Hermann Remsperger: Germany at the crossroads

Speech by Professor Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, at the Nomura Annual Euro Conference, Tokyo, 26 November 2002.

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Ladies and gentlemen

News and the tone of comments on the economic situation in Germany have been getting considerably worse over the past few weeks. Take, for example, the weekend edition of a well respected newspaper of 16 November. One of the views expressed there was that – and I quote,

"In Germany, nothing is going right. The government is boxed in by an inability to use monetary, fiscal or exchange rate policies to boost demand. Fear is growing that Germany will go the way of Japan, which has suffered 10 years of stagnation. The danger is that, like Japan, it would prefer to muddle through than take tough policy decisions. Germany is seen as a stricken giant, the sick man of Europe."

Such comments soon give rise to the notion that Germany is on the edge of deflation. To say it straight out: that is not a view which I share. I do recognise the large number of problems that exist in Germany, but I do not perceive any deflation. In other words, I do not expect the general price level in Germany to decline on a long-term basis and GDP to shrink over an extended period.

We at the Bundesbank are forecasting a continuing low rate of inflation and a moderate increase in GDP in Germany for the coming year. While the price outlook is gratifying, the prospects for growth are rather disappointing.

I shall return to that outlook and the subject of deflation in a few minutes' time. My simple proposition is that the outlook for Germany depends first and foremost on coping with the existing challenges to economic policy. In order to gain a better understanding of this, however, we should first take a look back.

A look back

Taking that look back reveals that, since the reunification boom petered out, Germany has been one of a 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 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 over 1 percentage point. In 2001, taken on its own, the figure was as much as 1½ percentage points.

In my view, both temporary and long-term factors have contributed to Germany's relatively poor performance in the euro area. As far as the temporary factors are concerned, 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. 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 is the crisis in the construction industry, especially in eastern Germany. In this sector, the capacity built up immediately after reunification exceeded the longer-term ability of the real estate market to absorb it.

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 as great. By contrast, construction activity in other European countries has remained an important mainstay of economic growth.

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.

One very important – if not *the* most important and continuing – reason for the inadequate pace of economic growth in Germany is the heavy burden of taxes and social security contributions. Added to this are strict regulations in some parts of the economy. Above all, there is too little labour market flexibility in Germany.

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.

In Germany, the incentives to take up employment are restricted 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.

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

As you may know, the German Parliament adopted a labour market reform only a few days ago. Its main focus is on a more efficient placement of unemployed persons in jobs and an increase in temporary employment through personnel service agencies. These initial steps towards a reform of the labour market are, generally, to be welcomed. However, there is a danger of regular jobs being replaced by subsidised ones.

If labour is not involved to a greater extent in the production process, it will be difficult in Germany to achieve a sustained high level of growth again. An environment that is conducive to growth, however, also has to include a fiscal policy which leads to a lower tax burden.

Budgetary and consolidation policy

In the current year, Germany will considerably exceed both the 3% limit for the deficit ratio and the 60% debt ratio. Now, the Federal government has promised a package of measures which are designed to reverse the rapid deficit increase and to go back down below the 3% limit in the coming year.

The volume of the package amounts to around ¾% of GDP in the coming year. In the years after that, it is envisaged that the volume will go up well above 1% of GDP.

Making a final judgement on the structure of the consolidation package is difficult. The proposed measures could still undergo changes in the course of the legislative process. I therefore wish to make only a somewhat more general assessment at this point.

The measures in the package include reductions in the labour-market-related spending and tax changes. In my view, the initiatives on the expenditure side are heading in the right direction. Through lowering the government spending, they are designed to reduce the burden of levies impeding growth in Germany. Cuts in subsidies and in labour-market-induced spending are especially conducive to improving the conditions for growth in the medium term.

While the spending cuts and the measures to increase revenues are intended to balance each other in the coming year, a distinctly greater role for the initiatives to increase revenue is envisaged for the years that follow. In principle, it is true that broadening the tax basis and abolishing tax exemptions can indeed be a part of a successful consolidation policy.

However, in the sense of a fundamental simplification of taxation – which is called for in Germany – a thoroughgoing reform would be desirable. This could then also be embedded in a marked lowering of the tax rates.

What is more: the tax initiatives by the German government are not just a matter of abolishing exemptions. They also include interference in regulations that are quite justified from a taxation point of view. For example: restricting the possibilities of offsetting losses would end the correct symmetrical treatment of profits and losses under the tax system. This would make investment projects less attractive – especially those associated with higher risk or with strongly fluctuating earnings expectations.

As I see it, when setting out the specific details of the individual tax measures, particular attention should be paid to their impact on corporate investment – something which is especially important for medium-term growth. Another point to consider is that the policy of enhancing the attractiveness of private old-age provision and of Germany as a financial centre – should not be disrupted by a rise in the tax burden.

Besides a reduction in the deficit ratio, it is also important not to lose sight of a lower overall burden of taxes and social security contributions. Above all, the high and rising social security contributions represent a significant obstacle to employment and growth. The comprehensive review of government activity and of state benefits which is needed has to include the social security sector too.

In this context, the tax reform that was adopted two years ago has brought some relief. The tax on retained profits was lowered from 40% to 30%. The top income tax rate will come down to 42% by 2005.

And there has been some 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 pension provision is being strengthened. Pension increases over the next few years will remain below the level of increases in wages and salaries.

Macroeconomic assessment and outlook

Ladies and Gentlemen, the cyclical worries in the global economy as well as in Germany have undoubtedly increased once more in the course of this year. Since the spring, the economic climate in Germany has become cooler again.

The slump in stock market prices and the rise in the cost of oil have played a major part in that. That development has been reinforced by the too high wage settlements in this year's pay round.

We in Germany are thus clearly in a very difficult economic situation. The current slight improvement is still very fragile. That improvement is due primarily to external stimuli and influences from inventories. The "cyclical breakthrough" has therefore not been achieved yet. In cyclical terms, we are still in the initial phase of an improvement that could quickly be put at risk again.

Even so, the economy did grow somewhat in the first three quarters of this year. Thanks to orders from abroad, exports have once again made a major contribution to growth. Owing to an increased number of car sales, private consumption has assisted growth.

In contrast to this, fixed capital formation is still putting a firm brake on growth. That applies not only to buildings but also to machinery and equipment. Although capacity utilization has picked up somewhat from its low at the start of this year, it continues to be significantly down on the normal level of capacity utilisation. Added to the problems in the corporate sector are financing conditions which, on the whole, have become more difficult.

In the corporate sector there is great uncertainty about future profits. If one looks – by way of an example – at enterprises listed on the stock market, analysts have now made a considerable downward revision of their medium-term growth forecasts for corporate profits. But even the down-revised assessments remain based on the expectation of a distinct recovery in profits.

The labour market has come even more heavily under pressure since the summer. It has been less and less the case that redundancies in manufacturing and the construction sector have been offset by a positive development in services. Economic activity is still too weak to relieve the labour market.

Taking together all the data that are currently available, the economy as a whole cannot be expected to improve in the immediate future. The rate of GDP growth for 2002 will be below ½%.

As things appear at present, the outlook for 2003 is, in fact, somewhat better overall. But many forecasts point to downside risks.

There might be cause for some optimism in a return to greater stability on the stock markets and if oil prices were to settle down at their present level. That would mean that risk premia on the financial markets could go back to normal again. That would then allow the favourable underlying monetary conditions to come into operation.

Finally, there might be some hope in the passing of the phenomenon of “perceived” inflation. Admittedly, not a great deal of momentum can be expected from all of the cited factors.

The underlying pace of economic growth will remain subdued in the first half of next year. When exports gain momentum and the negative confidence effects on investment and consumption peter out, the upturn from the second half of 2003 onwards will be somewhat stronger and more broadly based.

However, given the high degree of uncertainty and unused capacity, we expect no improvement in investment activity in the near future. We believe that investment activity will not take a turn for the better until the second half of next year. Experience of investment behaviour in the past may be a further indication that the pick-up of investment in machinery and equipment will be modest.

As regards investment in construction, leading indicators show that the downward adjustment process has not come to an end and is likely to continue in the near future.

As I said at the very beginning, the outlook for inflation is much better than the outlook for growth. But before I turn to the price-side of the German economy, I would like to conclude my remarks on the real side of the economy with a few sentences on Germany’s export performance.

Real world market shares of Germany

Recently, there have been repeated references to a sharp decline in German world market shares since the beginning of the 1990s, and this has been regarded as indicating Germany’s lack of competitiveness. Indeed, the development of world market shares may be misleading – if conventionally calculated on the basis of nominal foreign trade values in national currencies, which have been converted by current exchange rates into US dollars - whenever there are significant exchange rate movements of the dollar.

Thus, a depreciation of the euro against the US dollar, if considered in isolation, necessarily results in a fall in Germany's world market shares, even if its real market shares actually remain constant. To avoid these distortions it seems reasonable to calculate real world market shares, which are by definition adjusted for changes in inflation differentials and exchange rates.

In contrast to the nominal world market shares, Germany’s real shares have shown a significant increase since the mid-1990s. Germany’s share of global exports rose from 9 % in 1995 to 10 % at the end of 2001 and thereby regained the position held in the early 1990s. This upturn reflects, in particular, the improved price competitiveness of Germany’s industry.

Germany's retrieval of its former position on the world market since the mid-1990s becomes even clearer if the country's export performance is considered in relation to the other industrial countries and therefore account is taken of the fact that the industrial countries as a whole have been losing market shares to the emerging markets.

If viewed in this context, the German share of the real exports of the industrial countries has increased by 2½ percentage points since 1995. At just under 16%, Germany's share exceeded recently even its old record levels from the late 80s.

The debate on deflation

In all probability, the German inflation rate will remain at a low level next year too. Germany is among the countries with the lowest inflation rate in the euro area. Such a development in German consumer prices is often interpreted, in itself, as signifying a risk of deflation. Some analysts are already detecting conditions in Germany similar to those in Japan.

In contrast to that, I can see the low inflation rate as having advantages for a cyclical recovery. Price stability is bolstering households’ disposable income. That is all the more important since the burden of taxes and social security contributions on households is set to increase noticeably next year.

Furthermore, the labour market will be overshadowed by slow economic growth for some time to come yet.

So far, in Germany there are no signs of any price-expectation-induced restraint in private consumption. Exactly in view of Germany's long-standing stability culture, the idea that the expectation of higher inflation rates should have a growth-enhancing effect seems to me to be unrealistic anyway.

In terms of labour costs as well, there are no grounds in Germany for a deflationary spiral – in other words, a general and long lasting price slump combined with self-perpetuating recessionary pressure. This year's pay round has more than exhausted the real scope for income distribution.

Finally, it should be borne in mind that the ECB, in quantifying price stability, has factored in not only price measurement problems but also a safety margin from the deflationary zone.

What is making the deflation theory so popular in Germany at the moment is, I believe, weak potential growth. If potential growth is weak, even small disturbances can lead to very low growth rates or, in fact, to absolute declines in overall output. Looked at in that way, recessionary periods become more likely if potential growth is low. At the same time, the pressure on economic policymakers increases.

When deflationary risks are under discussion in Germany, attention is soon focused on monetary policy. Some economists claim that the ECB's policy is not expansionary enough for Germany. It is argued that real interest rates are higher in Germany than in many other euro area countries because of our low rate of inflation.

I believe, however, that it is not sufficient to look at real interest rates in isolation. We have to take into consideration at least two other factors. First of all, it has to be pointed out that the relatively low inflation rate in Germany results in a real depreciation within the euro area. By itself, this leads to increased competitiveness on the part of the German economy.

Second, with regard to wage rate policy, we repeatedly have to make clear that the rate of inflation in Germany is lower than the euro-area average. The more that fact is taken into account in collective wage negotiations, the lower will be the risk of deflationary tendencies.

Financial markets

In the discussions on deflationary risks in Germany, the question of the stability of the German financial system is always raised as well. It is argued that while, in the US, households are bearing the brunt of declining asset prices, in Germany a wide range of financial institutions are being affected by the deterioration in asset prices and credit quality. Allow me to make four comments on that.

My <u>first</u> remark concerns households. According to our own estimate, a 30% decline in equity prices dampens GDP by between 0.1 and 0.2 percentage point as a result of a fall in private consumption. This is much lower than estimates for the US. The difference is mainly due to the fact that, in Germany, only 20% to 25% of equities are held by households. The volume of total shares outstanding in relation to GDP is well below the US figure.

<u>Second</u>, I would like to point to the fact that a decline in equity prices also has an effect on corporate finance. In Germany, however, only 5% to 7% of the financial needs of the corporate sector are covered by the equity market.

Nevertheless, access to the bond market has also become more difficult for some enterprises owing to the fact that their credit rating has declined. For some firms, the high risk premium on corporate bonds has pushed up financing costs. Since German non-financial enterprises obtain no more than about 2% of their funds through bonds, however, no severe problems are to be expected on that front either.

German companies rely mainly on bank loans. And bank loans to the domestic private sector have shown hardly any further increase during the past few months. In September, they were only 1% up year over year. In actual fact, there are some indications that banks are showing a certain amount of restraint in their lending.

In addition to narrow margins in lending business, the very high number of business insolvencies and the fact that many enterprises have a low level of capital is likely to have played a part in this. The quality of banks' loan portfolios has deteriorated.

However, our empirical studies have also clearly revealed that the cause of the weak credit growth in Germany lies not so much in the banks' behaviour as in the situation of the economy as a whole. This means that the marked slowdown in credit expansion is mainly the outcome of a cyclically induced subdued demand for credit.

In my view, the currently weak development of credit cannot therefore be cited as evidence of a general credit crunch in Germany.

Allow me now to come to my third point and make a few remarks on the insurance companies.

The insurance sector in Germany is one of the most important institutional investors. In June 2002, the financial assets of the entire sector amounted to almost 1000 billion € at book values. More than one-third of that amount was invested in the capital markets.

By far the largest part of that figure was invested by life insurance companies, which – at the end of the first half of 2002 – had equities (excluding participating interests) and mutual fund shares to the amount of €160 billion. Life insurance companies have invested 20% of their financial assets in equities.

The fact that share prices have now fallen by around 60% from their peak in March 2000 has led to a significant fall in insurance companies' overall earnings and thus also to a reduction in capital bonuses for policyholders.

So far, however, this has not generated any destabilising effects on the capital market. Even in 2002, insurance companies have still been making new investments of around €12 billion net in equities and mutual fund shares.

Moreover, the insurance companies have a major self-interest in protecting the entitlements of their clients. They have has therefore established a rescue company for failing institutions, although – up to now – this company has not had to take any action. The extensive depreciation requirements due to the significant shares losses have been mitigated by legislation providing tax accounting relief.

Fourth, I would now like to take a look at the German banks. The decline in the equity market has led to a reduction in the amount of hidden reserves.

The growth weakness of the German economy is reflected, above all, in a high risk provision requirement for domestic lending business. Added to this are low earnings from commission business and own-account trading.

All of this has hit a banking system where, for structural reasons, margins are comparatively narrow anyway. By international standards, the German banking sector is characterised by a low degree of concentration as well as very strong competition.

In my view, it is not justified to say there is a banking crisis in Germany. There is no liquidity crisis. German banks are not facing a massive non-performing loan problem as are banks in Japan. And there is no real-estate bubble in Germany.

Above all we have to take into account that the German banks are currently taking comprehensive measures to improve their profitability. These measures concern, first of all, the cost side. The planned staffing adjustments will bring a significant easing of the situation. In addition to that, the process of consolidation which has been under way for some time among smaller banks will gain in momentum.

And, finally, the German banking industry is showing a heightened risk awareness at present. All of these factors together are likely to give a renewed boost to earning power and thus reinforce the stability of the German banking system.