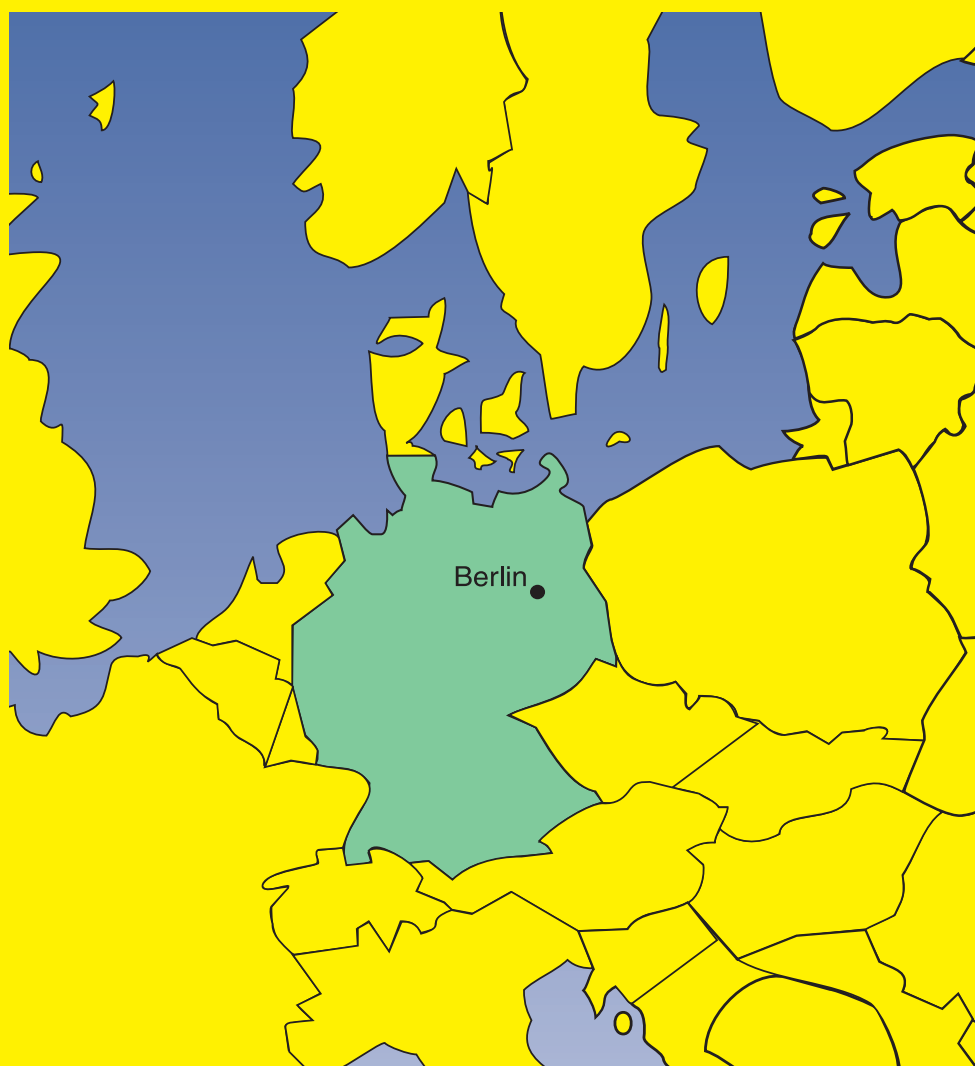


Nordic Outlook Update

SEB

January 2003

English edition



Economic Research

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**GERMANY:
FROM LOCOMOTIVE
TO DRAG ANCHOR**

SEB Economic Research

January 2003

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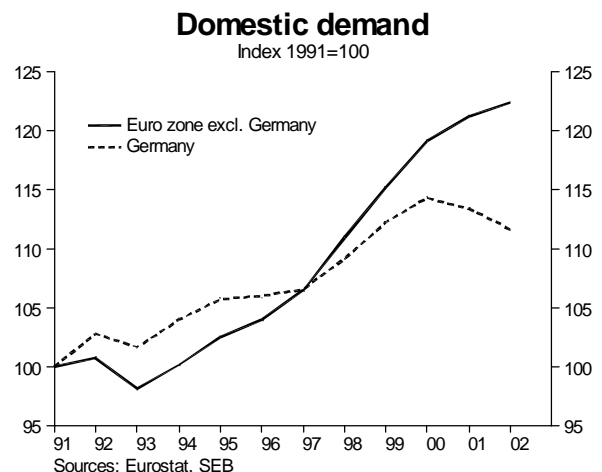
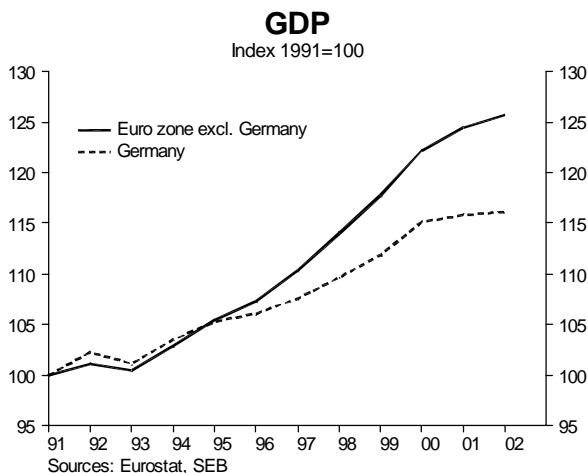
Summary

- Germany finds itself in a deepening economic and political crisis. Its roots must be sought more than a decade ago, in reunification.
- Economic policymakers have been incapable of dealing with the shock. On the contrary, structural growth obstacles, high costs and tax wedges have been perpetuated.
- These fragile structures and the lingering consequences of reunification have meant that the latest cyclical economic downturn has hit Germany harder than most other countries in Europe.
- One problem is that Germany's stabilisation policy is highly constrained by EMU (euro zone) membership. However, our analysis of the country's structural problems indicates that minor adjustments in stabilisation policy will not be enough to get the German economy off the ground again. This will require far deeper reforms of the labour market, taxes and pension systems.
- Such reforms are not visible on the horizon today. Instead, Germany is moving towards a political crisis, and its economic policies are characterised by unwillingness to tackle its structural problems. Our forecast is that for a number of years ahead, Germany will continue to be a drag anchor in Europe.

The structure of this analysis is as follows: We begin by showing certain differences between Germany and the rest of the euro zone, and then discuss the background of today's German problems, with a focus on the reunification between East and West Germany. Then we deal with structural problems, especially in the labour market field. Finally, we go through the economic situation and conclude with a discussion of the political situation and the chances for Germany to increase its growth potential.

1. Germany has lagged behind for years

Since the mid-1990s, Germany's annual economic growth has been about one percentage point lower than in the rest of the euro zone. Above all, domestic demand has lagged behind, averaging 1½ percentage point lower growth in Germany per year. Export growth, however, has been somewhat higher than in the rest of the euro zone. Thus Germany's problems may primarily be assumed to have domestic explanations.

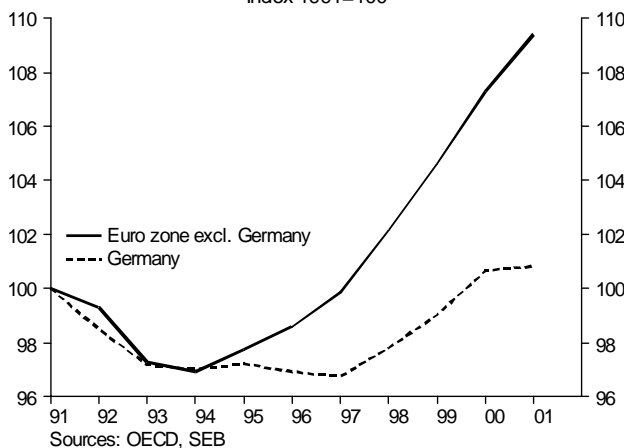


Differences in growth can be divided up into an employment component and a productivity component. Germany's productivity has largely increased in line with the rest of the euro zone, even somewhat more strongly since 1995. This indicates that the difference in GDP growth is mainly attributable to developments in the labour market. Employment in Germany rose by only 3.7 per cent between 1995 and 2001, compared to an increase of 11.9 per cent in the rest of the euro zone.

The fact that the German economy has grown more slowly than that of the euro zone for a whole decade indicates that **potential growth** is lower in Germany. The OECD has estimated euro zone potential growth at 2¼ per cent annually. Germany's potential growth instead seems to lie below 2 per cent; the OECD has estimated it at 1¾ per cent. If job creation could be strengthened, German potential growth could be raised towards the euro zone average.

Germany: Employment

Index 1991=100



If we study the trend of various demand components, we find that both investments and consumption have grown more weakly than in the rest of the euro zone. The weak **investment trend** can largely be attributed to falling construction investments. The weak **consumption trend** is based on weak employment

Average annual percentage change during the period 1995 – 2001

	Euro zone		Difference
	excl. Germany	Germany	
Private consumption	2.6	1.7	0.8
Public consumption	1.7	1.2	0.5
Investments	4.5	0.5	4.0
Domestic demand	2.8	1.3	1.5
Exports	7.1	7.6	-0.5
Imports	7.4	6.6	0.8
GDP	2.8	1.6	1.1
Labour productivity	1.0	1.1	-0.1
Employment	1.7	0.6	1.2
Disposable income	1.9	1.4	0.5

Sources: Eurostat and OECD

growth. As a result, household purchasing power has risen at a slower pace than in the euro zone, despite a similar trend in real wages and salaries.

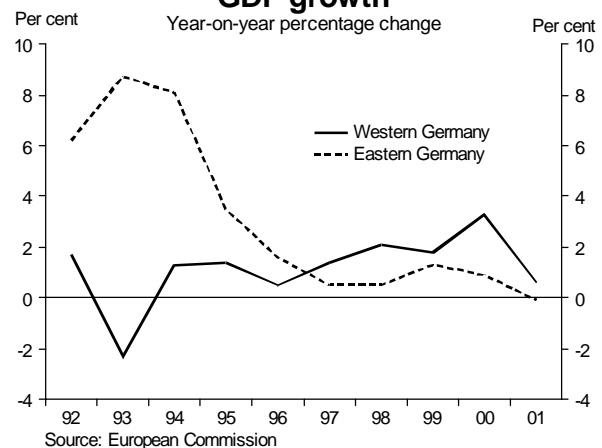
Weak domestic demand makes the German economy more sensitive to external disruptions. Germany's exports represent a somewhat larger percentage of GDP than those of France and Italy. Variations in exports are considerably larger in Germany. The reason is probably that German exports include a larger proportion of cyclically sensitive input goods.

2. Economic effects of reunification

In order to understand this gloomy trend, it is necessary to look back at events around the period of German reunification in the early 1990s. This reunification has sometimes been described as a political miracle, which was implemented faster and more painlessly than anyone dared to hope. However, this "miracle" was partly built on a fragile foundation and has generated various problems that continue to hamper the German economy. Above all, three factors are important to the German economic problems of today:

- The cost shock related to the currency reform and the first collective wage and salary settlements
- The impact of reunification on public sector finances
- The change in the construction sector from overheating to crisis

GDP growth

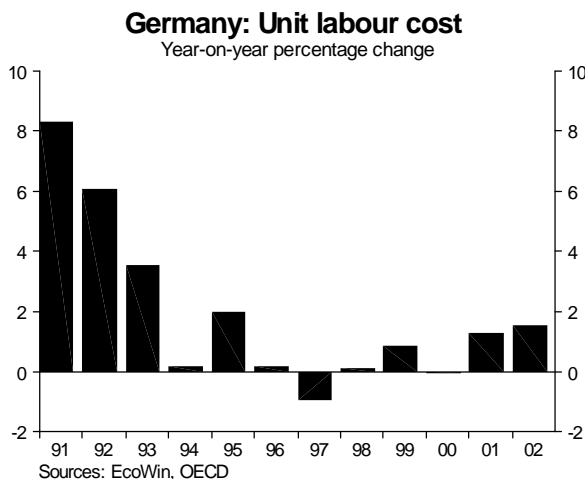


The cost shock

In July 1990, policymakers decided that the East German mark would be converted at a 1:1 exchange rate against the D-mark, compared to the 1:4.3 rate employed until then for East German exports to the West. Overnight, the competitive situation of East German industry thereby worsened drastically. But that was not all. In the collective wage and salary negotiations that followed the next year, the two sides agreed that wages in eastern Germany would converge with those in the west over a five-year period, even though productivity in the east was only about 30 per cent of the level in the west.

The negotiations were largely controlled by employer and employee organisations in the west. Political motives such as egalitarian ambitions and fear of mass migration from the east certainly influenced the collective agreements. Chancellor Helmut Kohl spoke of a rapid catch-up process and of “flourishing landscapes within a few years.” It is also likely that employers and employees in the west wanted to avoid low-wage competition and were thus eager to raise wages and salaries in the east.

Regardless of the motives, the outcome was a **veritable collapse** of the portions of the eastern German economy that were exposed to foreign competition. In the space of two years, the number of gainfully employed people fell from 6.8 million to 5.8 million, or by 15 per cent. Between 1990 and 1993, the cost per unit produced in Germany as a whole rose by 17 per cent. The increase mainly occurred in eastern Germany, where unit labour cost climbed sharply from a level already far above that of western Germany. But in the west, too, labour costs rose rapidly as a consequence of strong demand and rising social security costs. Meanwhile the D-mark was appreciating, which further exacerbated the cost situation of German industry.



In western Germany, pay increases slowed dramatically starting in 1993, while in the east they continued

to accelerate at a rapid pace until the end of 1995. However, wages and salaries in eastern Germany did not reach western levels, but stabilised at around 75 per cent of these. The main reason was that more and more companies left employer organisations in the east in order to circumvent collective pay agreements. This trend has continued, and today some 55 per cent of job holders in eastern Germany work in such companies. The effect has been that in recent years, wages and salaries have actually fallen slightly in eastern Germany.

These pay cuts have had relatively little effect, however, since the competitive problems in the east are of such gigantic dimensions. If we were to calculate a hypothetical current account deficit for the eastern states (*Länder*) of the Federal Republic of Germany, it would total around 50 per cent of their GDP. This is ten times higher than in countries like Poland and Hungary.

One lasting effect of the cost shock was that potential growth became lower for Germany as a whole. In the first stage, profit margins shrank drastically, forcing many companies in the east to shut down. Over time, high wage costs provided strong incentives for replacing labour with machinery – but capital spending was meanwhile hampered by lower return on equity. The result was **both lower employment and smaller capital stock**. Since 1997, machinery investments per capita have been lower in the east than the west, thereby eliminating the crucial force in the convergence process.



Looking at the trend of capital spending in Germany as a whole, it has been clearly weaker than in the rest of the euro zone since 1997. As already indicated, the same is true of employment. Today employment in Germany as a whole is no higher than it was at the time of reunification. Measured in the number of hours worked, it is lower.

The cost shock of the early 1990s has thus had major effects on both capital formation and employment. In

the eastern federal states, cost problems remain. However, it is not equally apparent that weak competitiveness should be a main explanation for the economic problems of Germany as a whole today. Indicators present a somewhat divided picture. On the one hand, Germany shows large and growing foreign trade surpluses. On the other hand, it has lost global market share, mainly to Asia, but no more than other major European countries.

It is thus difficult to view an excessively strong **conversion rate for the D-mark** when Germany joined EMU as a main explanation for the country's economic problems. Another argument against this, of course, is that the difficulties began several years before Germany's transition to the euro.

The outflow of **direct investments** from Germany has been substantially larger than the inflow. This indicates that Germany is not regarded as an attractive country to invest in. However, the reasons behind this are not only related to the cost situation, but may be based on a number of other factors such as strategic decisions in conjunction with mergers and buy-outs as well as the structure of ownership and the financial system in the recipient country.

There are various signs that the inclination of German companies to relocate or build up operations outside Germany has recently increased, not least in the neighbouring countries of Poland, Hungary and the Czech Republic, where wages and salaries are substantially lower than in Germany. These countries are important as trading partners, and this process will accelerate as they become EU members.

Repercussions of reunification on federal finances

The introduction of the D-mark in eastern Germany and the high pay increases resulted in sharply climbing unemployment. Meanwhile, when the generous economic security systems of western Germany were introduced in the east, public expenditures climbed sharply. In addition, privatisations and the modernisation of housing stock required massive subsidies. Furthermore, the infrastructure in eastern Germany was in very poor condition, requiring large public sector investment projects. Between 1991 and 1996, **public sector debt** thus rose from 40 per cent of GDP to 60 per cent of GDP.

Increased pressure on the social insurance system led to higher and higher charge levels. In spite of this, expenditures rose faster than the payments into the system. The deficit was covered by transfers from the federal budget. This was justified by citing the commitments that mainly burdened the pension system in conjunction with reunification. A large number of people who had paid no charges into the pension system now became entitled to disbursements from the system.

Subsidies to the pension system have grown into the largest item in the federal budget and today account for more than 25 per cent of total expenditures. Also notable is that what were planned as temporary transfers to the east have become permanent. During the past decade, these annual transfers have totalled nearly 4 per cent of total German GDP. Given the weak economic growth in eastern Germany, there is nothing that indicates an imminent phase-out.

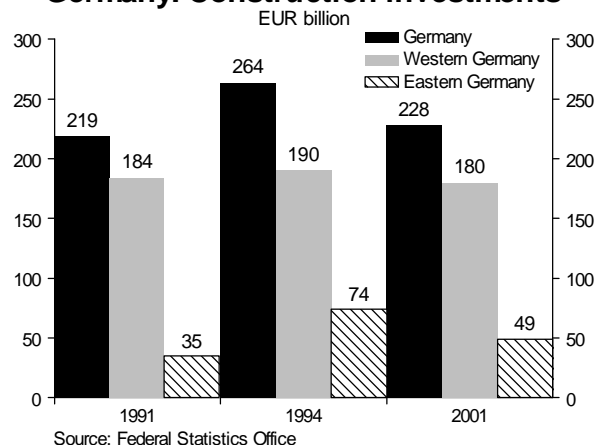
The strains on public finances have led to **increased tax wedges** and thus probably to negative effects on labour supply and potential growth.

Despite the rising tax burden, **steps to restore order to public finances have been insufficient**. During the second half of the 1990s, consolidation was instead somewhat less ambitious in Germany than in the other euro zone countries. According to OECD calculations, the structural deficit, i.e. adjusted for the economic cycle, was 1.7 per cent of GDP in 1997. Despite relatively decent economic conditions, the structural deficit did not improve at all between 1997 and 2001. The savings that were nevertheless implemented largely aimed at public sector investments, which probably worsened the growth potential of the German economy.

The construction sector – from overheating to crisis

After tremendous expansion during the first half of the 1990s, the construction sector has become an impediment to economic growth.

Germany: Construction investments



A number of factors triggered a **construction boom** in conjunction with reunification. The infrastructure of eastern Germany was in very poor condition and required large-scale public sector investments. There was also a strong political desire to modernise the housing stock with large subsidies. In addition, the large migration to western Germany from the east after the collapse of the Berlin Wall generated sharply higher demand for housing.

The construction boom culminated in 1994. Since 1991, construction volume had more than doubled in eastern Germany, while volume in Germany as a whole had risen by 20 per cent. But when the need for public sector investment declined and policy shifted towards cutbacks in housing construction aid and a tighter immigration policy, construction fell. From the peak year of 1994 until 2001, the total

downturn was about 13 per cent – much more in eastern Germany – and the decline continued during 2002. Fluctuations in construction were partly unavoidable, but the structure of aid and subsidies also led to unwise investments, making the situation worse. Today there are an estimated one million surplus housing units in eastern Germany.

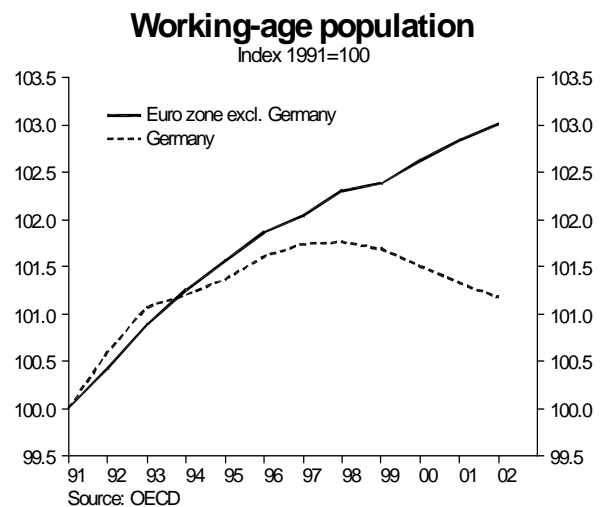
3. Structural problems in the labour market

The fact that the negative effects of reunification have been so large and so long-lasting indicates a lack of flexibility and adaptability in the German economy. In no other field is this as clear as in the labour market.

More than 4 million Germans are currently registered as unemployed. This is close to 10 per cent of the labour force. A considerable portion of this unemployment is structural in nature. Chronically unemployed people account for about half of total joblessness, and regional differences are sizeable. In the western state of Baden-Württemberg, unemployment is just over 5 per cent, while eastern states such as Sachsen-Anhalt have unemployment approaching 20 per cent.

Unemployment by state	
Per cent, November 2002	
Eastern Germany	17.6
Brandenburg	16.9
Mecklenburg-West Pomerania	18.7
Saxony-Anhalt	18.7
Saxony	16.6
Thuringia	14.9
Berlin	17.1
Western Germany	7.8
Baden-Württemberg	5.6
Bavaria	6.1
Bremen	12.5
Hamburg	9.0
Hessen	6.9
Lower Saxony	9.1
North Rhine-Westphalia	9.3
Rhineland-Palatinate	7.1
Saarland	8.9
Schleswig-Holstein	8.8
Total	9.7

As emphasised above, the trend of employment has been dismal. Part of this is explained by **demographic factors**. The working-age population in Germany has increased more slowly than in the rest of the euro zone. During the past three years it has actually



declined somewhat. However, of greater importance is that **labour force participation** has stagnated. There are several reasons for this:

- The **economic incentives** for employment are weak. The difference between wages and unemployment benefits is small. This is not only true of the level of benefits, but also of their duration and how a person becomes eligible for benefits. A large category of part-time employees also risk end up in “poverty traps”. One example is that part-time jobs paying a maximum of EUR 325 per month are exempted from social security charges. (Germany recently decided to raise the threshold to EUR 400.) The threshold effect of boosting one’s work hours from this type of job is considerable, which is a strong incentive to keep one’s working hours down. This is visible from the fact that about 4 million people have such “EUR 325 jobs” while the number earning between EUR 325 and EUR 670 is only about one million.
- Other obstacles to increases in working hours, especially for women, may be the **shortage of child care** as well as comparatively **rigid legislation** until now concerning retail store opening hours. On the latter point, some loosening of the rules has been initiated, but the degree of service remains low.

- While the demand for labour is increasingly focusing on well-educated employees, **educational level has stagnated** in the past decade. This has resulted in a wider gap between the qualifications in demand and the qualifications that the labour force possesses. One special problem has been that older employees in the east have often lacked the expertise that is in demand and that the further education programmes Germany has implemented have not been especially successful.
- High unemployment figures in the eastern federal states also illustrate the problem of **low geographic mobility**. The net flow between east and west was only 61,000 people in 2000, equivalent to 0.35 per cent of the population. This can be compared with the net flow in 1989, which totalled 383,000 people. Incentives to relocate are limited by large transfer payments, which are aimed at equalising living standards between regions, as well as by the comparatively small wage differences between east and west. In that sense, today's subsidy system is helping to perpetuate high unemployment in the east.

Rigid wage formation

Unit labour cost in Germany is among the highest in the world. During the past few years, however, the pace of wage and salary increases has slowed. During 2002, pay levels rose by 2.0 per cent, according to preliminary statistics. Meanwhile they are rising considerably faster in some protected areas of the service sector.

Two other characteristics of the German labour market are large regional imbalances and a low labour

market participation rate by less educated workers. This is probably related largely to a **rigid pay structure** that does not sufficiently take into account differences in productivity. Despite the very large differences in unemployment between various regions and groups with different qualifications, relative wages are stable. This may be partly due to the institutional framework of wage formation. As a rule, wage and salary negotiations occur at the industrial sector level in the states.

If these pay negotiations took place at the local level, wage formation would probably reflect the differences in productivity to a greater degree, which would lead to higher employment. What has happened instead is that a large proportion of the labour force is priced out of the market. One example of the German labour market's inability to employ less qualified workers is the comparatively small service sector. With less room for efficiency-raising measures than in manufacturing, for instance, high wage costs often drive the price of a service too high and the service is therefore never performed.

Aside from the lack of wage flexibility, demand for labour is also hampered by a number of **regulations** that limit mobility in the labour market. This may be true, for example, of the potential for temporary employment and flexible working hours, or high costs for getting rid of personnel. Also holding down employment are **high tax wedges** – the difference between what the employer must pay an employee and what the latter takes home after withholding taxes.

4. Downturn bares structural problems

In addition to the deep structural problems described above, there are economic difficulties due to more **short-term cyclical fluctuations**. As a result of Germany's structural problems, the country has been hard hit by the latest economic slowdown. In 2001, German GDP growth reached only 0.4 per cent, compared to 1.9 per cent in the rest of the euro zone, and unemployment rose more.

One reason why Germany was affected more severely and earlier than the other euro zone countries may be its greater sensitivity to oil price changes. The upturn in **energy prices** during 2000 and 2001 radically weakened German purchasing power, with the consequence that consumption slowed considerably late in 2000.

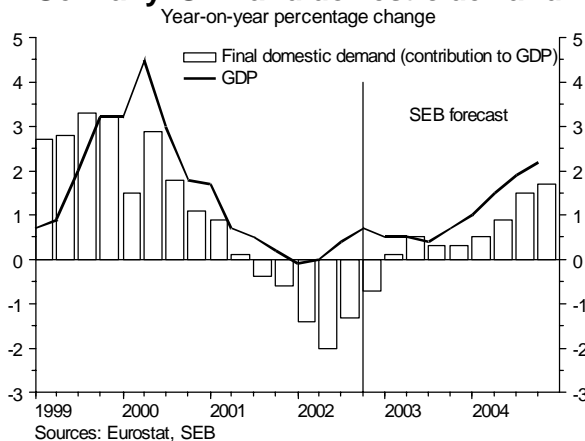
One complicating factor has been the **telecom crisis**. In Germany, third-generation (3G) mobile system

licences were auctioned off during 2000 at prices that later turned out to have been greatly inflated (a total of more than EUR 50 billion, or over EUR 700 per adult in Germany). The result has been enormous losses in the telecom sector, which have then had an impact on the banking sector.

The economic slowdown has driven up corporate bankruptcies to record levels, resulting in increased **credit losses for banks**. The major private banks in Germany have been hard hit and have seen their own share prices slide and their credit ratings downgraded. Efficiency-raising measures are now underway in the banking system, with large personnel cutbacks and increased tightening of credit as a consequence. As long as domestic demand does not recover, credit will continue to tighten and the problems in the banking sector will worsen.

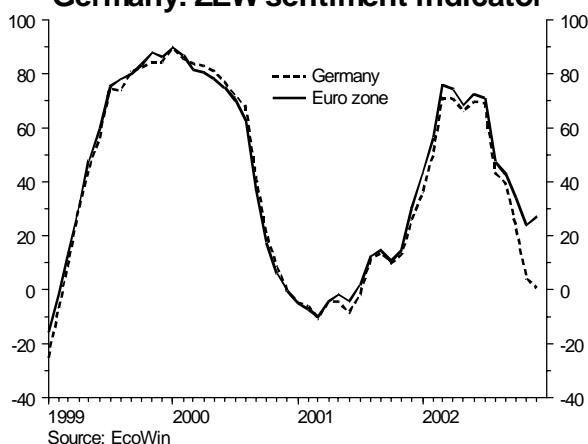
During the first half of 2002, foreign trade recovered somewhat. However, the economy was weighed down by falling private consumption and capital spending. The trend of real disposable income has been very weak, mainly due to declining employment. Altogether, GDP growth during 2002 was only 0.3 per cent, according to preliminary figures, compared to 1.0 per cent for the other EMU countries.

Germany: GDP and domestic demand



During the autumn of 2002, **the outlook for the export sector again deteriorated**, as uncertainty about the global recovery increased. Continued high oil prices and geopolitical instability surrounding Iraq will undermine willingness to invest. Meanwhile, the government will tighten its fiscal policy in 2003 both for households and businesses. The short-term economic outlook thus looks relatively gloomy, which is also confirmed by confidence surveys showing that **both companies and households have become more negative** about future economic developments.

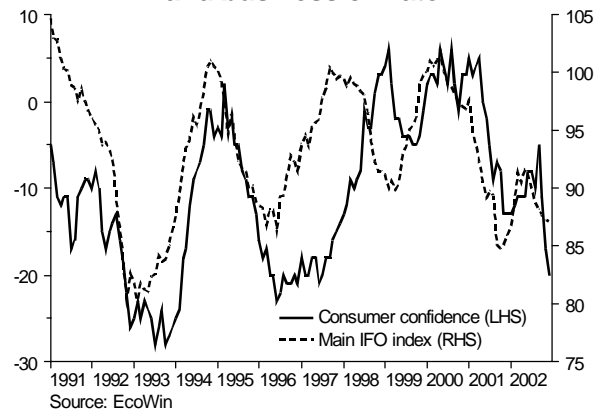
Germany: ZEW sentiment indicator



During the winter, capital spending and private consumption may be stimulated short-term by reconstruction work to repair the damage caused in Germany by last summer's floods, whose cost is projected at more than EUR 10 billion. However, the stimulating

effects will be limited by the fact that this reconstruction is largely being financed by higher taxes and by cutbacks in other public sector expenditures.

Germany: Consumer confidence and business climate



We expect a durable resurgence in exports only during the second half of 2003, when the international recovery kicks in – provided that the geopolitical situation around the Gulf stabilises. However, the chances that domestic demand will take off at that time appear relatively gloomy.

- Firstly, during 2003 the federal budget again risks exceeding the Stability Pact ceiling: 3 per cent of GDP. This means that **fiscal policy must become more restrictive** in the next few years, with dampening effects on consumption.
- Secondly, **the prospects of a recovery in capital spending look gloomy right now**. There are still no signs of an imminent turnaround in the construction sector. Instead, expectations for the future are at record-low levels, along with order bookings. Since the banking system has been hit by the stock market downturn and increasing corporate bankruptcies, the banks have become more restrictive in their lending.

However, this credit tightening should be a temporary factor, which will ease as the stock market stabilises and an international economic recovery begins. Furthermore, a larger proportion of the adjustment following the construction boom should have been completed. Since 1995, construction investments have fallen as a share of GDP and are now about 2 percentage points below where they were in 1991. There should thus be a chance of a slow recovery in underlying investment activity.

Altogether, GDP growth will accelerate weakly during 2003, to 0.6 per cent. This is still far below potential growth and means that capacity utilisation will continue to fall. Our forecast also assumes that international demand will actually get German exports moving during the second half. Only in 2004 will growth climb towards its potential level, reaching 1.7 per cent.

	2002	2003	2004
GDP			
Germany	0.3	0.6	1.7
Euro zone excl. Germany	1.0	1.5	2.5
Unemployment			
Germany	8.2	8.4	8.3
Euro zone excl. Germany	8.2	8.5	8.4
Inflation (HICP)			
Germany	1.3	1.4	1.5
Euro zone excl. Germany	2.6	2.1	2.1
Public sector financial savings			
Germany	-3.8	-3.2	-3.0
Euro zone excl. Germany	-2.1	-1.9	-1.6

Inflation has fallen and now stands at about 1 per cent, clearly below the average for the euro zone.

5. Economic policy

There are many calls for a more expansive **stabilisation policy**. But neither monetary nor fiscal policy is capable of stimulating the domestic economy to the extent that perhaps would be desirable in a shorter-term perspective. The European Central Bank sets its key interest rate on the basis of the inflation outlook in the euro zone as a whole, which means that this rate is not expansive enough for German conditions. Moreover, the Stability Pact limits Germany's potential for pursuing an expansive fiscal policy.

Early in December the ECB delivered a 50 basis point reduction in its refi rate, to 2.75 per cent. This interest rate cut was welcome. Earlier, the ECB had repeatedly rejected calls for a more expansive monetary policy on grounds that the tools for promoting growth in the euro zone are found in the governments of euro zone countries, in the shape of structural reforms.

At its latest interest rate meeting, the ECB did not send out any clear signals about the outlook for additional interest rate cuts. However, we anticipate a continued gloomy economic situation during the winter and continued low inflation. The strengthening of the euro also implies a certain monetary tightening. We therefore believe that **the ECB will lower its key rate by another 25 points** during the first quarter; if a war in the Middle East should result in real disruptions, the rate cut may be larger. This would give Germany short-term real interest rates of just above 1 per cent during 2003. We expect bond yields to rise somewhat during 2003 from today's comparatively low level.

Underlying price pressure is expected to remain relatively low during 2003, with inflation remaining below the euro zone average.

This year's cooling of inflation will primarily be due to the drop in food prices, which has been considerably larger in Germany than in the rest of the euro zone. The dampening effect of food prices on German inflation will nevertheless gradually fade. As in the rest of the euro zone, service prices have risen considerably faster than goods prices. This is partly explained by a sharp increase in unit labour cost. Gradually, service inflation is expected to slow somewhat. Tax increases on food, alcoholic beverages and energy will nevertheless push up inflation by between 0.5-1.0 percentage points in January 2003. We anticipate that oil prices will fall towards USD 22 per barrel after an Iraqi war. Germany's higher sensitivity to oil price changes will help slow inflation somewhat more rapidly than in the rest of the euro zone during the second half of 2003 and during 2004.

The Stability Pact includes a ceiling on budget deficits of 3 per cent of GDP. During 2002, Germany breached this ceiling, and this is very likely to happen in 2003 as well. The country has thus received a reprimand from the EU's council of finance ministers (Ecofin) and has been ordered to reduce its deficit. Among other things, the planned 2003 income tax cuts are being postponed by one year, and business taxes are being raised temporarily. Other planned measures are higher social security charges, cuts in unemployment benefits and decreased health care expenditures. As a result, German fiscal policy will assume a procyclical direction.

However, this fiscal policy distress is not due to the Stability Pact alone. One reason why fiscal policy freedom of action has become so constrained despite the economic downturn is Germany's imprudence in failing to consolidate its federal finances during the second half of the 1990s. With central government debt clearly above the average for other AAA-rated countries and with a clearly larger budget deficit, Germany's chances of pursuing a countercyclical fiscal policy have become increasingly limited – regardless of the Stability Pact.

But the budget also faces major challenges in the longer term. The task ahead will be to ease the pressure on public sector systems, especially the **pension system**, which will be subjected to major strains. Some steps have been taken in this direction, for example through less generosity with early retire-

ments, certain steps to stimulate private pension savings and indexing to the Consumer Price Index instead of wages and salaries. The latter step was only temporary, however, and indexing has now reverted to the more generous practice again – despite the federal budget difficulties.

The long-term ambition is to keep pension disbursements below 20 per cent of total wages and salaries until 2020 and below 22 per cent after 2030. But in order to achieve these targets, Germany will require considerably more vigorous measures than those implemented to date. A higher retirement age, labour immigration and less generous benefits are all conceivable but unpopular future measures.

In spite of protests against the Stability Pact and the ECB's interest rate policy, neither today's monetary nor fiscal policy should be blamed for Germany's problems. As indicated above, these problems are primarily structural and require other types of reforms. We should also bear in mind that monetary policy is incapable of influencing long-term growth, but is instead primarily intended to control inflation. Although a more expansive stabilisation policy might alleviate these problems in the short term, it is insufficient to accelerate growth in the German economy. What Germany needs more than anything else is structural reforms of the labour market, the tax system and transfer payments – for the purpose of stimulating labour supply.

The Hartz Commission

In Germany there has been lively discussion of what can be done to improve the functioning of the labour market. Some of the points that are high on the agenda of many economists, including those at the IMF and the OECD, are:

- **Strengthen the incentives to hold a job.** Introduce tougher requirements for receiving unemployment benefits, both with regard to conditions and durations. Lower social security costs. Increase the differential between after-tax pay and public sector benefits. Improve the efficiency of Germany's active labour market policy by increasing the focus on weak groups. Reduce regulation, among other things concerning the option of temporary employment. Eliminate obstacles that keep women from holding paid jobs, for example by improving child care.
- **Improve wage formation.** Take greater account of differences in productivity. Decentralise wage negotiations: more wage agreements at the company level.
- **Create a more open service sector.** Remove obstacles to start-ups. Liberalise the laws on business hours.
- **Decrease transfer payments to the east.** Focus on raising productivity there, rather than on maintaining the level of consumption.

How much of the above-listed steps are on the agenda of the German government is doubtful. In recent years, few reforms have been implemented. The autumn 2002 federal election campaign was dominated by promises of economic security. The main steps being discussed are the proposals of the **Hartz Commission**, which last summer unveiled a series of recommendations for improving the functioning of the German labour market.

The target is to halve unemployment by improving the match between job seekers and employers, creating new types of jobs and making labour market institutions more efficient. The proposals that appear likely to go into effect aim at such reforms as increasing the opportunities for temporary jobs, for example by allowing unemployed people to register with personnel service agencies that report to the Economics and Labour Ministry, but which may also be run under private auspices. These agencies will try to find temporary jobs for registered people. During the first six weeks, employees will receive unemployment benefits, and after that they will be paid according to collective wage and salary agreements, excluding fringe benefits. However, there will be an option to pay lower wages after approval from the appropriate trade union.

The government has also appointed another commission that will consider reforms in Germany's pension and sick pay systems. However, it is unclear what political potential there actually is for implementing far-reaching reforms. The current red-green coalition government is divided, with the Greens showing greater interest than the Social Democrats (SPD).

Towards a political crisis

The political situation and German political institutions are hampering reforms. Germany is a federation of 16 states, each with its own parliament and political organisations. The states have a strong influence on taxation policy through the upper house of Parliament (*Bundesrat*). The federal government's freedom of action with regard to budget policy is therefore greatly circumscribed. Any major reform must be negotiated both in the lower house of Parliament (*Bundestag*) – where there is often a tendency to delay or water it down – and with the 16 states in the *Bundesrat*. In addition, the composition of the *Bundesrat* is continuously shifting as a consequence of new state elections (about four per year). The result is often a deadlocked situation, where the lowest common denominator prevails.

The outcome of last autumn's **federal election** was that the SPD and the Greens managed to retain power

in the Bundestag by the narrowest possible margin. However, the federal governing coalition does not enjoy a majority in the Bundesrat.

Right now, all reforms are on hold while awaiting two major state elections in February. Only after these elections can new initiatives be expected in the reform process, in the best case.

But the public opinion situation and internal tensions in the governing coalition are also hampering the desire for reform. The SPD's public opinion figures have fallen sharply since the election, primarily because voters feel they were misled. Many people are now accusing Chancellor Gerhard Schröder of having falsely portrayed the economic picture as healthier than it was and of withholding from the public the truth about the tough measures now required.

In addition, there are growing protests from the **trade unions**. In some areas, there is great anger about broken promises, the weak trend of real wages and fiscal tightening. Germany risks major strikes, especially in the public sector, this winter and spring.

The rapidly eroding confidence in the government in general, and Chancellor Schröder in particular, is now leading the country towards a deep political crisis. To an outside observer, the political dynamic is highly reminiscent of the course of events that led to a national economic policy trauma in Sweden during the early 1990s. Others have drawn parallels between today's German political developments and the "winter of discontent" that brought Margaret Thatcher to power in the UK during 1979. Dramatic events wiped out many taboos in Swedish and British economic policy, respectively, making possible a major realignment of policies – however, after several years of deep recession.

It is an open question how long and deep the German trauma must be, before decisive reform measures are undertaken. Today it seems a long way until Germany will stand at the threshold of upheavals resembling those in Sweden and the UK. Crisis consciousness is weak. The most likely course of events is therefore that the country will muddle through, with weak growth for another few years. Obviously 2003 will be both economically gloomy and politically turbulent.