Hermann Remsperger: The Bundesbank's view of the economic outlook and economic policy challenges

Speech by Professor Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, at Swedbank's Economic Outlook Conference, Stockholm, 25 October 2004.

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I was very glad to accept your invitation to attend Swedbank's Economic Outlook Conference. To a German central banker comparing the economic developments in Germany and Sweden since the 1990s is interesting for a number of reasons. This also holds true for the question of how we in Germany should tackle the current economic policy challenges. Just an example: Last Wednesday I read an article in the Financial Times with the heading "Can Sweden give Germany fertile ideas to revive an ailing economy?".

In the past, Sweden was admired by many for its virtually "perfect" social welfare system. Today, Sweden is perceived as an example of successful reforms because it anticipated the need for economic restructuring at an early stage - namely in the early 1990s when the country suffered from a banking crisis and exchange rate problems. Sweden reacted by making its labour markets more flexible and adapting its social welfare systems to the new environment.

In Germany, by contrast, structural reforms had a much lower priority on the agenda in the 1990s. Unfortunately, German reunification was not seized as an opportunity to explore new approaches in economic policy. The preparations for European integration also tied up a lot of resources at the time.

In the meantime, however, a lot has been done to reform the labour market and the social security system. I will talk more about that in just a moment. But first I would like to make a few comments on the current economic situation and the monetary policy of the ECB.

1. Developments in the global economy

In the first half of this year, the world economy grew faster than many experts had been predicting in the spring. This is reflected in upward forecast revisions. The IMF's September forecast is an example. It suggests that the increase in global output in 2004 could turn out to be 0.3 percentage points higher and reach 5.0% on average. A rate of 4.3% is expected for 2005, which would be still pretty dynamic.

Since in many countries actual GDP growth is above the potential rate, a slight slowing of global economic momentum must not be viewed as completely negative. At the same time we have to take into account that the oil price has undergone further increases since September. In my view, the rising price of oil is not just a reflection of the good shape of the world economy. It is also due to a shortage of supply.

The consequences for each economy depend on the oil intensity. Production in developing countries and emerging markets is more oil-intensive than in the industrialised countries. Oil intensity in the industrialised countries has declined since the 1980s but has probably increased in the emerging market economies.

Although the effects are difficult to quantify, we at the Bundesbank assume that the increase in the price of oil will dampen world economic growth. But it will not prevent the global economy from growing further. This assessment is, however, subject to the condition that the high oil price level does not trigger second-round effects on prices.

There are still considerable regional differences in the pattern of growth. Strong impetus continues to come from the global growth centres, namely the United States and East Asia.

In China, the slight dip in growth in the second and third quarter has somewhat reduced the risk of the Chinese economy experiencing a hard landing, which would have considerable economic consequences for the neighbouring countries.

The cyclical recovery has continued in Japan despite a weakening of momentum in the second quarter. The upturn in the euro area has gathered pace. Even so, it is not yet as dynamic as in other regions of the world.

As I see it, this global constellation with persistent regional growth disparities is vulnerable to shocks owing to the ongoing current account imbalances. In this connection, the foreign currency markets merit special attention.

2. Economic situation and outlook in the euro area

The cyclical recovery in the euro area has gained momentum since the start of this year. In the second quarter of 2004, seasonally adjusted real GDP grew by 0.5 % as compared with 0.7 % in the first quarter. These growth rates are the strongest the euro area has seen since early 2001. According to the European Commission's short-term forecast, output will continue to expand within a range of 0.3% and 0.7% in the third and fourth quarters.

However, this upturn is not yet broad-based. Gross fixed capital formation has stagnated until now. Private consumption growth slowed to 0.3% in the second quarter. By contrast, exports increased by 3.1%. These figures primarily reflect the much improved external environment.

Against this backdrop, the ECB staff back in September expected annual average growth for 2004 to be in a range of 1.6% and 2.2%, for 2005 in a range of 1.8% and 2.8%. This corresponds with median values of 1.9% and 2.3%. As with any forecast, there are risks to this one, too. First and foremost, there is the oil price risk.

In this context, we of course have to take into account that the level of dependency on oil in the euro area is lower than it was during the oil crises of the 1970s and early 1980s. This reduces the negative effects of a rise in the oil price on euro-area growth. Furthermore, one should consider the price of oil in real terms.

Not surprisingly, consumer prices reacted immediately and sharply to the jump in oil prices. The ECB staff have revised their forecast on HICP inflation for 2004 slightly upwards to between 2.1% and 2.3%. Inflation in the euro area in September was 2.1%. It will probably not drop below the 2% mark until some time next year. For 2005, the ECB staff expect a range of between 1.3% and 2.3%. We assume that inflation will return to the stability range in the coming year.

It remains to be seen whether there will be a safe distance between actual inflation and the zone which lies outside our own definition of price stability. Moreover, we have to bear in mind that the marked expansion of the money stock between 2001 and 2003 was accompanied by a strong increase in excess liquidity in the euro area. At the present, estimates show the real money gap at around 6½%.

It is important to remember, however, that these figures primarily reflect the portfolio shifts of the past few years. It is not necessarily the case that these money holdings will actually be used to purchase goods. But I also would like to emphasize that the domestic forces behind monetary expansion are clearly gaining in importance. This is due not only to stronger economic growth in the euro area, but also to the very low central bank interest rates.

If the excess liquidity is still held after the uncertainty in the financial markets declines, the likelihood of the abundant liquidity being used to purchase goods will rise. The ECB Governing Council must therefore keep an eagle eye on monetary expansion so as to be able to stop higher inflation rates at their roots.

Interest rates in the euro area are currently very low, both in nominal and in real terms. This also holds true for risk premiums. For instance, euro-area enterprises with a BBB rating for bonds with a maturity of 7-10 years have to pay an average interest rate of only around 4¾%. This represents a premium of merely ¾ percentage point over comparable government bonds. On average, this figure has been twice as high since 1999.

At the present, corporate bonds are obviously also benefiting from a search for higher yields. Furthermore, euro-area bank interest rates are very low. Credit standards have not tightened further.

3. Economic conditions in Germany

Since early 2004, the economic situation in Germany has improved significantly. For a long time, Germany's growth lagged behind that of the other euro-area countries. This gap has now narrowed considerably. Germany is no longer trailing behind the rest of the euro area. In the second quarter of

2004, GDP increased by 0.5%. In the first half of this year the annualised growth rate was 1¾%. As potential growth in Germany is only about 1½% this means that there was an increase in capacity utilisation for the first time since many years ago.

However, the recovery in Germany is not broadly based. Domestic demand has not yet taken off. Growth has been driven mainly by exports. In the first half of this year, exports grew by 6.2%, while imports grew by 3.7%. From January to August 2004, exports were up by as much as 10.9%. This shows that the price competitiveness of the German economy is still very high, which enables German firms' to benefit from strong growth in their export markets.

It is striking that the appreciation of the euro has had a far less dampening effect on exports than many had expected. It seems that the increase in foreign demand for German products in the wake of the buoyant global economy has more than offset the effects of the exchange rate. Exports to the USA, for instance, which declined last year, have improved again. Exports to countries outside the EU in particular have increased strongly. From January to July our exports to Russia and China both grew by 22.7% on the year.

Despite all these positive figures we must not lose sight of our export dependency. The German economy remains vulnerable to a slowdown in global economic activity. This is the German economy's Achilles' heel.

Overall, domestic demand contributed little to growth in the first half of the year. The level of business investment was again disappointing. There was no increase in the second quarter, either.

Nonetheless, the conditions for an increase in investment are still good. Firms' cost situation has eased and is helping to stabilise their earnings. The financing situation is favourable. German enterprises are not suffering from overindebtedness. Corporate investment plans now point towards a recovery. The need for replacement investments is large. A lot of equipment has to be modernised.

We hope that the slide in private consumption will soon bottom out. Consumers' propensity to spend is, however, still low. A further reduction in income tax scheduled for January 2005 and the falling rate of inflation are likely to boost consumption somewhat, especially as the labour market could improve over the course of next year. I'll come back to this point in a minute.

All in all, from today's perspective, real GDP growth of just under 2% for this year seems to be realistic. However, this figure is inflated by working-day effects. Adjusted for working-day variations, the current year will show growth of just under 1½%. According to very preliminary estimates for 2005 (likewise adjusted for working-day variations) we expect a growth rate slightly above the 2004 outcome. But this forecast is a very conditional one. Above all it depends on the assumption that the oil price will come down from its current level.

4. Structural problems in Germany

The German economy's structural weaknesses are reflected in the persistent low propensity to invest. The total net investment ratio currently stands at merely 2¾% of GDP. The capital stock of machinery and equipment has not increased by more than 1% of late. As a result, potential output, with growth of 1½%, is rather disappointing. Our potential growth is considerably below that of the euro area and particularly that of the USA.

Alongside the burdens arising from reunification, the process of interest rate convergence during the transition to the euro is likely to have been a factor which has dampened Germany's position in the European growth league. Previously existing interest rate advantages were lost. From a German perspective, competition for investment has become stronger.

Problem area 1: the labour market

But over and above these special factors, a simple growth analysis shows that in Germany labour has contributed less to economic growth compared to other countries, particularly the USA. The US economy has obviously been more successful at integrating labour into the production process. In Germany, by contrast, the high structural unemployment has resulted in enormous production potential remaining idle.

It is also telling that unemployment in Germany has increased with every cyclical downturn. In the following upturns, we have failed to create jobs for the additional number of unemployed. The labour force is not being fully utilised owing mainly to labour market rigidities.

But now we should not overlook the fact that initiatives have been taken to reform the German labour market. There can be no doubt that the labour market has recently become more flexible both with respect to its institutional framework and as regards collective wage bargaining and working hours.

For example, the significance of industry-wide collective wage agreements has decreased. In 2003, only 63% of the employed persons in western Germany were covered by industry-wide wage agreements. In the 1970s, this figure stood at 70%. This suggests that greater account can be taken of local and firm-specific requirements. Naturally, industry-wide wage agreements still play an important role. Many enterprises which are not formally covered by them tend to adhere closely to them.

The experience of the past few years also shows that the wage drift, the difference between negotiated pay rates and actual earnings, acts as an important corrective of excessive collective wage agreements. So actual wages are more flexible than they appear at first glance. In both 2002 and 2003, for example, there was a negative wage drift of 1 percentage point. This trend continued in the first half of 2004.

While negotiated pay rates are largely sticky downwards, even collective wage agreements provide some scope for flexibility. This includes escape clauses as well as the suspension or postponement of negotiated pay rises at firms which are in a difficult situation.

Lower entry-level wages, pay ranges and performance-related wage components are also important elements of wage flexibility within the framework of collective labour agreements. By contrast, virtually no progress has been made in recent years with regard to the wage structure. Wage differentiation, especially at the lower end of the qualification scale, is urgently needed in order to create more employment opportunities for low-skilled people with low labour productivity.

Coming back to positive developments I'd like to point to increased flexibility in working hours. Many companies now operate with a system of working-time accounts. This allows firms to better adapt the regular working hours, which are paid at standard rates, to their operational requirements.

And, most recently, some companies have introduced longer working hours without additional compensation. Experience has shown that employees are more inclined to accept cuts in wages if these take the form of longer working hours or reductions in bonus payments.

The merger of unemployment assistance and social assistance to "unemployment benefit II", as we call it, will increase the incentive to find employment. Recipients of such social benefits will be expected to accept any work available. Moreover, unemployed persons will be allowed to earn a certain amount without any deductions. The maximum period of entitlement to the higher "unemployment benefit I" is being cut to one year. Until now, this benefit was paid for up to 32 months.

In my view, the labour market reforms justify the hope that the economic recovery will spill over into higher employment. Even so, increasing competition among domestic and international production sites will increase the pressure to become more flexible. As a result, further efforts are necessary, particularly in the area of wage structures.

The key need now is to generally reduce the tax wedge on the labour market. Particularly as a result of the significant rise in contribution rates to the social security funds, the ratio of wage tax and social security contributions to labour costs went up from 43% in 1991 to just over 48% in the past two years.

On balance, real labour costs per hour have risen by over 24% since 1991 (or by 1.8% per year), whereas real net earnings per hour have gone up by only 8% (or by 0.7% per year). This means that for every euro incurred by an employer as labour costs for his employee, the employee receives less than 52 cents.

Problem area 2: the social security systems

In our view, any assessment of labour costs has to include an assessment of the social security systems in Germany. The financing of social security benefits is largely tied to labor income, which is already driving up wage costs. Demographic developments are likely to push non-wage labour costs up further.

This is one of the reasons why the German government recently introduced a whole package of reforms. These are not just intended to bring about shortterm financial relief. Instead, the reforms aim to put the social security systems on a more stable footing in the longer term. Another objective is to curb future rises in overall levies and to foster a more efficient use of government benefits.

For example, a “sustainability factor” has been introduced into the pension system. As a result, future pension adjustments will be smaller if the ratio of pensioners to contributors increases. Furthermore, the possibilities for early retirement have been further restricted.

By implementing these measures, the government aims to limit the increase in the contribution rate from the current 19.5% to 22% in the year 2030. From today’s perspective, not implementing the reforms would see contributions rise to over 24% in the same period.

Rising life expectancy suggests that the statutory retirement age will also have to be raised. In future, we will not be able to dispense with the services of older workers so early as is the case today.

The healthcare system is another area due for reform. The health reform in 2004 reduced the range of insured services. In addition, patients have to pay more for certain services out of their own pockets. Finally, the traditional equal financing of the health system by employers and employees has been adjusted for some benefits in favour of the employer.

But despite all these measures, the underlying problems in the healthcare system have by no means yet been solved. There is still room for improved cost-effectiveness. It is therefore essential that the efficiency-enhancing price mechanism should be used as much as possible.

Furthermore, people must take greater responsibility for their own health. In our view, one of the main problems is that the health system is financed on a wage-related basis. A changeover to a flat-rate health premium with state aid to avoid hardship in certain cases is one possible solution.

Problem area 3: public finances

Germany will record a general government deficit of more than 3% of GDP in 2004 for the third year in succession. The country’s debt ratio actually reached an historical high of 64.2% in 2003 and will further increase in the current year. There is also a risk that the deficit may exceed the 3% ceiling in 2005. This highlights the need for substantial fiscal policy action, a need which will intensify in the long term owing to demographic changes.

Due to a fertility rate of 1.4 children per woman, which is well below the reproduction rate, the population will decrease. Against the backdrop of an increase in life expectancy of almost 1.3 months per year this implies an increase in the old-age dependency ratio. By 2050 the share of the population above the age of 64 to the population between 20 and 64, currently at 0.31, can be expected to rise to 0.55.

The consolidation of public finances is not an end in itself but rather an economic necessity. Rising interest payments on today’s deficits constrains the government’s leeway in the future. In order to foot the bill, other expenditures have to be reduced or taxes and contributions raised. Raising taxes and contributions is particularly problematic as the levy and tax burden in Germany is already high. You cannot impose a rising financial burden on a shrinking population.

When public finances are perceived as unsound, consumers and investors alike are worried about the future. This leads to excessive caution, which dampens economic activity.

The consolidation of public finances is a key task for all levels of government. For the past three years in a row, net borrowing in the Federal budget has exceeded the constitutional limit, defined as an amount equal to total investment expenditure, so that the Federal Government has repeatedly had to invoke the exemption clause by claiming that the macroeconomic equilibrium is temporarily disrupted.

Many state government budgets are facing similar problems. The general government deficit amounted to €81 bn in 2003. Around 42½% of this deficit was attributable to the regional and local level.

It is crucial to reduce the general government deficits, not least on account of Germany’s international commitments. In the run-up to European monetary union, Germany was the most vociferous advocate of a stability and growth pact. The adoption of the Stability and Growth Pact formed one of the cornerstones of a successful European monetary union.

The objective of the Stability and Growth Pact is to attain and maintain sound public finances in the euro area. In no way does the pact constitute an excessive constraint on the flexibility of member states' fiscal policy. A budget which is close to balance will generally enable the automatic stabilisers to take effect. Healthy public finances are essential so that the European System of Central Banks can maintain long-term price stability at relatively low interest rates.

The proposals made by the European Commission for a reform of the Stability and Growth Pact include widening the exemption clauses, which allow a temporary breach of the deficit criterion, and extending the deadlines for correcting excessive deficits.

We at the Bundesbank believe that, instead of strengthening the Stability and Growth Pact, the proposed changes would have a generally detrimental effect on it. Although some of the Commission's proposals lean towards a more consistent application of the Pact within its current framework, we feel that a reform of the Pact is not necessary. The problem with the Stability and Growth Pact lies not in its terms but in its implementation. Its credibility depends on the will of those responsible for national fiscal policies to support the objectives and underlying ideas of the Pact and to consistently penalise any breaches.

In conclusion, I would say that the attempts to tackle the economic policy challenges in Germany reveal a mixed picture of both light and shade. Advances in reforming the labour market and the social security systems are qualified by unresolved problems in the field of public finances. It is essential to undertake efforts to consolidate the public finances and to continue the process of reform of the labour market and social security reforms.

Last but not least, I'd like to quote a rather long sentence from a report published last week by the ECB: "With a view to increasing the employment and growth potential by making the economy more flexible, thereby maintaining the sustainability of public finances and price stability, national policies aiming at improving the functioning of product and labour markets are also needed, while social partners will need to ensure that wage developments are in line with labour productivity growth and developments in competitor countries."

I'm sure you know that this statement does not refer to Germany but to Sweden. In my view, however, it could be applied to Germany as well. Of course, instead of "maintaining the sustainability of public finances" we should read "aiming at the sustainability of public finances".