Mr Remsperger: Is there a New Economy in Germany?

Lecture held by Prof Dr Hermann Remsperger, Member of the Directorate of the Deutsche Bundesbank, at the American Institute for Contemporary German Studies, in New York, on 20 March 2000.

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Ladies and gentlemen,

perhaps I have gone a step too far in asking the question I am putting today: How can one dare to ask whether there is a New Economy in *Germany* if economists are still debating whether the notion of New Economy fits to the *US* economy? Besides, I have been warned against using the label New Economy in the first place since, especially with a view to the rapid spread of computer-aided technologies, the paradigm of interpretation used by the advocates of the "New Economy" is not so very new at all.

And indeed, it is quite appropriate in this context to recall the economic writings of Joseph A Schumpeter. As early as 1911, in his Theory of Economic Development, he highlighted the role of technological innovation. Following Kondratieff, Schumpeter established that long-term developments are initiated by basic technological innovations. He also pointed out two characteristics: They are produced from within the economy and generate long waves.

Schumpeter, who completed his academic work in the United States, furthermore held the view that these new combinations of production factors are not evenly distributed through time "but appear, if at all, discontinuously in groups or swarms".[1] In another passage he wrote: "What we are about to consider is that kind of change arising from within the system which so displaces its equilibrium point that the new one cannot be reached from the old one by infinitesimal steps. Add successively as many mail coaches as you please, you will never get a railway thereby."[2]

With these quotations from Schumpeter in mind, it is now easier for me to state what my comments today here in New York do and do not aim to achieve. It is not my intention to present a series of academic exercises on defining the New Economy. Instead, I aim to look at the German economy and economic policy from a perspective that has been created, as it were, in the "New Economy" of the United States. In doing so, I shall concentrate on four aspects: first, the labour market and inflation; second, growth and productivity; third, fiscal policy; and fourth, the financial markets.

Before I continue with these topics in detail please let me emphasise how closely the subject of the New Economy is linked to monetary policy. This applies not only to US monetary policy but also to the two pillar approach of the European Central Bank. Regarding the first pillar - which is the reference value for money supply - the Governing Council of the ECB has pointed out that the trend growth of the economy could be enhanced by structural reforms on the labour and product markets. The European Central Bank would take such improvements into account in calculating the M3 reference value. At the same time, the second pillar of the monetary policy approach - that is the broadly based assessment of the outlook for price developments - would have to pay heed to traces of a New Economy. However, it goes without saying that a conservative central banker cannot rely on hopes and expectations but only on reliable facts and established findings. To make it absolutely clear: My thoughts on some trace elements of a New Economy in Germany do not imply that I disregard the importance of the money supply for the medium-term price development in the euro area.

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[1] Schumpeter, The Theory of Economic Development, (1911), Transactions Publishers, 1993, p. 223.

[2] Schumpeter, loc. cit., p. 64.

But now let me get back to the four topics I have just mentioned. With regard to the labour market and inflation it is initially striking that the development of inflation in Germany over the last decade has been fairly similar to that in the United States. However, there was a certain time lag in Germany.

In the early 1990s, the German inflation rate was still around 5% owing to tight capacity utilisation. Since then it has fallen continuously. Since 1995 the inflation rate has been well below 2%. It is thus within a range that is consistent with price stability according to the ECB's definition.

In contrast to inflation, labour market trends in Germany during the 1990s have been fundamentally different from those in the United States. Whereas the US unemployment rate has continued to decline, the unemployment rate in Germany has been rising significantly for a long time since the cyclical slump in 1992-93. And this has been accompanied by a continued decline in employment despite an active labour market policy and the creation of early retirement schemes. The German labour market is, if you like, a classic element of an "old economy". It is only recently that the dent in growth caused by the Asian crisis has been overcome, that an improvement can be detected on the labour market.

The causes of the German labour market problems are primarily structural. This can also be seen by the comparatively large number of long-term unemployed. Wage formation is mainly geared to the interests of "insiders" who already have a job and not to those "outsiders" who would prefer moderate wage settlements. The accelerated adjustment of east German wages to the west German standards is one example of insufficient wage differentiation. It is precisely in the lower wage groups that it would be important to structure wage substitutes in a more incentive-friendly way.

From a current perspective it remains an open question whether the establishment of European monetary union will ultimately also lead to a reduction in labour market rigidities. However, I should add that we are witnessing a gradual erosion of industry-wide pay bargaining at least in eastern Germany. And we also observe working hours becoming more flexible. However, further steps will have to follow so that a wage policy which is in line with market requirements can help to stimulate employment friendly growth.

Furthermore, the non-accelerating rate of unemployment, or NAIRU, could also fall in Germany. In the United States all the signs indicate that the NAIRU declined significantly during the long boom. According to the Bundesbank's calculations, which may like other calculations be regarded with some degree of uncertainty, NAIRU has risen in Germany almost throughout the entire period since the end of the seventies. In western Germany, it is likely to have been above 8% towards the end of the 1990s.

When I now come to the second area of my comments, "Growth and Productivity", I do not have to tell you about the US economy's success story in the 1990s. It is well-known to you. In short: Output and productivity growth has been very buoyant especially since the mid-1990s - that is in an advanced phase of the upturn. The scale and the timing of these productivity increases can scarcely be explained in terms of the normal cyclical pattern. I wonder whether Schumpeter would have already interpreted the available evidence as a long wave.

In Germany, the GDP growth rate in the 1990s was almost 1½ percentage points below the corresponding US figure. Currently, the difference in the trend growth is likely to be slightly more than one percentage point.[3] When considering the individual components of demand, the different momentum of capital spending is particularly striking. Whereas real investment in machinery and equipment in the United States has been growing at an annual average of almost 10% since 1993, it is

[3] A precise quantification of this difference is not easily possible, since the forecasts of future developments are also of importance for estimates at the end of the series. For example, the OECD currently assumes a potential growth of the US economy of 3½%, whereas the IMF predicts 2¾%.

only in the last two years that Germany has seen a recovery of investment in machinery and equipment, albeit not with double-digit rates of growth (1998: 9.2%, 1999: 5.1%).[4]

If the different pace of economic growth is examined more closely, it becomes apparent that US output growth is supported by a sharp increase in both employment and in labour productivity. This is a strong indication that a balanced growth process is existing, in which labour and capital complement each other in terms of their contribution to output.

With an average growth rate of 2%, labour productivity in Germany was quite close to the US figures in the nineties.[5] When analysing this development, however, it has to be remembered that the productivity gains in Germany are also attributable to a fall in employment. The contrasting developments in labour productivity and employment point to an extensive substitution of labour by capital.

It is, of course, not sufficient to look only at the highly aggregated level.[6] The OECD comes to the conclusion that the development towards a services society has also made considerable advances in Germany: In a comparative study, it puts the share of "knowledge-based industries" in the United States and in Germany at just over 50% in each case.[7] And within the category of investment, as in the United States, investment in software shows by far the highest growth rate in Germany.[8] The pioneering role which the United States has assumed in the development of new technologies is, however, likely to be unchallenged. A study by the Munich-based ifo Institute on the spread of new information and communication technologies, for example, concludes that generating such technologies has not been a very prominent feature in Germany over the last decade as compared to the United States or Japan.[9]

This finding is broadly consistent with OECD studies on investment in R&D activities in the industrialised countries: Whereas the share of these expenditures as a percentage of GDP declined in Germany during the nineties, it has been rising again in the United States over the past few years following a decline in the early nineties.[10] These facts are hardly surprising as the United States is generally attested a leading position in terms of the factor human capital in highly qualified, research-intensive jobs. However, we should not lose sight of the fact that Germany is known as a country with a very good average quality of the factor human capital. This basically favours a broad application of new technologies and their adoption to particular enterprise-specific conditions.

What do all these findings now imply for future growth prospects? Most of the currently available forecasts agree that an economic recovery is to be expected in Germany over the next few years, whereas the pace of expansion in the United States is likely to decelerate, leading to a soft landing. To that extent, a certain convergence of cyclical growth can be expected. However, from the perspective of the debate on the "New Economy", the key question is whether the anticipated upswing in Germany will be more than cyclical in character and lead to a trend shift in the path of growth - in much the

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4 An interpretation of these figures should take into account the fact that direct comparisons are complicated by the different methods to adjust for price developments, especially in the capital goods sector. The depreciation components, which might differ for several reasons, should also be taken into account.

5 The figure relates to aggregate hourly labour productivity. The comparative value for the US corporate sector is 2.2%.

6 The term "New Economy" is also used especially "to describe the shift from the industrial production of goods towards the provision of knowledge-based services". "The new economy has arrived in Euroland", Goldman Sachs, European Weekly Analyst, 99/41, 199, S.1.

7 Science, Technology and Industry Scoreboard 1999. Benchmarking Knowledge-based Economies, OECD (1999).

8 This type of investment grew by an annual average of just over 8% in real terms in Germany in the nineties.

9 See in particular: Tertiarisierung und neue Informations- und Kommunikationstechnologien, ifo-Schnelldienst, 29/99, p. 23-34.

10 Quoted from the Federal Ministry of Education and Research, Zur technologischen Leistungsfähigkeit Deutschlands, Endbericht 1999, p. 29.

same way as in the United States in the nineties. I believe this is possible if the willingness to undertake reforms is followed by action to match.

What is of main importance to me in this connection is to point out that the integration of the European goods and factor markets inherent in the EU's single market programme is being accelerated by the single monetary policy in the euro area. The resultant intensification of competition combined with the exploitation of increasing returns to scale in the enlarged markets might have a sustained boosting impact on productivity. The changes in the telecoms sector are an example of how the deregulation of markets can make further progress in Germany as well. With the intensified competition, especially in an increasingly globalised competitive environment, this development will not only act as a damper on prices. It is also likely to lead to further surges of modernisation, in which new globally available technologies will be employed.

Before I come to the third area of my comments, I would like to touch briefly on the healthcare sector. It can be regarded as one of the engines of growth, provided it is not overly restricted by state regulations. In Germany, this sleeping giant is still waiting to be unchained. But let me now turn to fiscal policy.

Although fiscal policy is not at the actual centre of the New Economy controversy, I think it is a very important player in the macroeconomic setting.

In the United States, fiscal policy in the past decade has been characterised by a marked course of consolidation. For example, the initially quite high government budget deficits of almost 6% of GDP in 1992 were reduced completely and transformed into a slight surplus (1999: 1.0% of GDP).

In Germany, reunification confronted fiscal policy with its most difficult task since the period of reconstruction following World War II. The restructuring of the corporate sector in eastern Germany in conformity with the social welfare system, the enormous task to modernise the public infrastructure and the adoption of the west German social security system required huge transfer payments to the new Länder, the bulk of which was covered by public borrowing. As it happened, the opportunity of applying these measures as a tool for fundamental overall reforms was seized rather late and with little energy.

In the end, there has been a significant increase in the public sector's recourse to the resources of the economy as a whole: The ratio of public spending to GDP which had fallen to just under 46% in western Germany in 1989 rose to almost 51% by 1996. The public debt ratio increased from just under 42% to almost 61% in the same period. Moreover, the taxes and social security ratio grew from just under 42½% to slightly more than 43% owing to the sharp increase in social security contributions.

These unhealthy developments in public sector finances made a reversal increasingly inevitable. Moreover, the convergence criteria of the Maastricht Treaty had to be met. Since 1997, the deficit ratio has been declining as a result of increased consolidation efforts. However, the fiscal framework at the beginning of the new century cannot at all be described as optimal in macroeconomic terms.

Nevertheless, the decisions taken since summer 1999 give rise to the hope that important changes in the economy as a whole will also be supported by fiscal policy. However, the picture is very complex in this area.

It has to be regarded as positive for the future development of the economy that the German federal government is committed to pursuing a strict policy of consolidation. What is pleasing is that this course does not just exist in theory but has already been substantiated by measures which will have a rapid impact. Certainly, the savings package which envisages savings of DM 30 billion for 2000 and around DM 50 billion for 2003 does not correspond to effective savings of the same level. Nevertheless, the public sector's recourse to GDP is likely to fall.

Moreover, there are plans to reduce the public sector deficit ratio to ½% by 2003. At a first glance, this may not seem particularly ambitious. One might also have doubts as to whether the European Stability and Growth Pact target of achieving a budget close to balance or in surplus in the medium term can be met in full. However, it should not be forgotten that the consolidation course is to be accompanied by tax reductions on a quite impressive scale. Hence, the planned reduction in public spending from 48.5% of GDP in 1999 to 45% in 2003 is much stronger than the lowering of the budget deficit ratio.

The twin-track approach of tax cuts and a restrictive spending policy has paved the way for a sustained reduction of the public sector burden on the capital markets and hence the creation of greater scope for private investment. In addition, the conditions for investment and production in Germany are being improved through the tax cuts.

It is possible to detect a distinct shift in focus in German fiscal policy. The Tax Relief Act which came into force at the beginning of 1999 primarily aimed at providing relief to lower-income earners and households with children. The economy was to be boosted from the demand side. The price paid for this was a higher burden on enterprises and thus a deterioration in supply and investment conditions.

The government's plan for a reform of business taxation now aims to give relief to enterprises and thus create conditions that are more favourable to growth via the supply side. This reorientation is being accompanied by a further two-stage reduction in income tax in 2003 and 2005 which also covers the top rates. In 2005, the top rate of income tax would then be 45% compared with 51% at present. The CDU/CSU parliamentary group in the Bundestag would like to put through a reduction in the top rate of tax to 35% by 2003.

The government's planned tax reform will result in a substantial tax relief for enterprises in net terms as well, especially as a result of the sharp reduction in the corporate tax rate to a uniform level of 25%. At present, the corporate tax rates are 40% on retained profits and 30% on distributed profits. The tax cut will strengthen Germany's attraction as an industrial location. The planned tax exemption of corporations' profits from the sale of equity stakes will facilitate corporate restructuring. Germany is likely to become more attractive as a location for holding companies.

In all, the tax plans are an important and welcome beginning which should be followed by further steps. From the point of view of the tax system and in terms of a consistent and equal taxation of all types of income, the plans do have some shortcomings. Above all, problems are raised by the marked preferential tax treatment of profits retained in enterprises, which cannot be justified on macroeconomic grounds. This preferential treatment might also result in allocation distortions. Ultimately, a substantial reduction of all rates and a comprehensive widening of the tax assessment basis would be needed.

Whereas approaches to a solution are becoming evident in fiscal policy, this cannot be said for the severe structural problem of the statutory system of old-age provision. Here, the ageing of the population has led to an implicit public sector debt building up on a major scale. With the existing system of old-age provision this debt can only be repaid by further increases in employees' and employers' contributions. Official projections assume that this would result in the contribution rate having to rise to 24% by 2030. In addition, there would also be growing burdens in health and nursing care insurance. The associated obstacles to growth and higher costs would be a severe strain on the development of the economy. The reform measures proposed so far are not enough to prevent such a questionable development. Above all, what is needed is a restriction of the pension growth rate. This would create room for supplementary privately funded pensions. This would also benefit the capital markets. And mentioning the capital markets I have now arrived at the last topic of my presentation.

Undoubtedly, the "New Economy" is closely connected with developments in the financial markets. For example, the sharp growth in the supply of venture capital in the United States suggests that the momentum of the real economy is being underpinned by flexible, innovative forms of financing in the capital market.

The German financial system has been traditionally characterised by the dominant role of the banks. Such more "bank-based" structures should by no means be equated with backwardness, however. On the contrary, the credit institutions' intermediation can in some cases even be superior to the market-based financial system. Just to give a particularly important example: The corporate landscape in Germany has traditionally been characterised by small- and medium-sized enterprises. Long-standing, strong business relationships with specific banks are particularly suited to covering the financing requirements of such enterprises at reasonable costs even in periods of economic difficulty.

However, from the perspective of the New Economy, market-based financing is especially important. It is precisely young, innovative enterprises with uncertain earnings prospects that often have to rely on financing sources outside the banking system.

In this connection I would like to draw your attention to the rapidly increasing importance of the stock market in Germany. In 1999 alone, domestic enterprises issued shares with a market value of €36 billion. This is an increase of almost 50% compared with 1998 and three times the 1997 figure. Particularly noteworthy is the high share of initial public offerings in what is known as the "New Market", the market for young and innovative enterprises. More than 200 companies are now listed in this category which has thus become an engine for financing innovative enterprises in Germany.

However, the New Market is only appropriate for firms which have already established themselves in the markets. Hence, it is of particular importance that, along with the success of the New Market, venture capital business has simultaneously taken a rapid upswing. Venture capital invested rose by DM 5 billion in Germany in 1999. At the same time, the structure of venture capital investment has radically changed. Whereas it was more traditional sectors that attracted venture capital in the past, such investment now focuses on telecommunications, biotechnology and computing.

The growth of both the New Market and venture capital are interdependent. The New Market offers ideal conditions for transforming venture capital into risk capital traded on the stock exchange following the phase of venture financing. In the past, the lack of such an "exit" option was one of the obstacles to the development of a broader venture capital market in Germany. The rapid growth of the stock market would not have been possible without the general public becoming increasingly interested in share investments. Much use is being made of indirect stock market activity through investment funds.

Complementing the provision of risk capital via the stock market, there has been a sharp rise in the issue volume of corporate bonds. This instrument was also used in the past year to finance mergers and acquisitions - in other words, the restructuring of the corporate sector. However, this increase is also due to growing investor demand for higher-risk paper, since the scope of diversification has become much smaller through the elimination of exchange rate risks following the introduction of the euro. The German corporate bond market is still less developed than in the United States. However, there are indications that the emergence of corporate bonds as a means of long-term financing has become increasingly prominent in supplementing the use of bank loans. The momentum and strength of such an underlying trend seem to be influenced to a large degree by technological advances, the pace of structural change in the corporate sector and economic policy reforms, such as in tax law or old-age pension provisions. Additional impetus is being provided by European monetary union.

Ladies and gentlemen, let me finally return to my initial question: "Is there a New Economy in Germany?" This question cannot be answered with a sweeping yes or no. But it can probably be stated firstly that there are movements in Germany which are simultaneously beneficial to growth and price stability. I see traces of such a New Economy, above all, in areas of the economy which for a long time were subject only to limited competition, but which are now being deregulated. More growth in those areas may even be accompanied by falling prices. Second, the new technologies are available globally. They are also available as growth potential outside the United States. Third, the German financial system seems well equipped not only to accommodate the changes in the real sector but also to support them. In Germany, we need and have both market-oriented and bank-oriented financial services. I cannot and do not want to comment on the development of share prices in the New Market in Germany. But I do believe that traces of a New Economy can also be found in this market segment. On top of that, ever-increasing competition and technological progress are leading to a far-reaching renewal in the financial sector.

Fourth, the economic policy decisions taken since summer 1999 suggest that an upswing in the economy as a whole is supported by the fiscal framework. What is especially positive is the commitment to a strict consolidation course which is being reinforced by concrete savings measures. And, in line with Professor Issing, I would finally like to emphasise that monetary union in Europe and the completion of the single market are promoting corporate restructuring, which is improving the efficiency of the economy.

Let me conclude by saying that computers and the Internet alone will not create a New Economy in Germany by themselves. Only structural reforms will reduce the impediments to growth. A combination of technological change and structural reforms would make possible not only a better use but also a widening of the potential for growth in Germany.