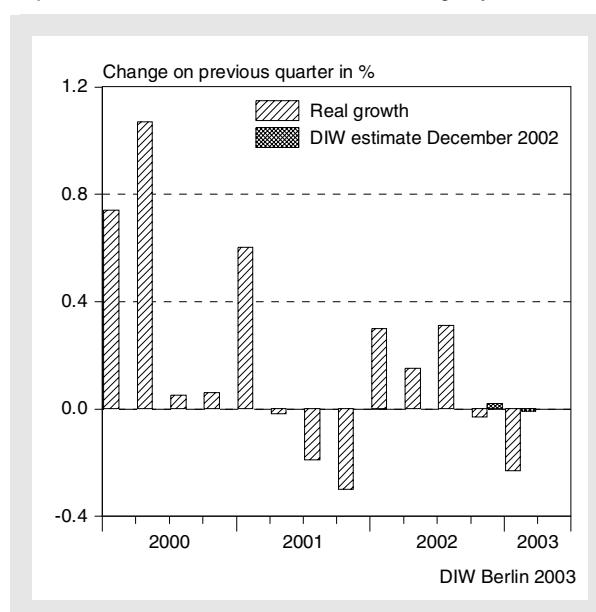
Imports of goods expanded quite strongly in the first quarter of this year, not least owing to the rise in private consumer spending. At the start of the prognosis period imports will fall owing to the fall in exports, which include a high percentage of imports, and as private consumer spending falls. However, these negative factors will be counterbalanced to some extent as falling import prices will encourage demand for imports. In the further course of the year imports of goods will grow only moderately as domestic demand remains weak. All in all a growth in imports of 4.7% is expected in 2003 and of 4.1% in 2004 (cf. figure 6).

After nearly stagnating at the start of the year import prices will fall at first during the prognosis period. This is because oil prices are falling again now that the Iraq war is over; they are expected to settle at about US \$ 25 a barrel. Furthermore, the external value

of the euro is higher. Altogether import prices will ease by 0.6% this year and rise by 0.9% next year.

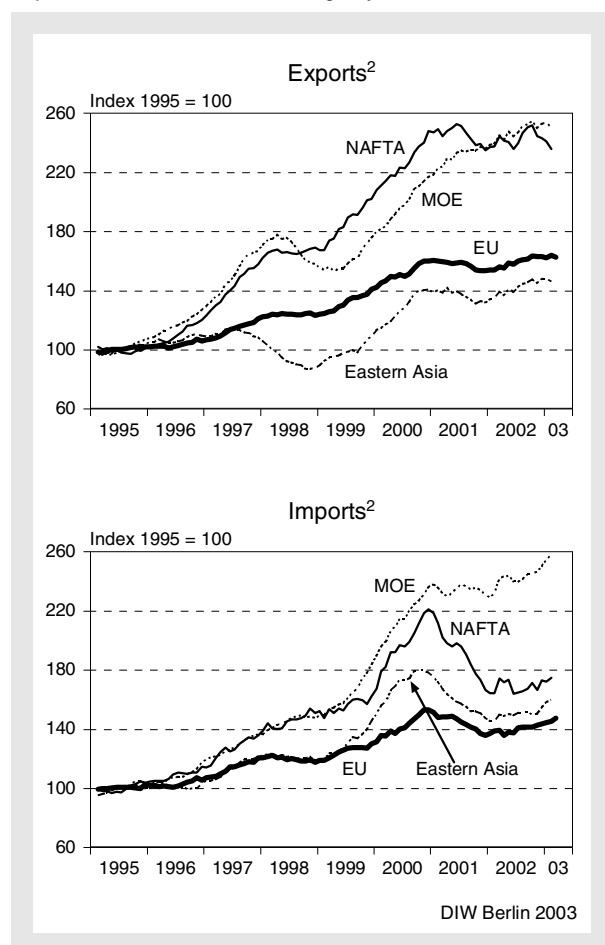
Export prices were stagnating at the start of this year and they will hardly rise in the further course of the year. That is firstly because demand from abroad will at

Figure 3  
**Prognosis and Actual Development  
 in Gross Domestic Product<sup>1</sup> in Germany**  
 Adjusted for seasonal fluctuations and working days effect<sup>2</sup>



<sup>1</sup> At 1995 prices. — <sup>2</sup> According to X12-ARIMA.  
 Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 4  
Regional Trends for German Foreign Trade<sup>1</sup>  
Adjusted for seasonal and working-day effects<sup>1</sup>



1 See Table 2 for classification of countries. — 2 Special trade, nominal; seasonally adjusted according to Berlin method (BV4); moving three-month average. Sources: Federal Statistical Office; DIW Berlin calculations.

first remain weak, while falling import prices ease the cost side for producers of export goods. Secondly, German suppliers will continue to try to compensate for part of the deterioration in their competitive position caused by the currency appreciation by keeping the rise in their export prices down. In the last three quarters the price index for exports of goods rose much more slowly than the producer price index, indicating that exporters have reduced their profit margins. Altogether, export prices will rise only slightly this year and next, by 0.4% and 0.9% respectively. Consequently, an improvement in the terms of trade can be expected this year, while they will probably remain unchanged in 2004.

### Little stimulus to private consumption

At the start of the year private consumer spending expanded at an accelerated rate despite the rise in social insurance contribution rates and the price rise from higher tobacco taxes. A special effect was probably mainly responsible for this as consumers brought more purchases of heating oil forward owing to uncertainty over the Iraq war. However, the mood among consumers was restrained and real retail trade turnover fell by just under 0.5%, while the savings rate fell slightly.

Consumer confidence is not expected to improve noticeably in the further course of this year. Continued job losses and only weak growth in disposable incomes are dampening prospects for consumption. Real wage rates are expected to rise by about 2% this year, but as employment will fall strongly, on balance an increase of only just under 1% is to be expected in earnings from employment. If the social insurance contributions and

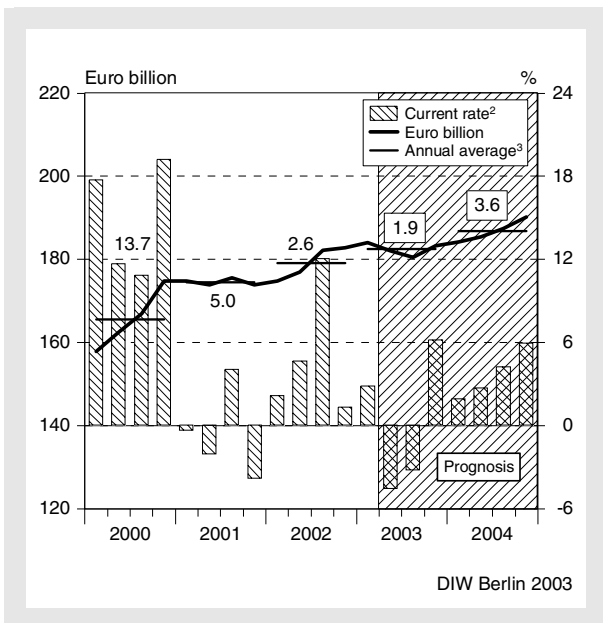
Table 2  
Regional Trends for German Exports (Special Trade)

Country group	1999	2000	2001	2002	1999	2000	2001	2002	1999	2000	2001	2002
	Euro billion				Share (%)				As % of GDP			
Total	510	597	637	648	100.0	100.0	100.0	100.0	25.8	29.4	30.8	30.8
EU	293	337	351	355	57.5	56.5	55.2	54.7	14.8	16.6	17.0	16.8
of which: EMU	230	265	275	276	45.1	44.3	43.1	42.6	11.6	13.0	13.3	13.1
EFTA <sup>1</sup>	27	31	33	32	5.3	5.1	5.2	4.9	1.4	1.5	1.6	1.5
NAFTA <sup>2</sup>	59	71	78	77	11.6	11.9	12.2	11.9	3.0	3.5	3.8	3.7
East Asia <sup>3</sup>	36	47	50	52	7.1	7.8	7.8	8.0	1.8	2.3	2.4	2.4
CEE <sup>4</sup>	43	53	62	66	8.4	8.9	9.7	10.2	2.2	2.6	3.0	3.1
Mercosur <sup>5</sup>	7	7	8	6	1.3	1.2	1.2	1.0	0.3	0.4	0.4	0.3
Others <sup>6</sup>	45	52	56	60	8.8	8.6	8.7	9.3	2.3	2.5	2.7	2.9

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

Figure 5  
Real Exports

Adjusted for seasonal and working-day effects<sup>1</sup>



<sup>1</sup> On the basis of X-12-ARIMA. — <sup>2</sup> Change (%) on the previous quarter, annualised rate (right-hand scale). — <sup>3</sup> Change (%) on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

taxation are taken into account the net sum of wages and salaries is actually down by -0.3%. Mass incomes, which include monetary social benefits paid by the state to private households as well as net wages, will rise by 0.7%. Incomes to the self-employed will probably increase again slightly after a marked fall last year, so that disposable incomes will rise by 1.4%. In real terms the increase will be just under 1%. With the savings rate hardly changed real consumer spending may be expected to increase by about 0.8% (cf. figure 7).

The fall in employment will come to a stop around the turn of the year 2003/2004. Collectively agreed wages will rise rather less than this year (2.3%), and with further cutbacks in payments above these scales incomes from employment will expand by about 1.5%. The increase in incomes from the second stage of the tax reform 2000 will be countered by higher contribution rates to pension insurance, so that the net effect will be almost nil. Extensive cutbacks in monetary social benefits paid by the state (unemployment benefit II) will dampen the development in mass incomes. Moreover, the adjustment of pensions will be only modest next year. Altogether disposable incomes will rise by 1.7% next year. With the savings rate almost unchanged private consumer spending will grow by 1.2% in real terms in 2004. However, this does not mean that consumer demand will be stable over the year, for a working days

effect will have a major influence on the average for the year, affecting the 2004 growth rate by 0.4 percentage points.<sup>1</sup>

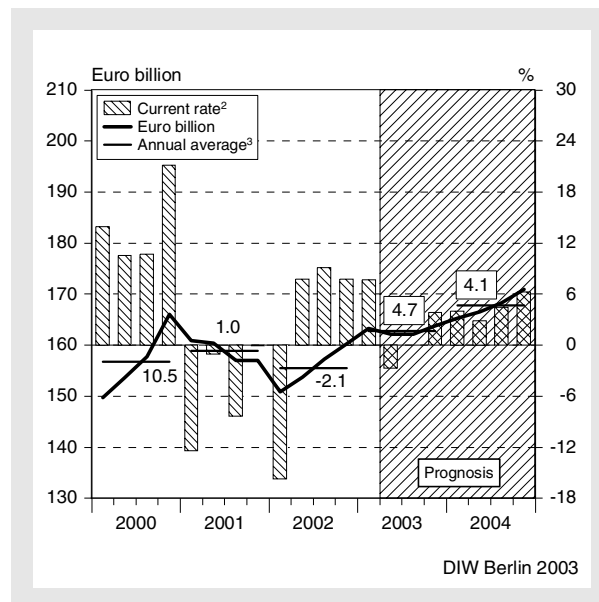
## Hesitant rise in investment in equipment

After a temporary rise of 5.7% in the fourth quarter of 2002, investment in equipment rose only slightly in the first quarter of this year (1.2%). The main reason for this is the renewed fall in companies' business expectations, indicating that the great uncertainty over the cyclical development in Germany persists. Sales prospects for exports are also more pessimistic in view of the appreciation of the euro. The dampening effects of this are only partly being compensated by the stimulus from monetary policy, and this is discouraging companies from any substantial increase in investment.

Next year the prospects for investment in equipment should brighten. Earnings expectations will be better, thanks to the recovery in exports and the stimulus from monetary policy. Demand for software remains stable, although investment in other plant is growing less strongly than a year ago. Altogether investment in

Figure 6  
Real Imports

Adjusted for seasonal and working-day effects<sup>1</sup>



<sup>1</sup> On the basis of X-12-ARIMA. — <sup>2</sup> Change (%) on the previous quarter, annualised rate (right-hand scale). — <sup>3</sup> Change (%) on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

<sup>1</sup> Cf. 'The German Economy in the Spring of 2003'. In: *DIW Economic Bulletin*, vol. 40, no. 5, May 2003, p. 149 ff.

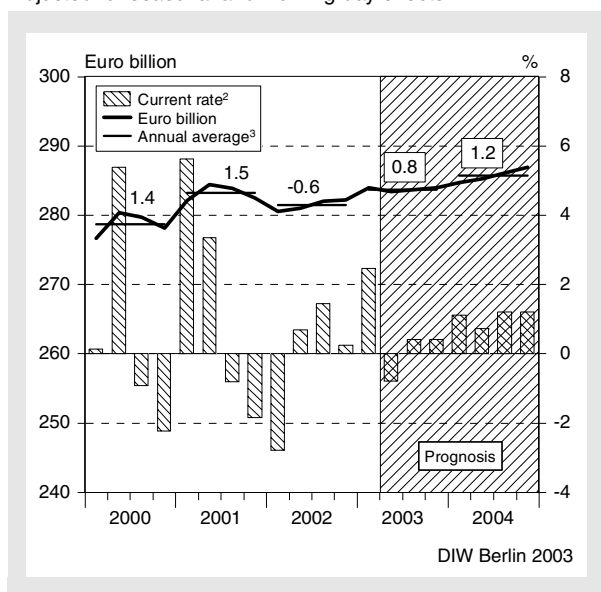
equipment (including investment in other plant) will grow by 1.6% this year and 4.6% next year (cf. figure 8).

### No recovery in construction

After declining strongly last year building investment fell further in the first quarter of this year, not least owing to bad weather. The fall was 3.3%. With real incomes stagnating, the negative basic trend in housing construction will continue in the prognosis period – in demand for both owner-occupied housing and rented housing. The announcement that the owner-occupier grant is to be cut had the effect of bringing some orders forward, but that was only enough to ease the negative trend slightly. Although the number of applications for building permits rose rapidly at the end of 2002 and in the first quarter of 2003 the inflow of orders is still falling so far. In fact, only some of the permits will lead to building work in the rest of this year. Normally building permits are valid for three years, and they can then be extended. Thus, many private households may well have applied for building permission in order to secure their claim to the owner-occupier grant that has been available until now, but do not intend to build in the short term.

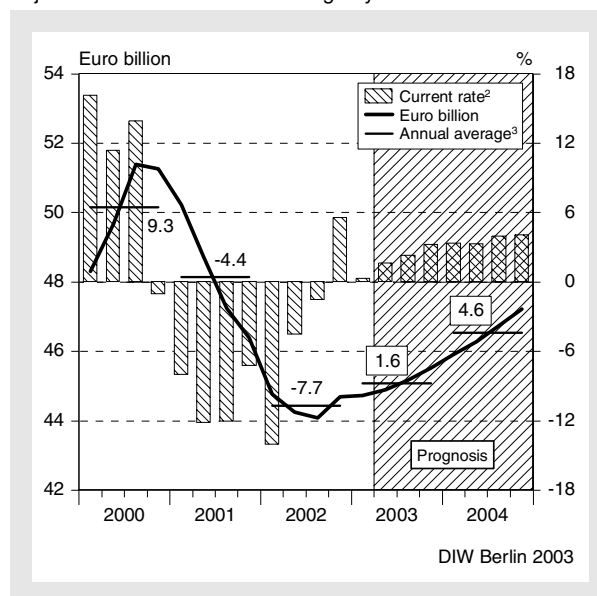
Figure 7  
Real Private Consumption  
of Private Households

Adjusted for seasonal and working-day effects<sup>1</sup>



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 8  
Real Investment  
in Machinery and Other Equipment  
Adjusted for seasonal and working-day effects<sup>1</sup>



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

The 2003/2004 Housing Modernisation Programme is only slightly reducing the decline in investment in housing construction, as the programme is giving rise to very little additional investment owing to considerable free-rider effects. All in all, investment in housing construction will shrink by 2.8% this year and by 0.5% next year (cf. table 3), but without the higher number of working days in 2004 the figure for that year would show a much greater fall of 2.1%.

Owing to the sluggish development in the economy as a whole, and especially the drastic fall in the service sector, commercial building will also continue to decline this year.<sup>2</sup> This is evident from the falling inflow of orders for this category of building. Companies' earnings prospects are improving with the hesitant economic recovery and low interest rates, but as capacities are under-utilised investment in commercial building can be expected to fall further next year. This year it will fall by 2.7% and next year by 0.9% (or 2.2% without the working-days effect).

Public investment in construction will decline further during the prognosis period, as the financial situation remains very tight on all three levels of government. However, dealing with the flood damage will continue to provide some stimulus for public building this

<sup>2</sup> The services sector accounts for a large part of commercial building.

year. The KfW Infrastructure Programme, which offers interest rate reductions, is not likely to stimulate much additional investment. However, investment projects that were already in the planning stage can now be financed on more favourable conditions. Many municipalities do not have the financial scope to borrow more.

Altogether building investment will decline by 3.6% on average for this year and 0.3% next year; adjusted for working days the reduction in 2004 will be around 2% (cf. figure 9).

## Deterioration on the labour market

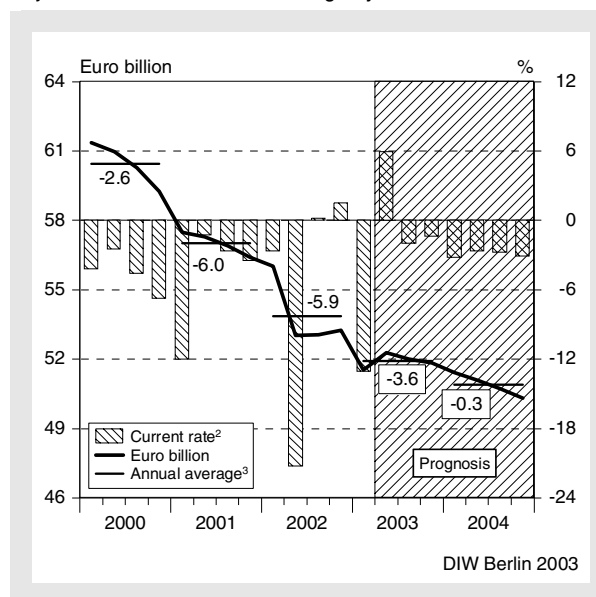
The persistent economic stagnation is still determining the development on the labour market. The number in employment actually fell more strongly in the first quarter of 2003 than in previous quarters. Particularly worrying is the trend in the services branches, which is stagnating or actually negative, for the services sector was the driving force of employment throughout the 1990s. Only the group of 'private and public services providers' showed a slight rise.

This year will see an even stronger fall in employment owing to the persistent stagnation (-1.2% compared with -0.6% last year; figure 10). That corresponds to a reduction in the number in employment of about 450 000 (cf. table 4). As many of the 'Hartz' measures, such as the 'Job Floater' or the Personal Service Agen-

Figure 9

## Real Investment in Construction

Adjusted for seasonal and working-day effects<sup>1</sup>



1 On the basis of X-12-ARIMA. — 2 Change (%) on the previous quarter, annualised rate (right-hand scale). — 3 Change (%) on the previous year.  
Sources: Federal Statistical Office; DIW Berlin calculations.

cies (PSA), can only have a real effect in a cyclical recovery, they will not bring great relief either this year or next. At the start of 2004 there will be signs of a positive development in employment, but the improvement will not become more evident until the second half of the year, when it will be reflected in a reduction in unemployment.

In keeping with the development in employment, the number out of work rose strongly in the first quarter of 2003. That may be due partly to the bad weather, the effects of which are not fully taken into account in the seasonal adjustment procedure. Another factor is the lessening effect of labour market policy in bringing about improvements. The number participating in job creation schemes has been declining for years, but the fall in the number participating in further vocational training courses is new since the end of 2002, and this is one of the most important areas of active labour market policy. Again, the implementation of the Hartz proposals and the Job-AQTIV measures are not yet helping to improve the labour market situation to the same extent. The direct promotion of regular employment (which includes the Ich-AGs or Micro firms, for instance) has met with a relatively strong response, but PSAs, Job Floaters and Employment generating infrastructure support (BSI) have not yet had any noticeable effect, so that on balance active labour market policy has not eased the situation over the last twelve months.

Table 3

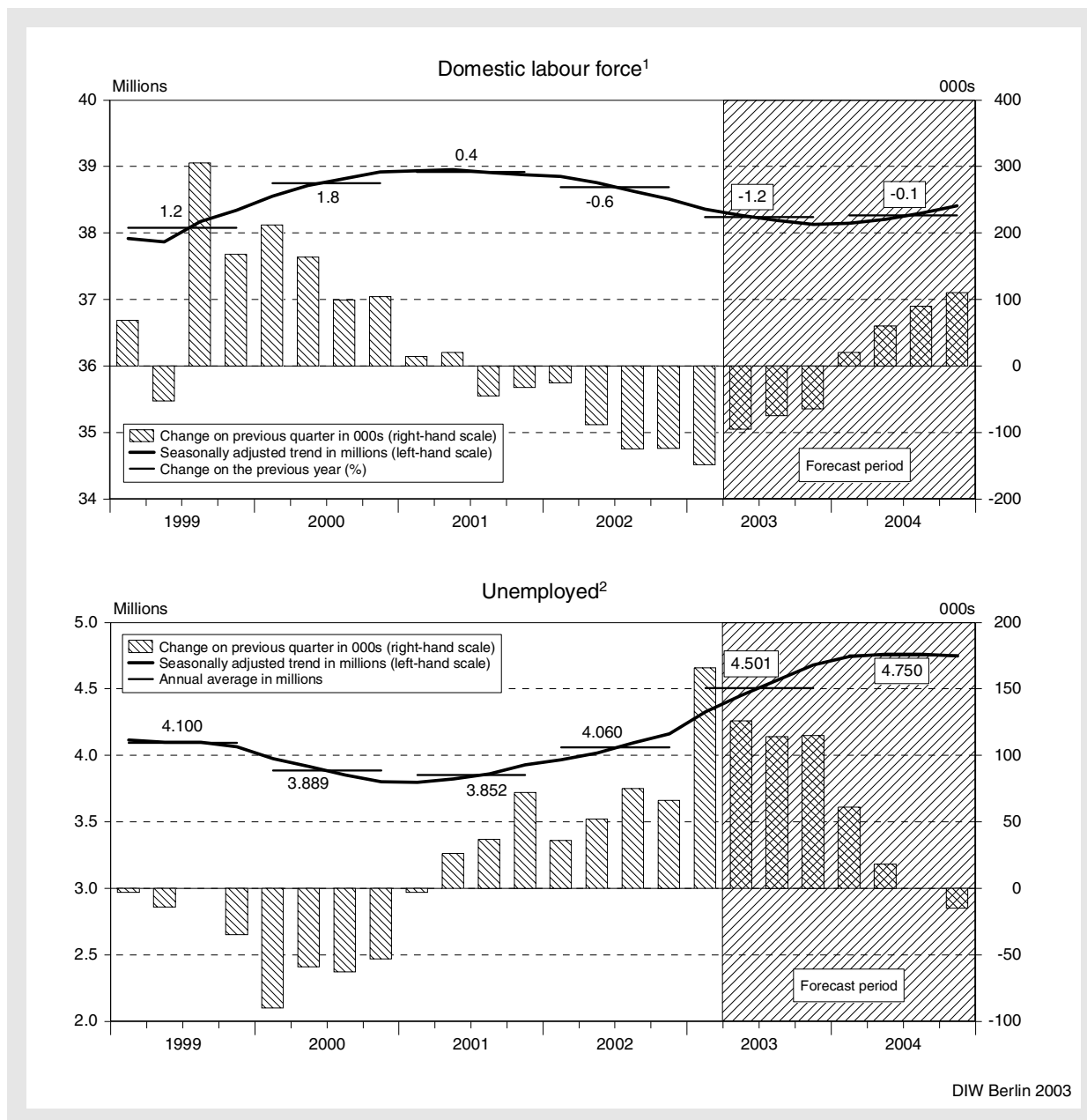
## Building Investment<sup>1</sup> in Germany

	2001	2002	2003	2004
Euro billion				
Housing	131.1	123.3	119.8	119.2
Non-residential <sup>2</sup>	96.6	91.0	86.7	86.6
Government	29.2	27.2	24.6	25.1
Other sectors	67.5	63.9	62.1	61.6
Total <sup>3</sup>	227.7	214.3	206.5	205.9
Change (%) on the previous year				
Housing	-7.1	-5.9	-2.8	-0.5
Non-residential <sup>2</sup>	-4.3	-5.8	-4.8	-0.1
Government	-5.0	-6.9	-9.6	2.2
Other sectors	-4.1	-5.3	-2.7	-0.9
Total <sup>3</sup>	-6.0	-5.9	-3.6	-0.3

1 At 1995 prices; on national accounting definitions (ESNA 95). — 2 Building construction and civil engineering for the public and private sectors. — 3 Figures may not sum due to rounding.

Sources: Federal Statistical Office; 2003 and 2004: DIW Berlin estimate and prognosis.

Figure 10  
Persons in Employment and Unemployed  
Seasonally adjusted



1 On the basis of X-12-ARIMA. — 2 Seasonally adjusted according to Berlin method (BV4).  
Sources: Federal Statistical Office; Federal Labour Office; DIW Berlin calculations.

Unemployment will continue to rise at first, and on average for this year the number out of work will reach 4.5 million. The change in the trend in employment early in 2004 will not be big enough to bring unemployment down in the first half of next year, and on average for 2004 a further rise in the number out of work by about 250 000 persons to 4.75 million is to be expected.

### Public budgets: high deficits persist

When Germany unexpectedly exceeded the deficit threshold laid down in the Maastricht Treaty last year, it was the primary aim of policy this year to bring the budget deficit down to 2.75% of GDP, despite the marked weakness in growth.<sup>3</sup> An economy programme

Table 4  
Key Forecast Figures for Germany

	2000	2001	2002	2003	2004
Gross domestic product <sup>1</sup> (percentage change over previous year)	2.9	0.6	0.2	-0.1	1.3
Western Germany	3.0	0.6	0.2	-0.2	1.3
Eastern Germany (excluding Berlin)	1.5	0.0	-0.2	0.4	1.4
Gainfully employed <sup>2</sup> (in 000s)	38 753	38 918	38 687	38 236	38 265
Unemployed (in 000s)	3 889	3 852	4 060	4 501	4 750
Unemployment rate <sup>3</sup> (as a percentage)	9.1	9.0	9.5	10.5	11.0
Not gainfully employed <sup>4</sup> (in 000s)	3 066	3 110	3 396	3 802	4 052
Percentage not gainfully employed <sup>5</sup>	7.3	7.4	8.1	9.1	9.6
Consumer prices <sup>6</sup> (percentage change over previous year)	1.5	2.0	1.4	0.7	0.7
Unit labour costs <sup>7</sup> (percentage change over previous year)	1.0	1.5	0.8	1.1	0.2
Public sector financial balance <sup>8</sup>					
Euro billion	22.8	-57.5	-76.2	-79.6	-65.9
as % of nominal GDP	-1.4	-2.8	-3.6	-3.7	-3.0

1 At 1995 prices. — 2 National (annual average based on quarterly figures). — 3 Unemployed as a percentage of the national workforce. — 4 In accordance with the convention of the International Labour Organization (ILO). — 5 Persons not gainfully employed as a percentage of the national workforce. — 6 Price index for the cost of living of all private households. — 7 Labour costs (compensation of employees per employee) in relation to labour productivity (gross domestic product at 1995 prices per person gainfully employed). — 8 As defined by the national income and expenditure accounts (ESVG95 – Europäisches System volkswirtschaftlicher Gesamtrechnungen – European System of Integrated Economic Accounts); net financial investment 2000 including special receipts from issuing mobile telephony licences (52.3 billion euros).  
Sources: Federal Statistical Office; German Bundesbank; DIW Berlin calculations; 2003 and 2004: DIW Berlin estimate and forecast.

of 14 billion euros (0.7% of GDP) was drawn up. The Federal Government, the Federal states and the municipalities had in any case agreed to keep the development in expenditures on an extremely moderate level in March 2002, on the basis of the national Stability Pact.<sup>4</sup>

According to the estimate presented here the target for the deficit will be missed by a long way again this year. The gap is put at 80 billion euros, i.e. even higher than last year. In relation to the gross domestic product the figure is 3.7%. The public sector financial position is deteriorating, although taxes and social insurance contributions have been raised and some special factors that have affected revenues have been removed as part of corporate taxation reform.<sup>5</sup> The reform of interest taxation and the reduction in tax concessions were also intended to bring additional revenues; but neither of

these projects could be realised, or they had to be greatly slimmed down. In fact tax revenues will probably only rise by 1.7% – and in cash terms by only 1.2%.<sup>6</sup> In contrast with the estimate by the Working Group on Tax Estimates the gap will be -3 billion euros. This is solely because economic activity is even more depressed, with declines expected particularly in wage tax and turnover tax. As contribution rates have been increased, revenue from these to the social insurance institutes should grow by 3%.<sup>7</sup> The decline in employment will have a dampening effect. All in all public revenues are expected to rise by only 1.7%.

The rate of public expenditure is similarly low. Expenditure on personnel should rise by 1%, that is, assuming that the number employed in the public service falls again (-1.5%). Monetary payments will grow at a much lower rate than last year, despite rising unemployment, and this will reflect the cutbacks, particularly

<sup>3</sup> Cf. Bundesministerium der Finanzen: 'Deutsches Stabilitätsprogramm, Aktualisierung Dezember 2002.'

<sup>4</sup> For 2003 and 2004 the Federal Government intends to lower its expenditure by 0.5% on average, while the federal states and the municipalities each intend to limit the growth in their expenditures to 1%. No expenditure targets are set for the social insurance institutes.

<sup>5</sup> At the start of this year energy taxes, tobacco tax and – for a period of one year – corporation tax were raised. These measures alone will bring extra tax revenue of 5.5 billion euros.

<sup>6</sup> The difference is mainly due to the period delimitation used in the national accounts and the funds that flow to the EU.

<sup>7</sup> The contribution rates to pension insurance have been raised from 19.1% to 19.5%, and the average statutory health insurance rate has gone up from 14% to 14.4%. The assessment thresholds have been raised in both pension insurance and unemployment insurance.

Table 5

Government Demand Impulses<sup>1</sup> (Local Authorities and Social Insurance)

+ expansion / – contraction

Euro billion

	1997	1998	1999	2000	2001	2002	2003	2004
<b>Taxes<sup>2</sup></b>								
Actual volume	422.04	443.64	476.05	495.81	473.92	474.7	483.7	497.7
Neutrality line	427.80	432.59	454.73	490.33	510.68	485.8	486.5	495.8
Difference	5.76	-11.05	-21.32	-5.48	36.76	11.1	2.8	-1.9
<b>Social insurance contributions</b>								
Actual volume	366.56	370.42	374.04	376.76	381.86	387.1	398.6	404.6
Neutrality line	363.57	375.72	379.68	385.26	388.06	391.4	396.7	408.6
Difference	-2.99	5.30	5.64	8.50	6.20	4.3	-1.9	4.0
<b>Other revenue<sup>3</sup></b>								
Actual volume	78.04	78.95	79.19	75.02	80.90	80.4	79.0	79.1
Neutrality line	84.19	79.99	80.92	81.57	77.27	82.9	82.4	81.0
Difference	6.15	1.04	1.73	6.55	-3.63	2.6	3.4	1.9
<b>Total revenue</b>								
Actual volume	866.64	893.01	929.28	947.59	936.68	942.1	961.3	981.4
Neutrality line	875.57	888.31	915.34	957.16	976.02	960.1	965.6	985.3
Difference	8.93	-4.70	-13.94	9.57	39.34	18.0	4.3	3.9
<b>Purchase of goods and services</b>								
Actual volume	234.83	237.00	242.27	244.11	246.53	250.2	253.3	254.3
Neutrality line	242.32	240.70	242.93	249.54	251.43	252.7	256.5	259.6
Difference	-7.49	-3.70	-0.66	-5.43	-4.90	-2.5	-3.2	-5.3
<b>Income from property (interest spending)</b>								
Actual volume	68.10	69.75	68.84	68.17	67.84	67.2	70.2	73.1
Neutrality line	69.01	69.80	71.49	70.91	70.22	69.5	68.9	72.0
Difference	-0.91	-0.05	-2.65	-2.74	-2.38	-2.3	1.3	1.1
<b>Transfers<sup>4</sup></b>								
Actual volume	578.98	593.28	610.15	626.14	643.86	667.4	680.7	685.5
Neutrality line	587.33	593.45	608.11	628.45	644.92	660.0	684.0	697.7
Difference	-8.35	-0.17	2.04	-2.31	-1.06	7.4	-3.3	-12.2
<b>Gross investment</b>								
Actual volume	35.50	35.74	37.66	36.33	35.75	33.7	32.9	31.2
Neutrality line	40.05	36.39	36.63	38.79	37.42	36.6	34.5	33.7
Difference	-4.55	-0.65	1.03	-2.46	-1.67	-3.0	-1.6	-2.5
<b>Total spending</b>								
Actual volume	917.41	935.77	958.92	974.75	993.98	1 018.4	1 037.1	1 044.1
Neutrality line	938.71	940.35	959.16	987.69	1 003.99	1 018.8	1 043.9	1 063.0
Difference	-21.30	-4.58	-0.24	-12.94	-10.01	-0.4	-6.8	-18.9
<b>Demand impulses including interest spending</b>								
Demand impulses including interest spending	-12.37	-9.28	-14.19	-3.37	29.33	17.6	-2.5	-15.0
<b>Demand impulses excluding interest spending</b>								
Demand impulses excluding interest spending	-11.46	-9.23	-11.54	-0.63	31.70	20.0	-3.8	-16.1

1 Excluding external transactions. — 2 DIW Berlin estimates. — 3 Excluding taxes of domestic sectors to the EU. — 4 Excluding EU subsidies to domestic sectors.  
Sources: Federal Statistical Office; DIW Berlin calculations.

in job creation schemes and advanced training courses run by the Federal Labour Office. Moreover, pension

adjustments will be lower because the pensions adjustment formula has been modified. Social benefits are

expected to rise less than in previous years owing to the decisions to economise in the health system.<sup>8</sup> This year a minus figure (around -2%) must again be expected in public spending on investment, even after the strong fall in 2002 – although measures to repair the infrastructure damaged by the flood are still being carried out in eastern Germany. The difficult financial situation is forcing the municipalities to procyclical investment behaviour.

For next year a fall in the public deficit to 66 billion euros is in sight. Nevertheless, the deficit rate will be 3%, as the economy will still be sluggish. It is becoming increasingly evident how much the development in the public budgets reflects the cyclical trend. In view of this efforts to limit the deficit with greater economies are like trying to hold water in a sieve.

Public revenues are forecast to rise by 2.2%. While tax revenues may be expected to grow by 3%<sup>9</sup> the rise in social insurance contributions will be only 1.5%. The second stage of income tax reform will bring tax revenues down by 6.5 billion euros, but another step towards 'normalisation' is to be expected in corporation tax revenues. Moreover, tobacco tax is to be increased again, and additional revenue is to be expected from the amnesty for earners in the black economy planned for 2004. One can only speculate on the volume the tax authorities may receive from their action on undeclared earnings. The Federal Government is hoping for additional revenue of 5 billion euros, and the federal states and municipalities will also benefit in accordance with their share of income tax. Other institutions are much more cautious in their estimate, particularly because there are still tax loopholes in Europe. In the prognosis presented here it is assumed that with a reflow of 10 billion euros about 2.5 billion euros in additional revenue will flow into the coffers.

The poor trend in employment is mainly responsible for the weak rise in social insurance contributions. The contribution rate to pension insurance is expected to rise from 19.5% to 19.8%, but the average statutory health insurance should remain unchanged. However, persons in employment will now pay 14.8%, while the contribution from the employer will go down to 14%. The aim of this redistribution is for sick pay to be financed entirely by those in employment.

The estimate that public expenditure will rise by only 0.7% next year is based largely on the assumption that the economies of 6 billion euros planned for the statutory health insurance institutes will really take effect.

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<sup>8</sup> For instance, chemists' shops and producers of drugs must grant discounts to the health insurance institutes; and the budgets for the hospitals and medical practitioners are not to be increased.

<sup>9</sup> In contrast to the result of the Working Group on Tax Estimates the deficit for 2004 will be 7 billion euros in cash receipts.

The question of higher prescription charges is still open. Expenditure on personnel will also help to keep the rise in public spending down; it is expected to fall – slightly – firstly, because further job cuts will be made in the public sector and secondly, because the public sector employers are expected to enforce cuts in holiday and Christmas bonuses.<sup>10</sup> Similarly, further cuts are to be feared in investment spending (-5%). If unemployment and social assistance benefits are merged, savings are probable here too. To conform to the pensions formula pensions should be increased by about half a percentage point in the middle of next year. It is assumed here that that step will not be taken. Otherwise, contributions to pension insurance would presumably have to rise even more.

Under the conditions and assumptions outlined here the public budgets will have a restrictive effect on the cyclical development this year and next (cf. table 5). According to DIW Berlin's Stimulus Concept,<sup>11</sup> however, the negative stimulus is small this year (2.5 billion euros), because the automatic stabilisers are fully effective. Next year 15 billion euros or 0.7% of GDP must be assumed, although the second stage of the tax reform will take effect. The intended cutbacks in spending and increases in contribution rates to social insurance will far more than compensate for that effect.

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<sup>10</sup> Under the federal regulations on remuneration in the public service officials do receive the collectively agreed increases – after a timelag, but the opening clause planned will enable cuts to be made in holiday and Christmas bonuses.

<sup>11</sup> The stimuli are held to be deviations from the actual volume in the previous year in revenues and expenditures effective in Germany – extrapolated with the nominal rise in macroeconomic potential output.

# Economic Policy

## Economic policy in crisis

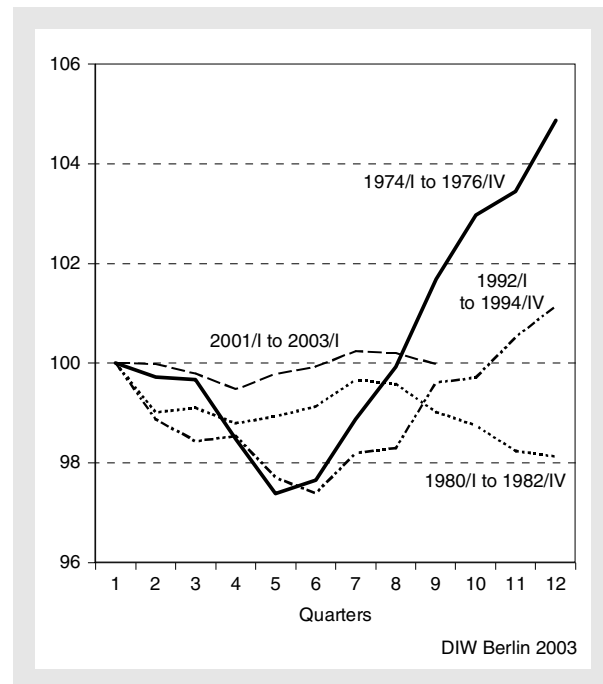
Germany is in economic crisis. This is not a deep recession, as we last saw in 1993, but during the past three years all economic dynamic has been extinguished. This is stagnation. As a result we have fast-rising unemployment, rapidly swelling public deficits and overstrained social security systems.

The prognosis presented here indicates that stagnation will persist this year. Next year we will see at best a slight acceleration in growth – and only assuming that the rise in the external value of the euro does not continue. The weak growth phase has now lasted very much longer than in earlier cycles, with the exception of the recession in the early 1980s (cf. figure 11). And now stagnation has spread to the whole of the euro zone, it is no longer a phenomenon that affects only Germany.

Economic policy is facing great challenges. In many respects a drastic change in course is needed to refocus on the macroeconomic tasks of economic policy, above all stabilising the cycle. The biggest danger of protracted stagnation is deflation. DIW Berlin was already

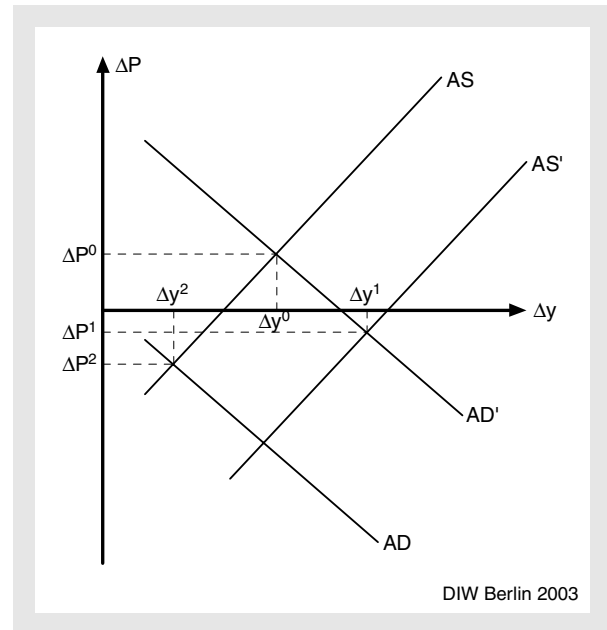
Figure 11  
Cyclical Downswings in Germany:  
Gross Domestic Product<sup>1</sup>

Quarter with each GDP peak = 100



<sup>1</sup> Seasonally adjusted, at constant prices; until 1990: West Germany (BV4), from 1991: Germany (X12-ARIMA).  
Sources: Federal Statistical Office; DIW Berlin calculations.

Figure 12  
Demand-induced  
and Supply-induced Deflation



considering the possibility of deflation last autumn, and we discussed it in detail at the turn of the year. Deflation is a process that starts gradually.<sup>12</sup> Once it has set in, it is very difficult to control, and precisely for that reason it is essential to fight it as early as possible through economic policy.

A growing number of analysts are now pointing to the danger of deflation.<sup>13</sup> A distinction needs to be drawn between two types of deflation – supply-induced and demand-induced.<sup>14</sup> Let us illustrate the difference using a simple AS-AD diagram. The inflation or deflation rate is shown on the ordinate and the growth rate in the economy as a whole on the abscissa (cf. figure 12).

In supply-induced deflation a continued fall in the price level in the economy as a whole is generally caused by considerable positive technological shocks, which lower the costs of production and cause competing companies to lower prices. This is not a single, unique effect; it results from a number of correlated positive shocks.

<sup>12</sup> Cf. 'A different opinion'. In: 'The German Economy in the Autumn of 2002'. In: *DIW Economic Bulletin*, vol. 39, no. 11, November 2002, p. 382 f and 'German Economic Trends 2003/2004'. In: *DIW Economic Bulletin*, vol. 40, no. 1, January 2003.

<sup>13</sup> Cf. Joachim Benner et al.: 'Deutschland erneut in der Rezession'. In: *Die Weltwirtschaft*, vol. 2, Kiel 2003; International Monetary Fund: 'Deflation: Determinants, Risks and Policy Options, Findings of Interdepartmental Task Force', Washington D.C., 2003.

<sup>14</sup> International Monetary Fund, loc. cit.

This is probably rather an unusual case but it could be observed recently in the transition economy in China. Supply-induced deflation can also be shown as a shift of the supply curve (AS) to the right. The inflation rate then falls from  $\Delta P^0$  to  $\Delta P^1$ . Deflation of this kind is generally actually accompanied by strong growth, as with falling prices demand rises and with it output.

In the longer term, however, problems can arise for economic stability. In any case, debts rise in value with deflation, and that causes particular problems for investors, who must expect their real debt burden to increase if they have borrowed to finance their project. Then there is a danger that the investment process will grind to a halt at some time. This will only be avoided if yield prospects are very favourable.

Much more serious are the dangers of demand-induced deflation, and this case is particularly relevant for Germany. Here the price fall in the economy as a whole is caused by negative demand shocks, meaning a shift in the demand curve (AD) to the left. The inflation rate moves from  $\Delta P^0$  to  $\Delta P^2$ . In this case production will fall; thus, deflation is linked to weak economic activity. As a result, exactly the same debt problems arise as with supply-induced deflation. Moreover, a downward price-wage spiral will probably be started that will intensify the debt problems.

How persistent deflation will be depends on market participants' expectations of future price developments.<sup>15</sup> If deflationary expectations have taken a firm hold – that is, if people generally expect prices to go on falling – there is an incentive to postpone expenditure. That, too, intensifies the economic crisis and can lead into a downward spiral.

If only for that reason it is of the greatest importance to combat deflation before it has really taken hold,<sup>16</sup> and the more so as monetary policy loses its main instrument if the short-term nominal interest rate has once come close to zero. The economy may get caught in a liquidity trap, and then it is of crucial importance for monetary policy to state credibly that reflation will be lasting.<sup>17</sup>

Under the conditions of demand-induced deflation fiscal policy comes under pressure from two sides: from the weakness in the economy and from the growing real debt burden.

In Germany all the conditions for deflation are present.<sup>18</sup> The inflationary trend has fallen below the 1 percent mark and is therefore in a range that can

already be regarded as pre-deflationary, taking into account errors in measurement. The protracted stagnation in Germany has led to considerable excess capacities, and these are exercising continued pressure on prices. That in itself is a major precursor of deflation.<sup>19</sup> The wage trend is coming under increasing pressure, independently of the negotiated rates. Companies are reducing overtime and cutting payments above collectively agreed rates. Some, particularly companies in eastern Germany, have already left the employers' associations or intend to do so, particularly those in the public sector, so that collective agreements are becoming less binding on firms. On the share markets, yield expectations have by no means returned to earlier levels, despite signs of recovery after the Iraq war, and finally, the development in lending is extremely weak. In addition, increasing pressure is being put on the domestic price level by imports as a result of the rise in the external value of the euro. All these factors together are a very dangerous mix.

It must therefore be the central task of economic policy to combat stagnation and the deflationary tendencies. The primary responsibility falls on monetary policy. It alone can build up a sufficiently strong barrier against deflation by pursuing an interest rate policy that will lower rates sufficiently, and well enough in advance, to cause expectations of price increases. Of course this argument is not sufficient for the ECB to take action if there is only a danger of deflation in Germany. The danger must also be evident for the euro zone as a whole. However, there are still great divergencies in inflation rates between EMU member states, and measured by the ECB's target for inflation many are high. This is because the repercussions of the oil price shock have not yet been overcome in every member state. Hence, *prima facie* strong reaction by the ECB would be difficult. However, in view of the fact that the stagnation tendency has now spread from Germany to the whole of the euro zone<sup>20</sup> and that the price trend has slackened almost everywhere, a clear signal on interest rates would certainly be appropriate.

In this situation fiscal policy is also challenged to move on to a decidedly expansionary course. Combating stagnation and the risks of deflation must have priority before short-term consolidation measures, for in a deflation, as we have certainly seen in Japan, any attempt at consolidation fails. In a long period of weak economic growth both tax revenues and income to the social

<sup>15</sup> Cf. Paul Krugman: 'Can inflation be prevented?' ([www.pkarchive.org/economy/deflator.html](http://www.pkarchive.org/economy/deflator.html)).

<sup>16</sup> Cf. Alan Ahearne et al., loc. cit.

<sup>17</sup> Cf. International Monetary Fund, loc. cit.

<sup>18</sup> Cf. International Monetary Fund, loc. cit.

<sup>19</sup> Cf. also Paul Krugman in the *New York Times* of 24 May 2003.

<sup>20</sup> Simulations by DIW Berlin have shown that deflationary tendencies in a relatively large country in the common currency zone cannot be overcome through foreign trade. Cf. 'German Economic Trends 2003/2004', loc. cit.

insurance institutes will be far too low and expenditure, particularly on social security, far too high to enable the government to come even close to the target of a balanced budget.

Only if such coordinated action in fiscal and monetary policy can be implemented will a clear signal be given that the deflationary tendencies are to be countered. If it does not happen, the tendency to stagnation will become firmly established, not only in Germany but throughout the euro zone. The path from that to deflation is short.

## More action needed in monetary policy

The European Central Bank changed the formulation and implementation of some important aspects of its monetary policy strategy in the spring. The changes largely corresponded to the proposals published by DIW Berlin and others at the start of the year.<sup>21</sup> Specifically, the medium-term nature of money supply as an orientation figure was confirmed and the ECB's inflation target set more precisely.<sup>22</sup>

In stressing the medium-term nature of the money supply the ECB confirmed its de facto monetary policy and removed a misleading representation of the importance of the money stock in monetary policy strategy. Money supply and the other monetary aggregates now have the role which they can indeed play, namely to function as information variables for the medium-term price outlook. In defining price stability – its inflation target – more precisely the ECB took its original definition as starting point. So it is still aiming for 'a rise in the harmonised consumer price index (HCPI) for the euro currency area of less than 2% from the previous year'. The problem of the lower threshold of the inflation target, that had not, until then, been clearly stated, was solved in that sustaining a medium-term rate of price increases of nearly 2% was expressly set as the target. In the new inflation target the upper limit, lower threshold and target point now de facto coincide.<sup>23</sup> As the reasons for this de facto increase in the inflation target the ECB names the scope for monetary policy in situations with a risk of deflation, possible errors in calculating the

HCPI and possible differences in inflation rates between countries in the euro zone. DIW Berlin had also stressed that a numerically precise inflation target will serve market participants, and especially those involved in the wage formation process, better as a guideline.<sup>24</sup> In confirming the medium-term upper limit for the inflation rate while at the same time moving the target point very close to that upper limit the ECB has now set a de facto target point of 2%, and at the same time stressed that it will not tolerate the target being exceeded by wage policy.

It is not clear why the ECB finds it so difficult to specify the inflation target and set it clearly at 2%. Furthermore, a clear statement from the ECB is missing on how it intends to fulfil the task laid down in the EU Treaty to support the general economic policy.<sup>25</sup>

The powerful rises in the external value of the euro since the spring of last year have put a further damper on economic activity in the euro zone, which was weak in any case. This is also reflected in the latest growth prognoses from the ECB, which is only expecting growth of 0.7% in GDP for this year and 1.6% for next year (cf. table 6).

Accordingly, the production gap will grow markedly this year and next year, while most of the inflation forecasts for the coming year are clearly below the ECB's target, and risks of accelerating inflation are minimal. In that situation a further relaxation of monetary policy is necessary. The expansive stimulus should have been stronger at the beginning of this year, for as early as December 2002 the ECB was revising its growth forecast of the year before markedly down – by 0.9 percentage points; in the latest prognosis the correction is by 1.8 percentage points. So far the ECB has only reacted to this drastic revision of the economic outlook by lowering its interest rate by 1.25 percentage points, which according to its own studies may be expected to have a real economic effect of only around 0.6% of GDP.<sup>26</sup>

In assessing the outlook for inflation in the euro zone a distinction has to be drawn between short-term developments and the underlying dynamic in inflation. At present the oil price is having a markedly dampening effect on prices. This is a positive supply shock, and it is primarily causing the price level to move downwards.

<sup>21</sup> Cf. Silke Tober: 'Reform der geldpolitischen Strategie der Europäischen Zentralbank', loc. cit.; 'The World Economy and the German Economy in the Spring of 2003', loc. cit., p. 137 ff.

<sup>22</sup> Cf. 'Die geldpolitische Strategie der EZB', press release by the ECB, 8 May 2003.

<sup>23</sup> Consequently, the ECB ought to raise the reference figure for growth in the money supply by half a percentage point, as hitherto it has been based on an inflation target of 1.5%. Cf. 'Reform der geldpolitischen Strategie', loc. cit.

<sup>24</sup> Cf. 'Die geldpolitische Strategie der EZB', loc. cit.

<sup>25</sup> The EU Treaty states: 'Without prejudice to the objective of price stability, the ECB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2'. The objectives include 'a harmonious, balanced and sustainable development of economic activities, (and) a high level of employment', Art. 105 (1) and Art. 2, Treaty Establishing the European Community, consolidated version.

<sup>26</sup> European Central Bank, Monthly Report for October 2002.

Table 6

## Forecast of GDP and Inflation (HICP) in the Euro Zone, 2003 and 2004

	GDP			HICP		
	2002	2003	2004	2002	2003	2004
ECB projection June 2003 <sup>1</sup>	0.9	0.7	1.6	2.2	1.8	1.3
ECB projection December 2002 <sup>1</sup>	0.8	1.6	2.4	1.6	1.5	1.6
ECB projection December 2001 <sup>1</sup>	1.2	2.5	.	1.5	1.9	.
OECD April 2003	0.9	1.0	2.4	2.4	2.0	1.6
Consensus June 2003	0.8	0.7	1.8	2.3	1.9	1.5
DIW Berlin July 2003	0.8	0.5	1.5	2.3	1.8	1.4

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

Sources: ECB; OECD; DIW Berlin calculations.

The strong rise in the external value of the euro is having a similar effect. However, the decisive factor in shaping monetary policy should be the underlying dynamic in inflation, and this is mainly influenced by the development in wages and profits. The development in wages should slacken, helped by the concretisation of the ECB's inflation target, as the second round effects of the increases in oil prices in recent years peter out. The development in profits will probably also remain rather weak as demand as a whole is slack, so that altogether the core inflation rate will also be clearly below the ECB's inflation target next year.

Monetary policy rules, such as the Taylor Rule, provide a range for the key interest rate, which is currently of equal importance, of between 0.6% and 3.5%, depending on how high the equally important real interest rate and the production gap are estimated to be, and how strongly the production gap on the one hand and the inflation gap on the other are weighted.<sup>27</sup> DIW Berlin regards a further reduction in interest rates – initially by 0.5 percentage points – as appropriate. This view is supported by the fact that owing to the high level of open and hidden unemployment in the euro zone the gross domestic product can grow much more strongly

over several years than many estimates of the production gap would suggest, as they derive a weak potential in their calculation based on persistent cyclical weakness. In the course of an upswing not only would the registered unemployed be integrated in the economic process; the workforce would also grow as job prospects improved. Moreover, it seems a high weighting of the production gap in monetary policy calculations would also make sense, as various studies have shown that the greater stability in production is bought at the price of only slightly higher variability in inflation.<sup>28</sup> Not least, the ECB should thereby signal that it is combating deflationary tendencies at an early stage.

## Wage Policy

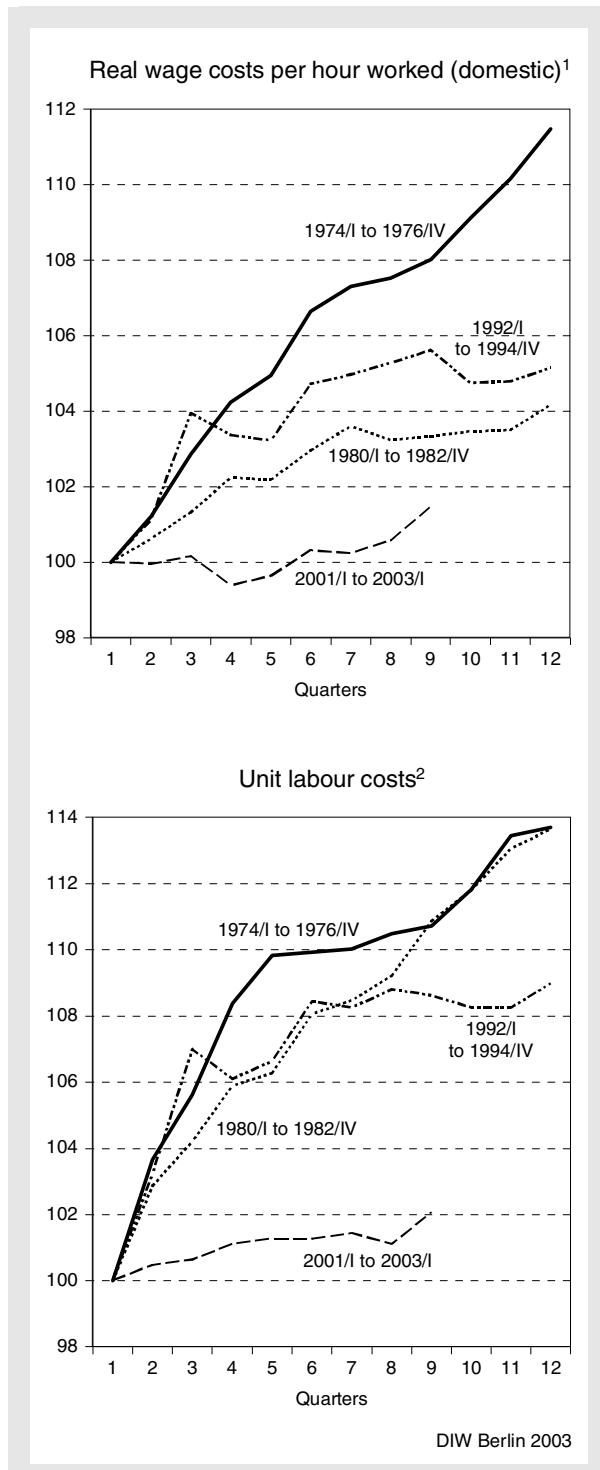
The deflationary tendencies have already left deep marks in the development in wages last year. The negotiated rates for 2002 were in accordance with stability, with an increase of 2.6% on average, and at 2.5% the same applies to this year. That is assuming a rise in the productivity trend of 1.5%, an acceptable inflation rate also of 1.5%, and a necessary discount of 0.5% for the rise in subsidiary wage costs.<sup>29</sup> Under 'normal' conditions the development in wages would therefore not have been an obstacle to an increase in employment. And the argument often put forward, that the development in productivity assumed is too high because it also includes gains in productivity from redundancies, is not

<sup>27</sup> A Taylor interest rate of 0.55% will result if a real interest rate of 2.5% and an inflation rate of 1.4% (2004) are assumed, and the inflation gap (1.4% to 1.9%) is weighted with 0.5 and the production gap for 2004 (-3.1%) with 1. The production gap is then based on an extrapolation of the International Monetary Fund's production gap on the basis of DIW's prognosis for GDP in 2004. On the other hand, a Taylor interest rate of 3.5% would result if the actual inflation rate of 1.9% as well as the real interest rate of 2.5% and a corresponding inflation gap of zero are assumed. In this case the OECD's estimated production gap for this year of -1.8% would be weighted with 0.5. On the calculation of the Taylor rate see also Silke Tober: 'Europäische Geldpolitik – Expansionskurs beibehalten.' In: *Wochenbericht des DIW Berlin*, no. 12/2002, p. 208. The IMF and OECD estimates of the production gap are in: OECD Economic Outlook, April 2003, p. 23; IMF: World Economic Outlook, Washington D.C., April 2003, p. 18.

<sup>28</sup> Cf. Lawrence Ball: 'Policy Rules for Open Economies'. In: John Taylor (ed.): 'Monetary Policy Rules', NBER, London 1999; John Taylor: 'A Historical Analysis of Monetary Policy Rules'. In: John Taylor (ed.), loc. cit.

<sup>29</sup> With the new accentuation in the ECB's strategy an inflation target of 2% can be assumed for the future as well.

Figure 13  
**Cyclical Downswings in Germany:  
 Real Wage Costs and Unit Wage Costs**  
 Quarter with each GDP peak = 100



1 Seasonally adjusted; deflated with the GDP deflator; until 1990: West Germany; from 1991: Germany. — 2 Wage costs (wage per person employed) in relation to labour productivity (GDP at 1995 prices per person employed); seasonally adjusted; until 1990: West Germany (BV4), from 1991: Germany (X12-ARIMA)  
 Sources: Federal Statistical Office; DIW Berlin calculations.

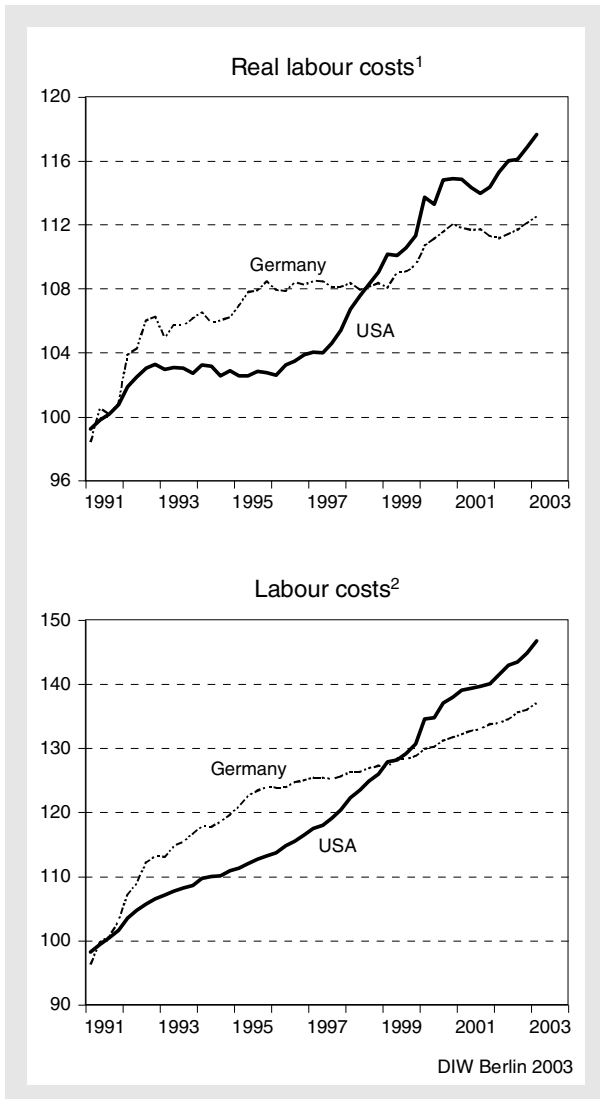
tenable for two reasons. Firstly, trend growth of 1.5% takes into account the weaker development in productivity in past years, so that it takes due account of the weakness in growth. Secondly, it is only appropriate to take 'redundancy productivity' into account if the redundancies can be shown to be due to excessively high wage agreements. In that case a correction through wage restraint could indeed follow. However, if the redundancies are the result of lack of demand, wage restraint will not bring about a correction in the employment trend either.

But all these considerations are rather of a theoretical nature in the present situation, for the negotiated wage rates have become less and less important for actual wages. The wage drift, that is, the difference between the actual increase in wages and the increase in the collectively agreed rates, was -0.8 percentage points last year, an extraordinarily low figure. It shows that companies are not only reducing more overtime, they are also increasingly cutting back on payments above the collectively agreed rates. This is precisely where the wage pressure manifests itself. It is characteristic of a pre-deflationary development. Thus, actual wages only rose by 1.8%.

This wage pressure will continue as economic activity is weak. But that means that the development in wages will continue to exert pressure towards ever lower price increases. In no other downswing have wage costs risen as little as at present (cf. figure 13). In all earlier downswings some considerable increases in unit wage costs were registered, and in some cases these were actually the reason for the Bundesbank to pursue a restrictive course, which induced the downswing. There can be no question of that now. At the start of the present downswing wage costs were hardly rising at all.

In past years the USA, a large economy, has registered the highest growth rates in employment. If the development in wages in Germany is compared with that in the USA, it is evident that in the early 1990s both nominal and real wage costs were rising much more strongly in Germany than in the USA (cf. figure 14). That was mainly due to the over-hasty wage adjustment in eastern Germany after reunification. Since the mid-1990s, however, the development has been the reverse, and since the end of that decade the level of labour costs, standardised to the level in the early 1990s, has been lower in Germany. As unemployment was higher in the USA than in Germany in the early 1990s the general development in wage costs cannot be the main reason why unemployment is so much higher in Germany today. That would only apply if wage costs here had risen more strongly over the period in question than in the USA. That does not exclude the possibility that in certain segments of the labour market lower wages or

Figure 14  
**Labour Costs in the USA and Germany**  
 1991 = 100



1 Wage per person employed; deflated with the GDP deflator. — 2 Wages to persons employed in national currency per person employed.  
 Sources: OECD; Federal Statistical Office; DIW Berlin calculations.

accelerated qualification can lead to higher employment (cf. figure 15).

An effect which many are hoping for from wage restraint is an improvement in the price competitiveness of German exporters on international markets, because unit wage costs particularly are rising less than those of our trading partners. More exports should bring the hoped-for recovery (cf. figure 16). If unit wage costs in the economy as a whole are taken as the standard, for they reflect the development in wages in relation to the development in productivity, Germany has actually gained competitiveness against all the major industrial

countries except Japan with its moderate wage development.<sup>30</sup> At present, however, the appreciation of the euro is hampering that. It is not lack of international competitiveness but weak domestic demand that is currently dampening economy activity in Germany. The current low level of exports from Germany is not the key factor, for exports by the other countries are even more depressed.

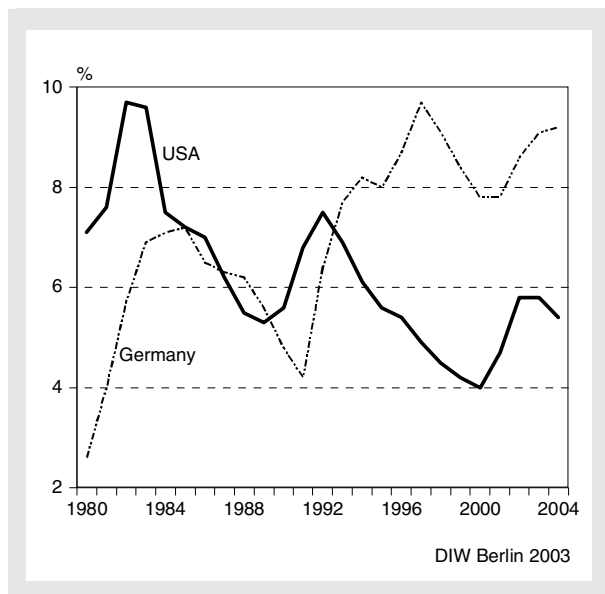
Following the oil price shock a remarkable wage divergence has developed within the euro zone. In such countries as Germany and Austria wage policy reacted with restraint to the shock, while in countries such as Spain, Italy and above all the Netherlands the shocks have caused notable secondary effects in the form of high wage increases. At present, then, the wage development in Germany particularly is helping to maintain price stability in the euro zone. This one-sided divergency in the wage development cannot last, for disequilibria would almost certainly develop in member states' competitiveness and the ability of the ECB to stabilise on the macroeconomic level would be reduced.

### Fiscal policy

Fiscal policy is facing the ruin of the strategy it has pursued for some years now. The attempt to consolidate the public budget on the basis of short-term deficit targets can be regarded as a failure. As we saw a good ten years ago in the USA, it has become evident that it is hardly possible to reduce the deficit without a cyclical tail wind. This is firstly because since the downswing started three years ago the consolidation effect of all the economy programmes has repeatedly been rendered useless by the negative effects on the public budgets of the level of economic activity. In turn, the efforts to economise in the public sector have slowed economic activity down further. Secondly, it has not proved possible to stimulate economic activity and growth with tax concessions, even though some were massive. As a result the deficits in the public budgets have risen to far beyond the expected level. Against that background it would be unjustified to argue that the high deficits are due to unsound fiscal management on the various levels of government. Germany's negative experience with consolidation strategy is shared by France, Italy and Portugal in their fiscal policy. In other words: the strategy on which the Stability and Growth Pact (SGP) is based is a

<sup>30</sup> This indicator is based on the economy as a whole and ignores exchange rate fluctuations. Thus, it is preferable to unit wage costs in manufacturing alone, in international currency, which is frequently used as an indicator and includes exchange rate fluctuations.

Figure 15  
Standardised Unemployment Rate  
in the USA and Germany



Sources: OECD; 2003 and 2004; DIW Berlin calculations.

failure, at least where economic activity is grinding down.

Italy and France are largely ignoring the Stability and Growth Pact now. Despite the attempts by the European Commission to assist Germany in particular in its fiscal policy by interpreting the SGP more flexibly, we are also in danger of finding ourselves with no sense of direction for consolidation policy. That must definitely be avoided. Certainly, greater cyclical flexibility than practised hitherto is urgently needed, but there is a risk that both the markets and the general public will lose confidence in medium-term budget consolidation, and this could have negative consequences on the capital markets.

For that reason a change in the strategy that takes due account of both objectives – medium-term consolidation and cyclical flexibility – is urgently needed. For a long time now DIW Berlin has repeatedly been pointing out the advantages in this regard of a consolidation strategy oriented to a fixed path of expenditure.<sup>31</sup> In the present situation an approach would be appropriate that on the one side would provide the urgently needed economic stimulus and on the other would ensure medium-term consolidation. Hence a decision to bring the tax reform forward and at the same time accelerate the reduction in subsidies, but extend this over a longer period, would in principle be meaningful. However, too

<sup>31</sup> Cf. i. a. 'German Economic Trends 2003/2004', loc. cit.

much should not be expected of bringing forward the tax reform. For this means firstly that the expansionary effects of the tax reform will compensate for the restrictive effects of fiscal policy that are due to be felt next year – higher contributions and cutbacks in spending. It must also be taken into account that the tax relief will mainly benefit higher income groups, whose inclination to spend is relatively low. Moreover, measures to finance the tax reductions will hinder the expansionary effect. It is clear that an upswing cannot be initiated solely by bringing the next stage of the tax reform forward, even if the reduction in subsidies to finance it will only take effect later. More far-reaching measures are needed if fiscal policy is to have any notable stimulating effect.

For example, persons paying social insurance contributions are still burdened with considerable non-insurance costs, despite high Federal Government grants to the social insurance institutes.<sup>32</sup> This mismatch could be corrected with an appropriate reduction in social insurance contributions financed with corresponding tax increases but at a later date; the result could be a notable stimulus. It would be the only tangible corrective course in fiscal policy, and it would at the same time bring desirable structural changes and so correct economic policy mistakes made during the German reunification process. Moreover, if fiscal policy stabilisation is carried out in a European context, particularly in cooperation with Italy and France, it would be a convincing contribution to stimulating the very sluggish economic activity in the euro zone as well.

### The effects of bringing the third stage of tax reform forward to 2004

The fiscal effects on income tax (including the solidarity premium) that result from bringing the third stage of tax reform forward to 2004 are shown in table 7. The differences from the expected effects on revenues and distribution under the current legislation – including the second stage of tax reform in 2004 – were calculated. The calculations were made with DIW Berlin's income tax simulation model,<sup>33</sup> which creates a detailed simulation programme that is very close to reality, using

<sup>32</sup> Cf. Volker Meinhardt: 'Weiterhin hohe Transfers an die ostdeutschen Sozialversicherungsträger'. In: *Wochenbericht des DIW Berlin*, no. 45/1999

<sup>33</sup> Cf. Stefan Bach and Erika Schulz: 'Fortschreibungs- und Hochrechnungsrahmen für ein Einkommenssteuer-Simulationsmodell, Project Report 1 on the Joint Research Project 'Mikrosimulation' with the Federal Ministry of Finance.' In: *Materialien des DIW Berlin*, no. 26, December 2002 ([www.diw.de/deutsch/publikationen/materialien/docs/papers/diw\\_rn03-05-26.pdf](http://www.diw.de/deutsch/publikationen/materialien/docs/papers/diw_rn03-05-26.pdf)).

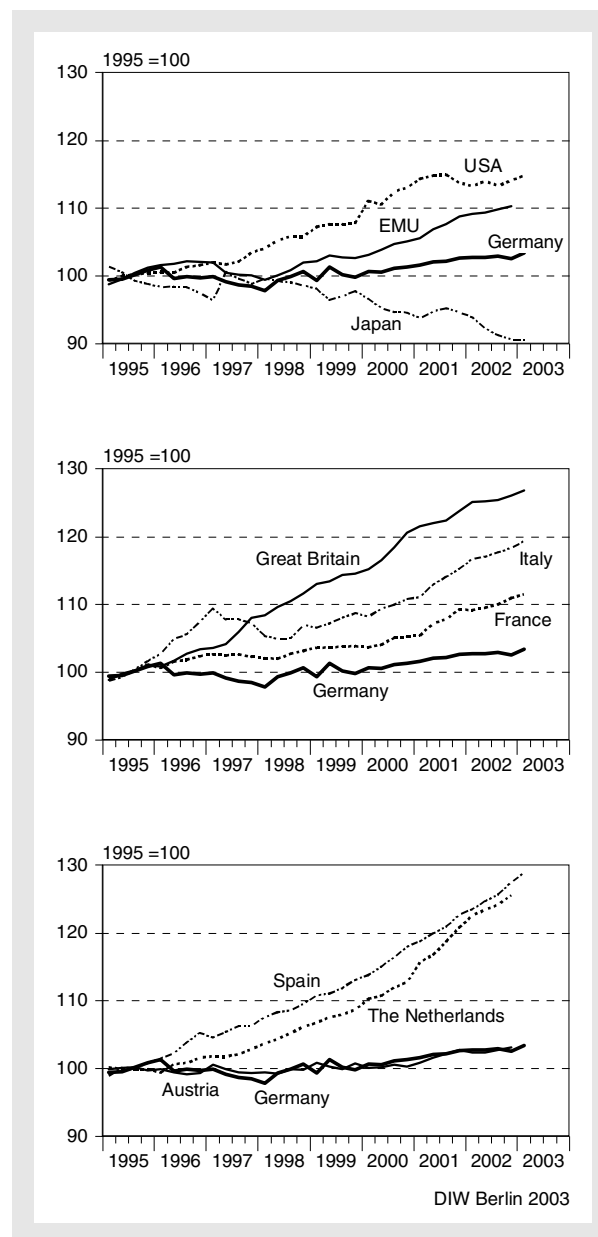
extrapolated assessment data from the income tax statistics under the income tax legislation currently in force.<sup>34</sup> The extrapolation of the basic data is made on the basis of the macroeconomic prognosis for 2004 presented here.

The simulations have shown that bringing the third stage of tax reform forward would reduce tax revenue in 2004 by altogether 16.3 billion euros; of this the solidarity premium would account for 0.8 billion euros. The difference from earlier calculations by the Federal Ministry of Finance, which resulted in a figure of 18 billion euros, occurs, because the income level and the employment level are now much lower than was assumed at that time. The model simulates the tax revenue after completion of the assessment for the calendar year 2004; so it could be that a small part of the tax relief will only reach taxpayers in later years – if the advance payments by the self-employed or those receiving high incomes from capital are not sufficiently adjusted.

The main tax relief will accrue to those on higher incomes. Only 32% of the volume of tax relief will go to taxpayers earning up to 50 000 euros – who account for 81% of all taxpayers.<sup>35</sup> The tax relief also rises with disposable income (i.e. income after tax and social insurance contributions).<sup>36</sup> The cumulation of tax relief in the upper income groups is due to the progressive tax scale and the marked reduction in the top rate of tax from 47% to 42% (cf. figure 17). The increase in the personal free allowance by 238 euros and the reduction in the bottom rates of tax will have only a slight effect for the lower and middle income groups.

The macroeconomic effects of bringing the third stage of tax reform forward to 2004 were calculated using the DIW Berlin econometric cyclical model (the EBC Model).<sup>37</sup> Of the expected total tax relief of 16.3 bil-

Figure 16  
Unit Labour Costs<sup>1</sup>  
in International Comparison



<sup>1</sup> Gross income from dependent employment as a share of real GDP; seasonally adjusted.  
Sources: OECD; Federal Statistical Office; DIW Berlin calculations.

<sup>34</sup> Stefan Bach, Hermann Buslei, Dagmar Svindland, Hans. J. Baumgartner, Juliane Flach and Dieter Teichmann: 'Untersuchung zu den Wirkungen der gegenwärtigen Ehegattenbesteuerung auf Grundlage von fortgeschriebenen Einzeldaten der Einkommenssteuerstatistik, Project Report 2 on the Joint Research Project – Mikrosimulation – with the Federal Ministry of Finance.' In: *Materialien des DIW Berlin*, no. 27, January 2003 ([www.diw.de/deutsch/publikationen/materialien/docs/papers/diw\\_rn03-05-27.pdf](http://www.diw.de/deutsch/publikationen/materialien/docs/papers/diw_rn03-05-27.pdf)).

<sup>35</sup> The average taxable income of married taxpayers is 48 000 euros, and that of single persons 24 000 euros; the figure for all taxpayers is 37 000 euros.

<sup>36</sup> For this calculation information from the tax statistics is used first to calculate a kind of gross household income as income before income tax. As well as the total taxable income this also includes tax-free income and tax concessions (that have reduced taxable income). Then an income after tax and social insurance contributions is calculated, as a kind of net household income, by deducting the income tax fixed, adding child benefits and deducting the solidarity premium, social insurance contributions paid by persons in employment and comparable expenditure by the self-employed, who are not liable to these contributions.

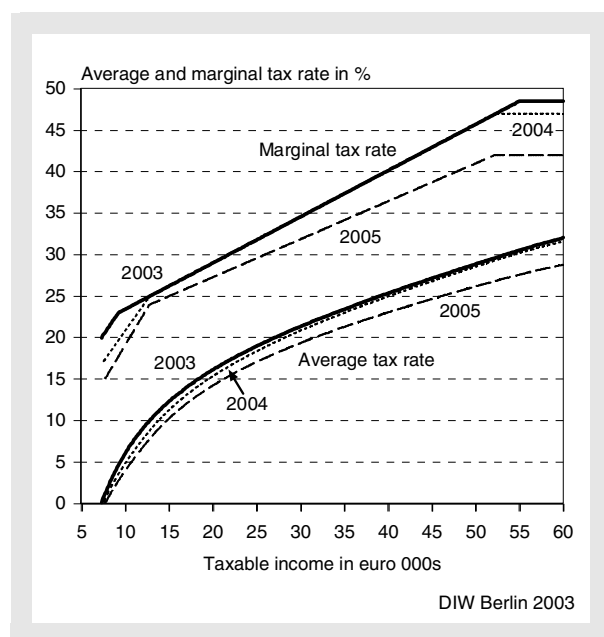
lion euros it is assumed that 12 billion euros will be wage tax and 4.3 billion euros assessed income tax. As a result of the tax relief economic growth should be 0.3 percentage points higher even in 2004, that is, altogether

<sup>37</sup> Cf. Rudolf Zwiener: 'Modelling the Public Sector of Germany in the European Business Cycle Model'. In: *Research Notes DIW Berlin*, no. 24, Berlin, January 2003.

1.6% instead of the forecast 1.3%. The model also shows growth effects for 2005. The biggest factor here will be the clearly better trend in private consumption. But private investment will also be stimulated. Private households' savings ratio will clearly rise in 2004 as a result of bringing the tax reform forward, but it will then return to normal: private households will thus react rather slowly in their consumer spending to increases in income. In the model, part of the stimulating effects to the economy are shifted to 2005. The public sector deficit will rise in 2004, almost to the full extent of the tax reduction, and the deficit rate will be 0.7 percentage points higher. The self-financing effects of the tax reform will only occur in later years. In 2006 the financing deficit will presumably be below that of the base year (cf. figure 18).

Another simulation shows, parallel to the advancement of the tax reform, a reaction by the three levels of government to the ensuing tax revenue shortfalls. This reaction reflects the bad financial situation, and it will probably consist in reducing public sector investment and consumption (expenditure on fixed assets and employment in the public sector). It is assumed that public sector investment and consumption in 2004 will each be 1.6 billion euros lower than they would be if the tax reform were not brought forward. A further assumption in the simulation is that to finance the tax reduction, subsidies will be gradually reduced (the owner-occupier

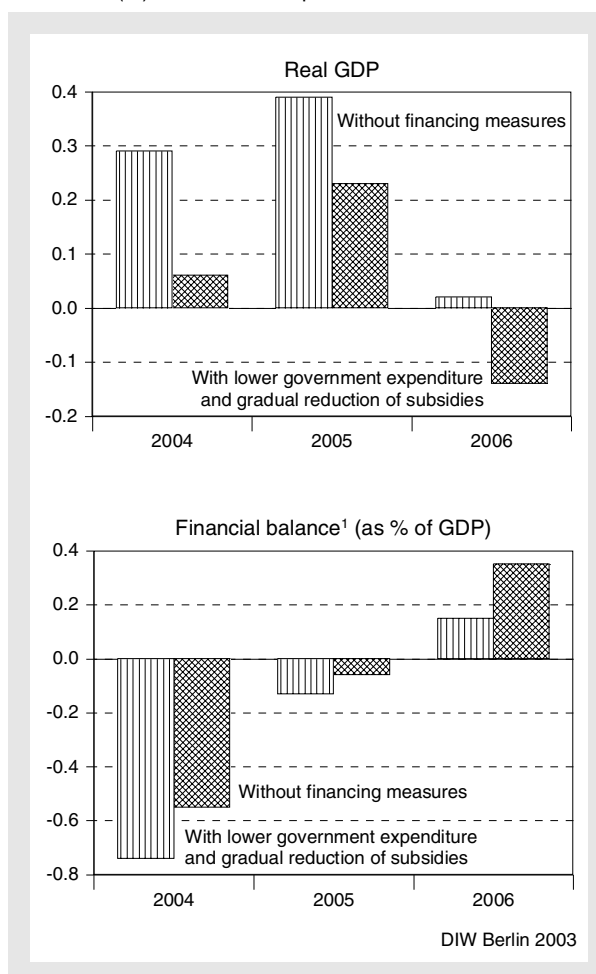
**Figure 17**  
**Income Tax Scale 2003, 2004 and 2005**  
Basic table



Sources: OECD; 2003 and 2004; DIW Berlin calculations.

**Figure 18**  
**Growth Effects of Bringing the Third Stage of Tax Reform Forward to 2004**

Deviations (%) from the development without this



1 - : higher public deficits.  
Sources: OECD; 2003 and 2004; DIW Berlin calculations.

grant, the long-distance allowance and tax exemption for bonuses for Sunday, public holiday and night work) by 1.6 billion euros and gradually in the two following years by a further 3.2 billion euros and 4.8 billion euros, respectively.

If the tax reform is brought forward and expenditure on public sector consumption and investment is lower, and if the reduction of subsidies starts in 2004, little will remain of the growth effects of bringing the tax reform forward, and macroeconomic growth would then be only 0.1 percentage points higher in 2004 and 2005. Ultimately, the withdrawal effects of lower public sector spending and reductions in subsidies will be almost as great as the stimulating effects of bringing the tax reform forward. Compared with a situation without the tax reform brought forward, the public deficit in this

Table 7

## Change in Income Tax and Solidarity Premium in 2004 by 2005 Income Tax Scale

By family status and income class

Total contribution from incomes <sup>1</sup> from ... to less than... 1 000 Euro	Fall in tax revenue/tax burden							Memo item: All taxpayers	
	Single	Married <sup>2</sup>	All taxpayers		Single	Married <sup>2</sup>	All taxpayers		
	in million euros			cumulative, (%)	percentage of income after tax and social security contributions <sup>3</sup>			in 1 000	cumulative, (%)
under 25	810	130	940	5.8	0.7	0.2	0.5	12 420	44
25 to 30	610	210	820	10.8	1.8	0.8	1.3	2 950	54
30 to 40	1 140	690	1 830	22.0	2.3	1.1	1.6	4 670	70
40 to 50	790	880	1 670	32.2	2.9	1.3	1.8	2 940	81
50 to 75	920	2 140	3 060	51.0	3.9	1.7	2.1	3 530	93
75 to 100	350	1 240	1 590	60.7	4.7	2.2	2.5	1 060	97
100 and more	1 460	4 950	6 410	100.0	6.1	4.5	4.8	890	100
Total	6 080	10 240	16 320	.	2.2	2.0	2.0	28 460	.

1 Taxable gross income. — 2 Married taxpayers (splitting table) are considered as one taxpayer. — 3 Sum of income plus tax-free income, tax free share of pension received, tax concessions and child allowances, minus assessed income tax, solidarity premium, social insurance contributions paid by persons in employment and comparable expenditure by taxpayers not liable for these.

Sources: Calculated using DIW Berlin' Income Tax Simulation Model.

simulation is around 12 billion euros higher in 2004 – and the deficit rate a good half a percentage point higher. Notable savings will only be achieved from 2006 onwards.

### Reducing subsidies

A consistent reduction of subsidies is not only indicated for economic reasons; it could also make an important contribution to successive financing. The realisation of the third stage of the tax reform ahead of schedule in 2004. If the Federal Government does not want simply to cut all subsidies by a specific percentage, use the 'lawn mower', in other words, it faces the difficult task of choosing which subsidies to cut. The choice can be made either by the potential for savings or – for lack of informative empirical analyses – on the basis of the suspected economic costs and benefits.

Housing construction receives the strongest promotion, according to the Federal Government's report on subsidisation, at a good 10 billion euros. Certainly this subsidy made a considerable contribution to ending the housing shortage in the past, but in view of the current over-supply on the housing market further promotion hardly seems economically meaningful. The owner-occupier grant in particular poses problems because it

encourages migration from the town into the surrounding area with the attendant undesirable effects (the 'bonus for emptying the inner cities'). Granting tax exemption for work on Sundays, public holidays and at night is questionable in terms of economic policy, as it may well entail tax revenue shortfalls of about 2 billion euros a year. Greater demands made on workers through shift work and so on should be reflected in their earnings and not paid for by the general public. The possibility of offsetting travel costs between home and work (long-distance allowance) from tax payable will cost an estimated 6 billion euros. It is not justifiable at least insofar as employees pay much lower prices for property or rent if they move well out of densely populated areas. There are also objections on ecological grounds.

Besides these significant fiscal concessions there are a large number of exceptions. Each in itself is of minor importance quantitatively, but they do give cause for concern because most are permanent subsidies that are primarily designed to secure incomes. They include, for example, cheaper gas and oil for farmers (300 million euros), support for German brandy distillers (150 million euros) and tax exemption for heavy oil used as fuel (240 million euros).

However, experience to date has shown that singling out individual subsidies and tax concessions, even if

### Possibilities for Taxing Income from Property and Capital

DIW Berlin carried out a study on possibilities for reforming the taxation of property in Germany.<sup>1</sup> It revealed that private households in Germany have considerable property. If all the fixed assets and monetary assets were included in the tax assessment (including monetary investments abroad) and real estate and commercial assets were valued at close to market rates (on average at least 80% of the saleable value) 1.6 billion euros would be taxed, even with a free allowance of 500 000 euros per household. A current property tax of 1% (this was the rate of property tax on private assets up to 1996) could therefore yield 16 billion euros in revenue.

However, in reforming the current taxation of property high marginal taxation of property earnings should be avoided as this demotivates investors and provides incentives to creative accounting or tax evasion. But even more effective taxation of profits and income from property in income and corporation tax could yield a similarly high additional revenue. It would also make the tax system more neutral and fair. A separate

property tax is only needed if the aim is decidedly to tap the potential yield on property. But the legislator could also incorporate elements of property taxation into income tax - for instance, with a minimum rate on property earnings or instead of taxing property earnings, as has been practised in the Netherlands since 2001.

There is an immediate need for reform of inheritance tax and land tax. Even after the 1996 reform of inheritance tax, real estate and commercial enterprises are still very privileged compared with financial investments. The tax courts are now criticising this and they have launched norms control proceedings in the Federal Constitutional court. Assessing real estate closer to market values would markedly increase the revenue from inheritance tax; in return the lower band of the inheritance tax scale could be reduced. Land tax urgently needs to be put on a new assessment base, and this should be done as part of municipal finance reform.

<sup>1</sup> Cf. Stefan Bach and Bernd Bartholmal: 'Perspektiven der Vermögensbesteuerung in Deutschland', Hans-Böckler-Stiftung Edition no. 82, Düsseldorf 2002 ([www.diw.de/deutsch/publikationen/forschungsergebnisse/docs/diw\\_gutacht\\_vermoegsteuer-lang200210.pdf](http://www.diw.de/deutsch/publikationen/forschungsergebnisse/docs/diw_gutacht_vermoegsteuer-lang200210.pdf)).

they are of fiscal significance, is quickly lost in the network of interests in fiscal policy decision making; we have seen this most recently in the discussion over the Law to Reduce Tax Concessions. What is needed is a comprehensive stocktaking of all public transfer payments as part of an enlarged report on subsidisation. The report should go beyond an account of the subsidies and their fiscal effects and include regular, standardised evaluations of the economic effects and cost-benefit analyses.

### Taxation of income from property and capital

On international comparison, property and income from property are taxed at a relatively low level in Germany. In recent years revenue from property taxes (land tax, inheritance and accessions tax, property acquisition tax) have only accounted for just under one percent of GDP, while comparable taxes on EU and OECD average at the end of the 1990s yielded revenue of around 2% of GDP.<sup>38</sup> An international comparison of all direct taxes on incomes and profits in relation to GDP also shows that Germany is achieving under-average revenue, despite high nominal tax rates. The gap to the EU aver-

age in relation to GDP was a good 3 percentage points at the end of the 1990s; the gap from the entire OECD average is still 2 percentage points.<sup>39</sup> This suggests that corporate and property income are not highly taxed in Germany on the whole through taxes on profits and incomes.

The reasons for the low German revenue from property and capital income taxes are well known. There are still many possibilities for shaping accounts for corporate taxation purposes, and many tax concessions. Investment in buildings, for instance, is systematically favoured in income tax law (short depreciation periods and declining balance depreciation on new buildings, generous definition of maintenance expenditure). Profits on sales have so far hardly been taxed as private income, while earnings on capital are hardly covered (banking secrecy in Germany and tax evasion by shifting capital abroad). Real estate and commercial assets are clearly undervalued for inheritance tax, and the old unit values are still applied for property tax.

Tax reforms here could bring greater efficiency, if property were consistently assessed and taxed, even if the rates were low; this could yield considerable additional tax revenue (see box).

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

<sup>38</sup> OECD: 'Revenue Statistics 1985 to 2001', Paris 2002, p. 84.

<sup>39</sup> OECD, loc. cit., p. 77.