The economic scene in Germany in autumn 1998

Overview

Business conditions

Economic growth

Business activity in Germany grew strongly again in the summer after it had stagnated for a while in the spring. After adjustment for seasonal and working-day variations, the real gross domestic product was almost 1% higher in the third quarter than in the second. Against the comparable period of the preceding year, aggregate output rose by about 2 ¾ %, just as in the first half of 1998 as a whole. The economic upswing which has now lasted for a good two years thus persisted.

Sentiment

Yet, at the same time, there is no mistaking the fact that sentiment has deteriorated distinctly since the late summer, especially in the manufacturing sector. Both the assessment of current business conditions and expectations for the next few months have worsened, according to surveys by the ifo institute. Although German business was largely able to detach itself from the pressures emanating from the world's crisis regions until well into 1998, now the global growth losses are adversely affecting the demand for German products. Strengthened by uncertainties regarding future cost and tax burdens in Germany, retarding forces have gained ground. For instance, the seasonally adjusted new orders received by industry between July and October were somewhat lower than in the spring, and only slightly higher than a year before.

Sectoral developments

Moreover, there are major differences in business activity between the various sectors. The growth of industrial output was driven to a large extent by demand for passenger cars. It seems that the new German models, in particular, are considered attractive by domestic and foreign buyers alike in terms both of price and of design. By contrast, such important sectors as mechanical engineering and the chemical industry recently sustained substantial losses – especially in foreign business – with the consequence that their output dropped perceptibly in the early autumn.

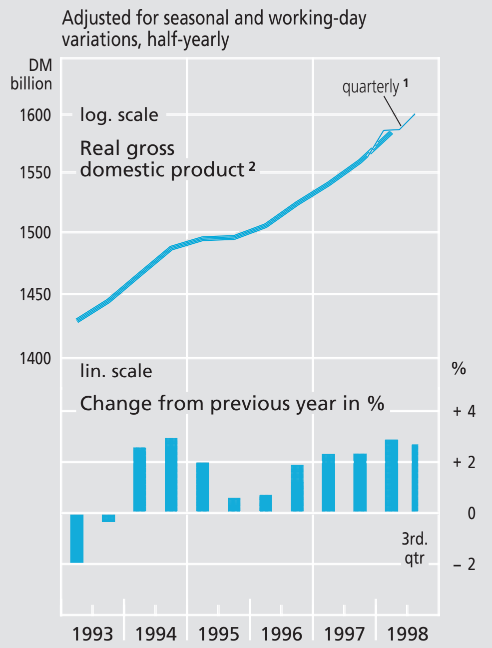
Foreign business

Viewed as a whole, the external stimuli which have hitherto been buttressing economic activity appear to have slackened. Merchandise exports started to moderate in the third quarter, after a long period of expansion. The inflow of new orders from abroad likewise slowed down distinctly. That was no doubt mainly due to the clouding of the international growth prospects. Major international organisations, such as the IMF and OECD, have revised their forecasts for global economic growth in 1998 and 1999 markedly downwards. The turmoil in the international financial markets has admittedly subsided; prices have rallied strongly again in many foreign exchange and securities markets. Even so, the real repercussions of the crises in various parts of the world may not yet have been mastered.

Developments in the crisis regions

Especially in Japan, hitherto there have not been any signs of a change for the better, despite a number of attempts at reforms. In Russia economic conditions have actually deteriorated further. In Latin America, the aid package supplied for Brazil has helped to stabilise the situation. The danger of contagion is, however, not yet completely averted. Resolute implementation of the restructuring programmes is required if the financial markets' confidence in the economies of the countries involved is to be regained and preserved. Financial assistance alone is unable to solve the structural problems – some of them deep-seated – besetting the crisis-stricken countries. Such aid must be supplemented and underpinned by stability-oriented monetary and fiscal policies and by a convincing structural adjustment programme. A number of countries, like Thailand and South Korea, have already made remarkable headway in that direction. The encouraging market responses to that progress, such as lower interest rates and the correction of the excessive depreciation of their currencies, should act as an incentive for other countries, too, to embark energetically on the doubtless painful, but unavoidable, adjustment process.

Economic growth in Germany



1 Quarters converted to half-years.— 2 At 1991 prices.

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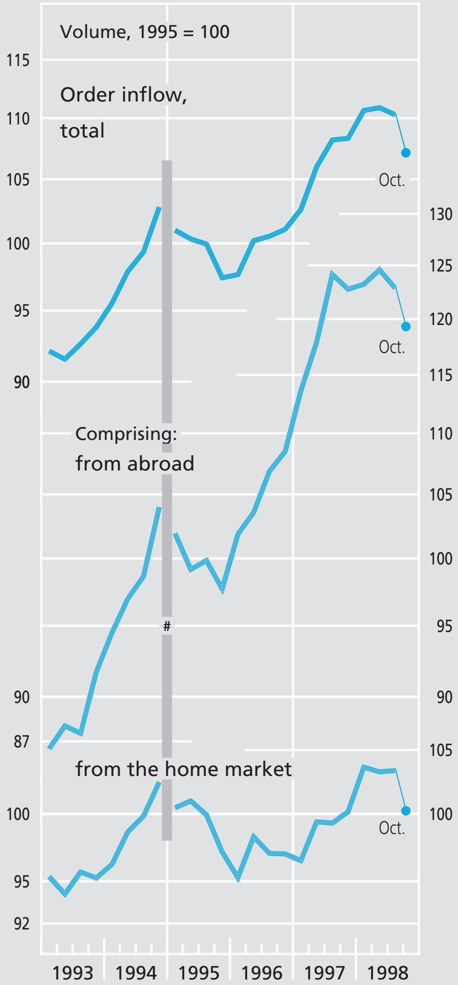
Demand in the manufacturing sector

Seasonally adjusted, quarterly, log. scale



Not fully comparable owing to the re-organisation of the statistics.

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Domestic demand

The slackening external economic stimuli in Germany were accompanied in the summer months by a strengthening of the domestic expansionary forces. The switch which is now under way from exports to domestic demand might, however, not be guaranteed to continue. The seasonally adjusted orders received from the home market by the manufacturing sector have not gone up any further during the period under review.

Investment in machinery and equipment

During the period between July and September, seasonally adjusted investment in machinery and equipment once more increased markedly against the previous quarter, following a temporary decline. Even so, the propensity to invest has latterly remained muted. According to ifo surveys, the utilisation of capacity in west German industry continues to be high, although it has not risen any further since the end of 1997, but has actually decreased somewhat. In addition, uncertainties originating in the international environment, as well as some "home-grown" ones, seem to be exerting a dampening effect. On the other hand, enterprises' relatively good profitability and the low level of interest rates continue to create favourable conditions for investment.

Construction

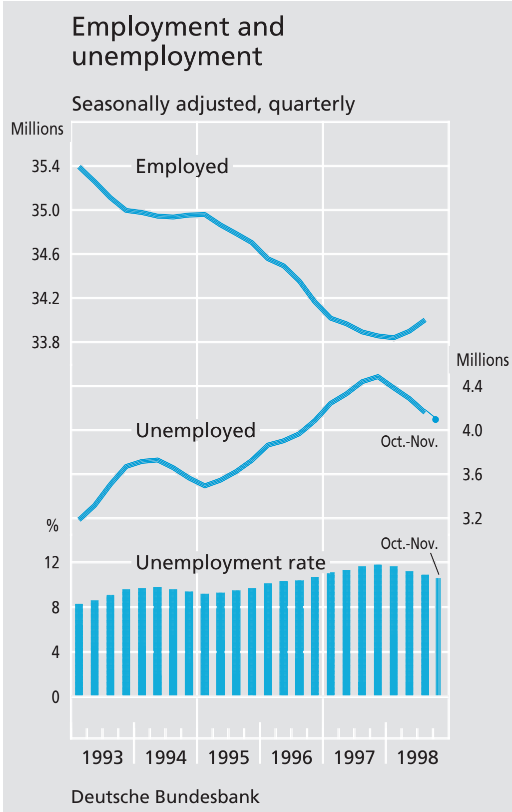
In contrast to the indications of a levelling-off of business activity in the manufacturing sector, signs of an improvement were evident in the construction sector (effectively, in all three major areas, i.e. in industrial and public construction as well as – albeit with some reservations – in residential construction). In that field, the seasonally adjusted orders received have increased distinctly so far this year. After a lengthy period of contraction, the bottom of the curve now seems to have been reached, although an unequivocal upward movement has not taken shape so far.

Private consumption

A positive impact on business activity was also exerted by private consumption; it went up appreciably during the summer months. That was mainly because of the higher level of employment, the steeper rise in wages and salaries than in the previous year and, not least, the virtual attainment of price stability, which ensured that nominal improvements in income raised real purchasing power to effectively the same extent. As a matter of fact, the expansion of consumption slightly overshot the increase in income. It was "co-financed" – albeit in small part – by a decline in private saving. That may reflect an enhanced confidence that is accompanying the higher level of business activity this year, but it also highlights the limits to the growth of consumption, especially since the private saving ratio, at 11¾ % of disposable income, has meanwhile reached a historically low level in Germany.

Labour market

Despite the recent slowdown in business activity and the increase in global risks to enterprises, conditions on the labour market have improved further. Between June and September, the seasonally adjusted level of employment rose by 95,000 persons; the number of those gainfully employed was thus 175,000 higher than a year before. At the same time, the number of unemployed fell noticeably (between the end of June and the end of November, by a seasonally adjusted 145,000 and, in a year-on-year comparison, by 375,000). Especially in western Germany, that mainly reflects the expansion of aggregate output. Following the numerous dismissals in previous years and the full utilisation of the scope for flexibility in many firms, numerous businesses evidently have no significant personnel reserves left to cope with the surge in economic activity, which has risen to a higher level. In eastern Germany, by contrast, it was the extension of labour-market-policy measures that played the crucial role. Among other things, attendance at courses of vocational further training increased in that part of the country.

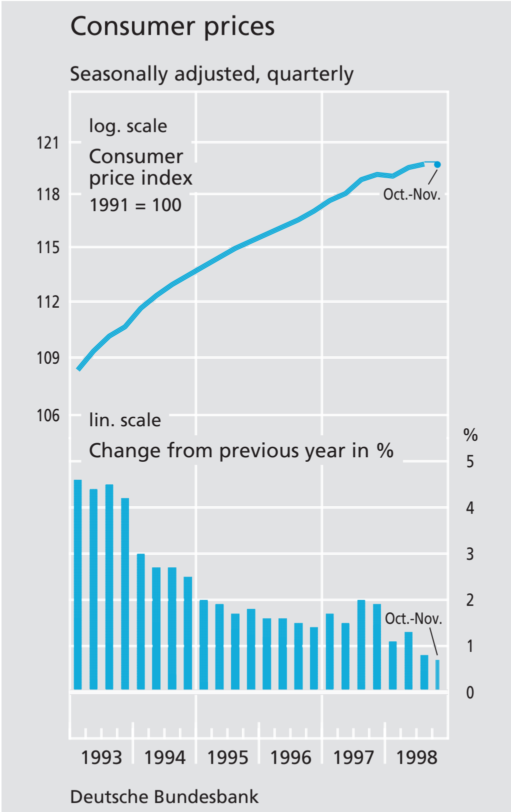


The unemployment ratio, i.e. the ratio of the number of unemployed to the number of persons in employment, continues to be decidedly high in Germany, at 10½ %. Numerous research institutes and international organisations, such as the IMF and OECD, have constantly drawn attention to the fact that much the greater part of unemployment in Germany (and in other countries of continental Europe) is due to structural factors. Specifically, the relatively high wage level and the lack of wage differentiation, the above-average burden of taxes and other public levies by international standards, wrong incentives in the social security system and numerous rigidities on the labour and merchandise markets are mentioned in this connection.

To be sure, after several years of wage restraint and willingness to display greater flexibility in the labour input, an improvement in the fundamentals affecting the labour market has meanwhile been brought about. That is reflected in the decrease in the unemployment figures. But a good deal of staying power is required if the progress made is to be safeguarded over the longer term and further employment opportunities are to be opened up. The parties to wage settlements must bear a special responsibility in this sphere. In order to create new jobs that can hold their own in the market, and thus durably reduce the number of unemployed, the real scope for distribution, largely marked out by the rise in productivity, should on no account be exceeded. Instead, it would be advisable to fall somewhat short of it, in order that enterprises have a new inducement to recruit labour. In addition, the state could contribute to heavier investment and increased recruitment if it offered enterprises a reliable prospect of an early, perceptible reduction in the burden of taxes and other public levies.

Price movements

With the effective attainment of price stability, an essential prerequisite of appropriate and lasting economic growth has been satisfied. In November, consumer prices were only 0.7 % higher than a year before. This low inflation rate owed something, however, to the worldwide, dramatic fall in commodity and energy prices, and to the huge supply of foodstuffs. If those factors are both disregarded, the inflation rate was a little over 1%. Even if account is taken of the statistical measuring problems posed by recording price rises, there can be no talk of deflationary trends. Furthermore, the raising of energy taxes planned for the spring of 1999 will increase the cost of living by about ½ percentage point.



For monetary policy in the European monetary union, the main thing will be to safeguard the high degree of price stability now reached. In monetary policy terms, the launch date for EMU is conspicuously favourable. With a year-on-year increase of 1% in the harmonised consumer price index in October, the union-wide inflation rate is in an area that is consistent with the stability target of the European Central Bank (growth rate of HCPI of less than 2 %). From the present perspective, neither deflationary risks nor inflationary dangers are discernible.

Fiscal and monetary policy

Budget position in the third quarter

The budget deficit of the central, regional and local authorities in the third quarter of 1998, at DM 23 billion, was slightly higher than in the comparable period of 1997 (DM 21½ billion). However, this was mainly due to the decline in the proceeds of privatisation, which had been particularly high in the previous year. Tax revenue rose strongly, especially on account of enterprises' improved performance. Overall spending increased moderately, if anything, despite a number of special burdens imposed on the Federal budget.

Public sector deficit over the whole of 1998

Over the whole of 1998, the deficit of the central, regional and local authorities will probably decrease substantially (by about DM 25 billion to under DM 70 billion). Although this will owe a great deal to sales of participations and to the exceptionally large Bundesbank profit, even if such financial transactions are disregarded (as provided for in the national accounts, and thus in the definition of the public sector deficit under the Maastricht Treaty), an improvement remains. According to the latest tax estimate of November, tax revenue is likely to rise, all told, by just under 4 % in 1998. With the gradual decline in the tax shortfalls due to investment promotion in eastern Germany, the erosion of the tax base seems to be dwindling in importance, so that the tax estimates are now standing on a sounder footing again. On the other hand, a relatively small increase in spending on interest and staff, and lower expenditure owing to falling unemployment figures, are curbing the growth of total spending. Altogether, the public sector deficit ratio in what is known as the "Maastricht definition" will go on declining distinctly in 1998.

Outlook for 1999

In all probability, the budget deficits will increase again in 1999 because the proceeds of privatisation and the Bundesbank profit will be considerably lower. However, tax revenue is likely to go on rising steeply, and the growth of government expenditure is expected to remain within strict limits, according to current declarations of intent and budget plans. A further decline in the deficit ratio (as defined in the national accounts) is therefore not unlikely.

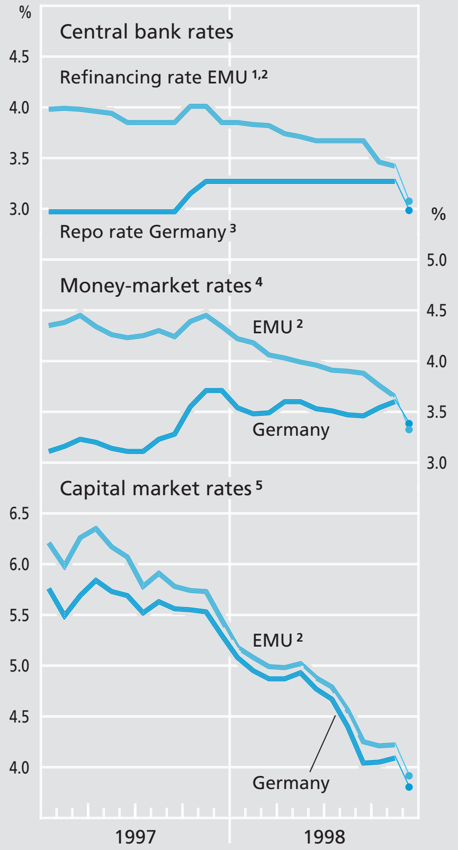
The new government programme

A focal point of the fiscal policy measures envisaged by the new Federal Government is the reform of income taxation. According to the coalition agreement, such taxation is to have practically no effect on the deficit in the next three years; not until 2002 is net tax relief totalling DM 15 billion envisaged. The main aim of the proposed package of measures is to reduce unemployment. To that end, the purchasing power of the lower income-earners, above all, is to be enhanced, primarily with the aid of tax relief and an increase in child benefit. The Federal Government expects that the resultant rise in consumption demand will stimulate business activity, in the wake of which corporate investment and aggregate output will likewise increase significantly.

The structure of the planned tax package is described in detail on page 40 ff. By the final year of 2002, gross relief amounting to DM 57 billion is envisaged (mainly through the reduction of the standard tax rates) under the current bill. At the same time, the widening of the tax base is to yield extra revenue totalling approximately DM 42 billion. Whereas households will benefit most from the tax relief, the financing will focus on enterprises, with the result that an additional net burden will arise in that sector, despite the lowering of the tax rates. Important though adequate demand is for the full utilisation of capacities and for corporate capital spending, given the globalisation of investment decisions, sufficiently attractive locational conditions are likewise essential. By international standards, the tax burden on enterprises in Germany remains relatively heavy. That alone should constitute an inducement to aim for the early and substantial net tax relief of corporations for the sake of a greater propensity to invest. Early in December, in the talks on an "Alliance for Work", bringing forward the corporation tax reform to the year 2000 was contemplated.

Interest rate movements in Germany and in EMU *

Monthly averages



* Excluding Luxembourg. — **1** Key refinancing rate, end-of-month levels; Ireland: until 10/98 call money, Italy: discount rate. — **2** GDP-weighted. — **3** Interest rate for two-week securities repos. — **4** Interest rates for three-month funds. — **5** Government bonds with residual maturities of about ten years. — ● = Latest position: Dec. 9, 1998.

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Coordinated interest-rate cut in December

The Bundesbank continued its "steady-as-she-goes" interest-rate policy during the autumn months. Initially, it left its interest rates unchanged. Then, at the beginning of December, it lowered the fixed rate for the securities repurchase transactions to be concluded in that month, and thereafter to be offered in the form of fixed-rate tenders, from 3.3 % to 3.0 %. It left the discount rate and lombard rate unchanged at 2 ½ % and 4 ½ %, respectively. The interest-rate cut was carried out in coordination with the other central banks of the future European monetary union, which lowered their key interest rates simultaneously, likewise to 3.0 % (except for Italy). That coordinated interest-rate move had been preceded by a virtual harmonisation of central bank interest rates in the future EMU countries at the bottom end of the range. After the considerable headway made in the convergence process, the question became more pressing as to the appropriate level of interest rates on the entry into monetary union at the beginning of 1999. A comprehensive appraisal of the situation and of the prospects in EMU led to the conclusion that a further interest-rate cut was advisable, which was also to include the low-interest-rate countries and was to bring the average level of key money-market rates down to 3 % by the time of entry into monetary union.

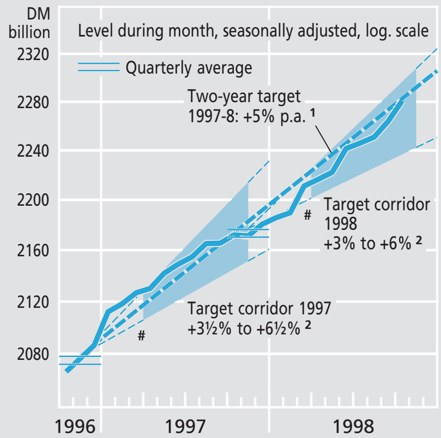
Monetary conditions

The Bundesbank's interest-rate cut is the German contribution to that coordinated operation, which will clarify the interest-rate horizon for the foreseeable future and will facilitate the start for the European Central Bank. The interest-rate reduction is consistent with monetary conditions and the monetary environment, both in EMU as a whole and in Germany. At the beginning of December, the ECB Governing Council set the first reference rate for monetary expansion in the euro area that is compatible with price stability at a growth of the broadly defined money stock M3[1] of 4 ½ %. The current money-stock figures for EMU are still subject to uncertainties. But they point to a rate of monetary growth which is consistent with that reference rate.

In Germany, the money stock is continuing to move within this year's target corridor of 3 % to 6 %. In October, it exceeded the average level of the fourth quarter of 1997 by a seasonally adjusted annual rate of 5.3 %; since the fourth quarter of 1996, it has grown at an annual rate of 5.0 %. In the autumn months, its growth rate admittedly accelerated somewhat. The reason for that was not a more vigorous overall credit expansion, but

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 4th quarter of 1996 and the 4th quarter of 1998. — **2** Between the 4th quarter of the previous year and the 4th quarter of the current year.

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rather a cessation of monetary capital formation owing to the low level and flat term structure of interest rates, and the interest-rate uncertainties prevailing at times in the capital market. Hence the slightly faster pace of monetary growth probably does not pose any threat of future inflation.

Overall economic situation

The interest-rate reduction is also in line with the overall economic situation. For one thing, both in EMU as a whole and in Germany it-

1 M3 comprises currency in circulation plus certain liabilities of the monetary financial institutions (MFIs) resident in the euro monetary area and – in the case of deposits – the liabilities of some institutions belonging to Central Government (e.g. of post offices and treasury departments). These liabilities included in M3 comprise: deposits payable on demand, deposits with an agreed maturity of up to two years, deposits with an agreed period of notice of up to three months, repo transactions, debt securities with a maturity of up to two years, money-market-fund certificates and money-market paper (net).

self, virtual price stability has been reached. There are no signs of this success being in jeopardy. For another, the international environment continues to be marked by considerable uncertainties and risks. The coordinated interest-rate cut by the EMU central banks is supposed to help counter the pessimism emerging in the corporate sector and to minimise the uncertainties besetting the financial markets.

Favourable monetary conditions

The interest rate reduction will further improve the monetary conditions, which have actually been favourable for quite a long time. In recent months, capital market rates have fallen to all-time lows. Even more than to Germany, that applies to many other EMU countries, which have not recorded such low interest rates at any time since the Second World War. In Germany, the yield on domestic bonds outstanding had fallen, with fluctuations, to below 3¾ % by mid-December. Real interest rates – regardless of the actual measuring method – are likewise to be rated rather low. In keeping with the movement of capital market yields, the effective rates for long-term fixed-rate loans have also fallen to new lows. For instance, mortgage loans secured by residential real estate (with interest rates locked in for five and ten years) cost only 5 % and 5 ½ %, respectively, in November.

Capital market trends

The prolonged decline in interest rates is a mirror-image of the favourable stability prospects. It has latterly also been fostered by the coordinated interest-rate cut by the EMU central banks. First and foremost, however, the movement of interest rates and of the term structure of interest rates in the German capital market reflects to a high degree the globalisation of the financial markets. Thus, until September the decline in interest rates was encouraged by massive capital inflows from abroad seeking secure and liquid investment. When, subsequently, conditions in the international financial markets and in a number of crisis regions settled down, nonresidents withdrew funds from the German capital market again.

With the moderation of the turmoil in the international financial centres, interest-rate uncertainty in the German bond market diminished, too. At the same time, the risk premiums for foreign Deutsche Mark bonds, which had previously risen steeply in some cases, decreased somewhat. Similarly, the yield advantage of bank bonds over federal bonds, which had widened appreciably on the eruption of the financial market crises, narrowed again. That widening probably owed not so much to a more sceptical assessment of the risks of default associated with bank debt securities, but rather was due more to the substantial liquidity bonus enjoyed by federal bonds. Because of their large issue volumes and the very liquid futures market in "bund contracts", the latter are particularly suitable for the temporary "lodging" of investible funds. Hence the expansion of the yield spread between bank bonds and federal bonds is not indicative of a deterioration in credit terms, let alone of a "credit squeeze" in Germany. Nor does bank lending, which remains stable, suggest that either. Monetary conditions are not standing in the way of a continuation of the economic upswing.