

East German enterprises' profitability and financing in 1997

In 1997 the 3,155 east German manufacturing, construction and wholesale/retail firms analysed in this study showed a marked rise in profitability on balance. For the first time since the 1991 financial year they were "in the black" overall, even though the process of economic recovery in the region faltered. This improvement was fuelled principally by the industrial sector. The gap between low-margin and high-margin firms in eastern Germany has narrowed to match that in western Germany. The rise in corporate earnings in the 1997 financial year was largely used to bolster enterprises' financial resources. As a result, their own funds – also in relation to the balance sheet total – have now reached such a level that the previous general shortage of capital on the part of firms in the new Länder no longer applies. However, the fact that east German firms have now started to become profitable and are moving closer to the financing level of their west German counterparts is merely a first major step towards creating a profitable and resilient corporate landscape in eastern Germany. Much more progress will have to be made if the persisting substantial shortfall between absorption and production and between supply and demand on the primary labour market is to be gradually closed.

Macroeconomic background

Ongoing structural change amid faltering recovery process

The overall pattern of economic development in eastern Germany in 1997 was characterised by two factors: a trend towards the normalisation of the region's economic structure and (not unconnected with the first factor) a marked weakening of the growth momentum. Although the restructuring process has fulfilled a major prerequisite for further narrowing the gap in economic performance between western and eastern Germany, it acted as a brake on the momentum of production in the short term. The upshot of this was that the manufacturing sector was unable to compensate in full for the retarding influences emanating from the construction sector, especially as the latter's share in total value added in the new Länder, at 14½%, remains three times as high as the comparable figure in the old Länder. The situation was exacerbated by the fact that the expansionary forces in the services sector also slowed perceptibly. As a result, the process of recovery in eastern Germany, which had already decelerated distinctly in 1996, faltered in 1997. For the first time since German reunification, the economy grew more slowly in the new Länder than in western Germany, where the pace of expansion accelerated appreciably owing above all to a more broadly based export base.¹

Sharp contraction in construction ...

The output of the construction industry, which had already fallen in 1996, contracted by a further 4½% in 1997. Construction investment, which additionally embraces the activities of the finishing trades and ancillary building services, likewise fell sharply in price-

adjusted terms.² For one thing, the decline focused on investment in industrial and commercial construction projects. For a long time building activities in this segment had been stimulated by massive tax depreciation allowances, leading to a surfeit, in particular, of unlet offices and administrative buildings which depressed the market and dampened expectations regarding rates of return. For another thing, during the year under review the public sector cut back its construction activities even more sharply than in 1996. By comparison, actual building activity – as opposed to demand – in the east German housing construction segment held up fairly well; thus the number of dwellings completed in 1997 showed a further year-on-year rise.

Measured in terms of the "old" classification of the national accounts, the wholesale/retail trade sector likewise exerted a contractionary influence on overall output in eastern Germany in 1997, although to a much lesser extent than was the case in the construction sector. This drop was due to an extremely unfavourable trend in the sub-sector retail trade, the turnover of which fell by over 3% in real terms compared with 1996. By con-

... and a drop in wholesale/retail trade

¹ With the changeover to the ESA 95 system of national accounts, which occurred at the end of April 1999 for the main aggregates of GDP output and expenditure, the previous approach of calculating GDP separately for western and eastern Germany was discontinued. However, there is much to suggest that there has been little change in the growth differential between western and eastern Germany as shown for 1997 before the aforementioned revision.

² In the following reference is made to the system of national accounts in use prior to the recent revision in which construction investment was still shown separately for western and eastern Germany. It should be borne in mind, however, that the decline in pan-German construction investment that has been evident over the past few years appears less steep when calculated according to the revised system.

trast real turnover in western Germany decreased by "only" ½%. Besides the generally sluggish consumption and the tendency (which has been evident for some years) for private consumers to obtain a declining share of their purchases from retail outlets, the consumption climate in eastern Germany was doubtless also depressed by the further deterioration of the situation on the labour market. By contrast, the wholesale trade in the new Länder registered a marked increase in both business activity and value added, albeit starting from a relatively low base, which probably owed much to the sharp expansion in industry.

*Manufacturing
sector again
buoyant*

Output growth in the manufacturing sector increased from 6% in 1996 to 9% during the year under review. Producers of intermediate goods recorded above-average increases, whereas the output of consumer goods and, even more so, the production of capital goods expanded more slowly than the manufacturing sector as a whole. The increase in turnover growth was even more pronounced than that of output. It shot up from 2½% to 8%, with external turnover in 1997 outstripping the previous year's volume by no less than 34%. The rate of utilisation of the available production capacity likewise rose noticeably to reach a new record high. At the same time, the loss of jobs in industry continued under the persistently intense pressure to rationalise, which was at best eased a little by the more moderate pay increases in 1997. At 8½%, industrial unit labour costs in the new Länder declined by a much greater margin than in western Germany (– 5%), as a result of which the wage cost-productivity

gap behind the West was all but closed in this sector, even though this occurred at the expense of employment.

Structural features of the analysed sample of east German firms

The study presented in this article was based on the balance sheets of 3,155 east German enterprises in the manufacturing, construction and wholesale/retail trade sectors, of which almost 3,000 also contained details on the number of employees. This means that the source material was only marginally less comprehensive than in the preceding two years. The annual accounts for both 1996 and 1997 were available for the firms included in the sample, thus making it possible to undertake a detailed study of the trend in their profitability and financing in 1997 compared with the previous year. The data presented here show a much more favourable picture for 1996 than the cylindered sample for the financial years 1995 and 1996 analysed last year, *inter alia* because the process of restructuring the east German corporate landscape made further progress in 1997 and hence led to the elimination of particularly weak enterprises from the market.

*Scope and
composition of
the sample*

Over the years the representational weight has shifted towards wholesale/retail trade firms and away from construction enterprises and – to a lesser extent – away from manufacturing firms. This comes as no great surprise in view of the necessary reduction of construction capacity and the ongoing structural streamlining of the industrial sector. In

the sample examined in this article, 1,081 sets of annual accounts relate to the manufacturing sector, 432 are from construction firms and 1,642 are drawn from the wholesale/retail trade sector. Measured by total output, however, industry continues to predominate, with a share of around 50 %, followed by wholesale/retail services with 42 %, while construction accounts for merely 8 %.

*Representative-
ness of the data*

The annual accounts were submitted to the Bundesbank largely in connection with its rediscount business. Although the Bundesbank's traditional discount credit facility was discontinued with the start of European monetary union, credit claims of banks on enterprises are eligible for use as collateral in the banks' refinancing business with the central bank. Hence the annual accounts of enterprises continue to be submitted to the Bundesbank to facilitate an assessment of their creditworthiness. Presumptions that they constitute a positive selection carefully sifted by the credit institutions have not been corroborated.³ On the contrary, the marked dispersion between high-margin and low-margin enterprises and between financially strong and financially weak firms, which is examined in greater detail below, indicates that the corporate balance sheet statistics contain a comparatively broad spread of balance sheet and profit and loss account data relating to enterprises with differing credit standings.

Annual results

*In profit for the
first time*

Despite the difficult overall economic environment in the new Länder, the earnings situ-

ation of the east German enterprises included in the study improved noticeably on balance in 1997. For the first time since these studies began for eastern Germany in 1993, covering the 1991 financial year, the sample of firms analysed showed an overall profit. Before taxes on income they showed an aggregate annual result for the year 1997 of DM 450 million, compared with a loss of DM 134 million in the previous year.⁴ The gross profit-turnover ratio (the annual result before taxes on income in relation to turnover) increased by almost 1 percentage point between 1996 and 1997 to 0.7 %. The annual result after taxes showed an even greater improvement than the corresponding pre-tax figure as taxes on income and earnings had a smaller impact in 1997. Nevertheless, with a net profit-turnover ratio of 0.5 %, east German businesses were still a long way from achieving an adequate level of profitability.

This is also borne out by comparing profitability in eastern and western Germany.⁵ On the one hand, the year-to-year rise in earnings

*Comparative
profitability in
eastern and
western
Germany*

³ For further details see Deutsche Bundesbank, The methodological basis of the Deutsche Bundesbank's corporate balance sheet statistics, Monthly Report, October 1998, page 49 ff.

⁴ The annual result used here corresponds to the profit for the year before profit transfers and provides a more informative picture of the real profitability of the enterprises analysed than does the profit for the year, as many firms are affiliated by means of profit/partial profit transfer agreements with enterprises which are not covered by the corporate balance sheet statistics (e.g. holding companies) to which they transfer their profits or which assume their losses.

⁵ For comparisons with the profitability and financing of west German enterprises in the year under review, the basis of reference used in this article is a cylindered sample of enterprises whose definition and structure are more akin to the source material on which the study of the east German firms is based than are the expanded results for western Germany published in the Monthly Report of October 1998.

Selected ratios from the annual accounts of east German enterprises *

Item	All enterprises 1		Manufacturing		Construction		Wholesale and retail trade 2		Memo item western Germany; all enterprises 3
	1996	1997	1996	1997	1996	1997	1996	1997	
	Balance sheet ratios								
% of balance sheet total 4									
Assets									
Tangible fixed assets 5	41.8	40.7	48.5	46.3	23.8	24.8	33.5	33.0	19.0
Stocks 6	22.5	22.7	16.1	16.5	40.2	40.2	30.3	31.2	22.7
Cash 7	4.4	4.1	3.9	3.9	7.9	5.7	4.2	4.0	5.2
Debtors	27.7	27.7	26.9	27.0	26.3	27.4	30.3	29.7	34.1
Short-term	26.8	26.5	25.8	25.6	25.6	26.5	29.7	28.9	31.9
Long-term	0.9	1.2	1.1	1.5	0.7	0.9	0.6	0.7	2.3
Investments	0.5	0.6	0.7	0.9	0.1	0.3	0.1	0.2	3.4
Participating interests	2.6	3.7	3.7	5.2	0.5	0.7	1.0	1.4	15.3
Liabilities									
Own funds 4, 8	23.1	24.6	28.8	31.0	7.6	7.5	15.8	15.5	23.9
Creditors	67.2	65.8	59.6	57.8	82.9	83.3	78.7	78.8	51.2
Short-term	45.0	44.8	36.6	37.1	69.5	68.5	55.1	54.6	42.0
Long-term	22.2	21.0	23.0	20.7	13.4	14.8	23.6	24.2	9.1
Provisions 8	9.6	9.5	11.5	11.1	9.3	9.2	5.3	5.5	24.7
Profit and loss account ratios									
% of total output									
Cost of materials 9	68.8	69.4	60.8	61.8	56.0	56.5	80.2	80.8	64.9
Labour cost 10	16.7	16.0	21.0	19.8	29.5	28.5	9.3	9.1	16.8
Depreciation	6.2	5.6	8.7	7.8	6.5	5.6	3.3	3.1	3.0
Interest paid	1.9	1.8	2.3	2.0	1.7	1.8	1.5	1.5	0.9
Taxes	0.9	0.8	1.4	1.2	0.4	0.4	0.4	0.4	4.4
Other cost	12.8	12.4	17.2	16.3	12.2	12.1	7.9	8.0	13.2
Gross income	31.2	30.6	39.2	38.2	44.0	43.5	19.8	19.2	35.1
Interest paid (net) 11	1.5	1.4	1.7	1.5	1.4	1.5	1.3	1.2	0.3
% of turnover									
Profit for the year	-0.3	0.5	-0.5	0.8	-0.1	0.1	-0.1	0.2	1.9
Annual result 12	-0.5	0.5	-1.0	1.0	0.1	0.0	-0.1	0.1	2.1
Annual result before taxes on income 13	-0.2	0.7	-0.8	1.1	0.4	0.2	0.2	0.4	3.1

* Results of a two-year cylindered sample of 3,155 manufacturing, construction and wholesale/retail trade enterprises. — 1 Consolidated results. — 2 Retail trade, wholesale trade and commission trade. — 3 Results of a cylindered sample of 34,569 enterprises for 1996 and 1997 from the corresponding economic sectors. — 4 Less adjustments to capital accounts. — 5 Including intangible assets. — 6 Including contracts in progress. — 7 Cash on hand and bank balances. — 8 Including pro rata share of special re-

serves — 9 Including expenditure on goods and services purchased. — 10 Wages, salaries, social security contributions and voluntary social security expenditure. — 11 Balance of interest paid and interest received. — 12 Profit for the year before profit/loss assumptions and profit/loss transfers. — 13 Taxes on income and earnings; in the case of partnerships and sole proprietorships trade earnings tax only.

achieved by the east German firms was steeper than that of the west German enterprises in the same three sectors as recorded in the corporate balance sheet statistics, which increased their average gross profit-turnover ratio by "only" 0.7 percentage point; on the other hand, the west German level of 3.1% in 1997 was markedly higher than in the new Länder. This difference is underscored by the fact that 79% of enterprises in the west German cylindered sample posted a profit in the year under review compared with 68½% in eastern Germany. If the enterprises in the two corporate samples are broken down by legal form, it can be seen that the highest portion of profitable firms, in both instances, was found among the sole proprietorships, at 87% in the old Länder and 82% in the new Länder – scores which were also very similar. It should be noted in this context that a large part of the annual result of these firms is accounted for in many cases by the "entrepreneur's remuneration". For firms organised in other forms, especially public limited companies and partnerships, the east German enterprises trailed their west German counterparts by a much greater margin.

Growing gap between the manufacturing and wholesale/retail sectors, on the one hand, ...

The improvement in the profitability of the east German enterprises included in the sample was concentrated on manufacturing firms. Owing not least to the more favourable industrial climate and also their growing competitiveness, these firms generated a gross profit-turnover ratio of 1.1%, following a deficit of 0.8% of turnover in 1996. In the reporting sample for the financial year 1991 a loss of more than DM 20 had been made on every DM 100 of turnover. The share of

profit-making enterprises increased by 5 percentage points to 64%, but this still fell far short of the corresponding west German ratio (79½%). Within the manufacturing sector – measured by this indicator – it was above all capital goods producers that fared better than in 1996, whereas, for example, manufacturers of intermediate goods for the construction industry (manufacture of glass and other non-metallic mineral products) and branches of industry oriented towards consumption, such as the manufacture of textiles and textile products or the furniture industry, did not participate in the positive earnings trend.

The enterprises in the wholesale/retail trade sector, which had shown an aggregate profit already in 1996, further improved their annual result before taxes in 1997, although only fairly modestly. Their gross profit-turnover ratio increased from 0.2% to 0.4%, but this was still a long way behind the comparable west German score (1.5%). This earnings gap was particularly pronounced in the case of wholesale trade enterprises, which remained in the red on balance in 1997, whereas east German retail trade firms, with a profit-turnover ratio of 0.9%, moved appreciably closer to the performance of their counterparts in the old Länder. This is corroborated by the fact that 75½% of enterprises in the east German retail trade sector made a profit in 1997 as against not quite 78% in western Germany.

Unsurprisingly, the earnings situation of the east German construction sector deteriorated in 1997, although far less than one might

... and the construction sector, on the other hand

Profit-turnover ratio by quartile *

%				
Quartile(s)	All enter- prises	Manu- facturing	Con- struction	Whole- sale and retail trade
0 % to less than 25 %				
1996	-9.3	-18.0	-5.0	-3.9
1997	-6.6	-10.6	-6.3	-3.6
25 % to less than 50 %				
1996	0.0	-0.8	0.2	0.1
1997	0.1	-0.2	0.0	0.2
50 % to less than 75 %				
1996	1.3	1.7	1.4	1.2
1997	1.4	2.1	1.1	1.3
75 % to 100 %				
1996	7.3	9.0	6.3	4.9
1997	8.1	11.4	5.2	4.5
All				
1996	-0.2	-0.8	0.4	0.2
1997	0.7	1.1	0.2	0.4
		Enterprises with a turnover of ...		
		... less than DM 5 million	... DM 5 million to less than DM 50 million	... DM 50 million or more
0 % to less than 25 %				
1996	-9.3	-10.9	-8.8	-12.0
1997	-6.6	-11.0	-5.9	-7.3
25 % to less than 50 %				
1996	0.0	0.1	0.0	-0.5
1997	0.1	0.2	0.1	0.0
50 % to less than 75 %				
1996	1.3	2.1	1.1	0.8
1997	1.4	2.0	1.1	1.6
75 % to 100 %				
1996	7.3	9.4	6.7	7.0
1997	8.1	9.6	7.0	9.0
All				
1996	-0.2	0.0	-0.3	-0.2
1997	0.7	0.0	0.6	0.9

* Average values per quartile. To determine the quartile categories enterprises were sorted separately by profit-turnover ratio for each year per sector and per size category. The profit-turnover ratio is the annual result before taxes on income as % of turnover.

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have expected in view of the generally slack momentum in the building trade. Thus the sector's gross profit-turnover ratio fell only marginally to 0.2 %, which matched the corresponding figure for western Germany, where the overall earnings result of the construction industry was notably depressed by a drastic slump in the earnings of some large construction enterprises. If the percentage of firms in profit is taken as the yardstick, the deterioration in earnings in 1997 was confined to eastern Germany, while in the western part of the country more firms were in the black than in 1996.

The dispersion between the respective profit-turnover ratios of the east German firms analysed narrowed perceptibly. Thus the differential between the profit-turnover ratios of the enterprises in the bottom quartile (ranked by this indicator) and those in the top quarter fell by 2 percentage points between 1996 and 1997 to 14 ½ %; this equalled the differential in western Germany as measured in a special study for the 1995 financial year.⁶ This can be seen as further evidence that the profitability of east German enterprises has made up much ground compared with the situation in western Germany. This progress occurred principally in the bottom quartile, where the average loss-turnover ratio of 30 ½ % ascertained in an earlier study for the year 1992 improved to 6 ½ % for the year 1997. The main positive impetus came from the manufacturing sector, whereas the position of the already low-margin construction firms wor-

*Dispersion
between
profit-turnover
ratios*

⁶ See Deutsche Bundesbank, West German enterprises' profitability and financing in 1996, Monthly Report, November 1997, page 43f.

sened further. In the top quartile the profit-turnover ratio improved between 1996 and 1997 by $\frac{3}{4}$ percentage point to 8%, which shortened the gap vis-à-vis western Germany (10% in 1995). By contrast, the profit margins of firms in the two middle quartiles remained meagre.

A major step towards achieving a more satisfactory level of profitability was taken in 1997 by larger firms with a turnover of DM 50 million or more. They generated a profit-turnover ratio of 1% on average, after having shown a combined loss in 1996. A substantial improvement in earnings was likewise evident in the turnover size category from DM 5 million to less than DM 50 million. Only the small firms (i. e. those with a turnover of less than DM 5 million), which had managed to break even in 1996, failed to make progress in the year under review. The chief reason for this presumably is that construction firms, which have been in the doldrums, are concentrated in the smallest size category, whereas the industrial enterprises, which in general have been faring better, are more heavily represented in the middle and top turnover segments.

Income and cost

Total output

The total output (i. e. turnover plus change in stocks of own products and other capitalised production) of the enterprises included in the study expanded by $7\frac{1}{2}\%$ overall in 1997. However, the individual sectors recorded very different trends, above all on account of the heterogeneous cyclical development in the

various industries as described above. Manufacturing firms raised their total output by 11%, which was not only the highest amount of any sector but also more than the aggregate rise in total output recorded by all the enterprises covered by the official turnover statistics (8%). The volume of business of firms in the wholesale/retail trade sector also expanded fairly sharply by $5\frac{1}{2}\%$. In marked contrast to the unfavourable outturn of the retail trade statistics for the new Länder mentioned at the beginning of this article, the retail trade enterprises in the cylindered sample raised their turnover in 1997 by no less than 7%. This discrepancy, which was evident in the two preceding financial years as well, may be due in part to the fact that medium-sized and large retail trade enterprises are very heavily represented in the corporate balance sheet statistics for eastern Germany; this category of firms again registered a buoyant level of business in 1997. In terms of the turnover statistics for the basic construction industry, the construction firms included in the sample, whose total output stagnated, likewise did relatively well. However, this comparison is somewhat distorted in that enterprises in the basic construction segment were doubtless hit much harder by the structural adjustment taking place in the east German construction sector than firms in the finishing and allied construction trades, which are engaged in performing much of the extensive modernisation and renovation work in the east German housing sector.

At just short of $6\frac{1}{2}\%$, the total cost incurred by the enterprises in the sample in 1997 increased only a fraction more slowly than total

Total income and cost

income (7%), which comprises total output, interest received and other income. But given the considerable "leverage" of these items, this sufficed to substantially improve the annual result – as described above.

Cost of materials ...

The cost of materials once again rose at a faster-than-average rate (8½%); its share in total output increased to 69½%. This was mainly attributable to the trend in the manufacturing sector, which for some time has manifested a shift towards greater expenditure on bought-in goods and materials. In 1997 the considerable increase in stocks of work in progress and of raw materials and supplies probably reinforced this effect. In east German industry the quota of purchased goods and services in 1997, at 62%, was 7 percentage points higher than the corresponding west German figure. On the one hand, this is a reflection of a shallower in-house production base, resulting partly from the increased use of modern, "lean" production methods and partly from a production system characterised by a rather low level of value creation. On the other hand, there have been indications for quite some time that, in order to penetrate new markets, east German firms (other things being equal) are often obliged to grant considerable price concessions in comparison with the prices bid by their west German competitors.⁷

The amount spent on materials and goods also increased sharply in the wholesale/retail trade (by 6%); the share of this item in total

⁷ See DIW, Zur Ertragsituation im verarbeitenden Gewerbe Ostdeutschlands im Jahr 1996. Wochenbericht, Heft 49, 1998, page 879f.

Profit and loss account of east German enterprises in 1997 *

Item	All enterprises 1	Manufacturing	Construction	Wholesale and retail trade 2
DM million				
Turnover	63,062	31,011	5,323	26,729
Total output 3	63,251	31,252	5,247	26,752
Interest received	238	153	15	71
Other income	3,849	2,887	245	717
Total income	67,338	34,291	5,507	27,540
Cost of materials 4	43,880	19,313	2,963	21,604
Labour cost 5	10,119	6,195	1,496	2,428
Depreciation	3,555	2,432	294	829
Interest paid	1,115	632	93	390
Taxes	498	373	20	104
on income and earnings 6	107	12	12	84
Other cost	7,868	5,102	634	2,132
Total cost	67,034	34,046	5,500	27,488
Profit for the year	304	246	7	52
Memo items				
Annual result 7	343	324	1	17
Annual result before taxes on income 8	450	335	13	101
Change from previous year in %				
Turnover	7.9	11.2	2.8	5.4
Total output 3	7.6	10.9	- 0.1	5.4
Interest received	- 0.2	- 2.2	- 8.4	6.3
Other income	0.2	- 1.2	- 20.5	16.9
Total income	7.1	9.7	- 1.3	5.7
Cost of materials 4	8.5	12.7	0.7	6.1
Labour cost 5	2.8	4.6	- 3.4	2.5
Depreciation	- 2.3	- 0.6	- 13.8	- 2.4
Interest paid	- 0.8	- 2.6	2.9	1.4
Taxes	- 3.1	- 4.9	2.9	2.3
on income and earnings 6	- 29.8	- 80.6	0.7	3.4
Other cost	4.7	5.0	- 1.0	5.8
Total cost	6.3	8.4	- 1.5	5.4
Change from previous year in DM million				
Profit for the year	483	398	10	74
Memo items				
Annual result 7	629	598	- 5	36
Annual result before taxes on income 8	584	550	- 5	39

* Results of a two-year cylindered sample of 3,155 manufacturing, construction and wholesale/retail trade enterprises. — 1 Consolidated results. — 2 Retail trade, wholesale trade and commission trade. — 3 Turnover plus change in stocks of own products and other capitalised production. — 4 Including expenditure on goods and services purchased. — 5 Wages, salaries, social security contributions and voluntary social security expenditure. — 6 In the case of partnerships and sole proprietorships trade earnings tax only. — 7 Profit for the year before profit/loss assumptions and profit/loss transfers. — 8 Taxes on income and earnings.

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output, at not quite 81%, was barely higher than in the old Länder, however. This is a further indication that in this field, too, the position in eastern Germany has largely converged with that in the old Länder. In the construction sector the cost of materials tended to rise only marginally in 1997 against the background of a stagnant level of business.

Labour cost ...

The improved profitability of east German enterprises in 1997 was assisted by the moderate overall increase in labour cost by not quite 3%; its share of total output fell further to 16%. This was due principally to the more moderate trends in wage settlements and actual earnings in eastern Germany compared with previous years. In the almost 3,000 firms which also provided details of their employee totals, labour cost per employee was "only" 3% higher than a year before, compared with year-on-year increases of 6% and 9% in the financial years 1996 and 1995. Although negotiated basic wages and salaries in eastern Germany increased during the year under review to more than 90% of the west German level, actual earnings in the east German firms in the sample reached only about 75%, regardless of the size category. The increase in labour cost was additionally held down by the fact that the number of jobs again declined, by just under ½%.

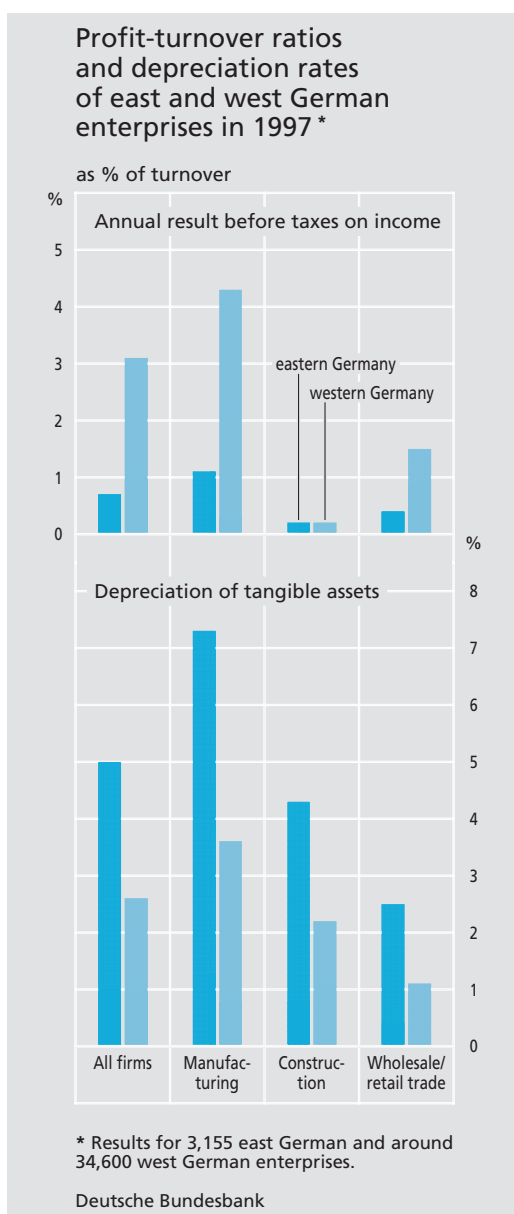
... mirroring trends in employment and wages

The fall in the level of employment was concentrated on the construction industry, where almost 4½% of jobs were lost. In the other two sectors, by contrast, new jobs were created on balance, albeit on a small scale. In industry only the larger enterprises expanded their workforce, whereas small firms reduced

the number of their employees. This is probably related to the fact that the main stimuli for the manufacturing sector in the new Länder in 1997 came from western Germany and from abroad, and thus had less of an impact on small firms – which are more reliant on local demand. In line with the different cyclical momentum in the three economic sectors, labour cost per employee rose most in manufacturing (by 4%). This was due to the linear rise of 1.5% in negotiated pay rates agreed for 1997 in the metalworking and electrical industries and, in particular, to the sharp rise in collectively agreed wages and salaries that took effect in mid-1996. In addition, there was a marked reduction in the amount of short-time working in 1997. In the wholesale/retail trade and construction sectors average earnings increased by almost 2% and just over ½%, respectively.

The cost of tax depreciation declined by 2½% overall in 1997. However, this overall figure masks countervailing trends in the depreciation of tangible assets, which showed a downward tendency (– 3½%) and in other depreciation (mainly losses on debtors and value adjustments on investments and participating interests), which increased by 8½%. The fall in the consumption of fixed capital was due partly to changes in depreciation modalities, specifically the reduction of special tax depreciation facilities for commercial buildings and for machinery and equipment. Another reason for the drop in the depreciation of fixed assets is that – according to the ifo institute – expenditure on new machinery, equipment and buildings again decreased noticeably, especially in the construction sector

Depreciation



and in industry. But at 5 %, the weight of the consumption of fixed capital – as a percentage of total output – was still twice as high in eastern Germany in 1997 as for the cylindered sample of west German enterprises. There were two main reasons for this: the high intensity of asset formation (investment per employee) and the utilisation of extra depreciation facilities granted specifically in connection with *Aufbau Ost*, the process of re-

constructing the east German economy. This needs to be taken into account when comparing east-west profitability because it implies that, as investment behaviour in the new Länder increasingly assumes a normal pattern and as the depreciation modalities in the two parts of the country converge more and more, the existing gap in the respective profit-turnover ratios in eastern and western Germany is likely to narrow appreciably.

Interest paid likewise decreased somewhat in 1997 compared with 1996. This was due mainly to a decline in the stock of interest-bearing creditors. By contrast, the average interest rate payable on those creditors remained unchanged at just over 5½ %; the rate charged to manufacturing firms was about 1 percentage point less than the corresponding rates in the construction and wholesale/retail trade sectors. This discrepancy probably reflects differences not only in the maturity and composition of each sector's creditors but also in the risk premia demanded by lenders. Interest paid amounted to 1.8 % of total output, which was double the corresponding west German ratio.

Interest paid

Balance sheet trends and structures

While the considerable increase in the business activity of the enterprises analysed in the year under review was clearly mirrored in individual balance sheet items, there was little change in the overall picture. The adjusted aggregate balance sheet total was merely 1½ % higher than the 1996 level. Even in industry which, at 4 %, recorded above-aver-

Balance sheet total

age growth, the change in total assets and liabilities failed to keep pace with the expansion of total output. The aggregate balance sheet total of the firms in the wholesale/retail trade and construction sectors actually contracted.

*Weak growth
of assets*

On the assets side this was caused first and foremost by a fall of over 1% in the stock of tangible fixed assets, a fall which was manifested by each of the sectors, albeit to differing extents. A key factor in this was the aforementioned tendency for the fixed asset formation of east German firms to gradually approximate to the west German norm, coupled with the still fairly high level of value adjustments. A particularly sharp drop occurred in the item Payments on account and tangible assets in course of construction, especially in the case of industrial enterprises; this perhaps indicates the completion of large-scale projects. On the other hand, tangible assets were boosted by a substantial rise in stocks in the manufacturing sector and, to a lesser extent, in wholesale/retail trade. As a result, total tangible assets (i.e. fixed assets plus stocks) stayed at the previous year's level. The ratio of this item to total assets fell by 1 percentage point to 63½% but was still half as high again as the comparable west German ratio.

Asset structure

This high share of non-financial assets remains the principal difference between the respective asset structures in the new Länder and the old Länder, although it reflects not so much a comparatively high real capital stock in eastern Germany as peculiarities with respect to financial assets. One thing that

stands out is that, totalling 3½% of the balance sheet total, the participating interests of east German firms – even though they have apparently stepped up their efforts of late to expand them – were much smaller than the equity holdings of their west German counterparts, which displayed a corresponding quota of 15½%. This discrepancy will presumably diminish in the future but is unlikely to disappear altogether because many enterprises in the new Länder are operated as subsidiaries of west German or foreign firms and consequently often lack both the financial capability and the decision-making competence to acquire participations in their own right. By contrast, there is now only a small east-west differential in other items which, like the stock of cash or short-term trade debtors, are closely linked with operational business.

The level of east German firms' provision with own funds in 1997 was likewise very similar to that in the old Länder. As their liable capital grew by 8½%, and hence far faster than the balance sheet total, their capital ratio rose by 1½ percentage points to 24½%, thereby marginally outstripping the west German figure (24%). It should be noted, however, that incorporated enterprises – which traditionally tend to show a more favourable level of provision with own funds in their balance sheets than unincorporated enterprises – are fairly strongly represented in the new Länder. Furthermore, the considerable average increase in the capital base masks sharply divergent developments in the individual sectors. For example, the stock of own funds of east German manufacturing firms surged by more

*Marked
increase in
capital...*

Balance sheet data of east German enterprises in 1997 *

Item	All enterprises 1	Manufacturing	Construction	Wholesale and retail trade 2
DM million				
Assets				
Tangible fixed assets 3	16,949	12,333	1,001	3,615
Stocks 4	9,438	4,395	1,627	3,416
Cash 5	1,693	1,030	230	433
Debtors	11,548	7,194	1,107	3,248
Short-term	11,043	6,807	1,071	3,166
of which				
Trade debtors	5,601	2,886	764	1,950
Long-term	505	387	36	82
Investments	264	233	11	19
Participating interests	1,556	1,376	29	151
Prepayments and accrued income	174	69	39	66
Liabilities				
Own funds 6, 7	10,252	8,249	301	1,703
Creditors	27,388	15,389	3,368	8,631
Short-term	18,637	9,886	2,769	5,982
Long-term	8,751	5,503	599	2,649
Provisions 7	3,938	2,967	373	599
Accruals and deferred income	43	25	1	17
Balance sheet total 6	41,622	26,629	4,043	10,950
Change from previous year in %				
Assets				
Tangible fixed assets 3	-1.2	-0.7	-1.7	-2.4
Stocks 4	2.6	6.3	-5.5	2.1
Cash 5	-6.1	3.5	-32.2	-7.4
Debtors	1.6	4.4	-1.9	-3.0
Short-term	0.5	3.1	-2.3	-3.6
of which				
Trade debtors	3.1	14.5	-3.4	-8.0
Long-term	31.9	34.2	13.1	31.2
Investments	31.4	30.6	95.5	17.5
Participating interests	45.2	46.8	31.2	34.6
Prepayments and accrued income	-5.4	-5.8	-17.2	3.9
Liabilities				
Own funds 6, 7	8.3	11.6	-7.4	-2.6
Creditors	-0.6	0.7	-5.2	-0.9
Short-term	1.0	5.3	-7.0	-1.9
Long-term	-3.7	-6.7	4.1	1.4
Provisions 7	0.3	0.9	-6.0	1.8
Accruals and deferred income	8.6	36.4	-88.5	28.5
Balance sheet total 6	1.6	3.9	-5.6	-1.0

* Results of a two-year cylindered sample of 3,155 manufacturing, construction and wholesale/retail trade enterprises. — 1 Consolidated results. — 2 Retail trade, wholesale trade and commission trade. — 3 Including intangible assets. — 4 Including contracts in progress. — 5 Cash on hand and bank balances. — 6 Less adjustments to capital accounts. — 7 Including pro rata share of special reserves.

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than one-tenth, mainly as a result of the improved earnings position, which enabled firms to transfer sizeable sums to their revenue reserves. At 31 %, the own funds ratio in this sector was even distinctly higher than among the same category of enterprises in western Germany. The contraction of the capital base of firms in the construction sector and wholesale/retail trade made somewhat greater inroads into their liable capital than the combined total of their creditors and provisions; but at 7 ½ %, the capital ratio in the construction industry remained largely constant, while in the wholesale and retail trade it declined only slightly to 15 ½ %.

The divergence in the level of own funds between financially strong and financially weak enterprises, which had widened in 1996,⁸ narrowed a little in 1997. This was due solely to the fact that the corresponding ratio in the top quartile fell slightly. In the two middle quartiles the capital increased as a percentage of the balance sheet total. By contrast, the firms in the lowest quartile showed an unchanged high level of balance sheet over-indebtedness on average; looked at in greater detail, the improvement in the provision with own funds of the industrial enterprises in this group was largely offset by the erosion of the capital base of the construction firms in the same quartile. The erosion of the liable capital of building firms was confined in any case to the bottom two quartiles, whereas the enterprises in the top half of the ranking further extended their advantage. The worsening of

... with a narrower dispersion between financially strong and financially weak firms

⁸ See Deutsche Bundesbank, East German enterprises' profitability and financing in 1996, Monthly Report, July 1998, page 47.

Own funds ratio by quartile *

%				
Quartile(s)	All enter- prises	Manu- facturing	Con- struction	Whole- sale and retail trade
0 % to less than 25 %				
1996	- 13.8	- 19.8	- 5.2	- 8.6
1997	- 13.9	- 16.6	- 13.7	- 8.8
25 % to less than 50 %				
1996	4.5	8.2	2.5	3.4
1997	4.8	8.4	2.0	3.6
50 % to less than 75 %				
1996	13.0	20.3	8.1	10.5
1997	13.6	20.9	8.5	10.7
75 % to 100 %				
1996	45.1	54.1	20.7	39.8
1997	44.5	54.1	21.5	38.4
All				
1996	23.1	28.8	7.6	15.8
1997	24.6	31.0	7.5	15.5
		Enterprises with a turnover of ...		
		... less than DM 5 million	... DM 5 million to less than DM 50 million	... DM 50 million or more
0 % to less than 25 %				
1996	- 13.8	- 24.8	- 10.6	- 6.4
1997	- 13.9	- 34.1	- 9.5	- 5.3
25 % to less than 50 %				
1996	4.5	2.0	4.9	11.8
1997	4.8	1.6	5.1	14.0
50 % to less than 75 %				
1996	13.0	10.1	13.0	24.0
1997	13.6	10.5	13.2	27.1
75 % to 100 %				
1996	45.1	39.3	39.7	58.7
1997	44.5	38.1	39.7	61.5
All				
1996	23.1	8.7	15.0	31.2
1997	24.6	7.5	15.7	33.7

* Average values per quartile. To determine the quartile categories enterprises were sorted separately by own funds ratio for each year per sector and per size category. The own funds ratio is the own funds as % of the balance sheet total (less adjustments to capital accounts).

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the financial position of the construction sector, which is dominated by fairly small firms, probably also explains why the balance sheet overindebtedness among enterprises with a turnover of less than DM 5 million increased from just under 25 % to 34 % of the balance sheet total.

Short-term debt owed to banks increased by just over 3 % in 1997 and long-term debt to banks by 1%, which on average was a little higher than the overall growth of the liabilities side of the balance sheet. This means that the heavy dependence of east German firms on bank financing increased further. One reason for this is the high volume of promotional loans; another is that east German firms have a far smaller stock of long-term financial resources in the form of provisions to draw on, especially provisions for pensions, than is the case in western Germany. It is unlikely that the east German firms will be able to catch up in this respect in the foreseeable future since many east German enterprises will not have the financial capability to do so. Moreover, company pensions have lost some of their attractiveness to enterprises in eastern and western Germany alike given the marked fall in both lending rates and capital market rates in recent years alongside an unchanged imputed interest rate for tax purposes of 6 % which has been applicable since 1982.

The prevailing public image of the east German enterprise sector is largely coloured by the low-margin and financially weak firms. But what people often fail to realise is that the profitability and financing of east German

*Liabilities to
banks and
provisions*

*Improving
underlying
conditions must
have priority*

firms, considered as a whole, have moved closer to the position in western Germany. The weaknesses and convergence deficits that remain should not be taken as an excuse to "blindly" conserve the present volume of promotional assistance or to create new pro-

grammes and instruments. Following almost ten years of reconstruction in eastern Germany, the priority task now would seem to be the ongoing and resolute continuation of the process of market-oriented renewal that has meanwhile been initiated.

