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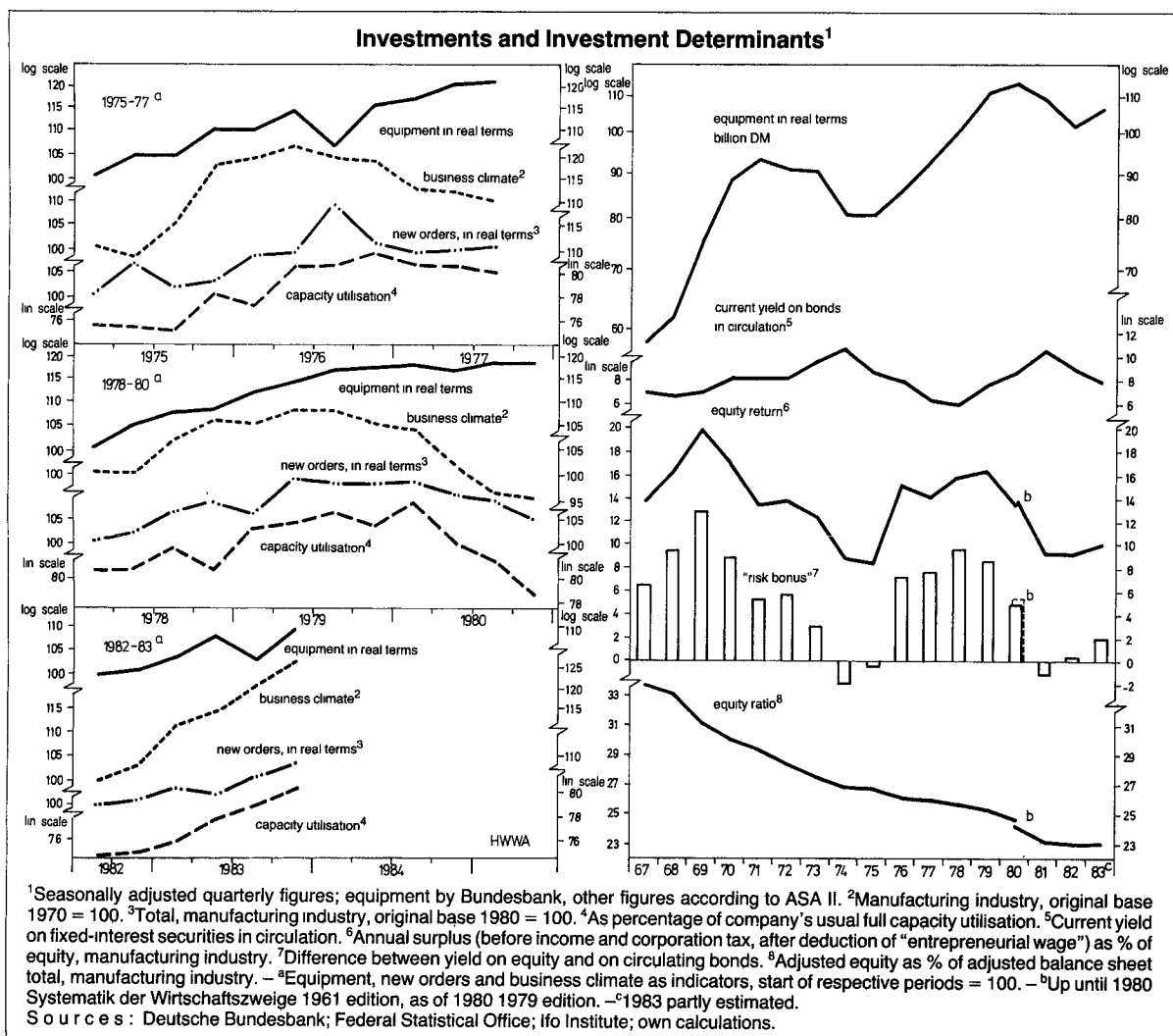
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Germany: Cyclical Increase in Investment

For over a year now the Federal Republic of Germany has been going through a period of economic recovery. Capital equipment investments in real terms have participated in this recovery, as they do in most cases, without delay. By the end of 1983 they were already about one tenth up on their low recorded in autumn 1982. However, the stepping up of deliveries towards the end of last year in an effort to meet the expiry deadline for the government investment allowance also contributed to the extent of this increase. Fears that, for the time being, there would be no increase in investment activities on account of idle capacities have once more proved to be unfounded. Compared to previous recessions the degree of capacity utilisation was in any case not particularly low; during the recession years 1967 and 1975 it had been at

a similarly low level and then, too, there had followed a speedy recovery of investment activities. Even in 1978, which saw the beginning of a self-sustaining upswing, the approx. 80 % degree of capacity utilisation was no higher than today's level. Underutilisation only has an adverse effect on investments in capacity extension. However, extension is only one of a number of investment motives, and in many cases not the primary one.

The cyclical improvement of major investment determinants has only been slightly weaker during the current phase of recovery than during comparable phases in the seventies. However, it is still nowhere near as pronounced as the improvement registered during the 1967-69 period. In terms of new orders in the manufacturing sector, for example, the almost 10 %



increase in demand recorded between the 3rd quarter of 1982 and the 4th quarter of 1983 resembled the increase in the 1975/76 period; the increase was somewhat greater in 1978/79. The cyclical improvement in profit margins, which usually precedes the general economic turnabout, was also no weaker than in 1975/76 and 1978/79; in fact its lead was even slightly larger than usual. On the other hand, it started from a markedly lower level than in the seventies. This explains why it did not lead to a rising propensity to invest at an earlier stage.

The fact that the real interest rate was much higher than during the second half of the seventies would appear to have been less significant than the aforementioned factors. The development of the business climate at any rate supports this assessment. Undoubtedly encouraged by the reorientation of economic policies, its speedy and clear improvement during the current recovery phase has been more pronounced than in 1975/76 and 1978/79. As a rule there is a close synchronisation between the indicators business climate and investment propensity; this reflects the substantial influence of expectations on investment decisions. A similarly close correlation between business climate and investment activities only exists during the upswing period. During periods of downward cyclical development the completion of investment projects already in progress tends to keep investment levels still rising, even though the overall business climate has already become less favourable. All in all, investors have reacted in their accustomed manner during the current phase of recovery; this would suggest that the repetition of earlier cyclical patterns can be expected to continue.

The speed of the increase in investment, however, is slow in comparison with former cycles. The development to date of orders for capital goods still does not indicate a noticeable acceleration of the rising trend.

The main difference to previous recovery periods is the comparative lack of dynamics in the pickup of capital spending. This is probably connected with the longer-term deterioration of major investment conditions, in particular of profitability and thus, undoubtedly, of profit expectations. The returns on sales, total capital and equity have demonstrated a clearly declining tendency since the end of the sixties; at the same time there has been a marked decrease in the equity ratio. This has led to a situation in which the taking of investment risks has become less and less rewarding. The so-called "risk bonus", i.e. the percentage by which an investment in physical assets is more profitable than an investment in – low-risk – financial assets, has tended to fall since the end of the sixties, while at the same time economic risks have grown. All this has reduced the ability and the desire to take on investment risks and increased the propensity to invest capital in financial assets.

Although the return on capital employed has again increased, it is not yet clear whether this is merely a cyclical recovery or a new trend. A lasting upswing of investment can only be anticipated if there is a long-term improvement in profit expectations. In its latest annual economic report the Federal Government made it clear that its aim is to further improve investment conditions. Monetary policy can contribute by maintaining its stability and growth oriented path. The greatest uncertainty surrounds the field of wages policy. Although this year's pay increases are likely to remain moderate in the face of high unemployment and relatively low price increases, thus providing scope for a further expansion of profits, the demand for a reduction of working hours introduces an element of considerable uncertainty. A lasting improvement in the investment climate, therefore, cannot yet be regarded as guaranteed. However, the existing tendencies towards a cyclical recovery are likely to warrant an increase in this year's investment in machinery and equipment by 5 to 6 % in real terms (1983: 4.5 %).

HWHA Index of World Market Prices of Raw Materials¹ (1975=100)

Raw Materials and Groups of Materials	1983		1984					
	AA ²	October	November	December	January	February	March 2	March 16
Total index	209.3	206.5	205.9	205.7	206.1	206.3	207.1	207.7
Total, excl. energy raw materials	122.8	128.9	127.7	127.4	128.7	128.8	130.4	132.3
Food, tropical beverages	116.8	127.1	127.0	126.7	128.4	126.1	127.0	130.2
Industrial raw materials	127.4	130.2	128.3	127.9	128.9	130.9	133.1	133.9
Agricultural raw materials	125.5	131.6	131.0	130.0	129.6	131.0	132.6	132.6
Non-ferrous metals	145.0	142.9	139.3	139.8	140.3	142.0	143.5	146.8
Energy raw materials	259.8	251.8	251.5	251.4	251.3	251.5	251.8	251.7

¹ On dollar basis. - ² Annual Average. For the method of computation of the HWHA Index cf. INTERECONOMICS No. 5, 1980, p. 261 ff.