

# The economic scene in Germany in spring 1998

## Overview

### Economic conditions

---

The economic upturn has been gathering momentum again since the start of 1998, while its base has simultaneously become broader. After adjustment for seasonal and working day variations, real gross domestic product was just under 1 % higher than in the last quarter of 1997, and 3 % higher than twelve months before. The slackening of the pace of growth towards the end of last year thus proved to be no more than temporary, even though the upturn most recently may have been exaggerated by special factors such as the mild winter weather and anticipatory effects resulting from the increase in the standard rate of value added tax as of April 1. In line with this, there has been an improvement in mood in major areas of the economy. According to the surveys of the ifo Institute, manufacturing enterprises rated their current business situation in much the same way as in the period of prospering economic activity at the end of the eighties.

*Economic  
growth*

The crises in East Asia have had scarcely any noticeable effects on the German economy as a whole so far. There has been a marked fall in exports to that region, and some enterprises' exports have declined sharply. At 5 %, however, the Asian crises countries' share in Germany's overall export business is, by itself, too small for a slowdown in this area to immediately jeopardise the continuation of growth.

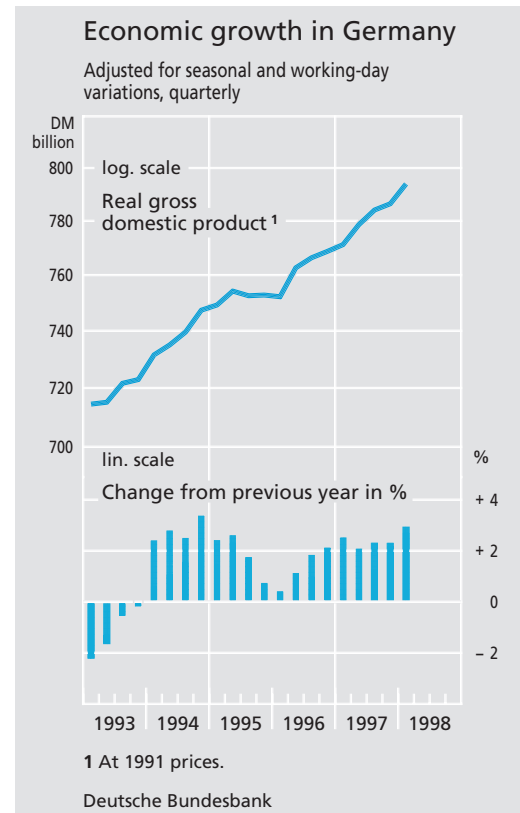
*Crises in East  
Asia*

Undoubtedly, the crises in East Asia have not yet been finally overcome. Japan is especially affected, where the economic downturn

since the start of the year again has become further accentuated. In its forecast for world economic growth in 1998, the International Monetary Fund has revised its autumn 1997 prediction downward, by just over 1 percentage point, to 3%. The adjustments mainly concern those countries which have especially close economic links with the regions in crisis. By contrast, the domestic forces of growth have gained momentum in the German export industry's principal sales markets, especially in Europe; as a result, the adverse effects of the crises in East Asia have had barely any impact.

*Foreign  
business*

German industry's foreign business was thus not only able to maintain its high level; despite the dampening influences emanating from East Asia, there was, in fact, a further marked rise in exports overall. It is gratifying that export successes are increasingly being achieved by east German enterprises, too. A greater number of German products were sold, especially in eastern Europe. Nevertheless, the pace of growth in exports has slowed down perceptibly compared with the boom-like upward trend between 1996 and 1997. Export orders received and the export expectations surveyed by the ifo institute indicate a move into somewhat calmer waters; given the preceding gains in market shares, this must be regarded more as a consolidation than as a cyclical slowdown. Exports were, at all events, a mainstay of the German economy up to the end of the period under review. Given the present exchange rate level and moderate wage increases and following the enormous rationalisation efforts in enterprises, German export products should re-



main competitive in the foreseeable future as well.

In comparison with the preceding year, the economic upturn has become more robust to the extent that there has been a marked increase in domestic demand. After adjustment for seasonal and working day variations, new domestic manufacturing orders in the first four months of this year were almost 5½% higher than the figure for the last four months of 1997.

*Domestic  
demand*

The demand for capital goods, in particular, has picked up perceptibly. A considerably larger number of orders were recorded latterly, above all, by manufacturers of machinery and transport equipment. A turn for the better seems to have occurred here

*Investments*

after enterprises had, for a long time, hesitated to invest. The utilisation of capacity in west German industry continued clearly to exceed the ceiling of the range of normal utilisation. The outlook for demand is now assessed favourably over the longer term, too. Above and beyond that, the trend in costs remained subdued. Owing to moderate pay settlements and comparatively high productivity gains, there was even a further decline in unit labour costs, and commodity prices tended to remain under pressure. Overall, there was a further improvement in the enterprises' earnings position. The continuing low interest rate level was also a factor contributing to the brightening of the climate for investment. Following demand from abroad, the upturn in investment has now evidently "ignited" the second stage of the economic upswing, even though the momentum and duration of the expansionary stimulus must inevitably remain an open question at the present time. It would undoubtedly be premature at this stage to relax efforts to bring about a further improvement in locational conditions in Germany.

*Private  
consumption*

In the first few months of this year, private consumption – in addition to investments – was likewise a mainstay of the economy. Although retail trade purchases were boosted in the first quarter by the increase in the standard rate of value added tax coming into force on April 1, there also seems to have been a slightly greater propensity to consume in general. Firstly, the general brightening of the outlook for the economy is likely to have positively influenced consumers. Secondly, there was greater scope for additional pur-

chases from the income side, even though nominal pay increases were moderate. In contrast to 1997, there was no increase in social security contributions at the beginning of the year; as a result of the lowering of the solidarity surcharge and the raising of the basic tax allowance, the overall burden of taxes and levies on households was, in fact, reduced. Furthermore, given the degree of price stability that has been achieved, the nominal rise in disposable income now signified greater purchasing power which could be used to step up real consumption.

Manufacturing and product-related services were the principal beneficiaries of the overall improvement in the economic situation. The east German industrial firms were able to make a well above-average expansion in output. The structural transformation in eastern Germany, implying a strengthening of the industrial base, was thus able to make further progress.

*Manufacturing  
and services*

Construction admittedly remained the weak spot in the otherwise favourable cyclical picture – especially in eastern Germany. Even though there was indeed a sharp rise in orders received by the east German construction industry at the start of the year, this probably has to be regarded as a reaction to the particularly unfavourable trend in the preceding months. Following the conclusion of many infrastructure measures, great advances in the modernisation of the housing stock and now that many office buildings are standing empty, a further adjustment of the (in comparison with western Germany) oversized construction sector is inevitable. The de-

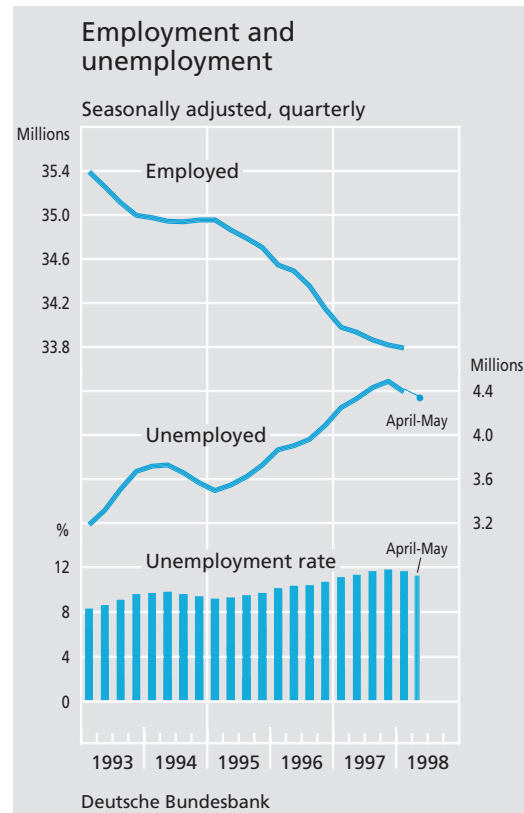
*Construction*

cline in the number of construction permits in all branches of the construction sector points to a continuation of the difficult situation in which many east German construction firms find themselves.

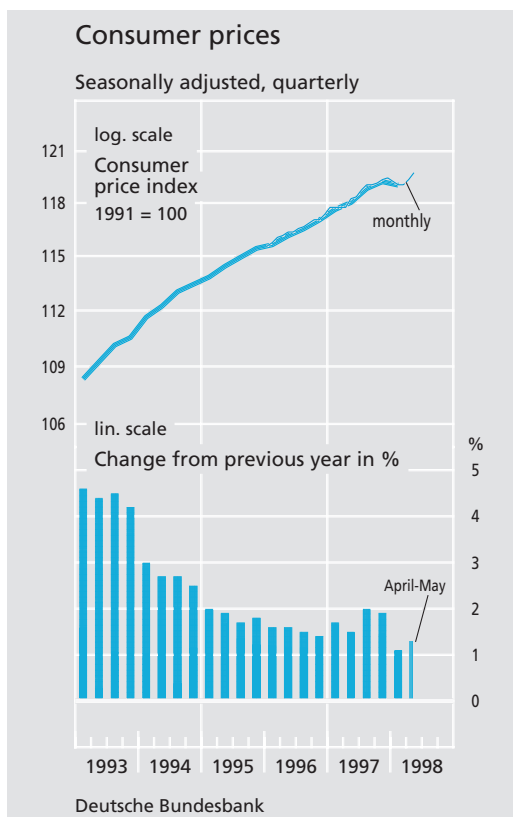
The economic situation of the construction sector likewise remained unfavourable in western Germany, although nowhere near to the same extent as in eastern Germany. The excess supplies of dwellings for owner-occupation in some regions is still depressing the market, and – despite a temporarily stronger demand for construction at the start of the year – the public sector is still showing restraint in terms of additional construction projects owing to the tight budgetary situation.

*Labour market*

In line with their unfavourable business situation, many construction firms, especially in eastern Germany, have continued to shed labour. Even so, there were a few bright spots on the labour market in Germany as whole following major losses in employment over the past six years. Additional staff were taken on – not only in the services sector, in particular, but also in industry – which created a counterweight to job losses in construction. In contrast to the preceding multi-year trend, there was hardly any further decline in the number of employed persons during the first few months of 1998. At the same time, a larger number of vacant positions were reported to the labour exchanges. Between the end of 1997 and the end of May 1998, the seasonally adjusted number of unemployed fell by around 200,000 to 4.32 million.



Despite these positive trends, the share of unemployed in the total labour force, at 11.2 %, remains unacceptable over the long term. In eastern Germany, the unemployment rate was as much as 18.7 %, even though a greater number of job creation schemes and training courses have again been available and subscribed to recently. Unemployment thus remains Germany's most pressing economic and economic policy problem; to solve this, not only a continuation or strengthening of economic growth is needed but also a large number of structural adjustments. Contrary to some opinions voiced publicly in Germany, monetary policy has not caused the high level of unemployment nor can it play a part in reducing it at present by means of interest rate policy measures. In line with its monetary target, the Bundesbank has provided adequate



liquidity for tension-free economic growth. For some time now, interest rates have been regarded as decidedly low by both enterprises and private investors, which means that they do not generate any decline in demand for capital and consumer goods.

Prices

The price trend in the first few months of 1998 was decidedly calm. At the producer level, prices in April were no more than 0.3 % higher than a year before; import prices even went down during this period by 0.5 %. Although, as mentioned above, the standard rate of value added tax was raised from 15 % to 16 % from April 1, it is obvious that not all enterprises immediately passed on this tax increase in full to their customers. In May, the consumer price index was no more than 1.3 % higher than its level in the previous

year (compared with just under 2 % in the fourth quarter of 1997 and on an average of 1997 as a whole). Taking into account statistical recording deficiencies, Germany has thus largely achieved the objective of price stability – a success which it will be important to protect in the period up to the start of European monetary union and, thereafter, within the new institutional and economic framework.

Fiscal and monetary policies

The deficits in the public sector budgets in the first quarter of 1998 were lower than a year before. In the case of the central and regional authorities (data are not yet available for local government), they fell by DM 1½ billion to DM 33½ billion, and in the case of the major sectors of social security by just under DM 3 billion to approximately DM 6 billion. The improvement was due, firstly, to a negligible rise in expenditure, and, secondly, to major sales of participations. By contrast, tax revenue was still marked by tendencies to weakness; it was only 1% higher than the amount for the corresponding period last year. The subdued trend in actual earnings as well as employment that was still declining when comparing this year with last year, were reflected in the trend in wage tax – factors which also contained the rise in social security contributions. Moreover, private consumption had not yet developed into a mainstay for receipts from turnover tax. On the other hand, revenue from assessed taxes stabilised, which was revealed by a major increase in corporation tax receipts.

*Fiscal situation at the start of 1998*

*Outlook for the  
year as a whole*

Following the trend at the start of the year, it is becoming apparent that the budget plans of the central, regional and local authorities for 1998 can be met in most cases. Above all, no sizeable shortfalls in tax revenue are to be expected for this year. The result of the official tax estimate in May was no more than DM 3 billion below the (comparable) forecast of November last year, on which budget plans had largely been based; a year before, expectations had had to be scaled down much more sharply. Given the stabilising trend in employment, the burdens due to the labour market are unlikely to lead to additional gaps in the budgets in the current year; the Federal Government had in any case made budgetary provision for this with a sharp rise in transfers to the Federal Labour Office.

In line with the plans drawn up, a sharp decline in deficits is therefore to be expected in the budgets of the central, regional and local authorities. Above and beyond that, the trend in the fiscal position of the social security funds will also become more favourable, especially in view of the fact that the pension insurance schemes will receive an additional Federal grant which is being financed by the 1 percentage point increase in the standard rate of value added tax from April. Admittedly, the budgets of the central, regional and local authorities have improved largely because of the inclusion of the extremely large volume of receipts from privatisation and the Bundesbank's increased profit transfer due to a higher valuation of the monetary reserves. These factors represent merely a shift in financial assets and are therefore recorded in

the national accounts with a neutral effect on the deficit.

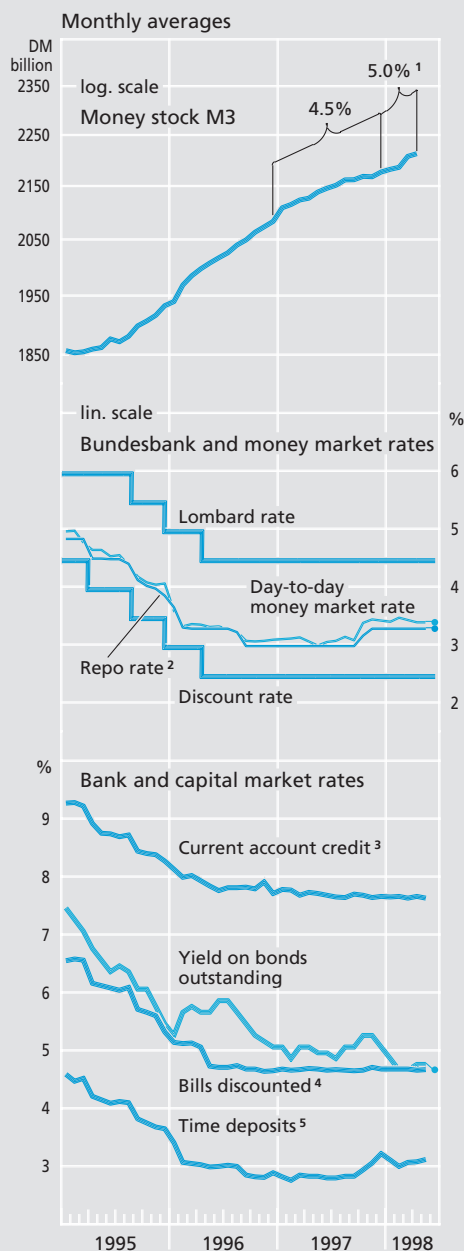
The goal enshrined in the Stability and Growth Pact prescribes a budget position for the countries participating in EMU which, in the medium term, is close to balance or in surplus. This objective requires that the budgetary measures taken by the central, regional and local authorities in the current year which have only a temporary effect, are to be underpinned by steps towards long-term consolidation. The budget plans made by the central, regional and local authorities for the coming year and the medium term must be geared to a consistent continuation of the reduction in the government ratio initiated last year.

*Consolidation  
requirements*

The Bundesbank maintained its steady interest rate policy stance during the first few months of 1998. It left the discount and lombard rates at 2.5% and 4.5%, respectively. It continued to offer securities repurchase agreements in the form of fixed-rate tenders at 3.3%, and announced their terms in all cases in advance immediately after the meetings of the Central Bank Council. Against that backdrop, the interest rate trend in the market for day-to-day money was quite steady, especially as it was possible to offset the transfer of the Bundesbank profit to the record amount of DM 24.2 billion on May 14 without any friction by means of a corresponding matching timing and reduction in the volume of securities repurchase agreements. Time deposit rates in the money market, on the other hand, increased slightly. At the same time, the central bank and money

*Steady interest  
rate policy*

## Money stock M3\* and interest rate movements



\* Average of five bank-week return days; end-of-month levels included with a weight of 50%. — 1 Change expressed as an annual rate. — 2 Monthly average interest rate for transactions with a maturity of two weeks. — 3 From DM 1 million to less than DM 5 million. — 4 Bills of less than DM 100,000 eligible for rediscount at the Bundesbank. — 5 Time deposits of DM 1 million to less than DM 5 million with an agreed maturity of one month (up to the end of October 1996: from 1 to 3 months). — ● = Latest position: June 12, 1998.

Deutsche Bundesbank

market rates of the countries participating in EMU continued to converge.

The steady course pursued in interest rate policy was in line with the macroeconomic and monetary situation. The price outlook remains favourable – not only in Germany but also in the countries taking part in EMU. Above all, the trend in the money stock was largely consistent with the target. Monetary growth – which was quite moderate around the turn of the year – accelerated somewhat in the spring, but remained within this year's target corridor of 3% to 6%. In April, the money stock M3 exceeded its average level of the fourth quarter of 1997 at a seasonally adjusted annual rate of 4.7%; it had been rising at the same pace since the fourth quarter of 1996.

*Monetary growth consistent with the target*

Monetary expansion in 1998 so far was particularly encouraged by increased lending by banks to the private and public sectors. However, a major part in this was played by credit institutions' sales of shares and public bonds; these took place largely in the secondary market and thus did not entail any new lending to the issuers. Furthermore, monetary capital formation slackened. Given the fact that the interest rate level has now fallen sharply, investors evidently have little propensity to invest in longer-term financial assets with banks. On the other hand, domestic non-banks again purchased foreign securities on a large scale. They also shifted cash holdings into Euro-deposits and money market fund certificates. The money stock M3 extended, which includes these financial assets, therefore grew somewhat more sharply than



the money stock M3 in the period under review.

*Low capital  
market rates*

Up to the middle of March, German capital market rates initially fell to an all-time low of less than 4¾% and then rose a little with slight fluctuations. When the crises in East Asia again came to a head in mid-June, they fell back to the low level of March. The decline in interest rates was concentrated on the long end, which resulted in a further flattening of the yield curve. The low capital market rates principally reflect the continuing favourable outlook on prices. The repercussions of the crises in East Asia have led not only to a worldwide shifting of financial resources to "safe havens", but also dampened expectations regarding economic activity and prices. Obviously, the markets are expecting a stable monetary environment for the period following the start of EMU, too. To take account of this, it is important not to bequeath any monetary potential for inflation to the European Central Bank (ECB). For that reason, the Bundesbank will incorporate European indicators

in its monetary policy deliberations to a greater extent during the further course of the year.

Owing to money and capital market rates that continue to be low, the financing terms for business remain very favourable. Effective rates for long-term loans have fallen to all-time lows. Mortgage loans secured by residential real estate with interest locked in for five and ten years cost 5⅔% and around 6%, respectively. Real interest rates, too, are at a comparatively low level. The sharp upsurge in the equity markets has likewise improved the opportunities which business has for procuring capital. This admittedly entails the risk of prices departing from fundamentally reliable evaluation criteria and the danger of setbacks – accompanied by adverse implications for the economy. The central banks would therefore do well to keep a close watch on the price trend in the equity markets and to counter exaggerations with a monetary policy that is consistently geared to price stability.

*Favourable  
financing  
terms*