# Hermann Remsperger: Economic outlook and economic policy challenges for Germany

Guest lecture by Professor Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, at the Norges Bank (Central Bank of Norway), Oslo, 23 September 2002.

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Ladies and gentlemen

Yesterday, we elected a new parliament in Germany. As you are aware, economic matters played a key role in the election campaign. I would like to take up some of these matters today in Oslo. Under the heading “Economic outlook and economic policy challenges for Germany”, I would like, first, to talk to you about the reforms that are needed on the labour market as well as in tax and social policy. Second, I shall also ask the question of whether we need a new policy mix. And, finally, I shall look at the eastward enlargement of the European Union as a major economic policy challenge.

My simple proposition is that Germany’s economic outlook depends foremost on coping with the existing economic policy challenges. I am arguing in favour of domestic reforms in Germany, for careful handling of EU and EMU enlargement and for maintaining the fiscal policy rules in the policy mix of European Economic and Monetary Union. Not least, these rules have to be applied in such a way that “budgetary exuberance” is avoided in an upswing.

I am therefore less concerned with short-term cyclical movements than with medium and long-term economic trends in Germany. For this reason, I shall start by looking back and, in doing so, have to state that Germany’s economic development over the past decade has often tended to be disappointing by international standards.

## I. A look back

In saying that, there was indeed some cause for optimism at the start of the 1990s: German unification, the opening-up of the east European markets, progress in European integration and, later, the introduction of the new currency provided a wealth of opportunities for growth. However, at least in some cases, things did not quite work out as had been hoped.

Since the reunification boom petered out, Germany has been part of the group of countries with weak growth. While the GDP of the present EMU countries has risen by a total of 15% since 1995, the corresponding figure for Germany is no more than 10%. In line with this, the annual average rate of growth in Germany, at a good 1½%, has been lagging ¾ percentage point behind. Comparing Germany with the euro area as a whole excluding Germany, the German shortfall in growth increases to just over 1 percentage point. In 2001, taken on its own, the figure was as much as 1½ percentage points.

Now, there are some commentators here and there who ascribe this performance to increasing globalisation. However, this argument does not hold up under closer examination. Following a period of export weakness in the early 1990s, the German economy achieved extremely good results in foreign trade between 1994 and 2001. Given an overall moderate growth in GDP during the period mentioned of 14½%, real exports increased by 79½% and real imports by 67½%.

One of the factors contributing to the positive development in exports since the mid-1990s was improved price competitiveness of the German business sector. This meant that earlier adverse developments were largely reversed. In the early 1990s, by contrast, price competitiveness had been severely affected by large wage increases, not least as a result of bringing pay in eastern Germany more closely in line with west German rates and also due to the sharp appreciation of the D-Mark.

Although the German economy has become more dependent on other countries, it has to be said that most of the structural problems in Germany cannot be blamed on developments in the global economy. They are mainly home-made.

Among other things, cyclical influences and special factors have contributed to Germany’s relatively poor performance in the euro area. Above all, it should be remembered that, already in the run-up to Stage Three of European monetary union, interest rates had fallen sharply in a number of EU countries with previously fairly high short and long-term rates of interest. For example, interest rates for long-term government bonds in Italy and Spain, even in 1995, were 5 to 6 percentage points higher than the rates for German Federal Bonds. Besides, improved fundamentals, market expectations of an early participation in monetary union are likely to have played an important role in the interest rate convergence process. As the home of the former anchor currency in the ERM, Germany did not benefit directly from this process of interest rate convergence.

Another cause of relatively weak growth in Germany to be mentioned is, of course, the crisis in the construction industry, especially in eastern Germany. In this sector, the capacity that was built up immediately after reunification exceeded the longer-term ability of the real estate market to absorb such capacity. Reduced construction activity depressed German economic growth. Without the decline in investment in construction since the mid-1990s, the shortfall in German growth compared with the euro area as a whole would therefore not have been so substantial. By contrast, construction activity in other European countries remained an important pillar of economic growth.

Finally, consideration also has to be given to the fact that living standards in the monetary union are still very disparate. Since the poorer countries are supposed to catch up with the EMU average, they have to go on growing more strongly than those countries which have already achieved a high level of income. A comparatively low level of growth in an already advanced country should therefore not have too much importance attached to it.

## II. Labour market problems

One very important - if not *the* most important - reason for the inadequate pace of economic growth in Germany is the continuing heavy burden of taxes and social security contributions as well as strict regulations in parts of the economy. However, these reasons cannot explain the differentials in growth among the core countries of European Union, which have similarly serious deficiencies in terms of reform. Rather, they are a major cause of the shortfall in growth vis-à-vis the United States. Above all, there is too little labour market flexibility in Germany. Also, wage rate policy was indeed characterised by restraint in the second half of the 1990s, but its overall stance was, at best, neutral. Furthermore, differentiating pay in terms of skills, sectors and regions is not enough. Wage policy did not make a major contribution to the creation of new jobs.

In periods of a cyclical downswing, the rise in unemployment in Germany was far sharper than the fall during periods when there was an upturn. For instance, the number of people out of work in western Germany rose from its cyclical low point between 1991 and 1997 by some 1.3 million to around 2.5 million. By 2001, the number of unemployed had been reduced by no more than just over half a million. An additional factor to contribute to the high level of persistent unemployment is that, as firms see it, the skills to work evidently decrease the longer unemployment lasts.

For non-working members of the labour force, the incentives to take up employment were limited by the high-level marginal burden imposed by taxes and other public levies. Most types of household in Germany have a marginal burden of taxes and levies of 50% or more. In other words, from every additional euro that is earned, around 50 cents are deducted. Moreover, social benefits which are at a high level by international standards act as a reservation wage. In Germany, it is difficult, especially for low-skilled persons, to find a suitable job. The “wedge” between gross and net wages also led to the emergence of a considerable black economy.

Furthermore, the skills profile of those seeking work often fails to match that of the jobs on offer. Unemployment would thus remain high even if the number of vacancies corresponded to the number of people looking for work. The German labour market is characterised by a high level of mismatch unemployment. The proposals of the Hartz Commission, which was set up by the previous Federal Government, and the embryonic reform of the labour exchanges, which is already under way, are an attempt to tackle that situation and to increase the efficiency of the job placement process.

The most pressing tasks of labour market policy from my point of view can be split into three categories: first, measures to increase the supply of labour; second, proposals on strengthening the demand for labour and, third, changes in the wage-formation process.

One of the things to be examined with regard to increasing the labour supply is whether, say, the period of time for drawing unemployment benefits does not lead to people remaining in unemployment longer than is absolutely necessary. As I have mentioned, in empirical terms, it is evident from the perspective of the enterprises that the skills of the unemployed rapidly lose their value the longer unemployment continues. For that reason, purportedly generous arrangements may even become “poverty traps” for the unemployed. Combining social assistance and unemployment assistance also has to be considered. Neither of these types of state benefit is an insurance benefit. Rather, they are granted according to specific need. They should therefore be merged.

Many experts agree that the demand for labour in Germany also suffers from the very complex legal arrangements relating to work contracts. Enterprises are so cautious in recruiting labour because it is so difficult to make redundancies.

If there is to be a sustained decline in unemployment, some elements of the wage-formation process have to be subjected to more scrutiny. Collective pay agreements should set only general framework conditions in order to take greater account of the individual situation in which firms find themselves.

We should now admittedly not overlook the fact that initial cautious steps have already been taken towards making the German labour market more flexible. The strict principle of regionally agreed pay deals has already been relaxed somewhat by opt-out and opt-in arrangements. Furthermore, the labour market has been made more adaptable with the extension of part-time work. Finally, with the help of Germany’s training system it has been possible to keep youth unemployment at a comparatively low level by European standards. According to Eurostat figures, the unemployment rate among under-25-year-olds amounted most recently to 9.3%, compared with 16.4% in the euro area as a whole.

## III. Tax and social policies

All things considered, the underlying conditions for the German economy have also been improved by the tax reform that was adopted two years ago. For incorporated enterprises, corporation tax was lowered from 40% for retained profits (and 30% for distributed profits) to 25%. For non-corporations, the previous burden imposed by trade tax has largely been removed. Furthermore, their situation is also being eased by the fact that the income tax scale is to be lowered in stages until 2005.

The tax reform makes restructuring in the corporate sector easier because profits from sales of corporations’ participating interests are no longer subject to taxation. However, the tax depreciation facilities for spending on fixed assets have been made worse.

There has been progress in Germany in the field of old-age pension provisions. The pension reform, which was adopted last year, pursues two objectives simultaneously. First, payments under the state pay-as-you-go scheme are being cut back, and, second, private provision is being strengthened. Pension increases over the coming years will remain below the level of increases in wages and salaries. This means that, in the long term, the increase in the contribution rate will be around 1½ percentage points lower than would otherwise have been the case.

The pension reform will mainly benefit the younger generations. They will gain from the lower burden of contributions. They will have greater scope for making their own provision. For those who are older, however, the cutbacks in payments will weigh more heavily.

The promotion of private old-age pension provisions nevertheless entails considerable burdens for the public sector budgets. Furthermore, what is known as the “Riester pension” has been constricted by a set of fairly tight regulations. The stock of capital that has been saved up may be paid out, for example, only in regular and life-long instalments. In contrast to this, at company level, a flexible instrument has been created in the form of the pension fund. Not only does this allow largely free decisions on investment, it also makes defined contributions possible for the first time. Precisely because of the associated fiscal strains, there is hardly likely to be a significant increase in national savings as a result of this reform. However, Germany as a location for investment will probably play a greater role in future in the increasingly important market for pension products.

All things considered, there has indeed been some economic policy progress in Germany. Unfortunately, it has been moving forward at no more than a snail’s pace. There is still much left to be done.

Further reforms of the labour market and the social security system are a matter of urgency in view of the increasingly unfavourable age structure of the population in Germany. The ratio of people aged over 60 to the group of 15 to 59-year-olds was just under 40% in 2000, but this ratio might increase to around 80% by 2050. The higher age ratio will have an adverse impact on the social security system and, given the existing entitlement to benefits, will call for higher contribution rates.

It is by no means certain whether the recent reform of the pension system will be sufficient to cope with these challenges. An additional factor is that demographic developments will place a strain on other parts of the social security system, such as the health insurance institutions and nursing care schemes. The welfare state system will have to be adapted to cope with these challenges if problems for future economic growth are to be avoided. As a general guideline, it may be said that a closer match in social security contributions along with a stronger personal contribution by the individuals concerned will improve economic efficiency and thus open up opportunities for growth.

## IV. EU enlargement

One of the reasons why I believe that the reforms inside Germany are so important is the fact the we are also facing challenges from outside. The planned enlargement of the European Union is certainly one to be mentioned. The negotiations which are currently being conducted with 12 countries, situated mainly in central and eastern Europe, are now far enough advanced for the first round of enlargement to take place as early as the middle of this decade.

Especially from Germany's point of view, setting the right course for the integration of the new member states is of considerable importance. Both Germany's geographical location and its close economic ties with its neighbours to the east mean that Germany is affected by EU enlargement more than other countries in the Union.

Despite considerable progress in terms of macroeconomic stabilisation and in the implementation of market economy reforms, the erstwhile socialist countries in transition, in particular, still display significant structural differences from the current EU member states. One of these differences is that the accession candidates are in a process of catching-up economically. They generally have inflation rates which are higher than those in the more mature and more slowly growing EU member states. This is an outcome, first, of differences in productivity gains across countries and sectors - known as the Balassa-Samuelson effect - and, second, of shifts in demand.

The resulting real appreciation does not pose an obstacle to EU enlargement in terms of progress in the liberalisation of foreign trade and its ensuing welfare gains for the EU as a whole. Nevertheless, if the EU accession candidates participate in monetary union before the existing structural disparities are eliminated, the single monetary policy in the euro area will not meet the needs of all the member states. A hasty enlargement of EMU would therefore harbour stability risks for the euro area and might generate tensions among the participating countries.

Accession to the EU, however, does not imply immediate full membership of EMU. Instead, the EU accession countries will participate initially as "member states with a derogation" in the Third Stage of Economic and Monetary Union. The precondition for full EMU membership is that the accession countries achieve a high degree of sustainable economic convergence. The convergence criteria laid down in the Maastricht Treaty are the yardstick for this. These criteria set unambiguously verifiable requirements in terms of price stability, long-term interest rate levels, the government fiscal position, and participation in the exchange-rate mechanism of the European Monetary System, ERM II. In addition, pursuant to Article 121 of the EU Treaty, the examination of the sustainability of achieved convergence "should also take account of ... the results of the integration of markets, the situation and development of the balances of payment on current account and ... the development of unit labour costs and other price indices".

The convergence criteria are designed to guard against inflationary tendencies within the monetary union and to prevent tensions arising from structural divergences in inflation. The task of stabilisation does make stringent demands on the monetary policy of the accession countries, but price stability may be regarded as a *sine qua non* of sustainable growth. For that reason, the accession countries - not least in their own interests - should not enter EMU until the process of catching up economically has already made significant headway and the adjustment function of the exchange rate can be more easily dispensed with.

Such a step-by-step enlargement process would also be in Germany's interest, since it would enhance the opportunities arising from an enlargement of the Union and limit the associated risks, especially the monetary policy risks.

## V. Policy mix

After discussing domestic reforms in Germany and my comments on EU enlargement, I would now like to deal with a third economic policy issue: the policy mix in the European Monetary Union. The present division of tasks is based on the insight that each area of policy should concentrate on its relative strengths. The monetary policy of the European Central Bank is geared to price stability, for example. In line with this perspective, wage policy is responsible for achieving a high level of employment and budgetary policy should ensure an efficient supply of public goods and fairness of income distribution but, in doing so, not impair incentives to work, to save or to invest.

This - as I see it - generally tried and tested allocation of responsibilities is often the subject of criticism, however. Calls are made to allocate macroeconomic responsibilities differently, accompanied by the demand that monetary, fiscal and wage policymakers should coordinate their operations instead of focusing on their own strengths.

According to this “new division of labour”, wage policy would have the task of keeping down inflation. This would be conditional on wage and salary earners and their trade unions forgoing pay rises precisely in periods when the economy is booming - at times when they could easily push through such increases. It is probable that there would then be a wage-price spiral, which also happens to be the historical experience in Germany and in other countries. There was no success in the early 1970s, for example, in restricting pay rises, even though the trade unions were tied into a corporatist alliance called “concerted action”.

Frequently, the call is made that monetary policy should not be geared - or not be primarily geared - to price stability, but attempt to stimulate economic activity. That way of seeing things, however, overrates monetary policy’s influence on developments in the real economy. Changes in the monetary policy stance act with varying time-lags on investors and consumers. Furthermore, it is often difficult to diagnose the cyclical situation properly. Finally, monetary policy action would have to be administered in the correct cyclical dosage. In the age of globalisation with open borders and integrated capital markets, that would be very difficult to do. In short, there is little to suggest that the monetary policymakers’ strengths lie in the fine-tuning of the business cycle. Monetary policy is far better suited to the long-term safeguarding of price stability.

In considering the appropriate policy mix in the monetary union, the terms of the Stability and Growth Pact mean that the role of fiscal policy undoubtedly occupies centre stage. In the field of budgetary policy, several countries are having considerable difficulties in fulfilling their existing European commitments. These provide for a 3% limit for the general government deficit ratio and, at the same time, a budgetary position that is in surplus or close to balance over the entire business cycle. Since the deficit in Germany, at 2.8% of GDP, already came quite close to the 3% ceiling last year - mainly on account of the tax reform - the risk that it might now exceed that limit in the current year has become greater. Furthermore, there are some doubts as to whether German fiscal policy will be able to deliver on the self-commitment - reaffirmed in spring - to achieve a budget position close to balance by 2004 unless there are further cuts in public payments.

Given the budgetary problems that also exist in other EMU countries and in view of the weak cyclical situation, calls are increasingly being made for a relaxation of the fiscal policy rules in European Monetary Union. The main point of criticism about the existing provisions of the Maastricht Treaty and the Stability and Growth Pact is their alleged inadequate cyclical flexibility. It is claimed, for example, that these rules force budgetary policy to act in a procyclical manner counter to the requirements of stabilising the economy.

Such criticism does not, however, take due account of the rules of the European Stability and Growth Pact. It is, in fact, precisely the task of this pact to ensure that government budgets can “breath” during the business cycle without breaching the deficit limit of the Maastricht Treaty. Such flexibility is to be achieved through a budgetary position which is at least close to balance over the medium term - in other words, when seen over the cycle as a whole. If that condition is met, the automatic stabilisers can develop their full effect within the 3% margin. The fact that there is, even so, only a narrow “safety margin” from the limit in some countries should not be blamed on the fiscal policy rules. It is rather the case that there has been a failure over the past few years to bring about a structurally balanced budget.

“Softening” the fiscal policy rules would undermine the credibility of the Maastricht Treaty and the European Stability and Growth Pact. The associated capital market effects would also have adverse implications for economic growth. The existing fiscal rules are necessary in order to counter the even greater latent incentives to borrow in a monetary union and to prevent monetary policy from being caught up in the slipstream of unsound government finance. The fiscal policy rules strengthen the functional independence of the European Central Bank and thus facilitate a stability-oriented monetary policy in the single currency area. Watering down those rules might give rise to conflict between fiscal policy and monetary policy. Therefore, German fiscal policymakers, too, must not shirk their responsibility to make further consolidation efforts so as to achieve a budgetary position close to balance in the medium term.

If one wishes to achieve a balanced budget over the business cycle - in other words, if the intended benchmark for the structural deficit is zero - in order to assess the fiscal position of a single year it is analytically necessary to adjust the budget balance for cyclical effects. This does not require any addition to, or modification of, the Stability and Growth Pact. It is, in fact, a matter of implementing its rules in the stability programmes in a consistent manner. And that naturally also implies not under any circumstance calling into question the nominal maximum limit for the deficit of 3%.

As I see it - and I would like to conclude on this point - more attention has to be paid in future to budgetary policy transgressions not being allowed in times when economic conditions are favourable. During an upswing there exists a risk of “budgetary exuberance” - in other words, a lower deficit being interpreted as progress in terms of consolidation, even though it is due solely to an improvement in the cyclical situation. Particularly in periods when the economy is improving, finance ministers who take consolidation seriously have to look not only at the unadjusted budgets. They have to look at the adjusted budgets too.

At the same time one should not make the mistake to see the problem with the adherence to the stability and growth pact under business cycle aspects only. In Germany these problems are also a symptom of an insufficient basic dynamism in the economy. We do not need to change the stability and growth pact. What we need are more reforms which lead to higher employment and growth. The newly elected German Parliament should approach these reforms with courage.