

The economic scene in Germany in summer 1998

Overview

Economic conditions

In the spring of this year, the basic trend of the German economy continued to be pointed upwards, too. Although real gross domestic product, after adjustment for seasonal and working-day variations, was hardly higher in the second quarter of this year than in the preceding three-month period, this was largely an expected reaction to the strong economic growth recorded at the beginning of this year, which had been given added impetus not least by the mild winter weather and anticipatory effects resulting from the increase in value added tax. In order to eliminate such special factors, it is advisable to combine the first two quarters of this year. In the first half of 1998, overall economic output – after adjustment for seasonal and working-day variations – rose by just over 1 ½ % compared with the second half of 1997; it was thus around 3 % higher than in the same period of the preceding year.

Economic growth

According to surveys by the ifo institute, an optimistic attitude continues to prevail in the economy. On the whole, the high level of economic activity and enterprises' improved earnings position have had a positive impact on the economic climate. However, assessment of the future business outlook has recently become more guarded. This is likely to reflect the turbulences in the financial and foreign exchange markets which is especially gripping East Asia and Russia. Slumps in the equity markets may additionally have tended to dampen the outlook.

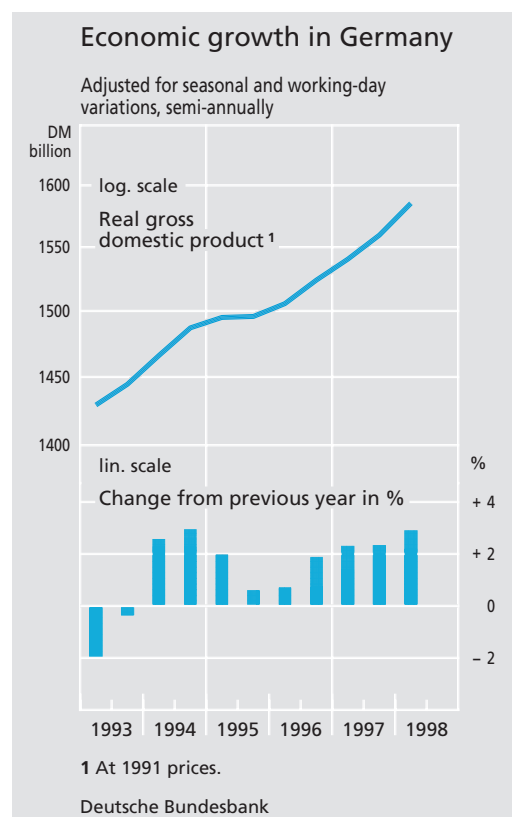
Attitude

Exports

Despite these detrimental influences and risk factors, exports of goods continued to fuel growth in the spring months of this year, too. Admittedly, East Asian business suffered considerable export losses; moreover, owing to the continuing drop in oil prices, the demand of oil producing countries has gone down, and in business with Russia, a visible slow-down seems to be taking shape, despite high year-on-year growth rates up to now. Yet in Europe, the main sales market of German exporters, and also in the USA – especially owing to the relatively strong economic growth recorded there – considerably more German products were sold; thus, overall exports of goods, seasonally adjusted, have risen considerably right up to the present.

Risks in
foreign
business

Export orders received are indicating, however, that the pace of exports is gradually slowing down. Since autumn of last year, the growth of foreign demand has been weakening noticeably. In the first half of 1998, the world economy perceptibly lost steam. The crisis regions themselves initially bore the brunt of this damper; besides, one must consider that there are relatively few direct trade links between Germany and East Asia/Russia. However, the accumulation of individual risks, the ever-persistent risk of contagion effects on other regions, and the indirect effects via the weakening demand in some industrial countries whose economies are more closely interlinked with the crisis countries, could also impair German export business – a fear which has already manifested itself in a worsening of export expectations, according to surveys by the ifo institute.



In order to contain the burden on the world economy, decisive action in the crisis countries is particularly necessary. In addition to stability-oriented fiscal and monetary policies, in particular structural reforms in the goods, labour and financial markets are required; it will only be possible to implement them if a stable political environment also exists. Financial external assistance – whether bilateral or provided by international organisations – can at best only complement or cushion a country's own measures, but by no means replace them. The causes of the crises need to be eliminated. This problem-solving process is likely to be more lengthy and painful for some countries than originally expected.

Reforms in the
crisis countries

The risks in foreign business contrast with improved basic trends in the domestic market,

Domestic
demand

even if, statistically speaking, the momentum has remained moderate up to now. In the period between April and July, new domestic orders received by industry remained just below their level of the first quarter of the year, during which, however, they had risen sharply due to bulk orders. They thus exceeded the previous year's figure by 4%, after having previously tended to be weak over a relatively long period of time. The enhanced economic activity is at the moment more broadly based than in 1997, when economic growth had been based in particular on the sharp rise in exports.

Investments

Enterprises' propensity to invest has continued to improve, even if in the spring months the corresponding expenditure – seasonally adjusted – lagged somewhat behind the high level at the beginning of the year. Compared with the same period of the preceding year, real investment in machinery and equipment rose by 7½% in the second quarter, after adjustment for working-day variations. In the first half of 1998, too, overall investment activity revived distinctly. According to surveys by the ifo institute, enterprises are planning to expand their investment distinctly in 1998. The fundamental conditions are favourable. Capacity utilisation continues to be high. Wage settlements in 1998 were once again moderate; the other cost trends remained muted. Thus, enterprises' profitability is likely to have continued its rise. Moreover, the low interest rates will probably promote new investment projects. Seen from a merely domestic point of view, following several years of muted investment, the opportunity for a continuation of the upswing in in-

vestment is quite present. However, it must remain unclear at this time whether and to what extent the recently rekindled risks for the world economy will have an impact on the propensity of German enterprises to invest.

Private consumption went back to a more uneventful stage in the last few months. However, this probably does not reflect a trend turnaround but is primarily a reaction to the preceding sharp rise in private consumption which reflected the increase in the standard rate of value added tax as of April 1. The slight improvement in the employment situation, the somewhat higher wage settlements vis-à-vis last year, and especially the achieved price stability perceptibly increased the purchasing power of households. The basis for an expansion of private consumption seems quite favourable, even if the cyclical stimuli emanating from consumption have up to now remained within narrow limits.

*Private
consumption*

Manufacturing output, as an average of the months between April and July, slightly exceeded the high level of the first quarter of 1998, after adjustment for seasonal variations. It was thus around 5% higher than the comparable figure of the previous year. In eastern Germany it even rose by 9% – a sign that many enterprises, following the long and sometimes painful process of modernisation, have become competitive now, both in the domestic markets and in international markets, as is borne out by the recent export successes.

*Manufacturing
output*

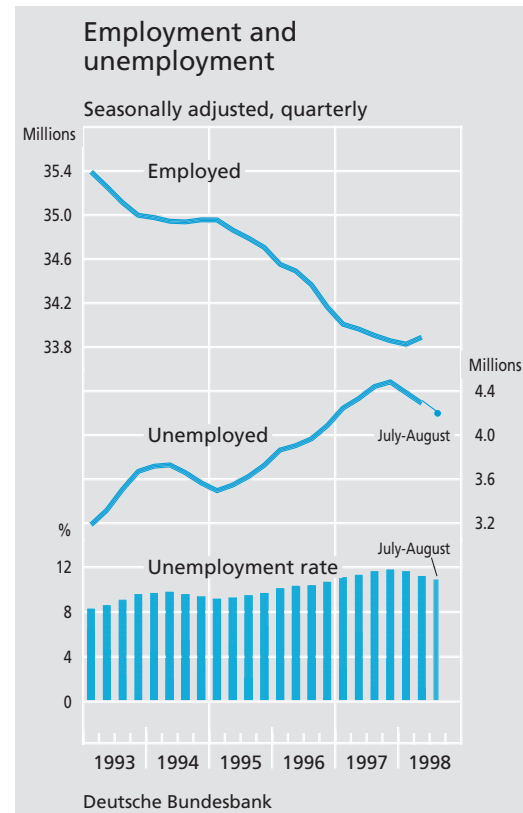
Construction

By contrast, the economic upturn continued to pass the construction industry by, on the whole. Output decreased markedly as of late, after having been fostered by the mild winter weather in the first quarter. However, the nadir seems to have been reached, and a gradual improvement seems to be taking shape. Public and industrial construction orders picked up. In western Germany, the demand for new one-family homes has remained relatively buoyant, too. By contrast, rented housing construction in eastern and western Germany has remained subdued despite stable construction costs and favourable terms of financing. Apparently the often large numbers of unlet properties in individual regions continue to depress the market.

Labour market

The labour market continued to ease, despite the persistently high unemployment. Over the course of the first half of 1998 – no further information is available yet – the number of persons employed rose by 100,000, seasonally adjusted. The number of unemployed persons went down by 320,000 between the beginning of 1998 and the end of August. At the same time, 90,000 additional vacancies were reported. The improvement in the labour market is due, for one thing, to the more favourable cyclical situation, with which – after exhausting fairly sizeable flexibility reserves – the demand for labour rose, particularly in western Germany. For another thing, labour market policy measures, the extent of which has increased sharply, particularly in eastern Germany, made an impact.

In order to create sustainable jobs that can survive competition, relying merely on con-

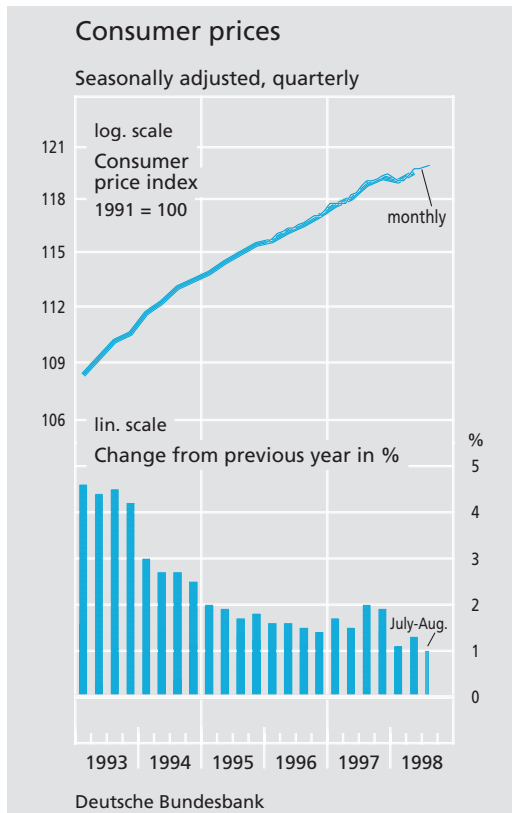


tinued economic growth will not suffice. In addition, it will be necessary to continue and intensify the structural adjustment measures which have already been introduced, with the wage bargainers taking on special responsibility alongside economic policy makers. At all events, the moderate wage settlements over the past few years, which also permit greater flexibility, have played an important role in re-improving locational conditions in Germany and thus laying the foundation for the present cyclical upswing. This path must be maintained in order to provide enterprises with reliable underlying conditions for investment and thus for the creation of new jobs in the long term, too.

Wage bargainers' responsibility

The calm price trend continued throughout the spring and summer. The consumer price

Prices



index was just 0.8% higher in August 1998 than a year ago. It is true that some special effects played a role here, including the now no longer existing effect from the rise in contribution payments to prescription medicines as from July 1997 and the sharp drop in the prices for heating oil and petrol. However, the rise in consumer prices also includes an increase in the standard rate of value added tax from 15% to 16%. Overall, the statistically recorded rate of inflation is likely to slightly understate the momentary fundamental trend. However, the objective of price stability remains virtually achieved – especially when considering the statistical measurement problems when recording the prices.

It is surely true that in individual sectors (particularly manufacturing) prices have gone down. However, as long as prices continue to rise in other sectors (such as the services sector), this – in the light of the necessary flexibility of individual prices in a market economy – cannot be called deflation. Deflation means a cumulative downward movement of the price level, which then perpetuates itself in an increasingly violent contraction of economic activity. Given a statistically measured consumer price inflation rate of just under 1% and a rate of economic growth that, according to most forecasts available for 1998, will exceed the rise in production potential, neither situation exists, nor are they to be expected at present. Rather, the achieved high degree of price stability in Germany (and Europe) creates a welcome counterweight to the aforementioned risks for the world economy. It promotes low interest rates and favourable terms of financing, facilitates the continuation of a moderate, employment-oriented wage policy, stimulates the purchasing power of households despite relatively low nominal wage settlements, and supports the necessary path of consolidation being taken by the public sector. In monetary policy terms, it is necessary to secure the success achieved in stability, in the interests of a continuing and justifiable pace of economic growth, as well as the highest level of employment possible, and to create favourable starting conditions for the euro.

No deflationary tendencies

Occasionally the presently calm price trend is already equated with deflationary tendencies.

Fiscal and monetary policies

*Public sector
budgets in
the second
quarter...*

The financial position of the central, regional and local authorities improved distinctly in the second quarter of the year, compared with the same period last year. The Federal Government and the Länder Governments (including the special funds) recorded a surplus of DM 6 billion, whereas a year ago they had run up a deficit of DM 17 billion. The turnaround in the second quarter is due mostly to the extraordinarily large profit transferred by the Bundesbank, which rose against the previous year from DM 15½ billion to DM 24 billion. In addition, tax revenue rose sharply, too, due to the increase in turnover tax and enterprises' improved earnings position. The fact that public spending rose only slightly overall owing to the continuation of retrenchment policy measures had a similar effect.

*...and over
the entire
year of 1998*

For the entire year of 1998, it appears that the budget deficits of the central, regional and local authorities will decrease by a considerable margin compared with the previous year. For one thing, temporary factors such as a high level of receipts from privatisation and the aforementioned profit transfer by the Bundesbank played a role. Another thing is that tax revenue – now more closely in line with the official tax estimates, as opposed to the previous years – is likely to increase distinctly, not least because the existing erosion of the tax base is gradually weakening. On the expenditure side, too, no particular risks can be recognised at present. Sufficient provision seems to have been made for unemployment payments and the extension of labour

market policy measures. As defined by the Maastricht Treaty, in which sales of participating interests are not relevant to balances, the government deficit for 1998 is likely to fall to just under 2½% of GDP (compared with 2.6% in 1997).

According to plans and declarations of intent up to now, the total government deficit for 1999 could well decline further to around 2% of GDP. As far as expenditure goes, a continuation of the previous retrenchment policy is assumed. Tax revenue is likely to increase somewhat faster than nominal economic growth. That means the government sector will once again come closer to the medium-term objective of a balanced budget, as is set forth in the Stability and Growth Pact, but will not have reached it yet.

*Prospects
for 1999*

Fiscal policy makers are faced with two major tasks. One will be to continue to make further reductions in the government deficit, not least to create room for manoeuvre in order to cushion "exogenous shocks" or other regional disparities in the early stages of European monetary union. Another is that the excessive burden of taxes and social security contributions must be reduced in order to improve Germany's locational conditions. Such a two-pronged strategy will continue to require strict discipline in spending, too; the spending ratio (in terms of GDP) must be reduced even more sharply than the taxes and social security ratio. It is true that for some time now, the right fiscal policy course has been set. Over the past two years, the government spending ratio – adjusted for the conversion of child benefit to a tax-reducing

Fiscal strategy

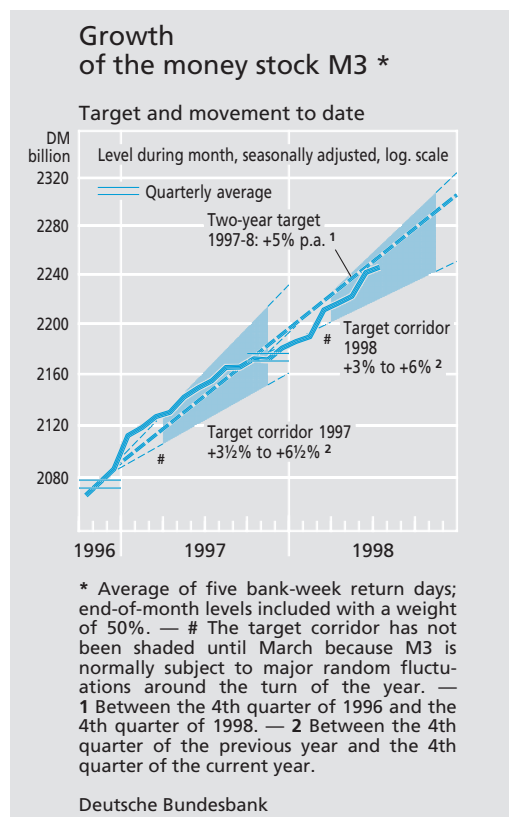
factor – has gone down by one and a half percentage points to 49 %. However, government spending (and also public sector deficits) – as a percentage of GDP – are still visibly above the corresponding figure at the end of the eighties, prior to German unification. Further efforts are necessary to place fiscal policy on a lastingly stable basis which can sustainably promote private economic activity.

Steady interest rate policy

During the summer months the Bundesbank maintained its “steady-as-she-goes” policy in the money market. It left the discount and lombard rates at 2 ½ % and 4 ½ %, respectively, and continued to offer weekly securities repurchase agreements at the fixed rate of 3.3 % in effect since October 1997.

Monetary growth consistent with the target

The steady interest rate policy was in line with the monetary and macroeconomic situation. The objective of price stability has currently been virtually achieved both in Germany and in EMU as a whole. Neither particular inflationary dangers nor deflationary risks are to be expected in the immediate future. This also holds in the light of the crises in East Asia and Russia and the associated uncertainty in the financial markets. As in the past, monetary growth remained within the corridor sought by the Bundesbank. In July, the money stock M3 surpassed its average level of the fourth quarter of 1997 by a seasonally adjusted annual rate of 5.0 %, and was thus in this year’s target corridor of between 3 % and 6 %. Compared with the fourth quarter of 1996, M3 rose at an annual rate of 4.8 % up to July. In the future EMU countries, the monetary dynamism is current-



ly strong, on the whole. The Bundesbank will continue to monitor the monetary and macroeconomic situation in the entire euro area carefully in the coming months.

In Germany, monetary expansion was once again encouraged by slackening monetary capital formation in the last few months. In the light of the low capital market rates, which continued their slide, the propensity of non-banks to invest in long-term financial assets with domestic banks remained low. However, lending by banks to the private and public sectors had a lesser impact on the process of money creation. The fact that the banks reduced their stock portfolios markedly after the sharp rise in the spring had a decisive impact on lending to enterprises and individuals. The public sector’s borrowing re-

quirements were reduced by the large profit transferred by the Bundesbank to the Federal Government in May.

*Decline in
capital market
rates*

German capital market rates sank to new all-time lows in the summer months. The yield on domestic bonds outstanding fell to just over 4% by September 10, 1998. The slide in interest rates was particularly noticeable on the long end of the maturity spectrum. The yield curve in the bond market therefore flattened further. These interest rate movements are particularly a reaction to the crises in East Asia and Russia, the repercussions of which led to a shifting of financial resources to "safe havens". Particularly Russia's moratorium in August apparently led to a reassessment of credit risks in emerging economies and countries in transition and to an expansion of international "interest rate spreads". Moreover, the continuing crises in Asia put a damper on worldwide cyclical and price expectations. The falling interest rate level and the further flattening of the yield curve are therefore also likely to be a reflection of a more favourable assessment by market players of the long-term stability prospects.

*Terms of
financing
favourable*

In step with capital market rates, the effective rates for long-term bank loans have recently also dropped to new all-time lows. For example, in August, mortgage loans secured by residential real estate with interest rates locked in for five or ten years cost slightly less than 5½% and just over 5¾%, respectively. Real capital market rates are also at a relatively low level. Therefore, the terms of financing for the economy are exceptionally favourable at present.

Central bank interest rates and financial market prices

Monthly averages



1 Average monthly interest rate for securities repurchase agreements at two weeks' maturity. — 2 Yield on Federal securities outstanding listed in the stock exchange. — 3 CDAX share index. — ● = Latest position: September 10, 1998.

Deutsche Bundesbank

*Sharp course
corrections in
the equity
market*

In the equity market, the worsening situation in East Asia and Russia caused sharp course corrections. Measured against the CDAX, quotations fell by 21% between mid-July and September 10, 1998. Admittedly, this fall must also be seen against the backdrop of the preceding upsurge in equity prices. To that extent, therefore, it represents a certain return to normalcy. On September 10, the quotations were still 10% higher than at the end of 1997. In the light of the fact that the

equity market plays a relatively minor role in corporate financing and financial asset formation by households, the immediate effects of the price falls on economic growth are likely to be small. In order to stabilise confidence in the financial markets, the best contribution monetary policy can make is to provide stable monetary underlying conditions which give economic agents a clear long-term orientation and thus help avoid uncertainty and volatility.