The economic scene in Germany in autumn 1996

Overview

Economic conditions

Economic growth

Since mid-year the German economy has remained on the growth path on to which it moved in the spring, after a fairly long period of sluggishness. In the third quarter, compared with the second, the real gross domestic product rose by 1%, after adjustment for seasonal and working-day variations; hence it was 2½% higher than a year before. Capacity utilisation in the manufacturing sector increased with the significant expansion of output and business confidence also improved further according to the surveys of the ifo institute.

Dichotomy in business conditions

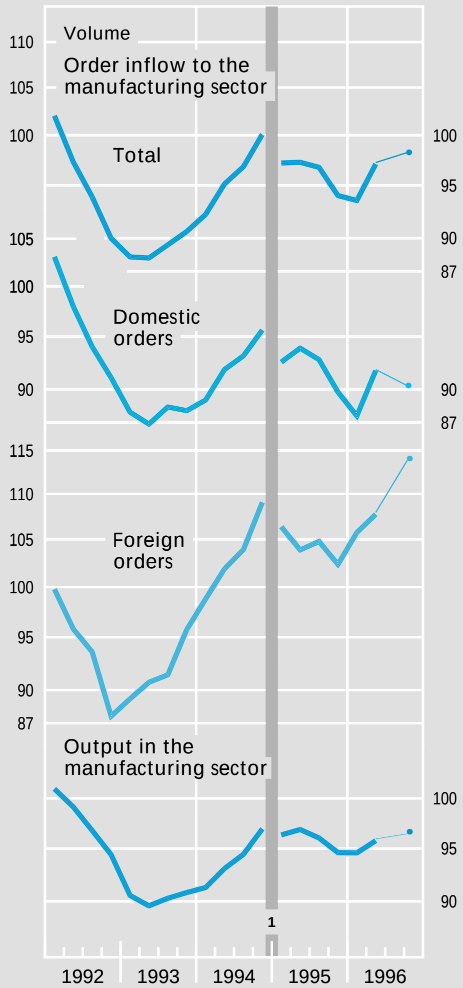
The sustained economic upswing forms something of a contrast to reports of depressed sentiment in many enterprises. As so often in the early stages of an upswing, it seems that not all enterprises are benefiting equally from the economic recovery. There are signs of a dichotomy in business conditions in two respects. In the first place, the increase in output was concentrated in western Germany. East German industry was unable to keep up the high level of production recorded in the second quarter. Now that the economic restructuring has made substantial progress, the expansionary forces in eastern Germany appear to be losing momentum. The normalisation of the growth process, the tapering-off of the construction boom and its greater responsiveness to changes in economic activity are once again posing the east German economy serious (albeit unavoidable) adjustment problems. Secondly, it was primarily enterprises with a strong export bias that benefited from the expansion of business activity. Domestic demand, by contrast, has hitherto tended to remain muted, so that a degree of restraint among the firms operating mainly in the domestic market appears to be thoroughly understandable. It remains to be seen how quickly the generally discernible economic recovery will spread to those regions and sectors that have hitherto lagged behind. Virtually all major forecasting institutions assume that the upswing now in progress will broaden out and, beyond the end of 1996, continue into 1997.

Foreign demand

The main driving force behind the economic recovery continues to be foreign demand. Between its nadir in autumn 1995 and the period from July to October 1996, both viewed as an average, it increased by a good 10 %. With a certain time-lag, export deliveries have likewise picked up distinctly in the meantime. The buoyancy of exports presumably reflects, firstly, the persistent strength of economic activity in Germany's major trading partners. The propensity to invest has evidently increased in those countries, and the German economy, with its focus on the production of capital goods, is deriving particular benefit from that fact. Secondly, German products appear to have become more attractive, both in price terms and in terms of the range of goods on offer, so that they have been able to participate fully in the growth of those markets. Unlike the situation in 1995, the exchange rate pattern now appears to be largely in line with the economic fundamentals. The strong appreciation of the Deutsche Mark at that time has meanwhile been completely reversed. Viewed as an average against 18 major currencies, the external

Demand and output
in the manufacturing sector

1991=100, seasonally adjusted, log. scale



1 Comparability impaired by changeover in the statistics. — • = July to October 1996.

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value of the Deutsche Mark is currently just about as high as it was at the end of 1994. In addition, foreign demand for German products is being bolstered by the stability of prices for industrial goods that obtains in Germany. Corporate restructuring operations have led to substantial increases in productivity, with the result that, since wages are rising moderately, unit labour costs in the producing sector have actually fallen perceptibly of late. However, this does not by any means imply that Germany's locational problems have been solved. The low propensity to invest and the high level of unemployment suggest that the need for adjustment in the German economy remains strong, even if exports are expanding.

Private consumption

Although consumer demand remained fairly buoyant in autumn 1996, it failed to impart any particular economic stimuli. In the third quarter seasonally adjusted real private consumption remained at the high level of the second quarter; it therefore rose by 1½ % against the comparable period of the previous year. Uncertainty about the safety of their jobs is causing many consumers to hesitate before committing themselves to major purchases. Besides, the income scope for stepping up consumption is fairly narrow, not least because wages and salaries have again been squeezed by higher public levies, namely the raising of the contribution rate to the nursing care insurance scheme, which came into force on July 1. Disposable income has gone up only marginally, and saving was therefore cut down in the third quarter in order to "finance" consumption spending. Households' saving ratio declined slightly to 12 %. The expansion of private consumption will probably proceed at a moderate pace as long as the trend in employment remains disappointing and as households are left without a clear idea of the tax and public levy burden that they will be required to shoulder in future. The private saving ratio is likely to go on serving as a buffer for consumer spending; but, in view of the low level it has already reached, there are limits to any buttressing of private consumption by a sustained decline in the saving ratio.

Investment

The key to a continuation of the, all in all, distinctly gratifying economic upswing lies with investment. Hitherto the engine "investment" has failed to start. Demand for German-made capital goods, after a short-lived revival in the second quarter, has latterly tailed off again. As before, there is a substantial volume of spare capacity, so that there is hardly any need to invest in the extension of production facilities in the short run. On the other hand, enterprises' profitability (a further major determinant of the propensity to invest) has improved distinctly on the whole in recent years, as is indicated *inter alia* by the corporate balance sheets submitted to the Bundesbank. However, this does not seem to apply equally to all enterprises, but primarily to those in sectors focusing on exports. Moreover, the level of earnings continues to be regarded as unsatisfactory. Furthermore, there is at present a discrepancy between expected earnings – which are what ultimately count – and current profitability, which may imply that the improvement in the profit situation is deemed not to be lasting.

In this connection, attention is frequently drawn to uncertainties in the field of wage and tax policy which are said to deter enterprises from entering into long-term commitments. The sharp raising of the contribution rate to the pension insurance scheme is likewise regarded as a sign that non-wage labour costs, which are excessive anyway, might go up even further. Against this background, it appears all the more important to reach moderate wage settlements which can be applied flexibly, and which reduce the overall burden of wages on enterprises. In addition, a realistic prospect of a substantial tax cut might well constitute a major incentive for enterprises to strengthen their propensity to invest.

Construction sector

Contrary to some fears, construction output held up well in the third quarter; after seasonal adjustment, it actually increased over the second quarter. Even so, the level of production in that sector remained distinctly low compared with previous years. Admittedly, the demand for housing construction rose right up to the end of the period under review (especially in eastern Germany, and to a lesser extent in western Germany, too), even though a marked housing glut was reported in some regions. Falling construction and house prices and low rates of interest may have prompted some interested parties to buy owner-occupied homes, in particular; an additional factor in eastern Germany was that the tax concessions for rented housing construction will be reduced sharply at the turn of the year, as a result of which some construction demand was brought forward. In the fields of industrial and public construction, by contrast, demand remains subdued, partly because of corporate reluctance to invest and partly because of the efforts of public authorities to contain expenditure. Viewed as a whole, the construction sector remains a weak point in the current picture of business activity. It cannot be expected to impart any particular momentum to economic activity in the foreseeable future either.

Labour market

The rapid pace of overall growth in the second and third quarters of 1996 failed to relieve the persistently tight conditions on the labour market. Employment actually decreased further during the summer; at the end of September the number of employed persons was 362,000 lower than a year before. Contrariwise, by the end of November the number of unemployed had risen on the year by 363,000 to a seasonally adjusted total of 4.10 million. In the manufacturing and construction sectors, employees continue to be laid off. The expansion of employment in the services sector did not nearly cancel out the unfavourable trend in other areas of the economy.

The same uncertainties which so far have adversely affected the propensity to invest also seem to have inhibited readiness to recruit new personnel. In addition, quite a number of specific rigidities and structural obstacles are operative on the labour market. It is true that their dismantling has begun, as the greater flexibility embodied in some wage settlements and a series of specific measures adopted under the government programme for more growth and employment demonstrate. But before such structural adjustments can have a beneficial impact on the labour market, a lengthy period of time will obviously elapse. Moreover, a one-off tour de force will hardly suffice. What is necessary, rather, is an unremitting effort to improve the locational conditions in Germany. Wage rate policy bears special responsibility for enhancing employment prospects by means of signals that are effective over the longer term. The globalisation of economic activity can be countered successfully not by isolating the economy with the aid of protectionist measures or by agreements that suppress competition, but only by a systematic adjustment of the domestic economy.

Prices

Price movements, on the other hand, have been heartening. In November consumer prices were only 1.4 % higher than a year before. Oil prices admittedly shot up until the end of October (thereafter they fell back again somewhat), with the result that overall import prices rose noticeably. On the home market, however, this rise was offset by a declining trend in unit labour costs, so that no particular inflationary pressures were felt even though the international environment was deteriorating. Germany has largely attained its target of price stability. For the Bundesbank, the crucial point now will be to safeguard this success over the longer term.

Fiscal and monetary policy

Public authorities in the third quarter

The financial situation of the public sector worsened in the third quarter. Despite great efforts to economise, the deficits of the central, regional and local authorities rose on the year. Tax revenue remained disappointingly low. The correlation between business activity and tax receipts has evidently weakened (not least on account of the numerous amendments of tax law), so that the recent upturn in economic activity has not yet been reflected in higher tax revenue. In the case of the social security funds, receipts have gone up only sluggishly (despite the increases in some contribution rates) owing to the unsatisfactory trend in employment and the moderate pace of wage rises, whereas aggregate expenditure has soared. The main reason for this was the growth of the expenditure of the Federal Labour Office in connection with the upturn in unemployment – which expenditure had to be financed by means of an increase in the Federal grant. The statutory pension insurance scheme and the statutory health insurance institutions likewise continued to register deficits.

Financial position in 1996 as a whole

The weakness of public revenue is also the main reason why the public sector deficit over the whole of 1996 is likely to exceed last year's figure significantly. In the definition of the national accounts, the overall public sector deficit, i.e. including the social security funds and the subsidiary budgets, will rise to roughly 3¾ % of GDP (against 3½ % in 1995) in the estimation of the Federal Cabinet. Thus, in 1996 Germany will finish up distinctly above the threshold figure of 3 % laid down in the Maastricht Treaty. Not only in order to meet the conditions for entry into European monetary union but also in the more narrowly defined national interest, the diminution of this "excessive" deficit ratio has the highest fiscal priority. The pressure to moderate expenditure will remain strong, especially since the objective of lessening the tax burden is being pursued in the medium term.

Consolidation strategy

In view of the excessive deficits, which are unsustainable in the long run, the efforts at consolidation can hardly be regarded as an avoidable economic handicap, even if very short-term demand shortfalls are associated with them. Instead, the reduction of the public sector deficits is imperative in order to improve the underlying conditions for economic activity and to create favourable growth prospects via greater confidence in orderly public finance and in a calculable (and henceforth lower) tax burden. In other words, it is not the consolidation strategy as such that tends to restrain economic growth, but rather the abstention from fiscal adjustment.

Budget planning for 1997

Correspondingly, the efforts to economise were stepped up in the budget planning for 1997. Even though the expectations for tax revenue were again revised downwards, there is thus a prospect that the deficit of the central, regional and local authorities next year will decrease perceptibly compared with 1996. Furthermore, a swing from deficits to surpluses is foreseeable in the case of the social security funds, since the statutory pension insurance scheme will have to replenish its much depleted reserves, and the contribution rate was therefore raised sharply. Given the risks to the budget figures, however, it is vital to try to ensure that the expenditure framework set is not overshot in the implementation of the budget. This is an essential precondition for the public sector deficit not exceeding the ceiling set by the Maastricht Treaty.

“Steady-as-she-goes“ interest rate policy

After the Bundesbank had reduced some of its interest rates to all-time lows in April and August, it pursued a “steady-as-she-goes” interest rate policy in the autumn. It left the discount and lombard rates unchanged at 2.5 % and 4.5 %, respectively, and the repo rate at 3.0 %. Moreover, it announced in advance, following the meetings of the Central Bank Council, the terms of its weekly repo transactions, which continued to be offered in the form of fixed-rate tenders. On account of this interest rate policy strategy, geared as it was to continuity, money market rates have likewise remained largely stable in the past few months. Day-to-day money market rates have mostly been close to the repo rate; forward rates have moved but little, so that the yield curve in the money market has been pretty flat. Although money market rates have continued to fall of late in many neighbouring countries, in Germany they have remained in the lower part of the international interest rate spread.

Somewhat faster monetary growth

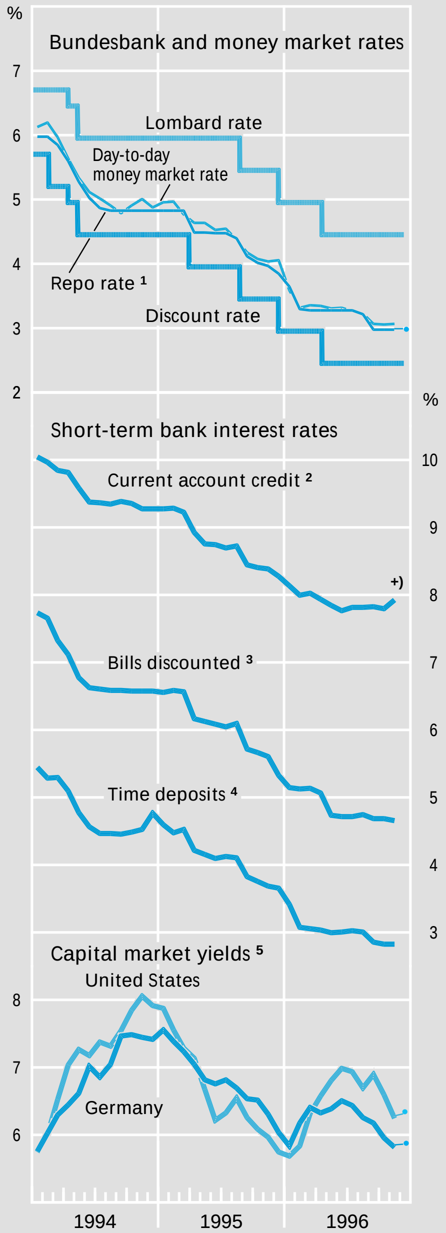
The “steady-as-she-goes” approach to interest rate policy during the autumn was in line with the monetary policy requirements. Neither the movement of the money stock nor the monetary policy environment made a further cut in interest rates appear advisable. The pace of monetary expansion, after having slowed down in the spring, has accelerated somewhat again since the late summer. In October the money stock M3 exceeded its average level in the fourth quarter of 1995 by an annual rate of 8.4 %, compared with 8.6 % in July and 12.8 % in March. Thus it has drawn rather nearer to this year's target corridor of 4 % to 7 %, although it is to be expected that the monetary target will be overshot at the end of this year as well.

More sluggish monetary capital formation

The stronger monetary expansion of late has been due, in the first place, to a somewhat slackening pace of monetary capital forma-

Interest rate movements

Monthly averages



1 Average monthly interest rate for securities repos with two-week maturities. — **2** From DM 1 million to less than DM 5 million. — **3** Bills eligible for rediscount at the Bundesbank up to less than DM 100,000. — **4** Time deposits with agreed maturities of one month to three months, inclusive, for amounts from DM 1 million to less than DM 5 million. — **5** Yield on government debt securities with a residual maturity of about ten years. — **+** Rise in Nov. 1996 due to collection phenomena. — • = Latest position: Dec. 11, 1996.

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tion. Between August and October seasonally adjusted monetary capital at banks grew at an annual rate of barely 5 %. Given the low (and further declining) capital market rates, the propensity to invest funds at longer term was comparatively weak. In addition, uncertainties probably arose in connection with stage three of European monetary union. Finally, the weak accrual of longer-term resources at banks presumably owes something to the fact that investors have been accumulating liquidity in recent months so as to be able to buy Telekom shares in November. This is suggested, in particular, by the abrupt rise in sight deposits in October.

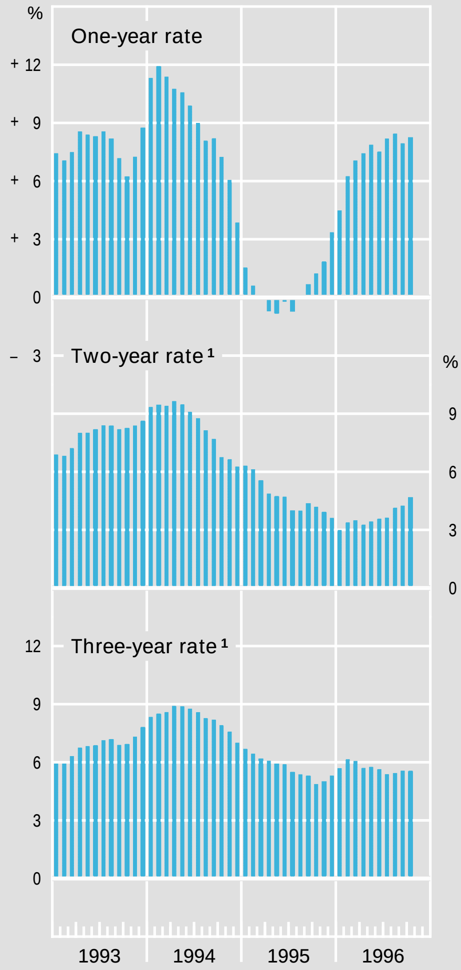
Faster expansion of lending business

Secondly, a faster expansion of banks' overall lending business also tended to speed up monetary growth in the autumn. Once again, the emphasis shifted from the “external” to the “domestic” components of money creation. Domestic non-banks received virtually no more funds from current and capital transactions with non-residents, in contrast to conditions in the preceding months. At the same time bank lending to domestic non-banks increased. In particular, public sector borrowing from credit institutions went up sharply, since public authorities met their borrowing requirements primarily via bank loans, rather than by selling debt securities to domestic non-banks and non-residents. Borrowing by the private sector, in contrast, rose but little. In this context, a somewhat faster expansion of housing loans and consumer credit was accompanied by a slower growth of lending to enterprises.

Provision of money appropriate in the medium run

Despite the current slight acceleration of monetary growth, it remains true to say that no particular risk of inflation is discernible on the monetary side. In the first place, monetary growth will probably proceed more moderately again once the expansionary influences emanating from the issue of Telekom shares and from borrowing by the public sector peter out. Furthermore, viewed over the medium term the provision of money appears to be not inappropriate; during the past three years the money stock M3 has grown at an annual rate of 5½%. Finally, the monetary growth reflected in the statistics overstates the economy's actual provision with liquidity. This is suggested by the steep rise in the special savings facilities included in M3, many of which serve for the temporary lodgement, at favourable interest rates, of resources available at long term. The fact that the money stock M3 extended (which includes, besides M3, notably the money market fund certificates in the hands of domestic non-banks and such non-banks' money balances in the Euro-market) has grown much more slowly than the traditional money stock M3 in the fairly recent past points in the same direction. Whereas M3, for instance, rose at an annual rate of just under 6% in the six-month period from April to September, M3 extended simultaneously increased at an annual rate of barely 4%. Non-banks evidently repatriated Euro-deposits and injected most of them into the domestic money circulation.

Growth rates
of the money stock M3 *



* Monthly average. — **1** Change in the last two or three years, respectively, expressed as an annual rate.

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Capital market rates at an all-time low

For a while in the autumn German capital market rates fell to an all-time low. At the beginning of December the yield on domestic debt securities outstanding, at 5%, was slightly lower still than at the end of January 1996, when it had reached its preceding record low. At the same time the yield curve, which had previously been very steep, flattened out somewhat. Latterly yields have risen slightly again in the wake of a setback on the US bond market. The decline in interest rates in the autumn took place against the background of globally diminishing yields. The main reason for that was presumably the rather favourable assessment of the prospects for inflation world-wide. The general decrease in interest rates is not least a token of how right and important it is for an increasing number of central banks to gear their policies primarily to the target of price stability. By contrast, putting monetary policy more in the service of stimulating economic activity would increase the risk premiums included in long-term interest rates and enhance the threat of speculative disruptions in the financial markets. A lasting contribution of monetary policy to low interest rates, favourable financing conditions for the business community and sustained growth can thus only reside in a consistent anti-inflationary stance.