Hermann Remsperger: Reforms must continue

Speech by Professor Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, at Barclays Capital Roundtable, Frankfurt, 10 February 2004.

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In terms of both economic development and economic policy 2003 was a year of important changes. The German economy, which had been stuck in a cyclical downturn during the first six months of the year, was finally able in the second half of the year to begin to break free from the underlying stagnation that had been persisting for approximately three years. In December the way was cleared for economic policymakers to introduce a whole raft of reform legislation, which came into force on 1 January 2004.

Although the agreed measures will set in train the long-overdue process of reform in Germany, it would be unrealistic to assume that they alone will completely remove the impediments to growth in the country. Further efforts are essential for that. The focal points of the reforms are well known: greater flexibility on the labour market, reform of social security and consolidation of public finances. I will have something to say on these areas of reform in the second part of my talk. However, I would first like to shed some light on the current economic situation.

I Economic situation and outlook

The **economy** in Germany took a turn for the better during the second six months of 2003. During this period real GDP after adjustment for seasonal and working-day variations rose by an estimated ¼% compared with the first six months when it had declined by a similar amount. That decline and the sluggish start to 2003 have meant that - according to initial preliminary figures from the Federal Statistical Office - aggregate output fell by 0.1% on an annual average.

The economic trend in 2003 was determined by persistently weak domestic final demand. Enterprises reduced investment for the third year in succession. There was also a further decline in residential building. Moreover, private consumer spending, which had already been muted, was again below the previous year's level. Inventory investment provided considerable positive growth stimuli as the process of destocking - to the extent identifiable - slowed down markedly. While exporters saw their turnover rise on an annual average, they lost international market shares, not least because of the appreciation of the euro. Despite significant improvements in the terms of trade, the external sector had a discernible retarding effect on GDP growth as there was also a relatively strong rise in imports.

Although in the case of Germany the appreciation of the euro means a considerable loss of price competitiveness since October 2000, based on long-term averages the implications for the country's competitive position should be largely considered neutral. The cost advantages enjoyed by German suppliers within the euro area provide a certain counterbalance to movements in the dollar exchange rate.

Of course, just as much attention should be paid to **imports** as to exports. After all, imports of goods and services account for almost one-third of GDP in Germany.

In contrast to exports, German imports of goods rose in seasonally adjusted terms in the fourth quarter of last year compared with the third quarter. The increase was particularly pronounced in the case of imports from China, which now account for about 5 % of Germany's total imports. In addition, significantly more goods were imported from the emerging economies in South-East-Asia and from the central and east European transition countries than in the reference period. Owing to the appreciation of the euro, most of these countries improved their competitiveness over euro-area suppliers. By contrast, imports from other euro-area countries increased more moderately.

Overall, the **economic outlook for 2004** is encouraging. From October through December, for example, the orders received by industry picked up markedly, and in the case of foreign demand the positive trend which had set in during the third quarter continued. In the final quarter of 2003, orders as a whole exceeded the third-quarter level by a seasonally adjusted 3.8%. The fact that the business climate in the manufacturing sector also improved further at the beginning of the year is consistent with this picture.

According to the IMF forecast, the growth of global GDP in 2004, estimated more than 4%, will be stronger than at any time since the boom year of 2000. The OECD forecast estimates that in 2004 world trade will increase by just under 8% compared with 4% in 2003. Despite the strengthening of the euro in the past few months, there is a good chance that the German economy will continue to benefit considerably from this world economic trend.

The strong impetus expected from the external sector will probably also boost investment in Germany. The substantial adjustments achieved by domestic firms in the past few years are also important in this connection. Other encouraging factors are that the cost of debt financing has been low for some time and equity prices are picking up significantly. It is not yet clear to what extent exchange rate volatility will affect German propensity to invest.

Price developments in Germany are still favourable. According to initial estimates, consumer prices in January were 1.3% above last year's level. The high degree of price stability is an important factor in encouraging private consumption, which continues to suffer from the declining level of employment. This is all the more important given the fact that, following the reform of the health service, the inflation rate for January contains a sharp rise in healthcare costs which more than offsets the base line effect resulting from the discontinued impact of the increase in indirect taxes at the beginning of 2003. An important statistical effect that should be noted in this context is that, as patients' own contributions to healthcare costs are being increased, the HICP will show an increase in inflation even if the market prices of the goods concerned remain unchanged. The overall price situation continues to be one of the German economy's great assets.

On the cost side, lower prices for commodities and intermediate goods due to the euro's appreciation will ease the burden on enterprises. This is becoming particularly marked in the case of crude oil prices; these are currently at a very high level in US dollars but in euro are much lower than a year ago. It is to be hoped that wages and salaries will continue to rise at only a moderate pace. There will be relief in the case of non-wage labour costs if - as already announced - a number of statutory health insurance institutions lowers their contribution rates in the course of 2004. However, the fall in rates is likely to be less than the federal government expected when it was devising the healthcare reform that has now come into effect.

Compared to 2003, there are almost five additional working days in Germany this year. However, it is not clear to what extent this additional working time will actually be used for production. If these days were to be used for production purposes on the customary scale, GDP could grow by between 1½% and 2% although at present the lower bound of the range seems more likely. That, however, would mean that the significant output gap which has already occurred would not be reduced on an annual average.

The improved cyclical outlook must not blind us to the prevailing risks. In view of the German economy's considerable dependence on the global economic situation, it is particularly susceptible to external shock.

The US current account deficit is just as unsustainable in the long term as the public budget deficits in some industrial countries. Although the recent depreciation of the US dollar is tending to counter the external imbalances, they cannot be remedied in this way alone. Instead, countries with weak growth performance, including Germany, must do more to accelerate their own growth rate by pushing on with domestic reforms.

II Reasons for sluggish growth and possible solutions

Problem area 1: labour market

From as far back as the mid-1970s a high and rising unemployment rate has been one of German economic policymakers' greatest challenges. Since that time unemployment has risen during each cyclical downturn but in every subsequent upturn policymakers have been quite unable to restore it to its original level. At the beginning of 2004 seasonally adjusted about 4.3 million people were officially registered as unemployed in Germany. According to the definition of the Federal Employment Agency, this was 10.2% of the civilian labour force. Germany's unemployment rate is also disproportionately high when compared with that of other EU countries.

Inflexible structures and protective mechanisms which, for the most part, were designed for an ideal situation of full employment are largely to blame for the difficulties on the German labour market. That is why structural reforms are necessary first and foremost to reduce persistent unemployment. This is a task for the legislators, on the one hand, and management and labour, on the other.

A start has already been made here. It began with the *Job-AQTIV-Gesetz*, an act which was designed to get people back into work and which came into force on 1 January 2002, and was followed at the beginning of 2003 by the first two pieces of legislation to promote modern labour market services, better known as "Hartz I" and "Hartz II". Hartz I deals mainly with the new personnel service agencies which are intended to make job placement more efficient. Hartz II is concerned with the creation of new employment opportunities in the form of one-person businesses and mini or midi-jobs, as they are called.

With the adoption of the **Agenda 2010** the federal government launched a series of bold reforms. This applies in particular to the tightening of job-acceptance criteria for the long-term unemployed and the amalgamation of unemployment assistance and social assistance in what is known as *Arbeitslosengeld II* or "unemployment benefit II". This could create an important precondition for restoring a market at the lowest end of the wage scale. This market segment, which has come under increasing pressure as a result of globalisation, could open up better employment opportunities to relatively unskilled persons with low productivity.

These measures, especially the lowering of unemployment assistance to the lower level of social assistance and the reduced offsetting of earned income against benefits, will create greater incentives to take up paid employment. The greater obligation now placed on the unemployed to take a more active part in looking for work and the shortening of the entitlement period for drawing "normal" unemployment benefit, *Arbeitslosengeld I*, have a similar objective. At the same time, it is expected that these measures will reduce the incentive to exploit benefit entitlements.

Furthermore, the raising of the threshold triggering formal employment protection measures at small enterprises as well as the limitation of the "social criteria" which inhibit the employer's discretion in the event of compulsory redundancies were the first, if somewhat timid, attempts to reduce the barriers to entering the labour market. The reform of the Crafts Code is also making it easier to set up new businesses.

All of these measures are helping to restore the satisfactory functioning of the labour market. Even so, major barriers to entering the labour market remain. Large sections of labour law need to be critically reviewed. As vaguely defined legal terms and catch-all clauses such as "important reason" in the employment protection legislation or the "favourability principle" are to be widely found here, judicial decisions are of vital importance. Yet the judges do not always take sufficiently into account the economic implications of their rulings. Especially in the case of small and medium-sized enterprises which cannot afford to have a legal department of their own it is often difficult to keep up with the current legal position. All of this results in enterprises being reluctant to recruit staff, and this has correspondingly negative consequences for the labour market.

To solve the labour market problems is not the responsibility of the legislature alone. Management and labour also have a duty. Indeed, employers and the unions have done a few things in the past couple of years to increase the flexibility of employment contracts. Examples worth noting are the working hours accounts that have now become commonplace in many sectors, the pay corridors in the chemical industry, and the renegotiation of the traditional Christmas bonus in some sectors.

However, further steps are imperative. This applies primarily to the favourability principle, which should be interpreted more widely to include measures that safeguard existing jobs. Furthermore, national and sectoral labour contracts should contain flexibility clauses permitting plant-level agreements so that prevention measures can be taken before a crisis situation develops.

Particularly in the wake of advancing globalisation and the transfer of production to more cost-effective countries, the employment structure in Germany has shifted significantly in favour of high-skilled labour at the expense of low-skilled labour in the past few years. If we are to improve the steering and market clearing functions of wages, negotiated wage policies must be even more flexible. In the middle and upper wage segments there is a need to create incentives to acquire higher qualifications through appropriately rewarding vocational training. In the less skilled segment remuneration must be brought more into line with the productivity profile of the job concerned. As already mentioned, this will probably be made easier by the recent decision to amalgamate unemployment assistance and social assistance.

In times of high and persistent unemployment it is not only measures to improve the efficiency of the labour market that are important. Wage policy also plays a key role. What we need is a moderate wage policy which has a steadying effect (ie stabilises expectations), one which gauges the scope for real income distribution conservatively and does not fully exhaust it. The basic rule should be that the increase in the real product wage remains below the (genuine) increase in productivity in order to make more jobs viable in the long term and to maintain competitiveness.

Problem area 2: public finances/consolidation

Like the labour market, the area of public finance has also significantly weakened economic growth momentum in Germany. The burden of taxes and social security contributions rose considerably during the 1990s. Last year this burden amounted to almost 42% and was far greater than in 1991. Taxes were not the reason for this. Their share of GDP has actually declined somewhat, particularly as a result of the sluggish rate of growth over the past few years and the reduction in income tax rates. Yet the burden of social security contributions has grown considerably even though an increasing proportion of the expenditure in this area has been financed through taxation.

At 4.0% of GDP, the general government **deficit** last year reached its highest level in more than two decades. According to our calculations, by far the greatest part of this deficit is of a structural nature and is not to be attributed to cyclical developments and other temporary influences. Since the autumn of last year the federal government has been assuming that the deficit ratio will again be over 3% for the current year. In an updated version of the German stability programme from January it forecasts a ratio of 3½% in the main scenario for 2004. This would mean that for the third time in succession Germany would exceed the reference value for the deficit ratio laid down in the EU Treaty, namely 3%.

In accordance with the **Stability and Growth Pact**, the next step in the excessive deficit procedure should therefore have been launched against Germany. However, the Ecofin Council rejected a recommendation to this effect from the European Commission on 25 November last year. This precedent has greatly undermined the Commission's credibility with respect to the threat of using sanctions when a country continues to pursue an undesirable fiscal policy. I share the European Commission's concern about the action of the Ecofin Council and respect its decision to take the matter to the European Court of Justice for legal clarification.

The Ecofin Council's decision reveals an in-built flaw in the pact, namely that to some extent sinners are passing judgement on sinners. Even so, I am sceptical about amending the EU Treaty or the pact. There is a danger in every amendment to the Stability and Growth Pact, especially in the present situation, that the existing rules will be relaxed. By contrast, the potential advantages seem to me to be comparatively small. However, I do think that the implementation of the pact could be improved.

In my opinion, undermining the pact poses considerable risks in the medium to long term, not least for growth potential. If fiscal policymakers are given politico-economic incentives to borrow, it could mean that in some countries excessive deficits would in the future tend to become the rule rather than the exception. They may also feel more inclined to neglect the objective laid down in the pact, namely of achieving a budgetary position which is at least close to balance in the medium term. It is not only on account of the growing interest burdens that rising government debt ratios restrict the available budgetary policy options for growth-promoting investment in, for example, education and make it harder to tackle the challenges posed by the foreseeable budgetary burdens arising from demographic developments. Persistently increasing government borrowing might push up capital market interest rates, and this would have a negative impact on economic growth potential and employment trends. It is precisely in the present situation that unresolved budgetary problems give rise to uncertainty about future fiscal policy. This encourages consumers and investors to adopt a wait-and-see attitude and thereby possibly curbs economic growth in the short term, too.

For that reason, I do not consider consolidating public finances and complying with the pact as ends in themselves or as a pedantic adherence to the rules. Nor are these objectives an impediment to an economic upturn. Instead, they promote medium and long-term growth prospects and are in Germany's best interests.

Against this background, I think the results achieved by the **Mediation Committee** at the end of December have to be assessed in a differentiated manner. For the current year it is now likely that the general government deficit will be somewhat smaller than what the government had led us to believe at the beginning of the inter-House mediation hearing. The main reason for this is that only part of the third stage of the tax reform will be brought forward to 2004. Another positive point is that further subsidies were abolished or tightened through the partial realisation of the Koch-Steinbrück proposals. On the other hand, the grant to home buyers and the tax relief on commuters' travelling costs were not cut nearly so dramatically as the government had originally announced. As these cost-cutting measures would not have exerted their full effect until later years, larger deficits than the government had originally planned can be expected from 2005. As things now stand, there is still no guarantee that in the coming year Germany will not exceed the 3 % deficit ceiling although that is essential if the country is to comply with its European commitments.

The persistently precarious state of public finances also needs to be borne in mind during the present debate on a **further tax reform**. In principle, any tax reform which makes it possible to lower tax rates by a further substantial amount through the abolition of subsidies and exemptions and, at the same time, greatly simplifies tax law is very much to be welcomed. It might release growth potential through improving incentive structures. In the present situation, however, a reform of this kind must be designed in such a way that it has a neutral impact on revenue.

Problem area 3: social security

Not only fiscal policy but the social security funds, too, must play a substantial part in reducing the growth-inhibiting levy wedge. Between 1990 and 2003 contribution rates rose from 35½% to 42% even though the proportion of expenditure for social security financed from tax increased significantly. Over the longer term a further rise in the contribution rates to the statutory pension, health and long-term care insurance schemes is inevitable, primarily as a result of the growing proportion of elderly people in the total population. This trend has to be limited. At the same time, an effort must be made to ensure that the increase does not result in rising labour costs.

The fact that **healthcare** spending could account for an increasing proportion of gross domestic product is not problematical in itself. This may simply reflect the preferences of an ageing and increasingly affluent society. Under the present system of financing the statutory health insurance scheme, however, it would place an even greater burden on labour as a factor of production. The result would be a curtailment of employment and growth.

To that extent, the measures approved last autumn for the statutory health insurance scheme are to be welcomed. A further rise in contribution rates has been avoided. Such an increase would otherwise have been necessary in order to prevent the health insurance institutions from running up new deficits and to pay off the debt incurred during the past few years. Patients' increased personal contributions towards costs will probably act as an incentive to deploy funding more efficiently.

Even so, these measures must be seen as no more than an initial step. In the light of demographic trends, there is a pressing need to restrict the increasing burden on labour caused by social security contributions. In my opinion, this can succeed only if the funding of the statutory health insurance scheme is decoupled from wages. Proposals on this are already on the table. These envisage switching to a system of standard premiums for all insured persons with a supplementary tax-financed element of social equalisation. Another requirement is to organise the healthcare system more efficiently on the supply side through increased competition.

Without the measures approved at the end of 2003 an increase in the contribution rate to the **statutory pension insurance scheme** would also have been necessary this year. However, stabilising the contribution rate was possible only by drawing to a not insignificant extent on capital assets and thereby incurring greater general government deficits. In the long term, future increases in contribution rates can be avoided only if the level of pensions is lowered or the statutory retirement age is raised. It seems to me that a combination of both approaches makes sense. With respect to the level of pensions the federal government has already made appropriate proposals with the introduction of a "sustainability factor". The resultant gap in pension benefits can be closed by increasing the weight of supplementary private pension schemes. A gradual increase in the statutory retirement age, which would take account of increasing life expectancy, has been postponed by the government. The decisive factor is ultimately the curbing of the contribution burden. Only in this way can employment and thereby the financing base of the social security system be safeguarded on a permanent basis.

Summary

Generally speaking, major reforms were initiated last year to counteract the weak economic growth in Germany. However, I think they are not sufficient. In my opinion, what is now important is to avoid being lulled into a feeling of security through the emerging cyclical revival. There is still considerable need for action and reform to improve long-term growth perspectives.