

The economic scene in Germany in spring 1997

Overview

Economic conditions

Following a pause in autumn 1996, the German economy returned to a path of growth at the beginning of this year. After adjustment for seasonal and working-day variations, real gross domestic product rose by ½% in the first quarter of 1997 compared with the preceding quarter. At first sight, that increase appears to be rather moderate. When estimating the underlying pace of economic growth, however, it should be borne in mind that the construction sector lost considerable output, mainly on account of the cold winter weather. By contrast, value added in services and, above all, manufacturing went up sharply.

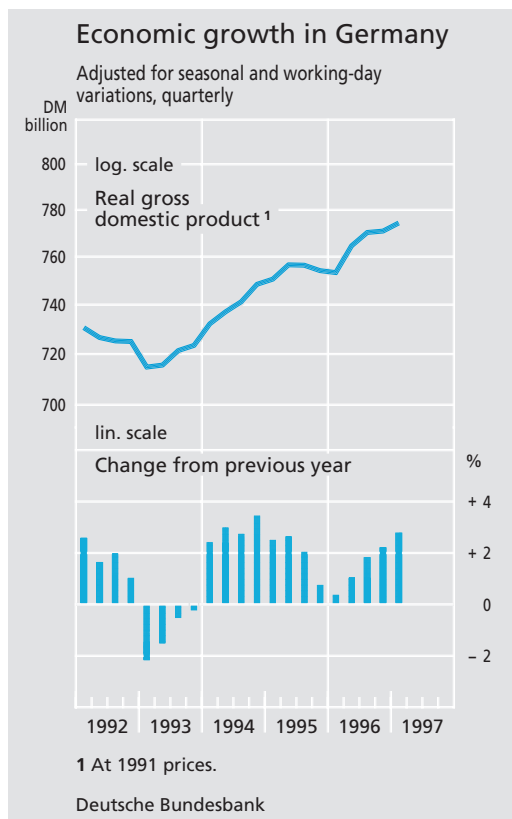
*Economic
growth*

According to the surveys of the ifo institute, industrial capacity is now being utilised far more heavily than at the end of last year. In general, the mood in the manufacturing sector has improved markedly. The favourable fundamentals, such as virtual price stability, moderate wage settlements, the normalisation of the exchange rate trend and, not least, the low interest rates, have evidently played a part in improving the climate for business. Nevertheless, the economic upturn has generated little momentum so far. Persistent structural problems in the goods and factor markets are still putting a brake on the cyclical upturn.

*Business
climate*

Foreign demand remains the most important mainstay of economic growth and of the improved prospects for the future. Right up to the present, orders received from abroad have been rising sharply. Firstly, this reflects

*Foreign
demand*



the fact that the pace of economic growth in the industrial countries (the chief market for German exports) has continued to accelerate. The higher level of economic activity in those countries is leading – as usual – to a disproportionately rising demand for imports, which is currently benefiting German exporters across the board. Secondly, industrial products from Germany are evidently competitive, which means that export enterprises are managing to participate fully in the growth of their sales markets. Besides successful rationalisation efforts, exchange rate movements, in particular, are likely to have contributed to bolstering exports. In foreign exchange markets that have been comparatively calm, Deutsche Mark exchange rate relationships have now emerged which probably correspond largely to the economic fun-

damentals. When this Report went to press, the real external value of the Deutsche Mark compared with 18 major currencies was lower than at the start of 1995, when the Deutsche Mark began to appreciate sharply. The exaggerated movements during that period, which – together with the sharp wage increases agreed at that time – had considerably hampered the price competitiveness of the German economy and resulted in a marked cyclical downturn, have now been more than offset.

In contrast to foreign business, domestic demand initially remained weak at the start of 1997. In March and April, the picture brightened somewhat, however; domestic orders picked up appreciably during that period. It remains to be seen whether this signals the awaited spread of cyclical momentum from exports to the domestic market. So far, the trend in the individual components of domestic demand does not suggest that there has been any fundamental move from the mainly export-led upswing to a more broadly based economic upturn.

The propensity to invest, in particular, has remained subdued. The inclination to expand capacity appears to be slight, especially in industries geared mainly to the domestic market. The technical limits of production may be reached earlier in the case of more export-oriented enterprises. But such firms are also more likely to consider whether any necessary investment in capacity extensions should be located in Germany or rather in other countries. The heavy outflow of funds for direct investment abroad continues to indicate an

Domestic demand

Investment

international diversification of German enterprises' production locations. Conversely, non-residents' interest in establishing additional production facilities in Germany has remained slight, which points to the existence of persistent locational problems in Germany. Critics frequently cite the mass of regulations, rigidities on the labour market, the heavy burden of taxes and non-wage labour costs as well as uncertainty about future economic developments and the economic policy setting. The Federal Government has initiated a large number of reform projects, but parliamentary approval is still required on key issues. A rapid clarification of this situation would undoubtedly help to improve conditions for production in Germany and hence to raise domestic and foreign enterprises' propensity to invest.

*Private
consumption*

Private consumption, too, remained quite muted at the beginning of 1997. Seasonally adjusted, it was no higher in real terms in the first quarter of this year than in the last quarter of 1996, in which it had fallen slightly. The main reason for this was presumably that households' scope of income was constrained by the rise in unemployment and by the sharp increase in the contribution rate to the statutory pension insurance scheme. Apart from that, job insecurity perceptibly dampened the propensity to buy. The labour market situation has thus increasingly become in itself an obstacle to economic growth. No particular stimuli are to be expected from private consumption as long as employment continues to decline. However, the key to rising consumption does not lie in any attempt by the government or wage bargainers to boost households' purchasing power but

rather in investment which creates jobs, which in turn raise disposable income. From that perspective, too, it is imperative to improve the general conditions for corporate capital formation to enable Germany to hold its own as a production centre in global competition.

The construction industry is a particular weak spot in the present economic picture. In the first quarter of 1997 orders received by the construction industry were 2% lower, seasonally adjusted and after allowing for price changes, than in the last quarter of 1996; they were 5½% lower than their level a year earlier. Industrial and commercial construction is being dampened by enterprises' subdued propensity to invest; in addition, there are now quite a large number of unlet office and commercial buildings, particularly in eastern Germany; these vacant properties will not be occupied until the economy has gradually expanded to fill them. The public sector is likewise tending to hold back from placing new construction orders, owing to the large budget deficits, even if there are upward fluctuations at times – as in the first quarter. The situation is especially difficult in rented housing construction. Appreciable supply overhangs exist in some areas, following the high number of completions in previous years, which has led to a fall in rents for dwellings that are newly let; furthermore, the return on investment in rented housing construction in eastern Germany has been depressed by the cutback in government assistance measures.

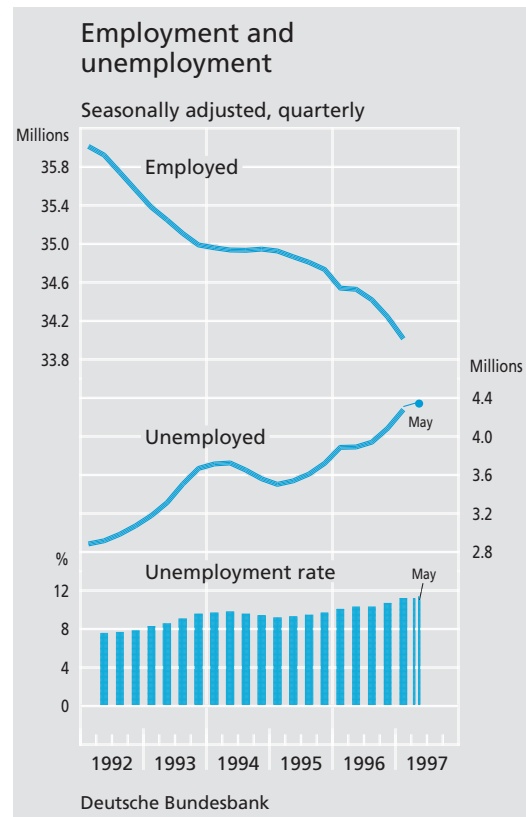
Construction

In the construction industry, a cyclical weakness in demand is currently coinciding with a

process of radical structural adjustment, especially in eastern Germany. The process of realigning capacity with a level of demand which may well have fallen permanently is undoubtedly painful but is probably unavoidable, given the specific situation on the property market. This adjustment process is a reaction, at least in part, to the exceptionally sharp expansion of construction work following German unification and, to that extent, must be seen as representing a return to a more normal situation.

Labour market

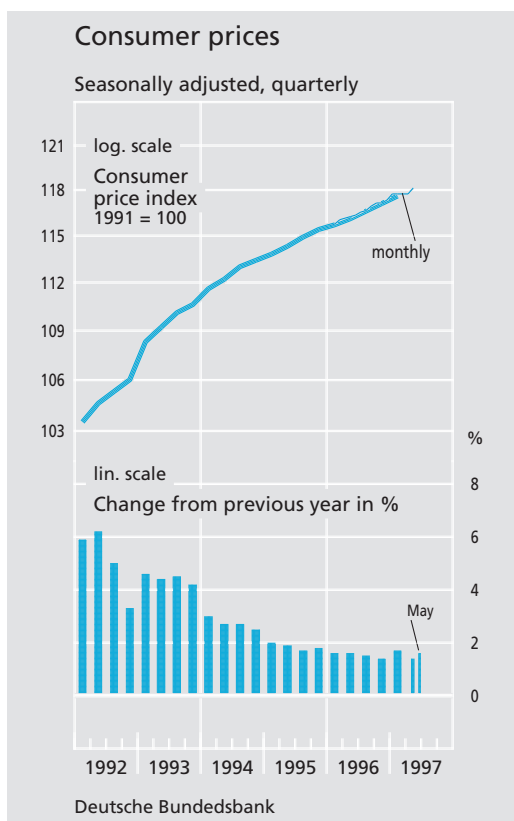
The problems of adjustment in the construction sector have been a major contributory factor in the further deterioration in the situation on the labour market. There has, however, been a continued reduction of the workforce in industry, too – mainly in order to cut costs in the production process. At the end of March, the number of employed persons in Germany was 450,000 lower than a year before. This was mirrored by the fact that the number of persons out of work showed a year-on-year rise of 437,000 to 4.26 million at the end of May. The unemployment rate was 9.9% in western Germany, seasonally adjusted, and 17.5% in eastern Germany. The fact that economic growth has started to pick up again will undoubtedly help to alleviate the strained employment situation somewhat. Much unemployment is due to structural factors, however, and calls for measures that will, above all, improve the efficiency of the labour market. In the longer term, it will be particularly important to create new, competitive jobs in the services sector in order to offset the continuing decline in employment opportunities in the producing sector. Wage



policy will have a key role to play in this process of structural adjustment between the economic sectors, just as it has in the equally important task of strengthening Germany's locational competitiveness as an industrial base.

The fact that pay settlements have been quite moderate for two years in succession is encouraging. The latest wage rises were in the order of 1½%. Furthermore, wage settlements are increasingly including elements of flexibility, such as working hours which are better suited to enterprises' needs or "wage corridors" which make actual earnings partly dependent on the enterprise's economic situation. There is evidently now a greater general willingness on the part of management and labour to replace (or at least supplement)

Pay settlements



the inflexible arrangements of past regional and sectoral pay bargaining by wage agreements that are tailored more to individual firms or industries. The high degree of price stability that has now been achieved should make it easier for both sides of industry to continue pursuing the course of wage moderation on which they have embarked. Conversely, moderate wage settlements can likewise strengthen public confidence in monetary stability.

Prices

The price climate remained favourable in Germany during the first few months of 1997. Unit labour costs in the manufacturing sector have been declining for some time, while import prices have stabilised again latterly following the previous sharp rise, which had largely been induced by exchange rate move-

ments. At the industrial producer level, prices in April 1997 were no more than 0.9% higher than a year earlier. The year-on-year rise in consumer prices to May was 1.6%. No inflationary stimuli are discernible at present either on the demand side or in terms of cost pressures. Monetary policy makers will now have to ensure that this success in achieving price stability is sustained in the long term.

Fiscal and monetary policies

There was a further marked rise in the budget deficits of the public authorities at the beginning of this year. Excluding the local authorities, for which data are not yet available, the deficits – at DM 34½ billion – were DM 8½ billion higher than the figure for the comparable period last year. However, some factors which had only a temporary impact played a part in this. Thus one reason why tax revenue was particularly low in the period under review was that some payment deadlines were brought forward and that, following the cessation of the income stream from the wealth tax, no revenue was yet received from the raising of the tax on the acquisition of land and buildings and of the inheritance tax. On the other hand, there is no denying the fact that the labour-market-related burdens on public expenditure, which are ultimately reflected in the Federal budget, have risen sharply. Even though the first-quarter figure is not necessarily representative and therefore should not be used to yield an annualised total, appreciable budgetary risks are now apparent which call for special measures if the deficits are not to get out of hand again.

Budget position at the beginning of 1997

*Public sector
budgets in
1997 as a
whole*

According to the official tax estimate of May 1997, considerable shortfalls in tax revenue are likely during the current year compared with the budget plans. In addition, unemployment will be markedly higher in 1997, in all probability, than had been assumed, for example, towards the end of last year. All levels of government are endeavouring to impose tight curbs on spending; thus despite the additional labour-market-related burdens, the share of public sector expenditure in GDP, i.e. the government spending ratio, will show a marked decline in 1997 for the first time since 1994. Nevertheless, it is likely that the deficits of the central, regional and local authorities will exceed the totals contained in the budget plans. The probable fall in the deficits may therefore be smaller than expected. On the other hand, the trend in the financial position of the social security funds is likely to be more favourable than that of the central, regional and local authorities. Following a deficit of DM 13 billion in 1996, a surplus is to be expected for 1997. This is mainly attributable to the increase in pension insurance contributions, which was necessary in order to bring the fluctuation reserves back up to their statutorily prescribed level.

*Budget
discussions for
1998 and the
following years*

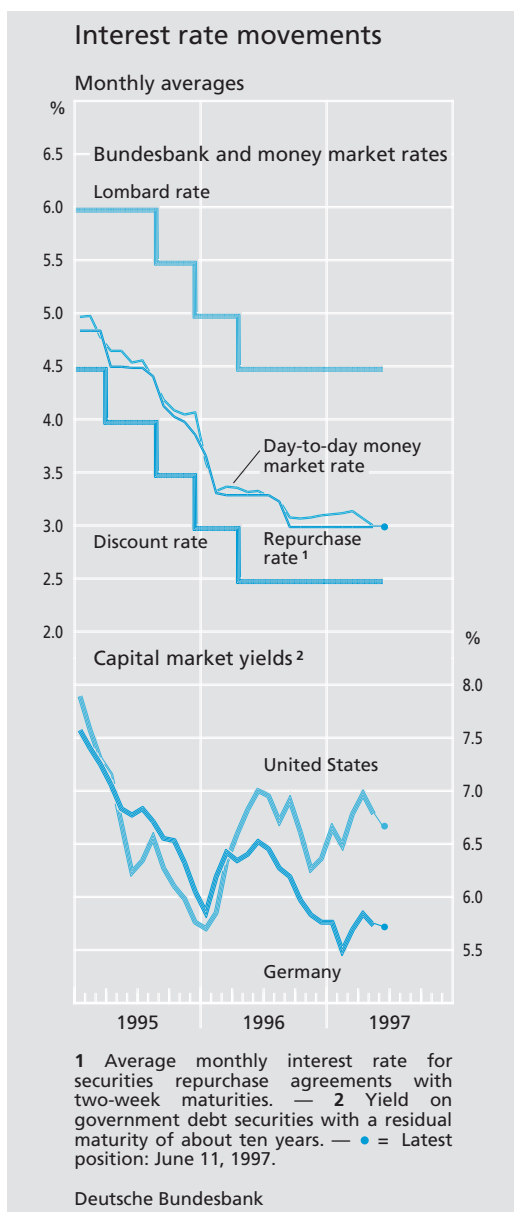
The budget consultations for 1998 and discussions for the following years must take account of a number of sometimes conflicting objectives in what is a difficult economic and political setting. The general government deficit must be reduced further, not least in order to meet the requirements of the envisaged European stability and growth pact. What is more, Article 115 of the Federal German Constitution stipulates that new borrowing

may not generally exceed government capital expenditure. At the same time, alleviating the burden of taxes and levies, especially on enterprises, is an urgent necessity; particular attention should be paid in this context to reducing non-wage labour costs. Finally, the tax system must be reformed, with lower rates of taxation and a broadening of the tax base, in order to improve production and employment opportunities in Germany. Achieving all this will only be possible if the public sector not only continues the stringent policy of retrenchment in respect of consumption spending but, if anything, adopts an even stricter policy in the medium term.

The public sector is currently facing important decisions that will affect the course of future developments. It is vital to pursue a convincing medium-term strategy that will simultaneously create favourable conditions for domestic economic growth and bolster confidence in the future single European currency.

In the spring, the Bundesbank continued its policy of keeping interest rates steady. It left the discount rate and the lombard rate at 2.5 % and 4.5 %, respectively, and the securities repurchase rate at 3.0 %. Moreover, it regularly announced the terms of its securities repurchase transactions, which continued to be offered in the form of fixed-rate tenders, in advance directly after the meetings of the Central Bank Council. Thus, in part, the central bank rates remain at the all-time lows to which they had fallen following the interest rate reductions in April and in August 1996. Given the stable central bank interest rates, there was little change in the spring months

*Policy of
keeping
interest rates
steady*



in the money market rates either; they are still in the lower regions of the international interest rate range.

A "steady-as-she-goes" approach to interest rate policy remained appropriate in the light of the monetary and overall economic situation. On the whole, the money stock grew somewhat faster in the first few months of the year than the Bundesbank had envisaged.

The trend in monetary growth was not steady, however. After a sharp rise at the beginning of the year, which was due mainly to a large "statistical overhang" at the end of 1996, the pace of monetary growth slackened perceptibly. In April, the money stock M3, at a seasonally adjusted annual rate of 6.7 %, exceeded its average growth in the fourth quarter of 1996 but drew markedly closer to the ceiling for this year's monetary target corridor of between 3 ½ % and 6 ½ %. The money stock M3 expanded at a similar pace over the past 12 months. The money stock M3 extended, which the Bundesbank likewise uses to assess the liquidity situation, was 5 ½ % higher in March than a year earlier. It thus grew at a somewhat slower pace than M3. The Euro-deposits and the money market fund certificates held by domestic non-banks, which are contained in M3 extended, showed little growth during this period or were even run down.

Overall, the money supply still appears to be fairly appropriate over the medium term. This is also suggested by the fact that, of the individual money stock components, the special savings facilities, in particular, have been growing sharply right up to the present. In part, such funds represent a latent form of monetary capital formation. Another indicator pointing in the same direction is the fact that monetary expansion was to a large extent still being driven by an exceptionally weak long-term inflow of funds to banks. After picking up slightly at the end of last year, the pace of monetary capital formation has slowed again so far this year. Besides the low and, at times, fairly strongly fluctuating

*Determinants
of monetary
growth*

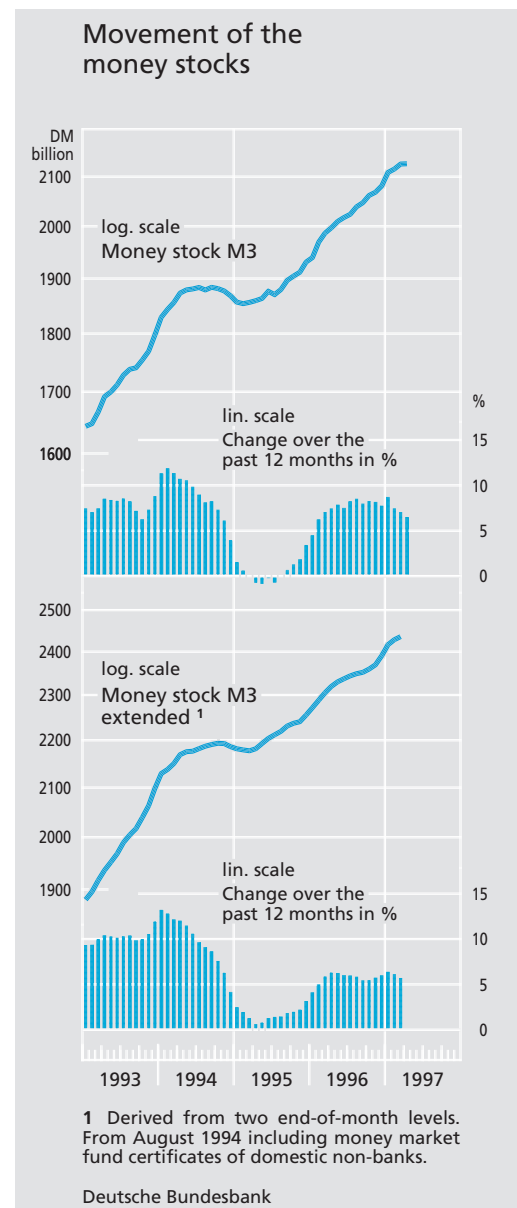
*Sharp but
volatile
monetary
growth*

capital market rates, one contributory factor in this might have been uncertainty in connection with European monetary union. Monetary capital with banks grew at a seasonally adjusted annual rate of no more than 4% in the first four months of this year. The public sector's cash operations likewise had a highly expansionary impact on monetary growth in the period under review. Besides the high level of borrowing from banks, the distribution of the Bundesbank profit in April also played a part in this.

On the other hand, there was a fall in bank lending to enterprises and individuals, which had shown a marked increase towards the end of last year in anticipation of the reduction from the start of 1997 in the special depreciation allowances on investment in eastern Germany and the increase in the tax on the acquisition of land and buildings. Against a backdrop of persistently high outflows on domestic non-banks' foreign payment transactions, however, bank lending nevertheless remained comparatively resilient. If bank lending to domestic non-banks and banks' net external assets are aggregated to form their asset-side business, this item grew in the last six months at an annual rate of just over 6½%. The banking system's overall asset-side business therefore contained a weaker expansionary impetus than domestic credit expansion alone, which grew at an annual rate of 8% during the same period.

Capital market rates

German capital market rates remained at a low level in spring 1997. After the yield on domestic bonds outstanding had fallen to a new all-time low of 4¾% by mid-February, it



subsequently increased slightly, amid greater volatility at times, but fell back below 5% by mid-June. At the same time, the German debt securities market managed to decouple itself to a greater extent from the US bond market; latterly, the yield on ten-year US Treasuries was almost 1 percentage point higher than the yield on comparable German Federal securities.

The persistently low capital market rates in Germany are primarily a reflection of the favourable outlook for prices and the rather moderate momentum of economic growth. The appreciation of the US dollar since the beginning of the year has had no adverse effect on the German capital market. The capital market players evidently regard this as representing a return to normal, not as an indication of a sustained weakening of the Deutsche Mark. Given the low interest rates

all along the curve, the normalisation of exchange rate relationships has further improved the monetary environment for a strengthening of economic growth. The task now is to improve the underlying structural conditions for investment in Germany. Monetary policy makers can provide effective support for the requisite fiscal, wage and social policy changes only by maintaining price stability.