The economic scene in Germany in summer 1997

Overview

Economic conditions

Economic growth

The economic upswing in Germany gathered momentum in the spring months of 1997. After adjustment for seasonal and working-day variations, real gross domestic product increased by 1% in the second quarter compared with the first three months and by 2 % compared with the same period last year, again after allowing for the different number of working days. Moreover, the first data available for the period beyond the spring quarter – such as the figures on the output of, and new orders received by, the manufacturing sector in July – indicate a continuation of the vigorous economic growth. According to the surveys conducted by the ifo institute, a majority of respondents rated business confidence optimistically, for the first time since autumn 1995, and their expectations regarding output levels were likewise more favourable.

Current account

The economic upswing continues to be fuelled principally by exports. Since the beginning of 1996 they have expanded substantially from quarter to quarter; in the second three months of 1997 they grew by almost 14 % in real terms compared with the level twelve months previously. As imports have not been growing at an equally rapid pace, a remarkable turnaround has occurred on balance in the current account. For the first time since reunification, Germany ran an (admittedly marginal) surplus on current account with non-residents after seasonal adjustment, following six years of regular and sometimes sizeable deficits.

Exports

The persisting buoyancy of foreign business is largely due to the fact that the growth trends on important sales markets for German exporters have continued or even strengthened. Given contracting capacity reserves in those countries, the demand for imported products has increased all round. In addition, German suppliers appear this year to have regained market shares which they had previously lost. At all events, German exports have risen far more strongly than real world trade, the growth of which for the year 1997 is estimated at roughly 7 % to 8 % by the major international organisations. That suggests that German industrial goods are competitive in terms of both price and quality. The high level of German direct investment abroad may have contributed to these sales successes, particularly inasmuch as they helped to tap new markets. But the principal reasons were probably that the last wage settlements were again moderate on the whole, that enterprises have undertaken considerable rationalisation efforts in Germany and that the effect of the resulting cost reductions has been reinforced externally by the appreciation of major currencies, especially of the US dollar.

External value of the Deutsche Mark

The real external value of the Deutsche Mark against the currencies of the 18 most important industrial countries declined substantially up to the beginning of August; it thereby more or less regained the level that it had reached at the end of the eighties. During the summer months the Deutsche Mark appears to have lost more ground in the foreign exchange markets than was warranted by the current economic fundamentals. On the one hand, the boost which the German currency's depreciation undoubtedly gave to foreign business was welcomed by many firms. On the other hand, the appreciation of the US dollar, in particular, increased the danger of importing inflation, not least via the higher cost of imported energy. In the course of August the Deutsche Mark again attracted more positive valuations in the foreign exchange market; previous excessive movements were corrected in part. Nevertheless, by the time this Report went to press, the Deutsche Mark had recorded a real depreciation of over 4½ % on a weighted average since the beginning of this year.

Domestic demand

In addition to foreign business, domestic demand has meanwhile picked up, too. New orders received by the manufacturing sector from domestic clients have risen continuously since the start of the year, with orders for intermediate goods particularly to the fore. All in all, the economic upswing is now more broadly based, even if the momentum in the domestic markets is not yet very pronounced.

Private consumption

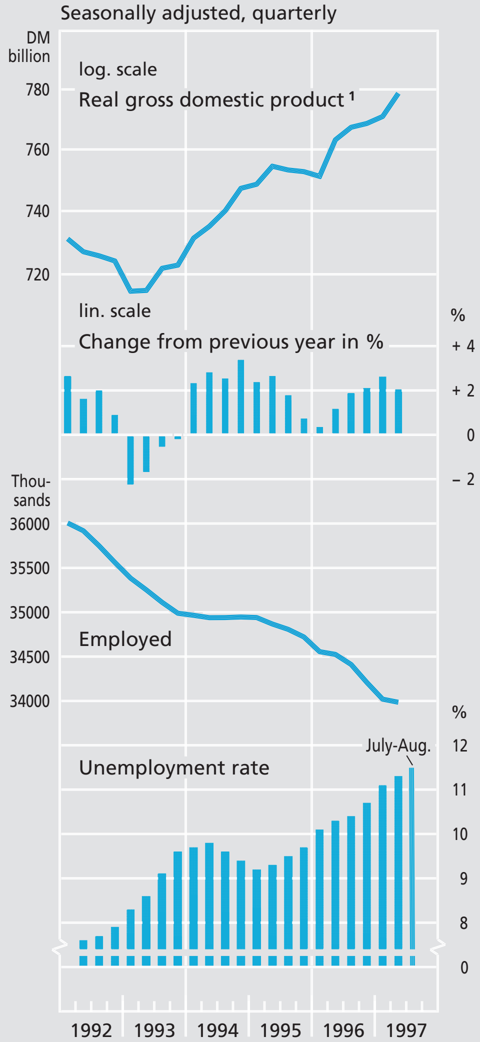
It was notably private consumption which revived in the spring months; after adjustment for seasonal and working-day variations, in real terms it was 1½ % higher in the second quarter than in the first three months of the year. It remains to be seen, however, whether this represents a lasting change for the better. At any rate, households' financial leeway for additional consumer spending remained slight, in no small measure owing to the fact that the number of employed continued to decrease up to the end of the period under review – albeit at a slower pace. On balance, the higher private consumption in the second quarter was partly "financed" by a decline in saving. The crucial prerequisite for a sustained recovery of consumption is a higher level of domestic investment; that will create additional jobs, which, in turn, will raise the volume of disposable income.

Investment

To date, however, no fundamental tendencies towards increased investment have been evident. Despite the distinctly higher levels of utilisation, the available technical capacity apparently suffices to satisfy the increased demand. Considerable new production capacity has been created in eastern Germany, in particular – not least because of generous government incentives – and is being utilised only gradually in the course of economic expansion. The underlying conditions for investment are quite favourable. Corporate profits are likely to have increased further in the context of moderate wage settlements, high productivity increases and low interest rates. But these trends towards improvement are perhaps not yet generally regarded as being sufficiently assured. What is more, the political uncertainty surrounding important reform projects may be causing potential investors to adopt a wait-and-see attitude. Greater clarity concerning the longer-term outlook in respect of wage, fiscal and structural policies could contribute decisively to boosting the propensity to invest and thus – in keeping with the pattern of previous recovery phases – to "igniting" the second stage of the upswing, following the initial stimulus supplied by exports.

Output and labour market

Seasonally adjusted, quarterly



1 At 1991 prices, additionally adjusted for working-day variations.

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Construction

The construction sector is still in a business cycle of its own. Although the demand for construction work appears to have stabilised in the second quarter, it is still running at a low level following the sharp slump towards the end of 1996 and in the first few months of 1997. Few construction orders have been forthcoming from industrial and commercial clients, in particular – mirroring enterprises' reluctance to extend their capacities. The level of housing construction in eastern Germany fell dramatically following the curtailing of government incentives and signs of market saturation in the wake of the preceding construction boom. In western Germany apartment house construction was likewise cut back; the demand for one-family homes, by contrast, remained comparatively high. All in all, the construction sector is undergoing a – doubtless unavoidable – process of restructuring, a fact which is also indicated by the depressed prices in parts of the real estate market. It is unlikely that this sector will provide any positive economic stimuli in the foreseeable future.

Labour market

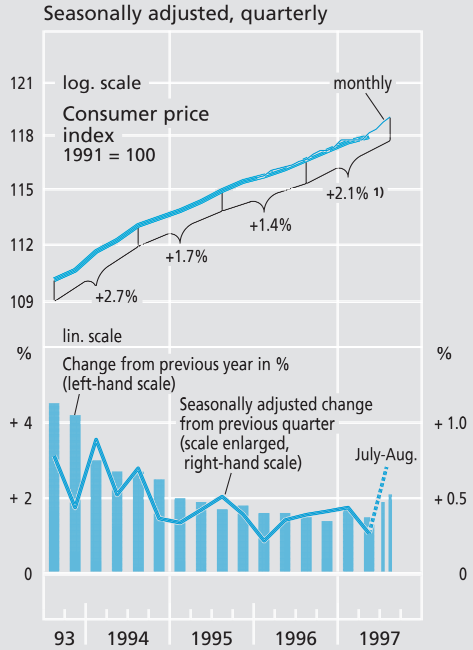
The cyclical recovery, which is quite considerable on balance, has not yet had any appreciable effect on the labour market. Employment seems to be stabilising in the services sector and also (albeit at a low level) in the construction sector. Among industrial firms, on the other hand, the reduction of personnel has continued right up to the present. At 34 million, around 530,000 fewer people were employed in Germany at the end of June than one year previously. By the end of August, the number of unemployed had risen by 470,000 over twelve months to nearly 4.4 million. Whereas in western Germany the demand for labour did not fall further in the summer months and the seasonally adjusted unemployment rate was unchanged, in eastern Germany the officially registered number of jobless persons rose appreciably. This was due not only to the serious adjustment problems which continue to beset many east German firms, but also in part to the fact that the Federal Labour Office curtailed its labour market policy measures under the impact of the high deficits. The number of participants in job creation schemes and vocational further training programmes decreased markedly.

If the unacceptably high level of unemployment is to be reduced decisively, it is crucial to create jobs that will be lastingly competitive. That necessitates gearing wage policy to the objective of higher employment on a longer-term basis, too, and introducing further measures of flexibility into the labour and goods markets. Advantage should be taken of the present upswing to dismantle the persisting structural rigidities and obstacles to employment. Despite the strong export growth and the encouraging progress being made by the government programme for more growth and employment, Germany is still far from having solved the problems it faces as a business location. The key criterion for lowering the high level of unemployment, as for achieving other objectives, is the propensity of domestic and foreign enterprises to invest in Germany.

Prices

The prospects for price stability dimmed in the summer months. The cost of German imports rose substantially, mainly on account of the appreciation of the US dollar. In addition, the raising of prescription charges and the changes in motor vehicle tax led to a steep increase in administered prices. As a result, consumer prices showed a perceptible upward movement after having been virtually static between January and April this year. The year-on-year rise in consumer prices up to the end of August came to 2.1%; it thus

Consumer prices



1 Change from August to August in each case.

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reached the upper limit of the medium-term price assumption of between 1½ % and 2 % which the Bundesbank incorporated in this year's monetary target.

The price stability achieved to date must not be jeopardised. The Bundesbank will therefore keep a particularly close eye on the further movement of the inflation rate and of those indicators which might point to any signs of incipient inflationary pressures. The provision of liquidity to the economy must not allow any room for a further acceleration in the upward thrust of prices. At the level of the real economy, it is not inconceivable that some enterprises may attempt to take advantage of the higher rate of capacity utilisation and the exchange-rate-related increases in import prices in order to push through general price adjustments. Notwithstanding such risks, which have undoubtedly grown greater, there is no cause at present to dramatise the trend in prices. At the moment, falling domestic unit labour costs – owing, above all, to sharp productivity gains – still constitute a counterweight to the "imported" trends towards higher prices. But the crucial need is for pay rises to remain moderate and for the parties concerned to refrain from attempts to neutralise the external price stimuli. The Bundesbank will pursue a monetary policy stance designed to prevent such exogenous price influences from becoming self-perpetuating and from triggering further price increases throughout the economy.

Fiscal and monetary policies

The public sector in the second quarter

The overall public sector financial position in the second quarter of 1997 was less unfavourable than in the same period of 1996. While the combined deficit of the Federal Government and the Länder Governments was roughly as high as a year before, the situation both of the pension insurance funds and of the health insurance institutions concurrently improved. Compared with the disappointing first quarter, in which the overall public sector deficit had climbed steeply, this is quite a positive sign. The reduction in the public sector deficit in the spring months was due chiefly to continuing strict spending discipline and the raising of the contribution rate to the statutory pension insurance scheme. On the other hand, the tax revenue accruing to the central, regional and local authorities was again lower than expected, although shifts in the timing of tax receipts within 1997 also played a role. Whereas the levying of wealth tax was discontinued at the beginning of the year, the extra receipts from the compensatory increase in the tax on the acquisition of land and buildings and in inheritance tax will only make themselves felt in the further course of the year.

Need for further spending discipline

However, the link between economic growth and tax revenue has loosened further in general, and there are no signs that this trend will reverse. Consequently, all levels of government remain under pressure to curb their expenditure if the deficit is to be brought down to a magnitude that is both tolerable and consistent with the Maastricht Treaty.

Financial position in 1997 as a whole

According to the latest revision of the national accounts just published by the Federal Statistical Office, in 1996 the public sector deficit (including the social security funds) came to 3.5 % of GDP, or to 3.4 % if a further statistical change in keeping with the Maastricht Treaty is taken into account; it was thus lower than previously estimated, in part because the social security funds recorded a smaller deficit at the end of last year than had originally been assumed. In the current year the public sector is having to cope with a number of burdens, such as the aforementioned tax shortfalls and higher payments for unemployment relief. Nevertheless, the general government deficit is likely to decline, principally because the social security funds look set to run a small surplus, following last year's large deficit. The substantial privatisation proceeds to be expected in the autumn of 1997 will further improve the liquidity and budget situation, especially that of the Federal Government; however, that will have no effect on the public sector deficit as defined in the national accounts.

Strategic orientation of fiscal policy

Fiscal policy makers are currently confronted with the dual task of further reducing the public sector deficit and concurrently helping to improve the underlying conditions for Germany's locational attractiveness through a comprehensive reform of the tax and pension insurance systems. A lowering of tax rates, coupled with a widening of the tax base, would make the tax system (which is currently conducive to tax avoidance strategies) more transparent, more efficient and, ultimately, also more equitable. A speedy adoption of the pension reform programme should produce greater clarity concerning the future distribution of the burdens arising from demographic trends. There is a particular need to lighten the heavy burden of non-wage labour costs without jeopardising the necessary reduction of the overall burden of taxes and levies. The general aim should be to bring the burden of taxes and levies back down to the level which prevailed prior to German reunification. All this will only succeed if the course of strict expenditure restraint which is now being pursued is steadfastly continued at all levels.

Federal budget for 1998

The draft budget for 1998 submitted by the Federal Government makes a major contribution to that objective. Expenditure growth over this year's supplementary budget is set at only 0.5 %, while the deficit is to fall by DM 13 billion. A number of crucial issues are still unresolved, however, such as the 1998 tax reform bill; moreover, the budget plans might have to be amended, not least on account of the persistent weakness of tax revenue. In the further budget debates the charted course of reform and consolidation should be adhered to. This would not only be in the more narrowly defined national interest but would also help in preparing the planned monetary union with a stable euro.

Central bank interest rates unchanged

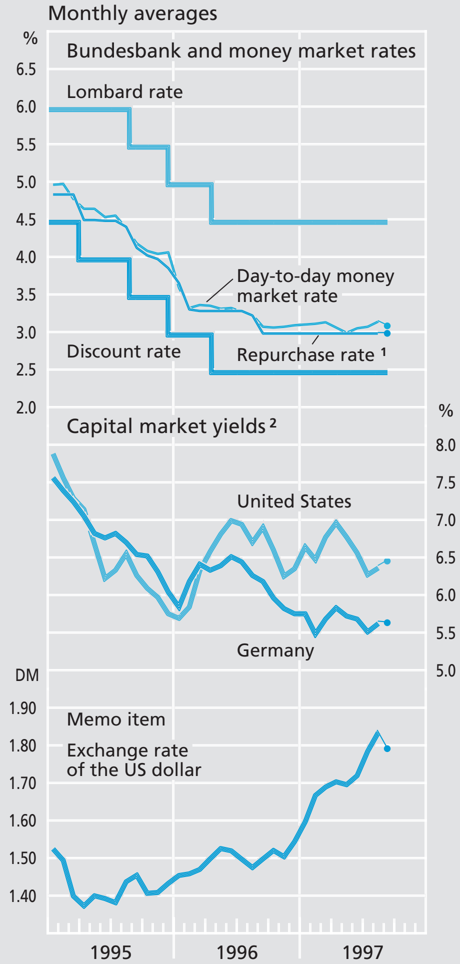
In the recent past the Bundesbank has left the discount and lombard rates unchanged at 2 ½ % and 4 ½ %, respectively, and the securities repurchase rate at 3.0 %. This means that the central bank interest rates, in part, are still at the all-time low levels to which they had fallen following the interest rate reductions of April and August 1996. Owing to the distinct weakening of the Deutsche Mark in the foreign exchange markets, especially against the US dollar, however, the monetary conditions in Germany have eased further this year.

Change in the method of announcing securities repuchase agreements

In the summer months the Bundesbank switched from preannouncing the type and terms of the weekly securities repurchase agreements immediately after the meetings of the Central Bank Council to announcing them only on the day of the tender. The reason behind the new method of announcement, which corresponds to the practice that prevailed until eighteen months ago, is the changed monetary policy setting. The recent exchange rate trend and the increased risks to stability (which were partly associated with it) implied that it would be appropriate to remain flexible in the short term in respect of interest rate policy options so as to be able to

Interest rate movements

Monthly averages



1 Average monthly interest rate for securities repurchase agreements with two-week maturities. — **2** Yield on Government bonds with a residual maturitiy of about ten years. — • = Latest position: September 11, 1997.

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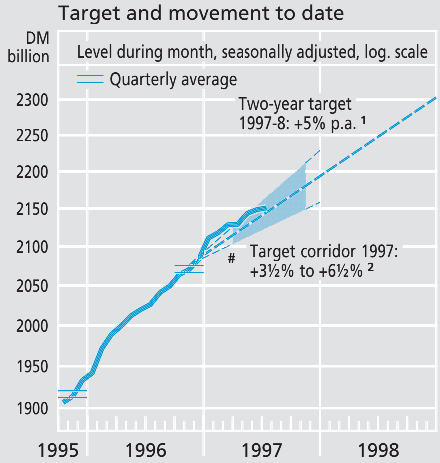
respond quickly to a change in the underlying conditions. To date, however, the Bundesbank has carried on using the fixed-rate tender and has kept the repo rate at 3.0 %. Given the increased interest rate uncertainty, rates in the money market rose a little, especially at the longer end. As a result, the yield curve in the money market has steepened markedly. That would appear to suggest that market expectations are geared to rising central bank rates.

Money stock within the target corridor

Monetary growth, which already slowed appreciably in the spring following the sharp rise in the money stock M3 at the beginning of the year, has remained moderate on the whole during the past few months. In June the rate of expansion of the money stock M3 came within this year's target corridor of between 3½% and 6½%, which it had overshot in the first five months; in July it moved further downwards from the upper reaches to the middle of the corridor. In that month it exceeded its average level in the fourth quarter of 1996 by a seasonally adjusted annualised rate of 5.7%, compared with 7% in May. In the course of the past twelve months the money stock M3 has grown by just over 6%. The narrow money stock M1, which comprises the liquidity directly available for transactions, expanded by 9½% over the same period. By contrast, the money stock M3 extended, which embraces M3 plus Euro-deposits, short-term bank bonds and money market fund certificates held by non-banks, grew somewhat more slowly than M3. Given the increased risks to price stability, the Bundesbank considers a further weakening of monetary expansion to be appropriate.

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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Determinants of monetary growth

On the one hand, the slower pace of monetary growth in the past few months was attributable to the fact that monetary capital formation at banks, which had come to a virtual standstill at the beginning of the year, picked up again somewhat. Between May and July the monetary capital deposited with banks increased at a seasonally adjusted annualised rate of just over 5½%, compared with 4% between January and April. On the other hand, lending to domestic non-banks slackened a little. That is true of both the private and the public sector. In the case of lending to businesses, however, this was mainly because banks purchased virtually no securities from the enterprise sector. As such securities transactions take place in the secondary market as a rule, they do not directly affect new lending to the issuers of such paper. By contrast, the demand for direct borrowing remained comparatively strong. That applies, in particular, to the housing construction sector, which was bolstered by the historically low mortgage rates. One factor in the slowdown in bank lending to the public sector was that the Federal Government had greater recourse to the capital market for a time.

Capital market rates

Capital market rates remained at a very low level during the summer months. Consequently, the financing terms for industry and the government alike continue to be favourable. Following a temporary rise in March, the yield on domestic bonds outstanding declined to just over 4¾ % in mid-July and thereby almost regained its all-time low. It rose again a little subsequently. Interest rate uncertainty increased at the same time. In the middle of September capital market rates stood at just over 5 %. But only the rates at the shorter end of the capital market increased against the spring, whereas there was little change in the term structure at the long end. The yield curve in the bond market has therefore flattened out. That indicates that the shorter-term interest rate and price prospects have worsened, whereas the long-term inflation outlook apparently continues to be rated not unfavourable. In order to strengthen these expectations and to durably avoid an increase in the inflation premium and risk premium in capital market rates, it is essential to nip inflationary dangers in the bud. That requires especial vigilance on the part of the central bank, particularly in situations in which the various monetary and real economic indicators provide a mixed picture – for example, because of rapidly changing conditions in the financial and foreign exchange markets.