The economic scene in Germany at the turn of 1998–9

Overview

Economic conditions

Gross domestic product

Economic activity slackened in the autumn of last year. According to the information available so far, real gross domestic product in the fourth quarter of 1998 is unlikely to have matched the figure for the previous quarter in seasonally adjusted terms. Although real GDP in the fourth quarter of 1998 was distinctly higher than in the same period of 1997, the rate of growth (after adjustment for variations in the number of working days) – at 2 % – was smaller than the rate of expansion of output achieved on an average of the first three quarters (almost 3 %). The retarding forces were particularly pronounced in the manufacturing sector, where output fell for the first time after nearly two years of vigorous growth.

Business sentiment

A certain deterioration in business sentiment had already begun to emerge during the summer. According to the surveys conducted by the ifo institute, the assessment of the business situation and business expectations worsened further up to the end of the year. New orders received by industry were unable to match the high level achieved previously; capacity utilisation declined.

Risks for economic growth

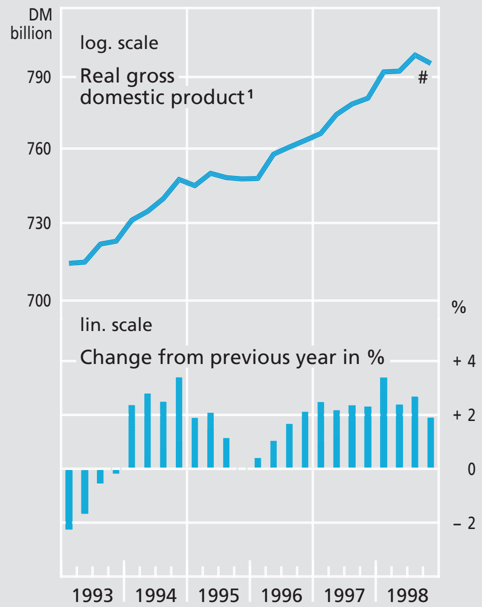
One reason for the growth losses was the downturn in demand in the crisis-ridden regions of the world. In contrast to the trend in the first half of 1998, Germany and Europe in general were less and less able to decouple themselves from the risks and strains in the global economy. Another reason, however, was the increased uncertainty surrounding the prospects for the economy and the perspectives for economic policy in Germany. The lack of clarity concerning future cost and tax burdens may be causing some enterprises to defer new investment projects. At the moment, however, it is not possible to say whether the recent downturn in growth merely constitutes a temporary interruption of a continuing upward economic trend. Although the uncertainty has increased, the underlying economic setting – in particular following the implementation of rationalisation and restructuring measures – appears to be sufficiently robust to prevent a slide into recessionary tendencies. The services sector, notably, is continuing to act as a mainstay of overall economic output.

Foreign business

In contrast to the situation in the first half of 1998, the foreign business of German enterprises provided no impetus for growth in the recent period. Exports declined from the third to the fourth quarter in seasonally adjusted terms. The volume of orders gained by domestic industry from customers abroad has likewise decreased perceptibly; it is now lower than at the corresponding stage of last year. However, this is not a reflection of a deterioration in the competitiveness of German products on foreign markets caused by exchange rate movements; towards the end of 1998, the real external value of the Deutsche Mark against the currencies of the 18 most important industrial countries was consistent with its multi-year average. The fall in exports is due rather to the accumulation of disruptions in global economic growth. Exports to south-east Asia, Japan, Russia and to the OPEC countries, whose foreign exchange earnings have dropped appreciably in the wake of the slump in oil prices, were substantially below their corresponding levels a year earlier.

Economic growth in Germany

Adjusted for seasonal and working-day variations, quarterly



1 At 1991 prices. — # Fourth quarter: Bundesbank calculation.

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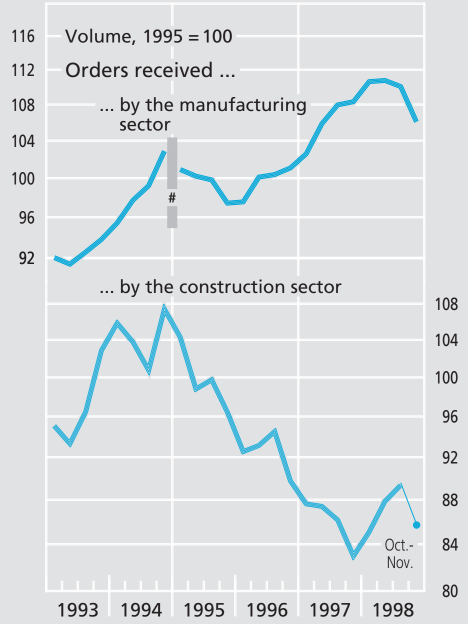
While the economic situation appears to be gradually improving in some crisis-ridden Asian countries such as Korea and Thailand, the economic problems in Russia and, to some extent, in Latin America, too, have grown more acute. The IMF has made several downward revisions of its forecasts for world economic activity in rapid succession. Initial calculations indicate that global output expanded by no more than 2 ¼ % in 1998, compared with 4 ¼ % in each of the two preceding years. The rate of growth of the volume of world trade declined from 10 % in 1997 to just 3 ½ %. As a country that is strongly export-oriented, Germany was

Trends in demand

Seasonally adjusted, quarterly, log. scale



Not fully comparable owing to the reorganisation of the statistics.

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unable to buck this trend, with more than one-tenth of German exports being accounted for by the regions currently in crisis. By contrast, German exports to its EMU partner countries held up fairly well. Their share in overall goods exports comes to 44 %. The German economy's integration into the single European market dampened the effect of the external disruptions.

Domestic demand

In the autumn of 1998 – in contrast to the situation in the first part of the year – the overall weakening impetus of foreign business was not entirely offset by the momentum of domestic growth. In fact, orders received by industry from domestic customers fell markedly in seasonally adjusted terms. Hence the economy's recent development has not followed the "conventional pattern" of a cyclical upswing in Germany where recovery begins with a sharp expansion of exports and then – buoyed by the associated improvement in capacity utilisation – spreads to domestic demand in a second step.

Capital formation

Capital formation, in particular, has lacked dynamism so far. Although investment in machinery and equipment increased by about 7 % in the fourth quarter of 1998 compared with the same period in 1997, it showed virtually no increase over the third quarter of 1998 after eliminating seasonal fluctuations. The level of orders received by capital goods producers from domestic customers actually fell of late. Many enterprises may be delaying their investments, firstly, because they are worried that, following some years of wage restraint, excessive pay settlements may now be agreed and, secondly, because many firms are anticipating a heavier tax burden – at least in the short run. It is true that there has been a substantial overall rise in corporate profits over the past few years, a fact which, together with the favourable financing terms, might be expected to facilitate a sustained revival in capital formation. However, firms' investment decisions depend not only on past profitability trends but also, in particular, on the future outlook for earnings. Reliable prospects of wage agreements that do not place an excessive burden on enterprises and of a decline in the level of corporate taxation (which in many instances is high by international standards) could contribute greatly to brightening the investment climate.

Construction

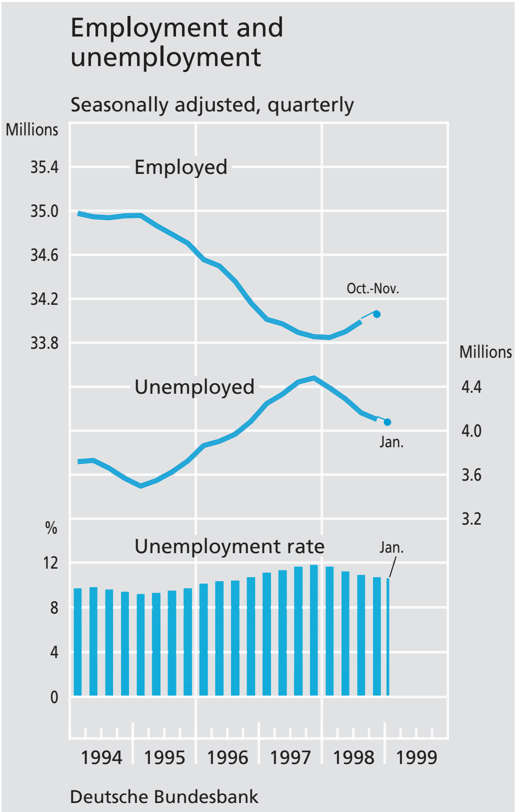
To date the construction sector has been a weak link in the cyclical chain. The slight revival in construction demand which persisted until the summer has not been maintained. In the field of residential construction, in particular, the level of orders fell further. While there is a continuing demand for owner-occupied one-family homes, the situation in the rented housing construction segment remains subdued, despite stable building costs and the very low mortgage rates. Some new dwellings remain vacant, thus tending to oblige owners to offer rent discounts in order to attract tenants. Nor have any cyclical stimuli been imparted by industrial and commercial construction measures – except for individual large-scale contracts commissioned by the German railways and post office – or by public sector construction orders. The construction sector in eastern Germany, in particular, remains in a difficult phase of adjustment following the end of the unification-related building boom.

Private consumption

By contrast, private consumption currently provides a certain ray of hope in assessing cyclical developments. In the fourth quarter consumption by households is likely to have increased by around 1% compared with the previous quarter, after adjustment for seasonal factors and the different number of working days. This higher consumption was funded not only by a rise in disposable income but also in part by a further drop in the saving ratio. In contrast to the assessment of the situation in the manufacturing sector, consumer expectations have actually improved. The rise in the level of employment in the course of the past year, the increase in purchasing power caused by the decline in energy prices and tax savings resulting from the lowering of the solidarity surcharge and the raising of the income tax payment threshold boosted the propensity to consume, especially as the persistent decline in the inflation rate meant that pay increases were not being "consumed" by price rises. The increase in value added tax which came into force on April 1, 1998 had a comparatively small negative impact. However, the saving ratio, which has now fallen to historically low levels, and the rather hesitant flow of orders to consumer goods producers from the wholesale and retail trade of late also show that private consumption is subject to certain risks, even though it appears fairly robust at present. It could be bolstered, in particular, by the adoption of wage and tax policies conducive to promoting employment which would lead to increased investment, thus creating jobs as well as disposable income for consumption.

Labour market

The recent slackening of economic activity has had no noticeable effect on the labour market to date. There was a further rise in employment into the autumn months. In November, the latest month for which figures are available, the number of employed was 175,000 greater than a year earlier. The seasonally adjusted number of unemployed showed no further fall towards the end of 1998 and in fact increased slightly. However, this was due mainly to the early onset of winter weather and to the slight reduction in job-creation schemes and vocational training measures, especially in eastern Germany. In January there was a further seasonally adjusted fall in unemployment, largely as a result of the comparatively mild weather; seasonally



adjusted, 10.6 % of the total labour force were jobless in that month.

Adequate economic growth and a corresponding level of domestic demand are undoubtedly major prerequisites for making headway in combating unemployment. With the objective of price stability having been virtually attained, monetary policy has made a substantial contribution to improving the underlying conditions for growth. A crucial additional requirement, however, is to tackle the structural causes of unemployment. According to calculations made by major international organisations and by national research institutes, the structural components of unemployment are far more significant than the purely cyclical factors. A successful employment policy therefore has to deal with the root-causes of unemployment. That is the essential yardstick by which to judge the national and European initiatives which have been under discussion for some time.

Prices

The price climate in Germany remained favourable. The year-on-year rate of increase in the consumer price index around the turn of 1998-9 amounted to no more than 0.5 %. This means that price stability has virtually been achieved. Furthermore, no particular inflationary dangers are discernible in the period ahead. Nor can there be any question of deflationary risks. Admittedly, the official statistics probably tend to overstate the rate of price increases somewhat, above all owing to the difficulty of making due allowance for changes in the quality of goods. However, the margin of error in measuring inflation, which a recent Bundesbank study put at up to ¾ percentage point, cannot simply be equated with a precise figure of 0.75 percentage point which is to be deducted automatically from the current official rate of inflation – an approach which some commentators have taken. Any attempt to eliminate by scientific means the statistical inaccuracies which constantly and inevitably occur should not and must not entail applying an adjustment factor to the official statistics each month.

The strong external influences on the inflation rate should likewise be taken into account when discussing alleged deflationary tendencies. Imported goods were 6 % cheaper in December 1998 over twelve months, notably on account of the fall in oil prices. This implies that the underlying inflation rate is currently somewhat higher than the official

Price movements

1991 = 100, seasonally adjusted, log. scale

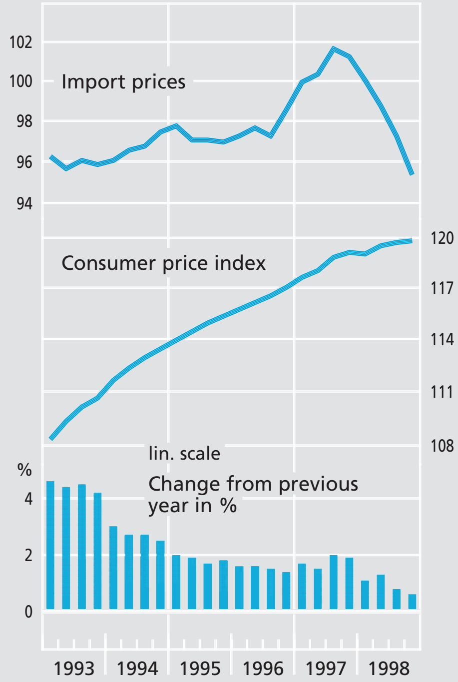


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figure for the rate of price increases at the consumer level.

The Harmonised Index of Consumer Prices in the European monetary union was 0.8 % higher in December 1998 than a year before. Hence the trend in prices is fully in line with the stability-oriented target of the Eurosystem. The need now is to ensure that this favourable development is sustained.

Fiscal and monetary policies

Public sector in the fourth quarter of 1998 ...

The financial trend of the public sector continued to improve in the fourth quarter – just as it had done in the preceding part of the year. This applies particularly to the Federal Government, which recorded a surplus of DM 4½ billion. By contrast, it had recorded a deficit of the same magnitude in the fourth quarter of 1997. The tax receipts of the central, regional and local authorities remained quite abundant, growing by 5½ %. These were supplemented by substantial proceeds from the sale of assets. On the expenditure side, the central, regional and local authorities pursued a policy of retrenchment. Of the social security funds, the statutory pension insurance fund closed the year with a more favourable financial result than in 1997. By contrast, the Federal Labour Office was running a higher deficit on account of the significant increase in active labour market policy measures.

... and in 1998 as a whole

In 1998 as a whole the deficits sustained by the central, regional and local authorities declined considerably. They decreased by an estimated one-third to a level of DM 65 billion. It should be pointed out, however, that a major role was played by the substantial privatisation proceeds and the sharp increase in the Bundesbank's profit due to the revaluation of Germany's foreign exchange reserves. But a marked improvement in the public finance situation is also shown in the fiscal balance as defined in the national accounts, in which a large part of these one-off receipts is disregarded. After including the social security funds, which likewise fared somewhat better than in 1997, the general government deficit ratio, as defined in the Maastricht Treaty, declined from 2.7 % to 2.1% according to provisional calculations made by the Federal Statistical Office. This was due in part to the sharp recovery in tax revenue, which was principally attributable to the sizeable growth of assessed tax receipts in the wake of the favourable trend in corporate profitability in the past few years. This effect was strengthened by a tight curb on expenditure which, at 1½ %, rose at a slower rate than gross domestic product; as a result, the general government spending ratio decreased by 1 percentage point to 48 %.

Outlook for the current year

The reduction in the deficits is unlikely to continue in the current year, however. On the one hand, a further appreciable increase in tax revenue may be expected, partly as a result of the planned higher taxation of energy consumption. On the other hand, social security contributions are likely to grow only marginally, not least because the contribution rate to the statutory pension insurance scheme is to be cut from April by 0.8 percentage point to 19.5 %. Finally, a somewhat greater rise in expenditure is to be expected. The new Government's draft Federal budget for 1999 – like the original plan drawn up by its predecessor – envisages a deficit of almost DM 56½ billion, which roughly equals the actual shortfall recorded in 1998.

Medium-term orientation of fiscal policy

The medium-term aim of fiscal policy is to resume the process of reducing the deficits which will probably be interrupted in the current year. Thus the stability programme which the Federal Government recently presented envisages a perceptible cut in the general government spending ratio so as to create scope for bringing down the deficit-to-GDP ratio (as defined in the Maastricht Treaty) to 1% in the year 2002 and for lowering the government levy ratio. This route to a sustained consolidation of public finance, which is prescribed by the Stability and Growth Pact for all the countries in the single currency area, should be followed even if unexpected additional burdens arise. The sooner a fiscal position close to balance or in surplus is reached, the sooner fiscal policy will be able, via the built-in stabilisers, to smooth out disruptions in national economic growth without jeopardising the long-term sustainability of public finance.

Coordinated interest rate cut in December

At the beginning of December the Bundesbank cut the interest rate for its fixed-rate securities repurchase agreements up to the end of December 1998 from 3.3 % to 3.0 % as part of a coordinated interest rate reduction within the European System of Central Banks. This move effectively set the initial level for the corresponding ECB interest rate for the start of Stage Three of EMU on January 1, 1999.

Transfer of monetary policy to the Eurosystem

At its meeting on December 22, 1998, the Governing Council of the ECB formally set the interest rate applying to the first main refinancing operation in 1999 at 3 % and reaffirmed its intention to adhere to this central rate for the money market for the foreseeable future. Consequently, all main tenders so far have been offered at this fixed rate. The terms were announced in advance in each case in order to stabilise market expectations. On December 22, 1998 the ECB Governing Council also defined the interest rates for the two standing facilities which form the interest rate corridor for the overnight money market. It set the marginal lending rate at 4.5 % – this matched the Bundesbank's former lombard rate – and the rate for the deposit facility at

2.0 %. For the first three weeks of operation of Stage Three the Governing Council narrowed the corridor to 50 basis points (2.75 % to 3.25 %) so as to make it easier for market participants to adjust to the new money market environment in the monetary union and to avoid undesirably large interest rate fluctuations in the overnight money market. In view of the continuing progress towards the integration of the national money markets and in the settlement of cashless cross-border payments, this transitional arrangement was terminated on January 22, 1999 as scheduled. The initially rather high level of utilisation of the marginal lending and deposit facilities in early January declined considerably and of late has been confined to frictional amounts. The overnight interest rate has settled, amid moderate fluctuations, at about 10 to 15 basis points above the tender rate.

Monetary developments...

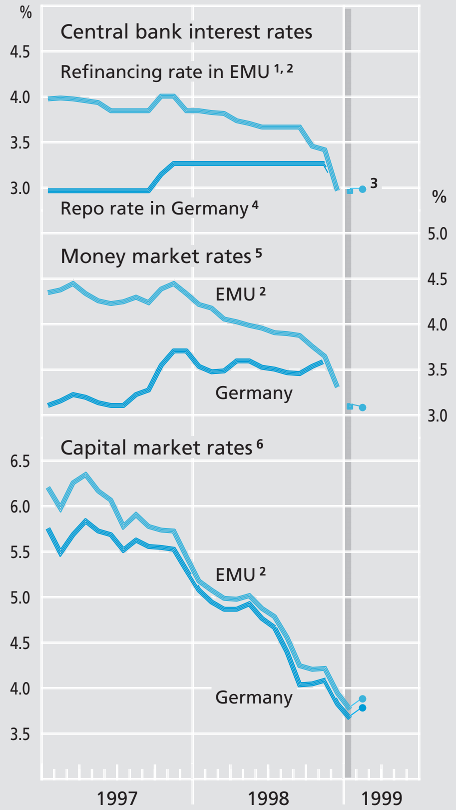
Time deposit rates fell perceptibly around the turn of 1998-9; there was a slightly inverse yield curve in the money market at the end of the period under review, which indicates that market players are expecting interest rates to be cut. In fact, however, the monetary policy

... in EMU

setting suggests that a steady-as-she-goes interest rate policy would be appropriate. The overall price outlook in the euro area remains favourable. As mentioned above, neither inflationary nor deflationary tendencies are discernible for the immediate future. The money stock M3 is growing in line with the target of the Eurosystem. In December 1998 the broadly defined monetary aggregate M3 in the euro area was 4.5 % higher than in December 1997, while on average during the months October to December it expanded by

Interest rate movements in Germany and EMU *

Monthly averages



* Excluding Luxembourg. — **1** Average of the principal refinancing rates. — **2** GDP--weighted. — **3** Interest rate for main refinancing operations of the Eurosystem. — **4** Interest rate for securities repurchase agreements with a maturity of two weeks. — **5** Interest rates for three-month funds, from January 1, 1999 quotation for EURIBOR. — **6** Government bonds with a residual maturity of around 10 years. — • = Latest position: February 12, 1999.

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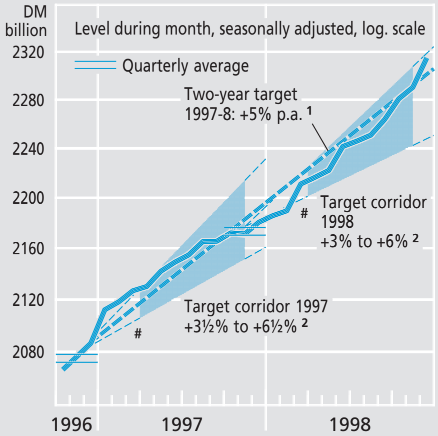
a year-on-year rate of 4.7 %. This pace of growth virtually equals the reference variable of 4½ % which the ECB Governing Council considers to be consistent with the objective of monetary stability. Given the quite muted price and economic trends in the euro area, the current provision of money to the economy appears to be appropriate and poses no obstacle to overcoming the cyclical weakness.

many was due to a low level of monetary capital formation and, more especially, to higher lending, although the latter owed something to special factors – such as changes in tax allowances for capital investment projects in eastern Germany – and to that extent should not be regarded as constituting a reversal in trend.

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 the previous year and the fourth quarter of the current year.

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... and in Germany

The same is true of the liquidity position in Germany, where the rate of monetary expansion accelerated distinctly towards the end of last year but remained within the target range set by the Bundesbank. In December the money stock M3[1] exceeded its average level in the fourth quarter of 1997 by a seasonally adjusted annual rate of 5.9 %. Over the fourth quarter of 1998 as a whole M3 was 5.6 % up on the same period in 1997. Between the fourth quarter of 1996 and the fourth quarter of 1998 it increased at an annual rate of 5.1%. Hence the monetary growth target of between 3 % and 6 % set for 1998 was achieved, as was the longer-term objective for monetary expansion in 1997-8, according to which the money stock was to grow by about 5 % in both of those years. The faster monetary expansion in Germany was due to a low level of monetary capital formation and, more especially, to higher lending, although the latter owed something to special factors – such as changes in tax allowances for capital investment projects in eastern Germany – and to that extent should not be regarded as constituting a reversal in trend.

Capital market developments

Capital market rates had fallen to new record lows by the end of January. Subsequently they rose a little. When this Report went to press, the yield on domestic bonds outstanding was around 3¾ %. In the other EMU member countries long-term interest rates were barely any higher. The decline in interest rates was prompted both by the growing indications of a cyclical slowdown and by the coordinated interest cut undertaken by the EMU central banks in December. An additional factor was the uncertainty in the international financial system engendered by the crisis in Brazil which triggered a renewed shift into "safe havens". Interest rates declined more sharply in the EMU member countries than in the United States; this is accounted for by the fact that they are at different stages in the business cycle. The yield spread of the US capital market widened to more than 1 percentage point.

The low nominal interest rates along the entire maturity range are conducive to encouraging growth and employment. In real terms, too, interest rates are relatively low. If capital

1 The money stock M3 which was calculated for Germany up to the end of 1998 was defined somewhat more narrowly than the euro aggregate of the same name. Specifically, it did not contain money market fund certificates.

market rates – which are important for investment decisions – are adjusted for the current rate of price increases at the consumer level, the resultant "statistical" real interest rate of around 3 % is more than 1 percentage point below the average level for the past 20 years. If, for the purpose of determining the real interest rate, the current inflation rate is replaced by long-term inflation expectations – a more important yardstick for investment calculations which project into the future – as ascertained from surveys conducted among market participants, the more meaningful "expected" real interest rate thus calculated comes to roughly 2 %. Capital market rates as low as that undoubtedly create propitious financing conditions for investment. However, they are no substitute for favourable earnings prospects and planning certainty.