The economic scene in Germany around the turn of 1997-8

Overview

Economic conditions

Growth of industrial output

The economic upswing in Germany continued in the autumn of last year. However, the pace of growth slackened. Especially in manufacturing,[1] output was stepped up only a little. Although it was 4 ¼ % higher in the fourth quarter of 1997 than it had been a year before, that mainly reflected the strong expansion in the first three quarters of last year. Compared with the preceding three months, the seasonally adjusted value added in manufacturing in the last quarter of 1997 rose by under ½ %. According to surveys conducted by the ifo institute, enterprises continued to view current business conditions and the outlook for the near future optimistically. Latterly, however, confidence has not strengthened any further, as it had done previously for over a year. In assessments of business prospects, greater emphasis is now often placed on the risks, and particularly on the uncertainties arising in connection with the crises in eastern Asia.

Foreign demand

Whereas the economic upswing had previously been driven mainly by exports, more recently the momentum of foreign demand has slackened. In the fourth quarter of 1997, the seasonally adjusted orders reaching manufacturing from abroad fell by 2 ½ % compared with the third quarter; even so, they remained 12 % higher than a year before. Whether the recent moderation of foreign demand reflects first signs of the crises

1 Figures from the national accounts on the gross domestic product and its components will not be published until the end of February. This delay has come about because the decisions on European monetary union have to be based on a sound statistical foundation.

in eastern Asia must remain an open question for the time being, considering that the regional foreign trade statistics are lagging behind.

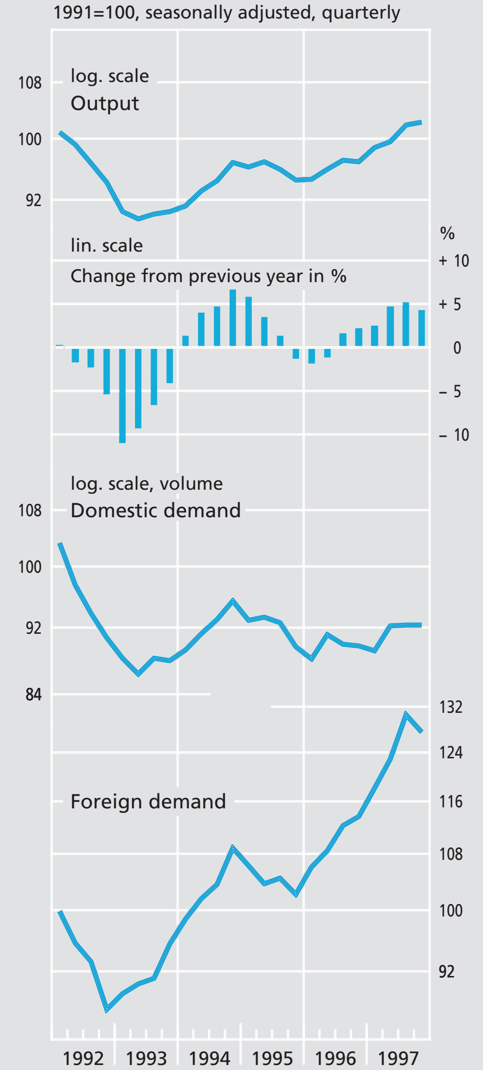
Crises in eastern Asia

The intensification of the crises towards the end of 1997 and the associated uncertainties about economic trends on major goods and financial markets may well have prompted a number of potential customers to exercise some restraint in placing new orders. The east Asian countries involved are currently going through a painful, albeit unavoidable, adjustment process, accompanied by a substantial drop in demand in that region. Furthermore, following the dramatic depreciation of some east Asian currencies (and despite the consequent prospective sharp rise in the cost of imported goods and services), the competitiveness of products from that region on world markets has greatly improved. This combination of slower market growth and fiercer competition may well pose considerable problems for individual sectors of German industry.

In the estimation of the major international organisations, however, the contractionary impact of the crises in eastern Asia on the European – and thus the German – economy as a whole is likely to remain within comparatively narrow bounds. In macroeconomic terms, the factors militating against potential sectoral difficulties are these: Germany sells only about 5 % of its exports in the countries mainly concerned, and the external value of the Deutsche Mark against the currencies of all major trading partners (including the east Asian countries, some of whose currencies have depreciated sharply) has somewhat decreased, rather than increased, on the year. Correspondingly, according to the ifo surveys, German enterprises have so far seen no reason radically to revise their assessment of their export prospects. Despite the current losses, the further outlook for foreign business continues to be viewed with confidence. In addition, following the reorientation of global capital flows, capital market rates in

Demand and output in manufacturing

1991=100, seasonally adjusted, quarterly



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Germany have gone down again, which – in itself – fosters the continuation of the economic upswing. Relief is also being afforded by the fall in oil and commodity prices in the wake of the crises.

Furthermore, the massive rescue operations mounted for east Asian countries should help to defuse, or at least regionally contain, the crises. Although the risk of other countries being "infected" cannot be ruled out completely at present (especially if other financial institutions were likewise to be dragged into the turmoil), conditions in the east Asian foreign exchange and financial markets appear to have stabilised of late. If the envisaged reforms (especially in the financial system and the corporate sector) are implemented energetically, there is a good chance of linking up again relatively quickly with the earlier dynamic rates of growth, even if the goods and financial markets in eastern Asia are at present still under the impact of the crises that so unexpectedly engulfed them.

Domestic demand

Unlike current foreign demand, the seasonally adjusted orders received from the domestic market remained static in the autumn; compared with the fourth quarter of 1996, they rose by 3 % in real terms. However, this also implies that the "cyclical spark" generated by the strong expansion of exports lasting until the early autumn of 1997 has not yet jumped over to domestic demand.

Demand for capital goods

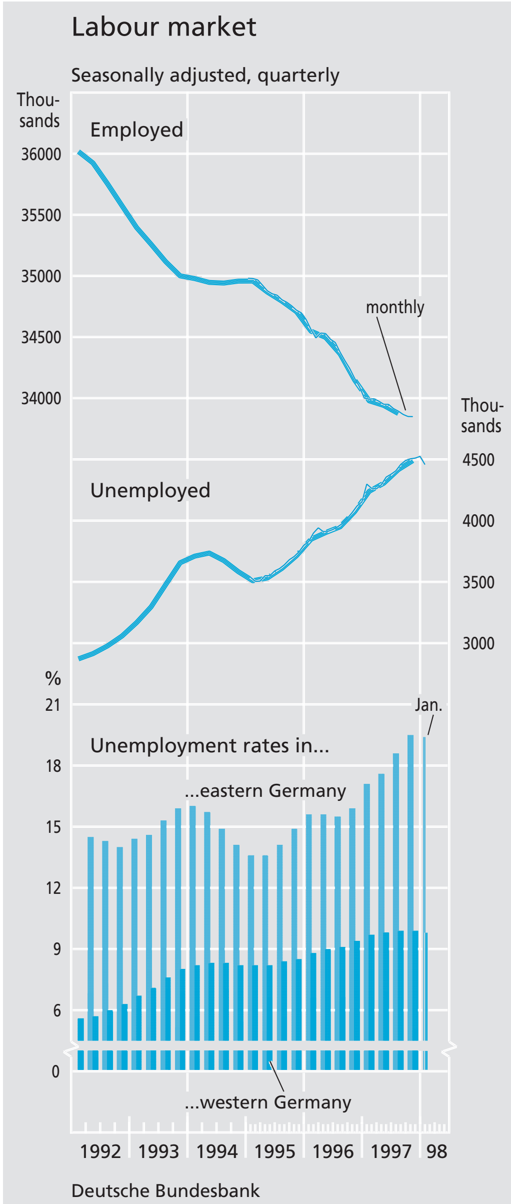
In particular, the propensity to invest has so far been unsatisfactory. Capacity utilisation in industry has admittedly continued to increase; it is meanwhile once again as high as it was at the time of the reunification boom early in the nineties. Corporate profitability has also improved, by and large. The rationalisation measures undertaken in recent years are now paying dividends; in 1997 wage rises were moderate, and interest rates still remain low. The fact that, even so (and despite proliferating reports on new capital projects), enterprises are reluctant to place orders with domestic capital goods producers may owe something, firstly, to the circumstance that the existing capital stock can now be exploited more flexibly than it could in the past, and that, to meet the demand, firms can fall back on up-to-date capacity in eastern Germany and abroad. Secondly, certain doubts may persist as to the durability of the improvement that has occurred in profitability. After two years of moderation, wage demands are now turning out larger again. Moreover, the high level of statutory non-wage labour costs has by no means been reduced enough up to now. The plans for a tax reform have likewise made very little headway. To safeguard the locational amenities of the German economy, it is vital to enhance confidence in both the private and the public sector's willingness and ability to reform. Wage-rate policy and the improvement of the underlying conditions set by the state both play a crucial role in that.

Construction

The present economic picture is clouded further by the fact that conditions in the construction sector have continued to deteriorate. True, construction output held up quite well in the fourth quarter – mainly no doubt owing to the favourable weather. Latterly, however, the order inflow to the construction sector has dwindled again along a broad front. Overhangs in the field of rented housing, enterprises' low propensity to invest in capacity extensions and the dire financial straits of the public sector have all continued to depress construction demand.

Labour market

Conditions on the labour market remained grim. The number of employed tended to decrease further; in November it was 315,000 lower than a year before. Particularly in eastern Germany employment fell steeply, in part because labour market policy measures were curtailed. Persons who were formerly attending further training courses or participating in job-creation projects consequently switched from previously concealed unemployment to open unemployment. At the end of January, 1.59 million people were registered as being out of work in eastern Germany; that was almost 180,000 more than a year earlier. Although the number of unemployed fell slightly (by 13,500 to 3.24 million) over the year in western Germany, the aggregate German unemployment figure, at 4.82 million, reached a new peak (+ 165,000).



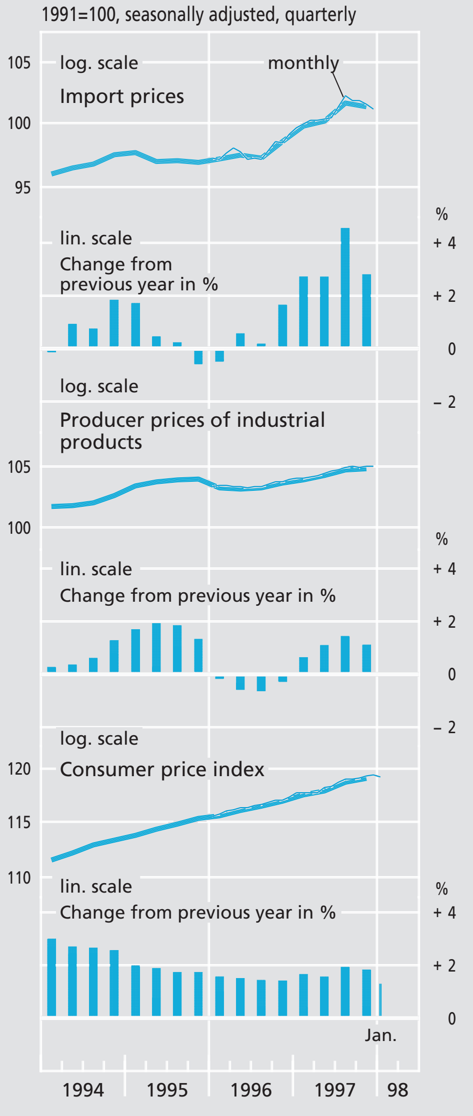
In January 1998, considered by itself, comparatively few of those hitherto in employment were newly registered as being out of work; this, however, was mainly due to the late onset of winter. Unlike the situation in the two preceding years, when particularly harsh conditions had obtained in January, this year it was generally possible to go on working in those occupations which are dependent on the weather. The usual methods of seasonal adjustment, which show a distinct decline in the unemployment figures in January (compared with December 1997), are unable adequately to capture such extreme swings in the weather. Hence developments in January, which seem at first sight to have been relatively favourable, do not in reality imply that there has been a change for the better on the labour market. At best, it can be stated that in western Germany the unemployment figures showed a tendency to stabilise.

Prices

The price situation in Germany around the turn of 1997-8 was decidedly quiet. The international prices of raw materials, especially oil, went down markedly, with the result that seasonally adjusted German import prices fell as a whole, despite the appreciation of the dollar. In the autumn producer and consumer prices remained virtually static (after seasonal adjustment). In January the consumer price index was only 1.3 % higher than a year before. Compared with the average year-on-year inflation rate during the last quarter of 1997 (amounting to 1.9 %), that constitutes a sharp drop. However, this fall owes something not only to the influence of the declining oil price but also to a statistical base-rate effect: early in 1997 radio and television licence fees were raised perceptibly.

Especially in the wake of the turmoil in eastern Asia, fears have sometimes been expressed that anti-inflation policy has gone too far, and that a threat of deflation is looming. Certainly, a steep fall in asset prices, particularly those of equities and building land, may pose severe problems for households and enterprises in the countries involved. But any such development – which is not discernible in Germany at present – should not be equated with the macroeconomic phenomenon of deflation, which is characterised by a sustained decline in the general price level of a wide range of goods. In Germany – just as in many other industrial countries – diminishing, but still positive, rates of inflation are visible on the goods markets. This is a disinflation process, which is now gradually tapering off after the virtual attainment of the target of price stability; it is not, however, deflation.

Price movements



All the major economic forecasting institutes expect to see sustained moderate price rises in Germany in the foreseeable future – rises which cannot be reinterpreted as deflation even by drawing attention to possible statistical measuring errors. Furthermore, at low inflation rates it is only to be expected that specific prices will sometimes go down, especially because of higher productivity in the manufacture of the goods, or in the event of fiercer international competition. That, too, is not a case of deflation, but rather the economically necessary "breathing" of relative prices in line with market movements.

Altogether, the Bundesbank is in a relatively comfortable position as far as its target of price stability is concerned. In the foreseeable future it will be faced neither with particular inflationary tensions nor with deflationary risks. The German economy has more or less attained price stability – a success that must now be safeguarded over the longer term.

Fiscal and monetary policies

Public sector budgets in the fourth quarter of 1997

In the fourth quarter the financial position of the public authorities improved over the same period of the previous year. In the case of the Federal Government, in particular, the deficit fell in that period from DM 23 billion to just over DM 4 billion. Towards the end of the year the movement of tax revenue was no longer as unfavourable as before, partly because, compared with the previous year, the tax-reducing effect of the lowering (at the end of 1996) of the special depreciation allowances on east German capital spending moderated, and partly also because of higher advance payments of tax by many enterprises, given that their profitability was continuing to improve. Moreover, the Federal Government received substantial proceeds from privatisation. The better overall performance of the public sector also owed something to the fact that the seasonal surplus of the pension insurance scheme rose because of the increase in contribution rates that came into force early in 1997. Finally, the financial result of the Federal Labour Office likewise improved, mainly because expenditure on vocational promotion (including job-creation measures) was cut.

Results for the whole of 1997

In 1997 as a whole, the public sector deficit (in the budgetary definition) seems to have decreased distinctly on the year. Among the central, regional and local authorities, it may well have fallen by roughly DM 20 billion to some DM 100 billion. The social security funds probably ran a surplus, after they had incurred a deficit of DM 13 billion in 1996.

Progress in consolidation

The public sector has therefore made some progress in its efforts at consolidation. This is the more remarkable as the sluggishness of tax revenue has persisted. The unfavourable trend in employment, the abolition of property tax and the erosion of the tax base as a result of the profusion of tax options and partial tax concessions (to mention only the most important factors) caused tax revenue to drop by ½ % compared with the previous year. The central, regional and local authorities thereupon intensified their retrenchment policy, not least by introducing expenditure freezes in the context of budget management. This enabled the volume of expenditure to be kept down to the previous year's level. This has to be rated a notable success, even if it was scored at the expense of spending on tangible fixed assets, which went down for the fifth year in a row.

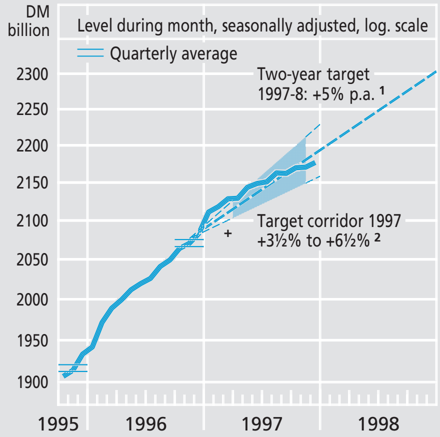
Budget plans for 1998

According to the budget plans, the central, regional and local authorities' consolidation policy is to be continued in 1998. However, the envisaged reduction of the deficits remains hampered by the fact that tax revenue will probably again fall short of the growth rate of nominal GDP (albeit not so far short as in the preceding years). It is true that the standard rate of value added tax will be increased by 1 percentage point (to 16 %) with effect from April 1, in order to finance an additional Federal grant to the pension insurance scheme, thus avoiding a rise in the contribution rate, which would otherwise have been necessary. But this will be accompanied by a lowering of the solidarity surcharge by 2 percentage points, a further raising of the basic tax-free amount and the continued intensive exploitation of all options for tax avoidance.

Hence a strict limitation of the volume of expenditure remains imperative. According to the budget plans, central, regional and local authority spending is to go up by no more than 2 %. A large part of the adjustment burden continues to be borne by expenditure on tangible fixed assets; such spending is to be reduced further. Restraint in capital spending, too, is no doubt acceptable for a while, especially since not all government investment contributes equally to the enhancement of macroeconomic productivity. In the longer run, however, the public sector should retrench primarily in the area of consumption expenditure, in order to foster consolidation in "qualitative" terms as well. An easing of the pressure on the public budgets thereby is not yet in sight, not least because the requirements of the Stability and Growth Pact will have to be met after the start of European monetary union.

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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Steady-as-she-goes interest rate policy

Against the background of the above-described macroeconomic outlook, which warrants fears neither of particular inflation risks nor of a threat of deflation in the near future, there has been no need for the Bundesbank to take action of late in the field of monetary policy. It therefore left its monetary policy stance, which it had tightened somewhat in October 1997, unchanged. It conducted all its weekly securities repos at the rate of 3.3 %, which it had increased in October (from 3.0 %), and announced its terms in advance following the meetings of the Central Bank Council. It kept the discount and lombard rates, as before, at 2.5 % and 4.5 %, respectively.

It was primarily the monetary situation that argued in favour of a steady-as-she-goes

Monetary target for 1997 attained

stance in the area of interest rate policy. As regards monetary growth, the slowdown deemed necessary by the Central Bank Council when it reviewed last year's monetary target (in July 1997) in fact materialised. During the fourth quarter of 1997 the money stock M3 was on average 4.8 % higher than a year before. As a result, last year's monetary target, which had been distinctly exceeded in the early months of the year, was ultimately met. In the end, monetary growth was in line with the rate of about 5 % per annum which was compatible with the expansion of potential GNP, and which formed the basis of the two-year guideline for 1997-8.

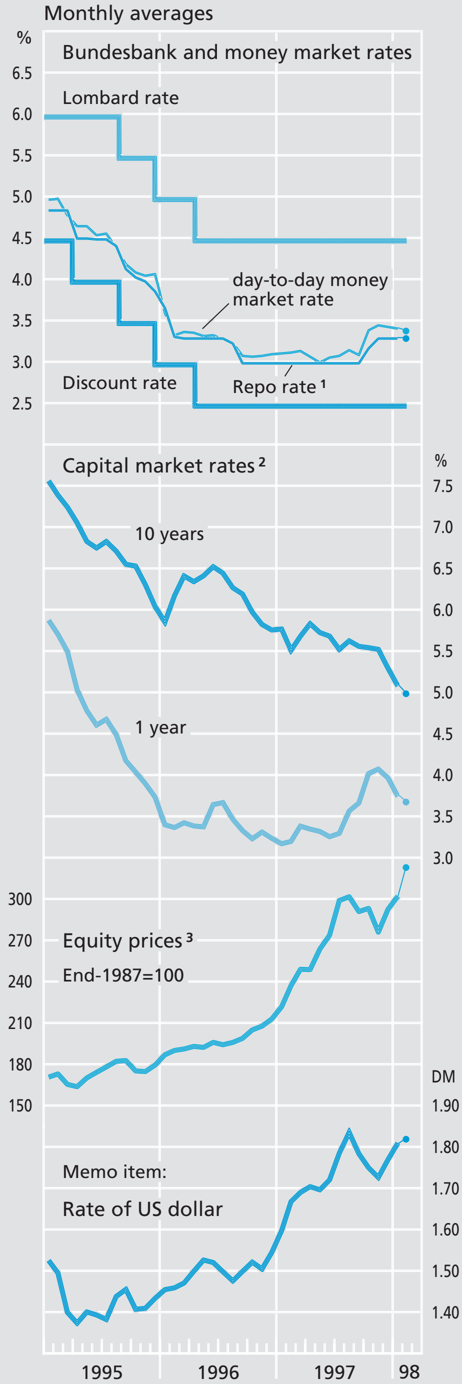
Monetary growth in keeping with the target was fostered by a normalisation of private credit expansion (which had been very high around the turn of 1996-7), and by outflows of funds in the area of non-banks' external payments. Moreover, towards the end of the year bank lending to the public sector, which had previously been strong, slackened and monetary capital formation picked up slightly. On average, however, the growth of the money stock M3 during 1997, at just over 6 %, was faster than had been envisaged because of the steep increase at the beginning of the year. Hence the supply of liquidity in the economy remains abundant, if anything. The Bundesbank took this fact into account when setting the monetary target for 1998 and, compared with 1997, narrowed the target corridor by ½ percentage point to 3 % – 6 %.

Decline in capital market rates ...

The customary financial market indicators likewise point to expansionary monetary conditions. The external value of the Deutsche

Central bank rates and financial market prices

Monthly averages



1 Average monthly rate for securities repurchase transactions with two-week maturities. — 2 Yields on listed Federal bonds outstanding. — 3 CDAX share price index. — • = Latest position: Feb. 11, 1998.

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Mark against the US dollar weakened again around the turn of the year. At the same time, capital market rates fell to a new all-time low of barely 4¾%. In real terms, too, they are running at a low level. Adjusted for the ongoing very small price rise at the consumer level, they currently come to about 3½%, and are thus almost 1 percentage point below the average of the last twenty years. The decline in interest rates at the long end of the capital market was more pronounced than that at the short end; hence the yield curve has continued to flatten out.

... in the wake of the crises in eastern Asia

The falling capital market rates and the narrower interest rate differentials reflect in good part the direct and indirect impact of the crises in eastern Asia. The crises have resulted in a shifting of resources into "safe havens" with minimal creditworthiness risks, liquidity risks and exchange risks. Moreover, in their wake economic prospects have clouded somewhat worldwide, and inflation expectations have improved. However, seen from the present viewpoint, as mentioned above, there are no indications that the crises in eastern Asia might culminate in a global deflation. Not least the strong upturn in prices in the equity market, where record levels were reached at the beginning of February, is a token of the fact that the business outlook is still being rated optimistically.

Financial conditions favourable

Thanks to the recent decline in interest rates, the financial conditions for business have improved further at the long end of the market. Fixed-rate mortgages on residential real estate with interest rates locked in for ten years cost an average of barely 6½% in January. At the short end, the interest rates for bank credit remained persistently low. The raising of the repo rate in October ultimately failed to affect the terms for short-term lending. Now it is essential to convert the financing terms, which are favourable throughout the entire maturity range, into job-creating investments. The key to any such development is radical reforms and a consistently moderate wage-rate policy, both of which will help to reinforce the competitiveness of the economy further.