The economic scene in Germany in autumn 1997

Overview

Economic conditions

Economic growth

During the summer months and in the early autumn, business conditions in Germany remained favourable. After adjustment for seasonal and working-day variations, the real gross domestic product rose by nearly 1 % in the third quarter against the preceding three months, and thus almost as fast as in the second quarter, when the economic upswing gathered pace after a sluggish start at the beginning of the year. Between July and September aggregate output was 2½ % higher than a year before. With the strengthening of the expansionary forces, confidence in the economy likewise improved perceptibly. The latest surveys by the ifo institute and the Association of German Chambers of Industry and Commerce increasingly suggest that economic conditions are now being rated more optimistically. Although risks or pressures undoubtedly exist – for instance, on the East Asian markets, in the construction sector, or in the political sphere (where there are many unsolved structural problems) – most people are expecting the ongoing upswing to continue.

Mixed picture of business conditions

However, economic growth has so far been relatively uneven. As before, the picture presented by business conditions is mixed in several respects – between the external and the domestic driving forces, between industry and construction, and between western and eastern Germany.

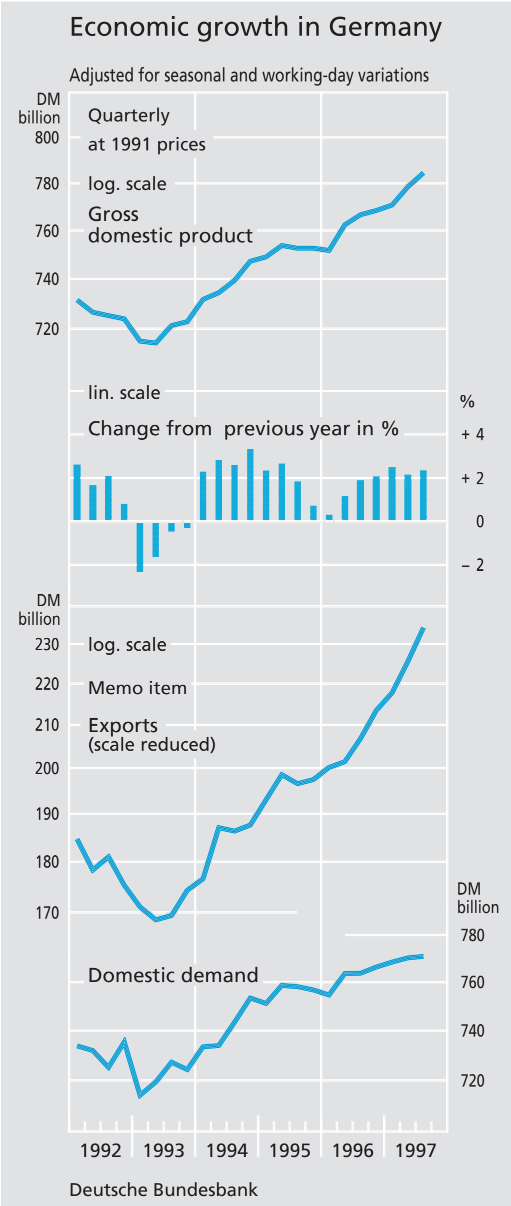
Exports

The economic upswing continues to be buttressed mainly by foreign demand. Exports again increased strongly in the third quarter, viz. by 14 % in real terms over the same period of last year. Imports failed to keep pace with that growth, and the German foreign trade surplus therefore expanded sharply. As the traditional heavy deficit on invisible current transactions stabilised at the same time, the current account as a whole improved further. For the second successive quarter, seasonally adjusted current transactions with non-residents yielded small surpluses, after almost continuous deficits had previously been recorded ever since German unification.

East Asia crisis

Exports benefited from the sustained strong growth on our principal sales markets. Hitherto, the crisis in East Asia has not impaired the overall demand for German products. However, there is no mistaking the risks that have arisen in this context. The direct repercussions on German exports will admittedly no doubt be insignificant since only 6 % of total exports go to that region. But if the crisis continued to smoulder, it might involve a risk of "infection" for other countries, and therefore curb the pace of expansion of the world economy as a whole. Viewed in itself, that would also dampen German sales prospects.

An unprecedented, huge rescue operation mounted under the auspices of the International Monetary Fund is intended to help defuse the crisis in East Asia, to confine it to that region, and thus to contain the adverse effects on the world economy. In the countries concerned, far-reaching consolidation and restructuring programmes are being designed to facilitate a return to orderly financing and economic relations, and thus to lay down a new and lasting basis for a resumption of the strong growth process in that region, which – at least potentially – will no doubt remain dynamic. Most of the available studies take it for granted that, notwithstanding the turmoil in East Asian financial markets, the dynamism of world trade will fundamentally be maintained.



Exchange rate movements

So far this year, German enterprises have profited to a disproportionate extent from the expansion of their foreign sales markets, and thus have regained market shares they had previously lost. Their international competitiveness has obviously improved. The success of German exporters owes something not only to cost-cutting exercises at home (unit labour costs have dropped appreciably since the start of 1996), but also to exchange rate movements. Although, at the time of going to press, the Deutsche Mark was running 2½% higher than at the beginning of August against 18 major currencies on a weighted average, that must be seen against the backdrop of a temporary downward trend on the part of the Deutsche Mark, which reached its peak in the summer. Recent exchange rate movements have reversed this trend only in part. Viewed overall, at the time of going to press, and after adjustment for the differing price movements in Germany and abroad, the Deutsche Mark was still being valued 3½% lower than at the end of 1996; against the end of 1995, it actually lost 7½% in value. The competitiveness of German exporters therefore continues to be enhanced, as is borne out by the high level of new orders from abroad and by the favourable responses to the surveys of export expectations.

Domestic demand

In contrast to the strongly expansionary trend of export business, aggregate domestic demand remained subdued. Between July and October, the new orders reaching the manufacturing sector from the domestic market were not above the average level of the second quarter.

Consumption

In particular, private consumption – after a short-lived revival in the spring – is once again ranking among the weak spots of domestic business activity. Sluggishness was the predominant feature of the retail trade; only passenger cars were in significant demand. The prevailing uncertainties with regard to jobs and the pressures on incomes evidently prompted households to exercise restraint when buying consumer durables and non-durables. Unlike the situation in the preceding quarters, consumers – on the whole – no longer dipped into their savings to "finance" their purchases; households' saving ratio remained at the low level it had reached. This might signify that consumers have gradually come to terms with their more modest income prospects. A lasting recovery of private consumption is only to be expected after an upturn in capital spending which would precipitate a simultaneous increase in employment and disposable income. By contrast, any acceleration of wage rises would jeopardise more jobs and endanger the associated improvement in earnings.

Investment

Overall, aggregate investment has likewise hitherto remained muted, although distinctly more was spent on machinery and equipment in the third quarter, seasonally adjusted, than in the previous three months. Enterprises remain reluctant to place orders with domestic capital goods producers. However, there are increasing signs that enterprises are becoming better-disposed towards new capital projects. In view of the higher capacity utilisation, the low rates of interest and the better profitability, the fundamentals affecting the propensity to invest have improved significantly. The latest surveys by the Association of German Chambers of Industry and Commerce and the ifo institute suggest that the propensity to invest is gradually increasing, although how quickly the plans for additional investment can be converted into actual orders remains an open question.

Industry and construction

A fanning-out of economic stimuli is reflected not only in the diverging trends of the components of demand but also in the origin side of the gross domestic product. On the one hand, aggregate industrial output grew strongly after mid-year, with the result that capacity utilisation, which had already overshot the top edge of the zone of normal utilisation, went on rising. On the other hand, the underlying trend of construction remained decidedly weak. Output in that sector was far lower than a year before right up to the end of the period under review, and a stabilisation at a low level only gradually appears to be taking shape. After years of exceptionally steep growth, the construction sector is undergoing an inescapable adjustment process, which is being accentuated by overhangs in rented housing, enterprises' hitherto low propensity to invest and the necessity for the public sector to cut costs.

Economic activity in eastern and western Germany

In regional terms, too, the German economy presents a mixed picture, owing mainly to the differences in the significance of exports and of the construction sector in eastern and western Germany. The recovery in economic activity has hitherto focused on western Germany, whereas the growth stimuli in eastern Germany have slackened. In the new Länder, the year-on-year rise in the real gross domestic product in the third quarter, at just under 1 ½ %, was slower than that in the old Länder, where it amounted to 2 ½ %. For one thing, eastern Germany continues to be under-represented on Germany's foreign markets, with the result that enterprises there derive relatively little benefit from the strength of exports. For another, eastern Germany was particularly hard hit by the tapering-off of the construction boom once the most pressing pent-up demand had been satisfied. Roughly 17 % of the east German labour force was employed in the construction sector in 1996 (compared with 6 ½ % in western Germany). Despite undeniable successes in many industrial areas, business conditions remain difficult in eastern Germany, which fact is primarily reflected in the labour market.

Output

1991=100, seasonally adjusted, quarterly

Figures not fully comparable owing to the restructuring of the methodology.

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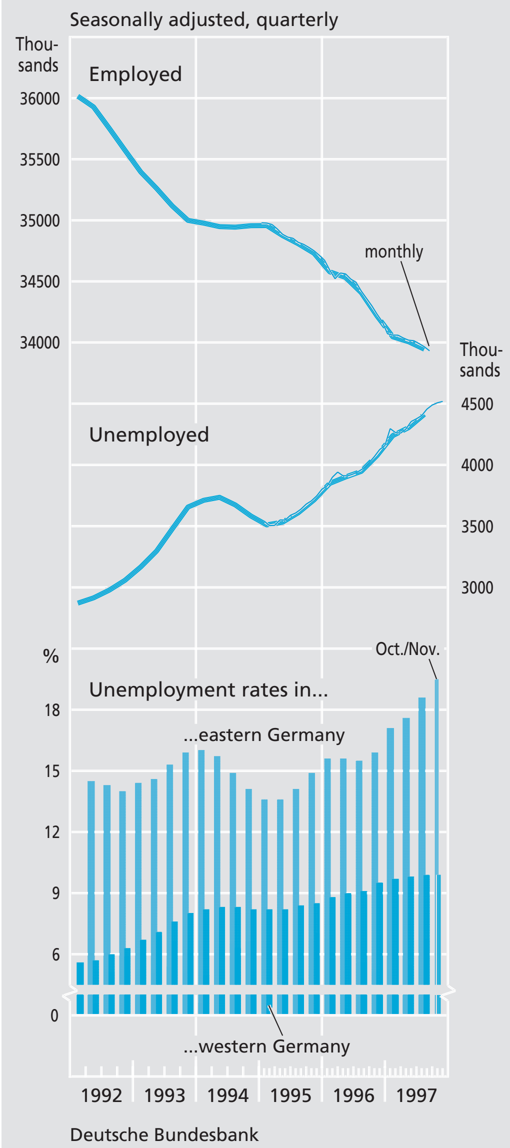
Labour market

For instance, the shedding of labour has persisted in eastern Germany, whereas it appears to be petering out in western Germany. Correspondingly, unemployment has gone up sharply in eastern Germany; at the end of November the seasonally adjusted ratio of those registered as unemployed to the total labour force stood at 19.6 % (compared with 17.1 % in the first quarter of 1997). This owed something not only to the specific problems faced by the construction sector but also to the curtailment of labour market policy measures. In western Germany, by contrast, the unemployment rate at the end of November, at 9.9 %, was only half as high as in the new Länder; moreover, it has risen much less steeply (by 0.2 percentage points) since the start of 1997.

Altogether, latterly 4.53 million persons have been registered as unemployed in Germany (after seasonal adjustment); that is 380,000 more than a year before. Hence unemployment remains Germany's most pressing economic policy problem. Encouraging signs in the movement of wages and of working hours – where clear indications of tendencies towards greater flexibility are manifest – are accompanied by a reform logjam in other areas, not least in the fields of tax policy and pensions policy. In order to create jobs which can hold their own in a competitive environment, it is vital to strengthen Germany further as a location for business – a task which has not nearly been accomplished yet, as the disappointing course of capital spending to date shows.

Labour market



Prices

After having clouded over during the summer months, the price situation has brightened again of late. The rise in import prices was reversed after quotations on the international commodity markets had fallen and the US dollar had decreased in value against the Deutsche Mark. In addition, the disruptive effects of the increases in administered prices tailed off. Hence the seasonally adjusted consumer price index has risen only a little in the past three months. In November it was 1.9 % higher than a year before, after the inflation rate at the consumer level had been as high as 2.1 % in August. The impact of the inflation stimuli emanating from abroad was evidently limited. This was largely because of persistently declining unit labour costs.

Fiscal and monetary policy

Public authorities in the third quarter of 1997

The deficit situation of the public authorities improved noticeably in the third quarter, compared with the comparable period of the previous year. The deficit of the central, regional and local authorities fell from about DM 30 billion to DM 22 billion, mainly on account of economies on the expenditure side and additional receipts from sales of assets. The deficits of the social security funds, viewed as a whole, likewise declined. In the case of the pension insurance funds, it was the raising of the contribution rate and the cuts in benefits in the field of rehabilitation that had the biggest impact. The Federal Labour Office restrained its "active labour market policy" and sold assets. The statutory health insurance institutions derived relief above all from larger personal contributions to pharmaceuticals.

Annual out-turn for 1997

Over the whole of 1997, too, the total deficit of the central, regional and local authorities and the social security funds is likely to be lower. The Federal Government assumes that the public sector deficit, as defined in the Maastricht Treaty, can be limited to 3.0 % of the gross domestic product in 1997 (against 3.4 % in 1996).

Tax shortfalls

However, this intrinsically encouraging trend does not imply by any means that the pressure for the adjustment of public finance has diminished. Tax revenue, in particular, continues to fall far short of expectations. As long ago as May 1997 the working group on "tax estimates" reduced its forecast for this year by DM 18 billion; in November 1997 the tax expectations were lowered by a further DM 17 billion. In other words, the erosion of the tax base has persisted. For one thing, very great advantage has continued to be taken of tax concessions and the scope for manipulation. For another, the abolition of wealth tax has not yet been offset by additional revenue from the reform of inheritance tax and the raising of land transfer tax. Given the persistent sluggishness of tax revenue, the financial scope of the central, regional and local authorities remains decidedly limited; no relaxation of the need to contain public spending is in sight.

Budget plans for 1998

In their budget plans for 1998, the central, regional and local authorities are endeavouring to reduce their borrowing further in spite of the tax shortfalls. Judging by the available draft budgets, expenditure is likely to rise by no more than 2 % in 1998. In addition, privatisation is being contemplated on an increasing scale. The Federal Government, in particular, is planning to curb its net borrowing substantially in 1998. However, some of the relief measures are of a one-off nature or will result in lower revenue at other levels of government, such as the reduction of the grants to the Redemption Fund for Inherited Liabilities. It is imperative for the central, regional and local authorities to abide unreservedly by the precept of lasting budgetary consolidation, not least in order to satisfy the requirements of the European Stability and Growth Pact.

Pension insurance

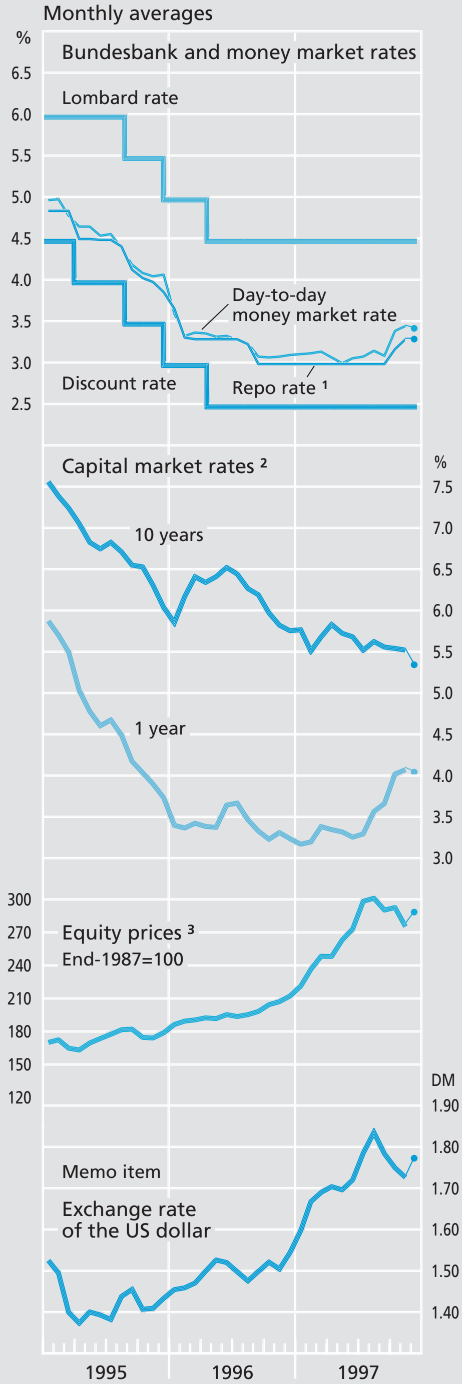
The financial situation of the pension insurance scheme also remained under pressure, despite the recent improvement. Mainly because of the unfavourable trend in employment, contribution receipts (even after the drastic increase in the contribution rate – by 1.1 percentage points to 20.3 % – since the beginning of 1997) are insufficient to bring the fluctuation reserves up to their statutory minimum of one month's expenditure. If the statutory provisions remained unchanged, a further increase in the contribution rate to 21.0 % would be necessary from the beginning of 1998. In order to circumvent the associated raising of the cost of the labour input, under the terms of the agreement reached in the Mediation Committee of the Bundestag and Bundesrat, the standard rate of value added tax is to be raised by 1 percentage point to 16 %. The extra receipts expected as a result will be used to enlarge the Federal grant to the pension insurance scheme. The overall burden of taxes and social security levies on the population will, however, not be altered by these switches in public revenue.

Slight tightening of interest-rate policy

In the autumn the Bundesbank somewhat tightened the expansionary monetary policy stance it had been pursuing for quite a long time. After it had left its central bank rates unchanged for over a year (keeping them, on the whole, at all-time lows), in mid-October it raised the securities repo rate from 3.0 % to 3.3 %. It left the discount rate and the lom-

Central bank rates and financial market rates

Monthly averages



1 Average monthly rate for securities repos with two-week maturities. — **2** Yield on listed Federal bonds outstanding. — **3** CDAX share price index. — • = Latest position: December 11, 1997.

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bard rate at 2.5 % and 4.5 %, respectively. By this slight adjustment, the Bundesbank responded to changes in the monetary policy environment during the summer months. The monetary conditions at home had eased further owing to the weakening of the external value of the Deutsche Mark. At the same time, the price situation deteriorated, mainly on account of an increase in the cost of imports and the raising of administered prices. The price stimuli were, however, accompanied by declining unit labour costs, so that there was no reason to dramatise the upturn in prices. Nevertheless, the risks to stability had grown.

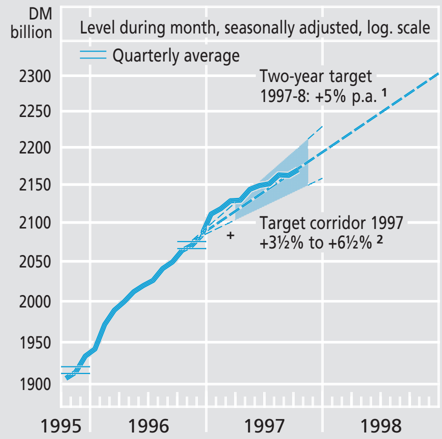
Counteracting those risks in good time improves the prospects of steadying the growth process and prevents an inflation potential from developing in the run-up to the European monetary union. The Bundesbank primarily has to ensure that the liquidity supplied to the economy provides no margin for an acceleration of price rises. In order to guarantee this for the future, in the light of the strong monetary expansion in 1996 and at the beginning of 1997, the Central Bank Council thought it necessary as early as July, at the time of the review of the monetary target, to dampen the expansion further. The slight tightening of interest rate policy was intended to achieve that.

Since then, steady-as-she-goes interest-rate policy

After the securities repurchase rate was raised, the Bundesbank continued to announce the terms of upcoming securities repurchase transactions in advance at intervals coinciding with those of the Central Bank Council meetings. It also stuck to the fixed rate tender and the interest rate of 3.3 %, thus helping to stabilise market expectations. The steady-as-she-goes interest-rate policy has been facilitated by a slight brightening of the monetary setting in recent months. Monetary growth has meanwhile slowed down perceptibly. In October, the money stock M3 exceeded its average level in the fourth quarter of 1996 by an annual rate of 5.1 %, compared with 5.8 % in August. It thus lay virtually in the middle of this year's target corridor of 3 ½ % to 6 ½ %, after having distinctly overshot it up till May. Furthermore, the price pressure at the preceding production stages slackened again. The exchange rate movement of the Deutsche Mark against the US dollar also moderated somewhat.

Growth
of the money stock M3 *

Target and movement to date



* Average of five bank-week return days; end-of-month levels included with a weight of 50%. — **+** The target corridor has not been shaded until March because M3 is normally subject to major random fluctuations around the turn of the year. — **1** Between the fourth quarter of 1996 and the fourth quarter of 1998. — **2** Between the fourth quarter of 1996 and the fourth quarter of 1997.

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Capital market rates

The financing conditions for a sustained economic upswing continue to be favourable. The interest rates for short-term bank loans remained virtually unchanged after the raising of the securities repo rate in October. In the bond market, the slightly upward interest rate trend visible at the shorter end since the beginning of July initially persisted in the autumn months, whereas yields at the long end, which are determined more by international influences, fell. This owed something both to waning inflation expectations in the United States and more recently to shifts from equities into bonds in response to the turmoil in the international equity markets. The yield on domestic bonds outstanding, which had risen to 5 ¼ % by October, fell back again to just over 5 % in mid-December.

Equity market upheavals

In the autumn months the German equity market was affected by the global turmoil in the financial markets. Both the adjustment in the US equity market in August and the crisis in the East Asian financial markets resulted at times in sharp falls in prices. By mid-December equity prices were on average 9 % lower than at the end of July, albeit 33 % higher than at the beginning of the year. The macroeconomic implications of the equity market upheavals will probably be comparatively small in Germany. Equities are not so significant as investment and financing instruments that swings in prices are likely to have a major impact on households' consumption demand, banks' propensity to lend or corporate financing. Under conditions of unstable financial markets, monetary policy makers face the task of laying down clear guidelines by adhering to a stability-oriented policy stance. This helps to preclude fundamentally unwarranted assessments in the financial markets and to forestall the emergence of speculative bubbles.