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Strong Economic Upturn in Germany

A strong economic upturn has developed in Germany. But are there disparities between eastern and western Germany? What developments have there been in foreign trade and monetary policy? Are stimuli from fiscal policy to be expected? How good are the prospects for the year ahead?

The economic situation in Germany, as in the other countries of the euro area, is better than it has been for a long time. A strong upturn has developed over the past twelve months. Real gross domestic product is now expanding noticeably faster than production potential, resulting in a perceptible increase in the utilisation of capacity; in the industrial sector it is already higher than the long-term average again. There has been a marked rise in employment since the autumn of 1999, and the number of unemployed has fallen considerably – by 213 000, seasonally adjusted, from September 1999 to June of this year. The picture is marred to a certain extent by price trends, with consumer price rises accelerating considerably during the course of this year. In June, the inflation rate was 1.9%, only marginally below the 2% mark regarded by the European Central Bank (ECB) as the upper limit reconcilable with the target of price stability. However, this price acceleration is largely the result of soaring oil prices and the ongoing weakness of the euro. There has been no more than a relatively minor increase in the “core rate”, which remains at around 1%.

Contrasting Effects of the Euro's Weakness

Exports are still providing considerable impulses to the economy; in the first four months of the year they were around 16% higher than last year in value terms (see Figure 1).¹ The ongoing strength of exports is primarily due to the brisk expansion of the world economy and to the continuing boom in the USA in particular. Moreover, the weakness of the euro – the external value of which has fallen by around 15% since January 1999² – has improved the competitiveness of products from the euro area considerably. This led to renewed acceleration of export growth to non-European countries at the start of the year; in value terms, exports to the USA in the first four

months of the year were actually one fifth higher than a year previously. In Europe, too, demand has strengthened considerably since the end of 1999 in the wake of the region's economic upturn; this year, exports to EU countries have expanded at much the same strong rate as those to the USA.

However, the depreciation of the euro has not only had stimulating, but also dampening effects on the economy. For it was primarily the weakness of the euro, together with soaring oil prices, that led to a rise in the cost of imports and so to an acceleration of the inflation rate in Germany and in the other countries of the euro area. Consumer prices have risen by a good 1% since the end of last year, implying a similar loss in real income. This is a principal reason for the fact that private consumption has remained relatively weak during the course of the year so far, despite the tax relief measures that came into force at the start of the year; private consumption actually declined in the first months of the year. As a result of the sharp rise in energy costs, private demand for cars in particular has cooled off considerably.

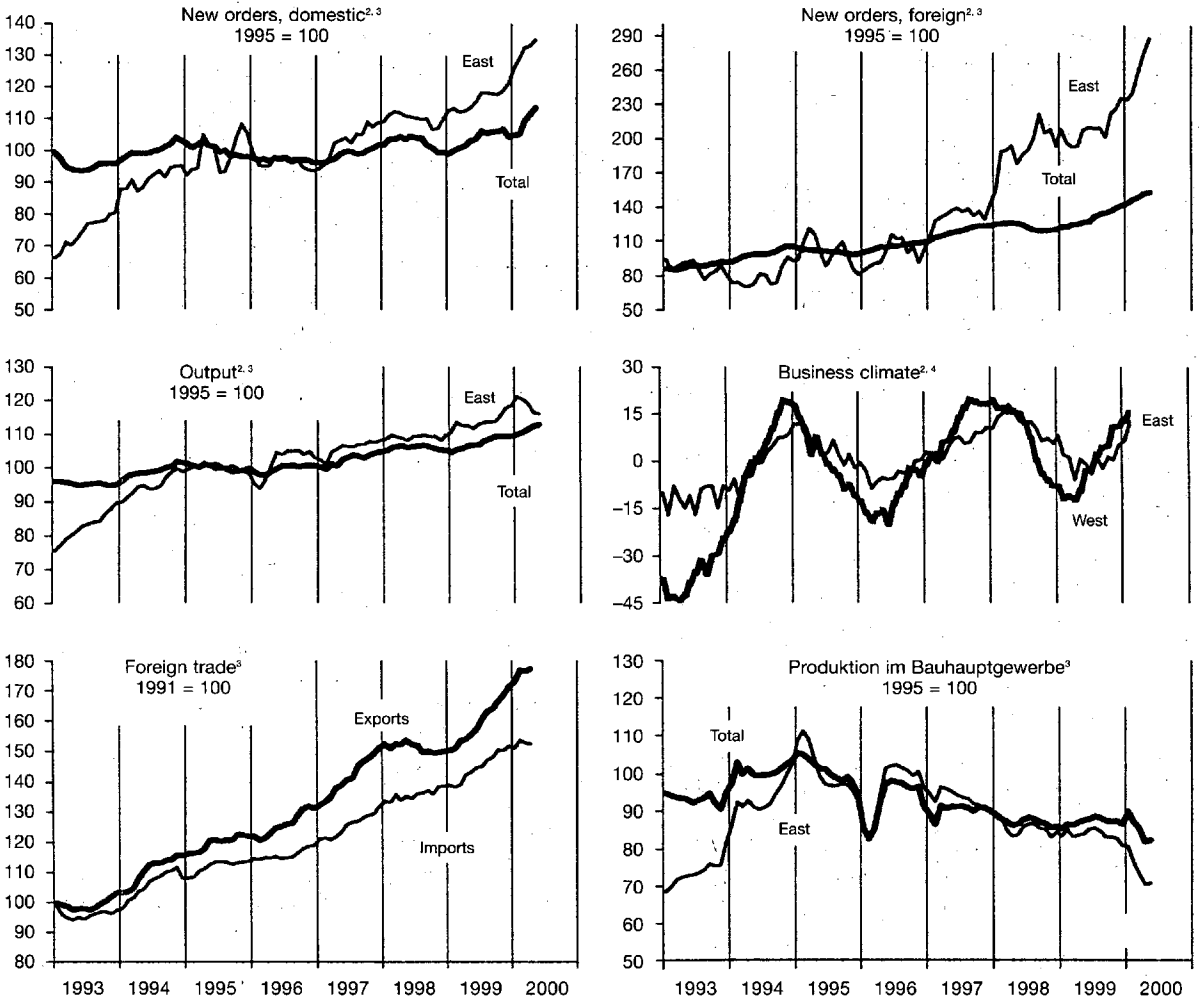
In spite of the weak trend in private consumption, domestic demand – which, during the economic slump prompted by the financial crises in Asia, Latin America and Russia, had already proved relatively robust and had thus prevented an even greater setback – has, on the whole, continued its brisk expansion. While this was partly due to stimuli emanating from the stockpile cycle, the decisive stimulus was provided by the vitality of investments. Encouraged by a marked improvement in sales and earnings prospects both for exports and domestic

¹ Merchandise exports according to the special trade categories of the balance-of-payments statistics.

² Measured in terms of the effective exchange rate of the euro as calculated on the basis of the narrow group of partner countries. On the calculation of the effective exchange rates see European Central Bank: The nominal and real effective exchange rates of the euro, Monthly Bulletin, April 2000, pp. 39 ff.

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Figure 1
Economic Indicators for Germany¹



¹ Seasonally adjusted using method ASA II (HWWA version). ² Manufacturing industry. ³ Three-month moving averages. ⁴ Balance of firms' positive and negative reports.

Sources: Statistisches Bundesamt, ifo Institut; HWWA calculations.

trade, businesses have been exceedingly active in expanding their inventories of plant and equipment. In contrast, construction investments remained weak.

Disparities between Western and Eastern Germany

A clear growth divide still remains between western and eastern Germany. Ten years after the launch of economic and monetary union there is still no indication that the catching-up process – which has made little progress for some years now – could be speeding up once more. Recovery has taken hold in eastern Germany, too, and industrial demand and output are even expanding faster than in western Germany. However, the construction sector, which, given the

sheer size of the industry, has a decisive impact on the health of the economy as a whole, continues to be in decline. At least the fall in construction investments appears to be slowing down gradually. Investment in machinery and equipment also seems to be on the decline in eastern Germany.³ All in all, growth in

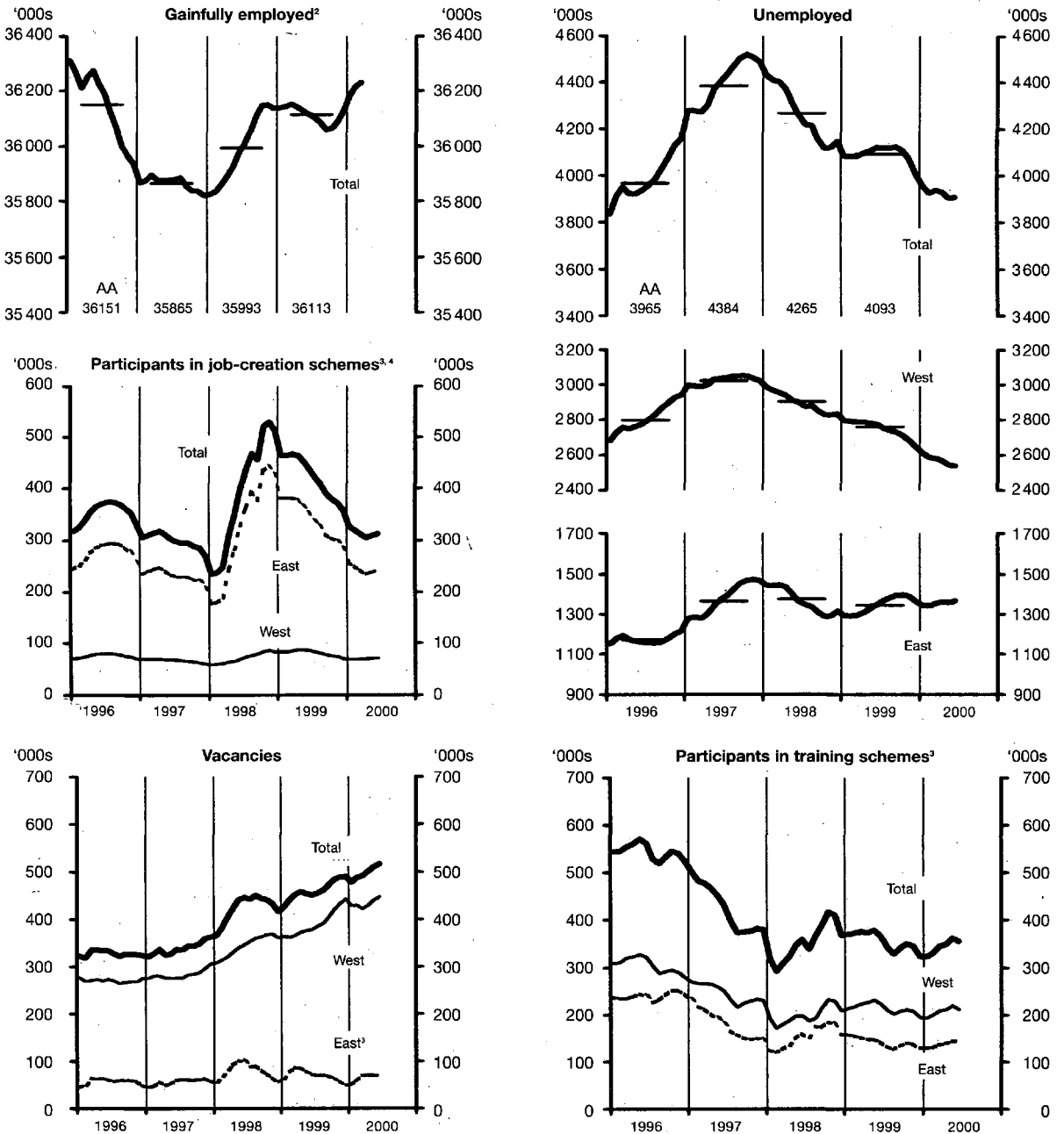
³ According to the investment calculations of the ifo institute, investments in manufacturing industry fell by around 7% in 1999, with a similar drop expected for this year. Cf. Peter Jäckel in collaboration with Sonja Siebolts and Gertrud Krug: Ostdeutsche Industrie: Erneuter Investitionsrückgang nach Abschluss von Großprojekten, in: ifo Schnelldienst, No. 8/2000, p. 4. Investments in machinery and equipment in eastern Germany are now even lower than in the West, while construction investments per member of the labour force remain considerably higher. Cf. Albert Müller: Aufholprozess der ostdeutschen Wirtschaft stagniert, in: ifo Schnelldienst, No. 3/2000, p. 4.

eastern Germany thus continues to lag behind that of the West despite the revitalisation of the economy that can be observed there too.

The difference is still very pronounced where the labour market is concerned (see Figure 2). Employ-

ment growth is centred in western Germany; in eastern Germany – partly as a result of stagnating funds for labour market policy measures – the number of people in work is still clearly in decline. There has been a marked drop in the number of unemployed in

Figure 2
Indicators of Labour Market Trends in Germany¹



¹ Seasonally adjusted monthly figures. ² Place of residence concept. Seasonal adjustment according to the Census-X11 procedure. ³ Not seasonally adjusted. ⁴ Including participants in structural adjustment measures.

Sources: Bundesanstalt für Arbeit; HWWA calculations.

the old federal states, and the unemployment rate has now fallen to 7.7%. In the new federal states on the other hand, the seasonally adjusted number of people out of work has been rising again since the spring of 2000, and the unemployment rate stands at 17.4%. Even the marked increase in industrial output has failed to translate into additional employment; instead, there has been an increase in productivity and a subsequent improvement in competitiveness. Today, industrial unit labour costs are, on average, probably not much higher in eastern Germany than they are in western Germany; as a result, the decline in employment in this sector can be expected to slow down markedly. Across the economy as a whole, however, eastern Germany is still at a considerable disadvantage with regard to unit labour costs; they are still approximately 25 per cent higher than in the West.⁴

External Stimuli Losing Strength

On the whole, Germany's economic prospects continue to be favourable. However, the stimuli for the country's exports will gradually lose strength. Economic development outside Europe in particular will not be as dynamic as before. In the USA, for instance, we can expect a more subdued rate of growth as monetary policy measures begin to slow the economy down. On the other hand, this will reduce the danger of sharp interest rate hikes in America that would also spread to Europe. It is also unlikely that the economic recovery in Asia's emerging economies will continue at the same brisk rate seen so far.

Exports will also be affected as the stimulus provided by the depreciation of the euro gradually

diminishes. The euro has regained stability in recent weeks. In view of expectations that, with the boom in the USA on the wane, the gap between the US and European economies will begin to close, it is assumed for the forecast that the exchange rate of the euro will continue its moderate recovery up to the end of next year. To a certain, albeit minor, extent, the competitive advantages spawned by the previous depreciation of the euro would thus be lost once more. On the other hand, there should be an improvement in Germany's competitiveness within the euro area, since any increase in unit labour costs will probably be more restrained than in other EMU countries.

Tightening Monetary Policy

During the course of this year, the European Central Bank (ECB) has tightened the monetary reins appreciably, raising the main refinancing rate step by step to 4.25%. Given the strong economic upturn in the euro area and growth rates which, ever since the autumn of last year, have been significantly higher than those of production potential, the measures undertaken by the ECB are perfectly legitimate, especially as the M3 monetary aggregate has expanded at a rate considerably in excess of the reference value of 4½%. This year's interest rate increases have probably marked a turn in the tide of monetary policy, moving from an expansive to a neutral course. The implication is that a stronger dampening of the economy will not take place, especially as the rise in ECB interest rates was not accompanied by interest

⁴ Cf. Institut der deutschen Wirtschaft: iwd No. 25, p. 5.

Jocelyn Kellam

The Contract – Tort Dichotomy and a Theoretical Framework for Product Liability Law

A Comparison of the Elements of Liability in Product Liability Law in Australia, France and Germany

Australia, France and Germany have now all introduced laws based on the EC Product Liability Directive 1985. Notwithstanding, the laws of the jurisdictions are characterised by individual differences while recognising a common distinction between contract and tort. This work examines product liability laws in the three jurisdictions.

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rate increases at the long end of the market. Yields in the euro area and, accordingly, in Germany, have even fallen during the course of this year (see Figure 3). This is primarily a reflex reaction to interest rate developments on the international money markets and to developments in the USA in particular, where the underlying decline in long-term interest rates represented by government bonds with a remaining term of ten years has been even more pronounced than in the euro area. However, by dampening expectations of inflation, the ECB's monetary policy has buttressed the trend towards lower long end interest rates.

The strong expansion of the money supply at rates which, despite a tightening of monetary policy, are still well above the reference value, is an indication that a risk of inflation continues to exist for the medium term. This holds true even if one considers the ECB reference value of 4½% to be too low and sets it – as recommended by the German economic research institutes, for example⁵ – at 5% instead. There is also a suggestion of possible demand side inflation as the “output gap” in the euro area is expected to close during the course of next year, implying the full utilisation of production potential. For this reason, a further slight increase in ECB interest rates is assumed for the forecast. Even then, the course of monetary policy will still not be particularly restrictive. This view is further substantiated by the current level

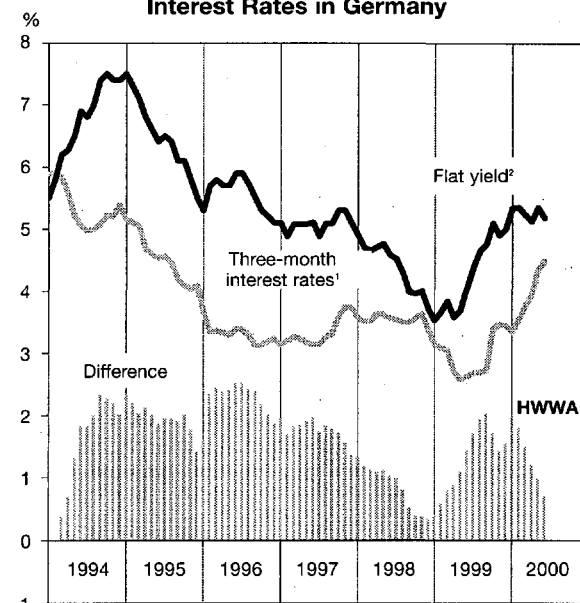
of the “Taylor rate”, a popular yardstick which is still well above the three-month interest rate.⁶ Another slight increase in ECB interest rates in the euro area would probably have little impact on money market interest rates. At any rate, this assumption is supported by the fact that, with the expected economic slowdown in the USA and the consolidation of recovery in the emerging economies, demand on the international money markets will not be quite as vigorous as it has been.

Strong Impulses from Fiscal Policy in 2001

All in all, fiscal policy is tending to have a slightly dampening effect on the economy this year. On the one hand, tax relief measures for private households came into force at the start of the year, as well as an increase in child allowances and a further marginal drop in the level of pension contributions. At the same time, however, the government passed a package of spending cuts that will reduce public authorities' budgets by around DM 17 billion this year;⁷ in addition, further tax increases were introduced in the guise of the ecological tax reform. Further significant tax relief for both businesses and private households is planned for the year 2001 with the proposed corporate tax reform and the reduction of income tax rates. Our forecast is based on the provisions of the government's draft tax reform bill, which provides for tax cuts of around DM 45 billion for the year 2001. While last year's package of spending cuts continues to have a dampening effect on the economy, and although the continuation of the ecological tax reform will lead to further tax increases, these factors will be more than offset by the relief provided by the tax reduction bill, so that fiscal policy will be a source of distinctly expansive impulses in the year 2001.⁸

These tax cuts will lead to a renewed increase in the state financial deficit. According to the European System of Accounts 1995 (ESA 95) it will grow by half a percentage point to 1½% of gross domestic product before falling again in the following years. The initial deficit increase thus by no means implies that Germany is turning away from a course of budgetary consolidation, nor would it lead to a violation of the Stability and Growth Pact, which foresees a modest surplus in the medium term.

Figure 3
Interest Rates in Germany



¹ Up to the end of 1998 3-month Fibor, then EMU's Euribor. ² Fixed-interest securities of domestic issuers.
Sources: Deutsche Bundesbank, EGB; HWWA calculations.

⁵ Cf. Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Frühjahr 2000, HWWA-Report No. 201, p. 69 f.

⁶ Cf. on the Taylor rule, Günter Weinert, Eckhardt Wohlers et. al.: Deutliche Erholung der Konjunktur, HWWA-Report No. 200, p. 31.

⁷ Cf. Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Frühjahr 2000, op. cit., p. 50 ff.

Wage Settlements Compatible with Stability

The results of this year's wage round so far – including some relatively long-term settlements that will continue to influence wage developments into the year 2002 – point to collective pay increases of slightly more than 2¼% for this year and slightly less than 2¼% for next. Fears expressed in some quarters that foreign trade developments, and inflationary impulses emanating from the rise in oil prices in particular, would as in the past trigger off a wage/price spiral and strengthen price increases have thus not been borne out. On the contrary, pay increases will be lower than in 1999 when collective wages on an hourly basis rose by 2.9%.

As a result of the moderate wage developments and greater increases in productivity due to a higher level of capacity utilisation, there will be no rise in unit labour costs either this year or next. Thus, as far as costs are concerned at least, Germany's stability will not be at risk.

Upturn Continues while Driving Forces Shift

Given the conditions mentioned above, we can expect the economic upturn in Germany to continue both this year and next. The rate of growth will remain relatively high. Although the diminishing vitality of the economy in the USA in particular, the weakening of those impulses spawned by the depreciation of the euro, and the tightening of monetary policy in the euro area – the full effects of which will not be felt until next year due to the relatively long time-lags involved – will tend to slow down the pace of expansion, particularly in the year 2001, these factors will be largely offset by the stimulating effects induced by fiscal policy. Any weakening of the basic economic trends will thus not become the subject of closer focus until the second half of next year.

⁶ The forecast does not take into account the effects of the auction of UMTS licences, which is due to take place at the end of July; this will generate considerably greater revenues, but also lead to a loss of tax income. It has not yet been decided whether the auction revenues are to appear in their entirety in the European System of Accounts 1995 (ESA 95) in the year of sale or whether they are to be spread over a period of twenty years – the duration of the corresponding licence contracts. Furthermore, the volume of additional revenues is still uncertain, with estimates ranging from DM 60 to DM 120 billion. Nor have the losses in tax revenues been taken into account that will arise from the fact that the licence purchasers will offset their expenses as procurement costs against tax. The volume and timing of these revenue losses depend to a very large extent on the depreciation period which has still to be established. Given a 10-year depreciation period, and assuming a corporate tax rate of 25% as provided for in the corporate tax reform and a trade tax of 16.6%, a shortfall in annual revenues of up to DM 4½ billion could arise; if, however, a depreciation period of only 4 to 5 years is established on account of the fast rate of technical advances in the field of telecommunications, annual shortfalls of up to DM 11 billion could result.

There will be a shift in the driving forces, however, with exports slowing down as a result of a less favourable foreign trade environment, and domestic demand expanding at a stronger rate to become the mainstay of the country's economic upturn. Private consumption in particular will gain momentum, partly due to the tax relief measures. All in all, gross domestic product will grow by 3.0% in real terms this year; average growth in the year 2001 will be little lower at 2.9% (see Table 1). At the same time, there will be a further increase in the utilisation of capacity,

Table 1
Key Data of the Forecast for the Federal Republic of Germany

	1997	1998	1999	2000	2001
Gross domestic product ¹ (% change on previous year)	1.5	2.2	1.5	3.0	2.9
Private consumption	0.7	2.3	2.1	1.7	2.7
Government consumption	-1.1	0.5	0.2	0.2	0.3
Gross fixed capital formation	0.5	1.4	2.3	4.4	3.7
Plant and equipment	3.4	9.2	5.1	7.6	5.5
Buildings	-1.4	-3.9	0.0	1.8	2.0
Other fixed assets	5.9	15.1	9.4	9.7	8.4
Domestic demand	0.7	2.5	2.2	2.2	2.7
Exports	10.9	7.0	4.2	10.9	8.0
Imports	8.3	8.5	7.1	8.5	7.7
Gainfully employed ² (% change on previous year)	-0.8	0.4	0.3	0.6	0.8
of which: West Germany	-0.6	0.6	0.5	0.8	0.9
East Germany	-1.8	-0.7	-0.7	-0.5	0.0
Unemployed (1000 Persons)	4385	4279	4099	3825	3450
of which: West Germany	3020	2904	2756	2485	2150
East Germany	1364	1375	1344	1340	1300
Rate of employment ³ (in %)	10.9	10.6	10.2	9.5	8.6
of which: West Germany	9.4	9.0	8.5	7.7	6.7
East Germany	17.1	17.3	17.1	17.1	16.7
Consumer prices ⁴ (% change on previous year)	1.0	1.0	0.6	1.6	1.4
Unit labour costs ⁵ (% change on previous year)	-0.8	-0.4	0.7	-0.4	0.0
Public sector borrowing requirements ⁶ (in % of GDP)	-2.6	-1.7	-1.1	-0.9	-1.5
Balance on current account ⁷ (Mrd. bn.)	-2.5	-6.5	-37.5	-47.5	-37.5

¹ At 1995 prices. ² Domestic gainfully employed. West and East Germany: residents. Estimate based on the number of employees subject to social security contributions and on the microcensus. ³ Unemployed as a percentage of the resident labour force (place of residence concept). ⁴ Price index for the cost of living of all private households. ⁵ Total compensation per employee as a percentage of GDP at 1995 prices per gainfully employed person. ⁶ As defined in the European System of National Accounts (ESA 95). ⁷ As defined in the balance of payments statistics.

Sources: Statistisches Bundesamt; Deutsche Bundesbank; Bundesanstalt für Arbeit; 2000 und 2001: HWWA forecasts; some figures are rounded.

although no significant strain is expected. All this will occur against a backdrop of generally stable prices; with the inflationary impulses emanating from foreign trade beginning to slacken off, consumer prices will increase by a good 1½% this year and by slightly less than 1½% next year.

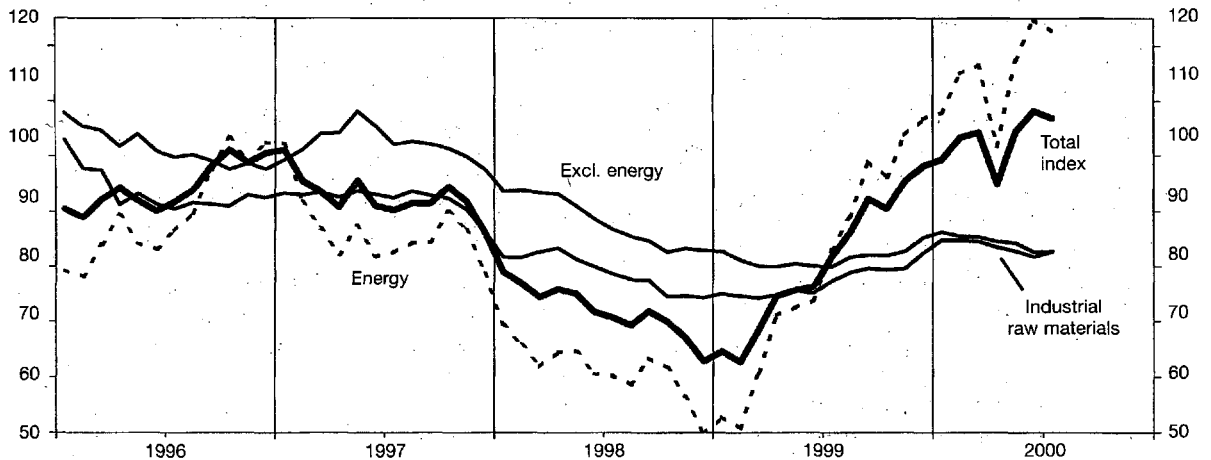
The labour market situation will improve perceptibly as the economy picks up. Employment will expand quickly and, supported by a further reduction in the labour force, there will be a marked decline in the number of people out of work; on average in the year 2001 the number of unemployed will be 650,000 lower than in 1999. Labour market improvements continue to be centred on western Germany. While eastern Germany is expected to catch up with the West as far as growth is concerned, little difference will be felt on the labour market. One small consolation is that the decline in employment will probably come to a standstill in 2001, and there will be a slight drop in the

number of unemployed, albeit primarily due to demographic factors.

The forecast is based on the assumption that the US economy pulls off a soft landing. If the economic slowdown in the USA were to assume a sharper downward trajectory due, for instance, to a stock market crash, this would also have a negative effect on the economies of Europe and of Germany. A further assumption is that there will be appreciable tax cuts for businesses and private households, and that these will come into effect as planned at the start of 2001. Should these tax reforms be blocked or fail completely, the dampening effects of foreign trade and monetary policy would come to the fore, considerably weakening growth and diminishing the labour market improvements forecast here. In this case, model calculations indicate a loss of growth of a little more than half a percentage point and over 150,000 fewer new jobs.

HWWA Index of World Market Prices of Raw Materials¹

(1990 = 100)



Raw Materials and Groups of Materials ¹	1999	Jan. 00	Feb. 00	Mar. 00	Apr. 00	May 00	June 00	July 00 ²
Total Index	80.5 (11.8)	99.3 (53.8)	103.3 (64.6)	104.2 (52.4)	94.9 (27.2)	104.3 (38.0)	108.1 (41.9)	106.8 (30.6)
Total, excl. energy	81.5 (-7.7)	86.2 (4.2)	85.4 (5.2)	85.2 (6.5)	84.4 (5.6)	84.2 (4.6)	82.6 (3.2)	82.7 (3.5)
Food, tropical beverages	94.2 (-18.7)	90.5 (-14.2)	87.5 (-12.9)	87.5 (-10.1)	87.6 (-8.1)	88.6 (-7.0)	85.1 (-10.0)	83.1 (-5.4)
Industrial raw materials	77.2 (-2.2)	84.7 (13.0)	84.6 (13.5)	84.4 (13.9)	83.4 (11.5)	82.7 (9.6)	81.7 (8.8)	82.6 (6.9)
Agricultural raw materials	78.6 (-0.9)	83.4 (7.3)	82.9 (5.9)	83.4 (7.3)	83.8 (8.7)	81.5 (5.1)	80.4 (3.3)	81.2 (3.8)
Non-ferrous metals	71.9 (1.0)	86.9 (37.0)	86.9 (37.3)	84.6 (33.4)	80.1 (19.2)	82.3 (19.2)	80.9 (20.0)	82.6 (12.4)
Energy	79.9 (30.1)	107.8 (104.4)	115.0 (126.5)	116.5 (91.8)	101.7 (43.1)	117.4 (62.1)	124.8 (69.4)	122.5 (47.7)

¹ On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

² Up to and incl. 21st July.