

The economic scene in Germany around the turn of 1996-7

Overview

Economic conditions

The upturn in German economic activity came to a halt towards the end of 1996. After the real gross domestic product had risen sharply in the second and third quarters of 1996, it no more than maintained the previously achieved higher level in the last quarter, after adjustment for seasonal and working-day variations. It was therefore just under 2% up on the year. However, this slackening of economic activity is not to be equated with a change in trend. Interruptions of growth were likewise common in earlier economic upswings. Major conditions for a sustained recovery (such as price and exchange rate movements, in particular) are more favourable today than they have been for a long time. Despite a number of rather pessimistic observations on the part of certain economic sectors and enterprises, sentiment in the economy as a whole has improved distinctly compared with the summer months, according to surveys by the ifo institute; further business expectations are decidedly sanguine. Even so, there is no mistaking the fact that the economic upswing has so far lacked self-sustaining momentum. A significant mitigation of the pressing problems facing the labour market is therefore not yet in sight.

*Economic
growth*

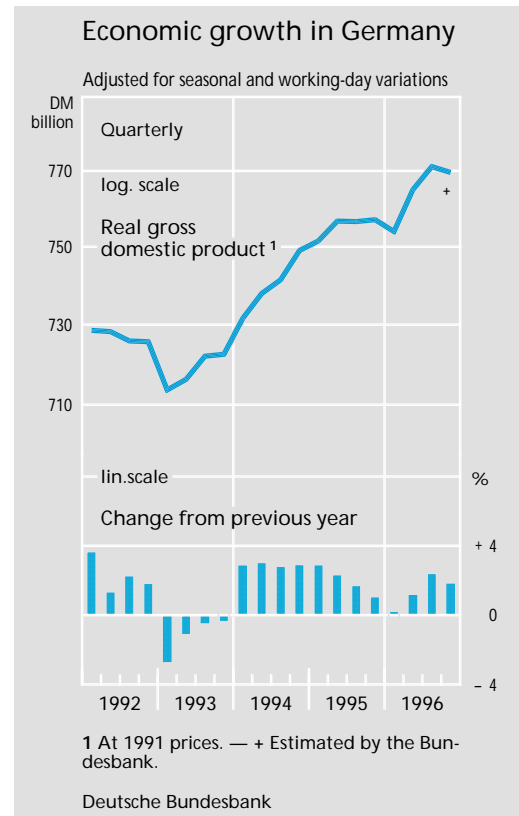
Since the summer of 1996 the seasonally adjusted number of unemployed has risen, sometimes precipitously, from month to month. In January it reached a new peak, at 4.3 million, although this also owed something to special factors, such as the exceptionally cold weather and the tendency of

Labour market

many building contractors to lay off some of their workers, on weather grounds, after the expiry of the provisions on bad weather compensation. Eastern Germany was especially hard hit by the increase in unemployment, primarily because of the comparatively great significance of the construction sector. Between September 1996 and January 1997 the seasonally adjusted unemployment rate there rose by 2 percentage points to 17.3%. In western Germany it simultaneously went up by ½ percentage point to 9.8% (in each case, measured relative to the labour force). Correspondingly, employment declined substantially. In the course of 1996 about 500,000 people lost their jobs in the German economy.

Causes of unemployment

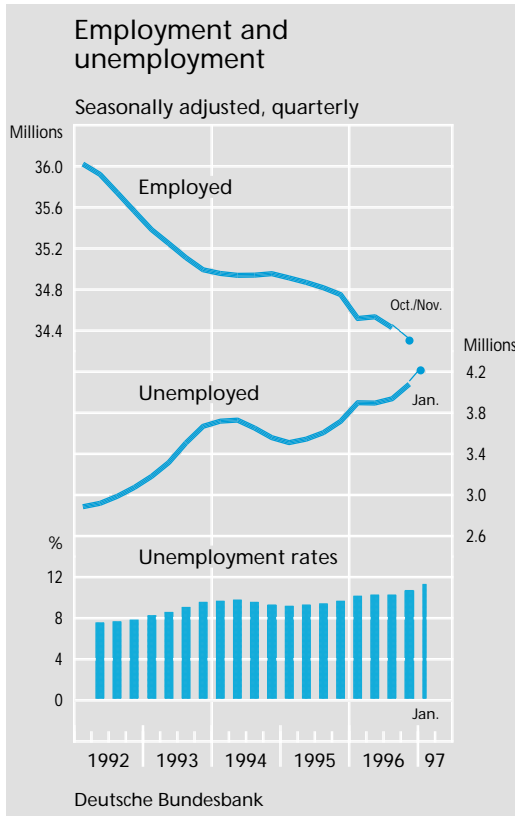
Around the turn of 1996-7 conditions on the labour market deteriorated further. The generally expected resumption of economic growth will not produce any radical improvement in the situation, either, in the short run. Numerous publications by major international organisations, German economic research institutes, the Federal Government and the Bundesbank as well have constantly drawn attention to the underlying causes of unemployment, such as the high level of wages, the inadequate wage differentials, the burden imposed on enterprises by non-wage labour costs, taxes and other public levies, specific impediments inherent in the social security network, the incidence of red tape and the lack of flexibility shown in necessary adjustments to changes in market conditions or in technological innovations. The high level of unemployment cannot be put down to a single cause, but is due to a whole host of



factors which differ widely in detail. The globalisation of the economy and the associated intensification of competition by no means generated these problems, but merely exacerbated them and exposed the causes.

It is auspicious, at all events, that an adjustment process now seems to be taking shape which might help to dismantle the structural obstacles and to strengthen Germany as an economic location. The latest wage settlements have all been moderate; moreover, manpower can now be deployed more flexibly in many cases. Many measures deriving from the government Programme for More Growth and Employment unveiled in spring 1996 have already been put into effect. In addition, extensive reforms of tax legislation and in the field of social security are being

Measures to ameliorate the labour market situation



were about 10% up on the year. The export expectations elicited by the ifo institute's survey have improved right up to the present. German exporters are evidently accounting for their due share of the persistent growth of their foreign markets. In most of our major trading partners, business activity is continuing to point distinctly upwards, with the demand for imports, as usual, rising disproportionately fast. The buoyant export performance of German industry is also being buttressed by exchange rate movements. The strong appreciation of the Deutsche Mark early in 1995 has been more than reversed in the meantime. When this Report went to press, the real external value of the Deutsche Mark against 18 major foreign currencies was roughly as high as the average level of the last twenty years. This implies that the exchange rate pattern is now much more in line with the economic fundamentals than it was before.

planned, and ought to improve corporate competitiveness. If security is ensured rapidly in this field, this might help materially to enhance enterprises' propensity to invest, and thus to create new jobs. To be sure, some time will elapse before these adjustments are reflected in the labour market. It is probable that the measures which have been taken or projected to date will not suffice finally to settle all the structural problems. But the signals have been set in the right direction.

Private consumption slowed down perceptibly towards the end of the year. After having held up remarkably well in the preceding three quarters, it decreased by almost 1% in real terms in the last quarter, after seasonal adjustment. Households' income afforded no latitude for additional consumption. Given a distinct increase in unemployment, moderate wage rises and some frozen special payments around the end of the year, disposable income failed to expand. Moreover, uncertainty about their jobs probably prompted many consumers to exercise caution with regard to buying major consumer durables. For instance, registrations of motor vehicles by individuals declined sharply. On the other

Private consumption

Foreign demand

Foreign demand continues to constitute a ray of hope in the latterly somewhat clouded picture of economic conditions. Although the seasonally adjusted orders received from abroad by the manufacturing sector in the fourth quarter just failed to regain the high level of the preceding three months, they

hand, the private saving ratio rose slightly, although this may have had something to do with increased purchases of owner-occupied homes. Since the beginning of 1997, private consumption has probably also been adversely affected by the substantial raising of pension insurance contributions and the abrupt upturn in unemployment, so that no particular economic stimulus is to be expected from this angle for the time being.

Investment

But the principal blemish in the present economic picture remains the low corporate propensity to invest. After a temporary revival in the spring, enterprises' demand for machinery and equipment persisted at the low level of the summer months. This restraint in capital spending forms something of a contrast to the improvement in underlying economic conditions. Short and long-term interest rates are conspicuously low, exchange rates have returned to normal again – as mentioned above – after the undue appreciation of the Deutsche Mark, virtual price stability has been reached and unit labour costs fell sharply in the course of 1996 under conditions of moderate wage settlements and impressive productivity gains. The fact that, even so, the investment engine failed to start probably owes something, firstly, to the considerable amount of idle capacity that continues to exist, with which the extra demand deriving mainly from foreign countries can be met. This is presumably a consequence of the fact that production capacity was greatly expanded – especially in eastern Germany, but also in the west – in the wake of German unification. Secondly, there continues to be a great deal of uncertainty about

future economic developments and the economic policy stance, with the result that such investment in capacity extensions as may become necessary is being deferred or transferred abroad. Early clarity on the requisite reform measures in the area of tax and social security policy, with a prospect of a distinct reduction in the burden of taxes and other public levies, would undoubtedly help to improve the conditions for investment in Germany.

The construction sector is particularly affected by the sluggishness of investment and the structural adjustments which are taking shape. Producing enterprises are reluctant to expand capacity and, accordingly, are slow to place construction orders. The public sector is subject to pressure to consolidate its budgets, which likewise gives rise to retrenchment of construction demand. In the field of residential construction, supply overhangs and falling real property prices are depressing the market in some regions; moreover, in eastern Germany the tax promotion of rented housing construction was reduced markedly at the end of 1996. Altogether, the inflow of new orders to the construction sector plummeted in autumn 1996. Over the whole of 1996 it was probably some 8% lower than in 1995. This implies that a painful adjustment process is taking place, especially in eastern Germany. Now that the most urgent demand for the modernisation of the infrastructure and of private businesses has been satisfied, construction activity – macroeconomically speaking – will no doubt gradually return to a level consistent with that obtaining in other highly developed economies. That trend will involve

*Construction
sector*

a decrease in employment, which was already reflected around the turn of 1996-7 in a steep rise in the east German unemployment figures.

Prices

Price movements remained favourable around the turn of 1996-7; in Germany virtual price stability continues to prevail. In January, it is true, consumer prices rose on the year by 1.8%, and thus somewhat faster than in the whole of 1996; but this was partly due to factors that were operative only temporarily, such as the increase in the prices of heating oil and food on account of the weather. No particular inflationary stimuli are visible at present. The rising import prices in connection with the appreciation of the dollar and the higher prices of crude oil on world markets are being offset by falling unit labour costs in Germany. Through the monetary target it announced in December 1996, the Bundesbank made it clear that, by means of its monetary policy stance in 1997 and 1998, it intends to safeguard over the longer term, too, the degree of price stability now achieved.

Fiscal and monetary policy

Public authorities in the fourth quarter

According to the incomplete data so far available, in the final quarter of 1996 the central, regional and local authorities incurred a distinctly higher deficit than in the comparable period of the previous year. Tax revenue again disappointed expectations; in the fourth quarter it decreased on the year by 2%. Efforts to economise in the course of implementing the budget succeeded only in

keeping the deterioration in the budgetary situation within bounds.

Over the whole of 1996, owing to the sluggishness of revenue and despite the slower rise in expenditure, the budget deficit of the central, regional and local authorities probably turned out to be up to DM 10 billion larger than in the preceding year, when it had amounted to some DM 110 billion. In the definitions of the national accounts and inclusive of the social security funds, the public sector deficit, according to a preliminary estimate by the Federal Statistical Office, came to 3.9% of the gross domestic product. Thus the limit of 3% laid down in the Maastricht Treaty was overshot even more markedly than in 1995, when the deficit ratio had been 3.5%. If adjustment is made for the restructuring of child benefit (which reduced the budget volume), the ratio of government spending to GDP went up by almost ½ percentage point compared with 1995. This primarily reflected the considerable increase in social transfers, which was partly due to labour market conditions. The ratio of public levies to GDP remained close to its 1995 level. The decline in the tax ratio under the impact of the raising of the basic tax allowance, the improvement of the children's benefit system and the abolition of the "coal penny" was accompanied by a rise in the social security contribution ratio owing to higher contribution rates.

The budget plans of the central, regional and local authorities for 1997 are marked by even greater efforts to retrench, if anything. Altogether, according to the plans, expenditure

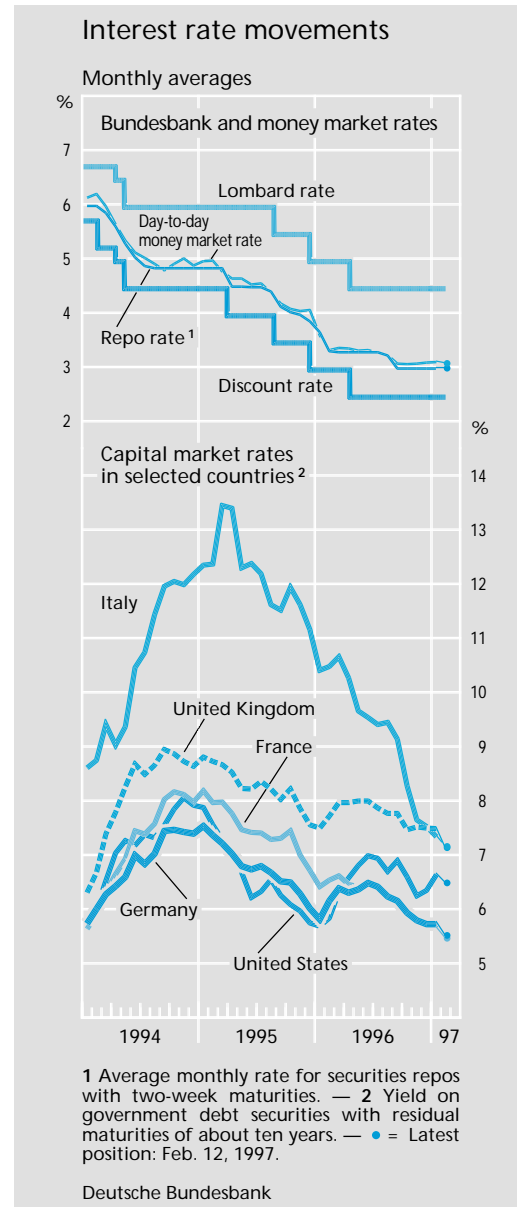
Provisional out-turn for the whole of 1996

Budget plans for 1997 and the associated risks

will be only a little above its 1996 level. Moderate growth is envisaged for tax revenue, which will be reduced only marginally on balance by the changes that came into force at the beginning of the year. However, further budgetary risks are already looming relative to the plans. For instance, tax revenue in 1996 fell almost DM 5 billion short of the official forecast of November. In addition, the Federal Government's Annual Economic Report for 1997 now expects that the nominal growth of GDP this year will be somewhat smaller than was thought in the autumn. Moreover, the average unemployment figure for this year is no longer expected to be unchanged against 1996, but rather about 200,000 higher, which would have some impact on labour-market-induced spending.

Budget prospects for 1997, as seen from the present viewpoint

Against the background of the budget plans of the central, regional and local authorities and in the light of a marked improvement in the performance of the social security funds (primarily as a result of a higher contribution rate to the pension insurance scheme), the Federal Government had believed in the autumn that it would be feasible for the public sector deficit to be lowered to 2.5% of GDP in 1997. In the light of the new budgetary risks, however, in the Annual Economic Report it expects the deficit to be lowered only to 2.9% of GDP. This means that the safety margin which had appeared to exist vis-à-vis the 3% reference figure laid down in the Maastricht Treaty has evaporated. Hence every effort must be made, in implementing the budget, at least not to overshoot the planned expenditure appropriation, but rather (if at all possible) to under-



shoot it. In the light of the underlying conditions for economic activity, too, it is imperative to preserve confidence in the ability of fiscal policy makers to make lasting progress in the field of fiscal consolidation.

Around the turn of the year, the Bundesbank abided by its interest rate policy stance of "steady as she goes". It left the discount rate at 2.5%, the repo rate at 3.0% and the

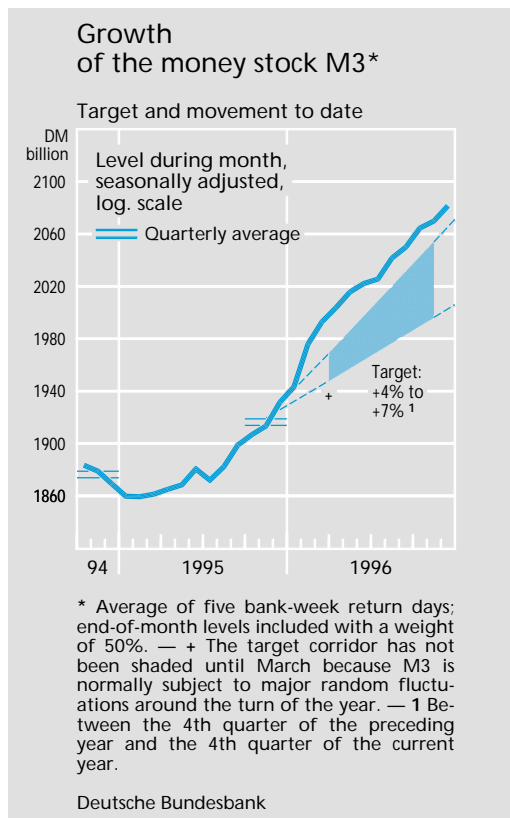
Interest rate policy

lombard rate at 4.5%. In addition, it regularly announced the terms of its repo transactions, which continued to be offered in the form of fixed-rate tenders, in advance directly after the meetings of the Central Bank Council. Some central bank rates therefore still remain at the all-time lows to which they had fallen after the interest rate reductions of April and August last year. Forward quotations in the money market have tended to decline in recent months, with the result that the yield curve has flattened out in that area. Judging by that fact, market expectations are still pinned on unchanged central bank rates. By international standards, German money market rates remain in the lower part of the interest rate spread.

Monetary growth

Against the background of the macroeconomic and monetary situation, there has been no need for the Bundesbank to take interest rate policy action of late. Both the pace of monetary expansion and the 1997 monetary target suggested adhering to a "steady-as-she-goes" policy in the money market. Monetary growth has speeded up again slightly since the summer of last year; notably in December the money stock M3 increased strongly. Taking the average of the fourth quarter of 1996, it exceeded its level in the fourth quarter of 1995 by 8.1%. The monetary target for 1996, which provided for an expansion of 4% to 7% during that period, was therefore overshot.

This overshooting was qualified by the much more moderate expansion of the money stock M3 extended last year. All money balances that are relevant to expenditure seem



to have increased less than the statistically recorded money stock M3. The fact that M3 growth was largely fuelled by special saving schemes, which in part constitute veiled monetary capital formation, points in the same direction. In the medium run, the provision of money continues to appear to be not inappropriate.

The money stock M3 grew rapidly in December, especially in the course of the month, so that the advent of the 1997 monetary target, which provides that the money stock M3 is to increase by 3½% to 6½% in the course of the year, was affected by a fairly large "statistical overhang". This probably owed something to the bringing forward of lending to the private sector because of the lowering of depreciation allowances (par-

Determinants of monetary growth

ticularly for new rented apartments and company buildings outside the manufacturing sector in eastern Germany) and to the raising of real property transfer tax from the beginning of 1997. These factors were compounded by major, presumably temporary re-transfers of Euro-deposits to the domestic banking system.

The increase in the money stock and in lending is mostly to be regarded as an "outlier", which should be followed in the further course of the year by a more moderate expansion. This is also suggested by the fact that outstanding commitments for longer-term loans decreased significantly in December. On the other hand, the "liquidity base" that came into being in that month will probably dissolve only gradually. Moreover, the ongoing monetary expansion is likely to continue to be fostered by the public sector's strong demand for credit and the moderate pace of monetary capital formation. Although the propensity to accumulate longer-term financial assets picked up somewhat in the final quarter of last year, the inflow of longer-term funds to banks continues to constitute no adequate counterweight to the expansionary impact on monetary growth exerted by credit institutions' lending business in the light of the low level of long-term interest rates and the uncertainties affecting European monetary union.

*Capital market
rates*

In recent months German capital market rates have fallen to historic lows. In January they dropped below 5% for the first time; by mid-February they were standing at 4³/₄%. Against the background of the different pos-

itions of the US and German economies in the business cycle, the German capital market was able to detach itself rather more markedly from the interest rate trend in the US bond market; in Germany ten-year Federal securities have recently been yielding 1 percentage point less than in the United States. In Europe, by contrast, interest rate differentials have continued to narrow in the light of the ongoing discussion about the selection of the countries participating in the start of European monetary union.

In view of the low level of interest rates, the financing conditions for new investment are very favourable at the moment. In January fixed-rate mortgages secured by residential real estate with interest rates locked in for five years cost an average of 6%, and those with interest rates locked in for ten years 7%. According to the redesigned statistics on lending and deposit rates, rates between 6¹/₂% and 6³/₄% were charged for fixed-rate loans to enterprises with agreed maturities of four years and more (see also page 25 ff.). In real terms, too, German capital market rates are comparatively low. The "statistical" real rate of interest (yield on bonds outstanding, adjusted for the current inflation rate at the consumer level) in the fourth quarter of 1996 was approximately 3³/₄%, compared with an average of about 4¹/₂% during the eighties. The underlying monetary conditions for a strong revival of economic activity have recently been improved by the fact that the external value of the Deutsche Mark, especially against the US dollar, has declined perceptibly.

*Risks posed by
an anticyclical
monetary
policy*

However, as new lows have been reached in capital market rates, the susceptibility to upheavals and the volatility of the bond market have increased again. In these circumstances it is vital not to let any doubts arise as to the consistent anti-inflationary orientation of monetary policy – or as to the durable consolidation of public sector finance. The crucial contribution the central bank can make to economic growth consists in ensuring that market players and investors alike adjust to long-run price stability. This is an essential prerequisite of low and barely fluctuating capital market rates as well as of the efficient deployment of resources. By contrast, a monetary policy geared more to influencing business activity, such as the Bundesbank is

sometimes advised to pursue in order to overcome the current weakness of capital spending, might easily turn out to be counter-productive because it would result in losses of credibility, rising inflation premiums and risk premiums in the capital market rate and a price-boosting depreciation of the German currency. Especially in the run-up to European monetary union, such dangers should not be underrated. Another factor that militates against any more anticyclical orientation of monetary policy is that – as mentioned above – the current economic problems facing Germany are mostly of a structural nature. They can be resolved only by means of economic policy reforms, but not by recourse to monetary policy instruments.