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Eckhardt Wohlers\*

# German Economy Without Momentum

*Following a noticeable upturn in the summer six months of 1996, the economy in Germany has more recently shown signs of retreating into winter hibernation.*

*To what should this be attributed?*

*How should the economic prospects for the rest of 1997 be judged?*

Economic recovery in Germany faltered again at the end of last year. There was a further slight easing in aggregate demand and a significant slowdown in demand for consumer goods. Real gross domestic product in the final quarter of 1996 was about stagnant, in both the West and the East of the country (see Figure 1). At the same time, the situation on the labour market has worsened further. The fall in the numbers in employment continued unabated. The number of those unemployed has risen since the turn of the year at an accelerating rate, though the early onset of winter and the low level of acceptance of new rules governing bad-weather allowances in the building industry – resulting in a large number of temporary dismissals – have had a significant impact on the figures.

## Investment: a Source of Weakness

An important reason for the still languid nature of the economic recovery to date is the unsatisfactory level of investment activity. Interest rates are very low and company profits, according to provisional data in the 1996 national accounts, have continued to improve, albeit at a far slower pace than in the previous years. Nonetheless, companies have been reluctant to increase investment. Capital expenditure grew only 2.6% in 1996 and at the end of last year was still only just 10% higher than the low of the autumn of 1993; so far, capital investment has recovered by only one half – in west Germany by only one third – of the decline experienced in the preceding recession. Thus the propensity to invest has been significantly more restrained than in previous upswings.

The improvement in profitability in the past few years has clearly varied widely from sector to sector and among companies, depending on their size. A reading of company surveys suggests that, partly as a result of the higher external value of the D-Mark in the

period 1992-95, in manufacturing industry, which in west Germany accounts for one third of the total equipment, it was significantly weaker than the average for the economy as a whole.

Moreover, an initial provisional analysis by the Deutsche Bundesbank of the annual results of west German companies suggests that the profit position of large firms has significantly improved, above all among export-orientated companies;<sup>1</sup> one factor was the correction of currency relationships and the associated devaluation of the D-Mark. But the improvement in profitability appears to be due in part to increased foreign investment and is thus unlikely to provide an incentive to invest at home. Along with large companies, small firms also increased their earnings substantially last year, in the latter case mainly by cutting costs. In contrast, the improvement in the earnings position of medium-sized companies was less marked, and in many cases their position worsened.<sup>2</sup>

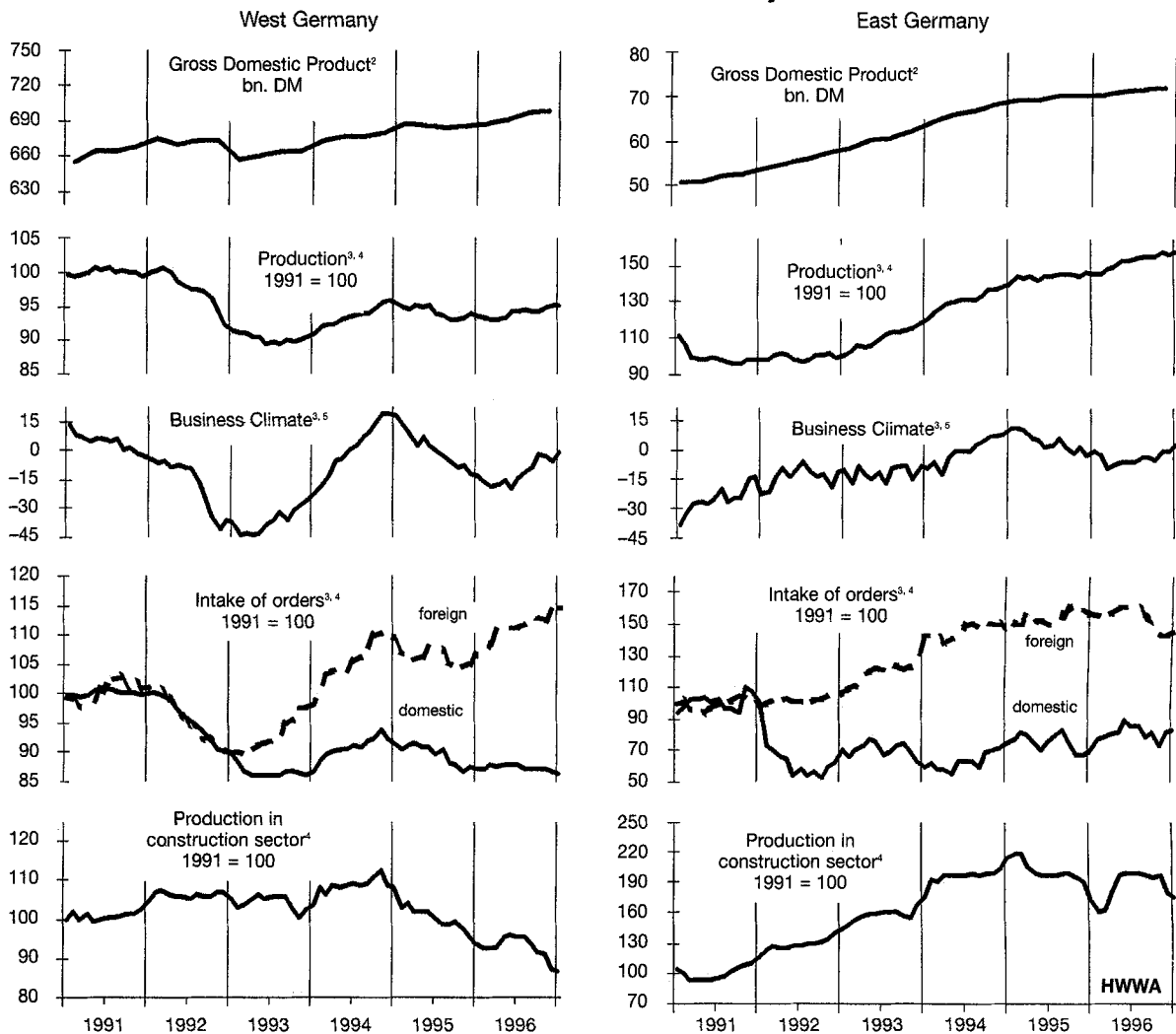
It is possible that companies viewed the improvement in their earnings as a passing phenomenon with the result that profit expectations, which are a major determinant of the propensity to invest, remained depressed. In the light of the experience of 1995 – a faltering economic recovery which was then barely sustained after an upswing of only a year and a half – there appears to be widespread uncertainty about the durability of the upward trend. Also, there is continuing scepticism over the future course of wages and, especially, of financial policy. The moderate wage agreements of last year have clearly been insufficient to counter the loss of confidence resulting from the “wage shock” of 1995. And the government’s

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<sup>1</sup> See Deutsche Bundesbank: Die Wirtschaftslage in Deutschland um die Jahreswende 1996/97, Monthly Report for February 1997, p. 64 ff. Large firms are defined as those with annual turnover in excess of DM 100 million.

<sup>2</sup> Ibid. p. 64 ff. Small firms are defined as those with a turnover of up to DM 10 million, medium-sized companies with a turnover of between DM 10 million and DM 100 million.

Figure 1  
Economic Indicators for Germany<sup>1</sup>



<sup>1</sup> Seasonally adjusted using method ASA II (HWWA-Version). – <sup>2</sup> In 1991 prices, quarterly measure. – <sup>3</sup> Manufacturing industry. – <sup>4</sup> Three-monthly averages. – <sup>5</sup> Balance of firms' positive and negative reports.

Sources: Statistisches Bundesamt, Deutsche Bundesbank, ifo Institut; HWWA calculations.

toing and froing on fiscal policy has bred rather than reduced uncertainty.

The lack of dynamism in investment is undoubtedly related in part to the intensification of international competition in the wake of the growing globalisation of markets in the nineties. One indicator of this is the variation in the level of capital investment of companies of different sizes in the manufacturing sector in west Germany, even though it should be noted that official figures in this respect are only available up to 1994. Investment trends for individual firms of different sizes ran largely "in parallel" during the eighties. But in the last few years, the cutback in investment among companies with 1,000 and more

employees, accounting for a good half of all capital investment in manufacturing, has been far more severe than in smaller and medium-sized enterprises. The same is true of employment trends; here too the reduction was far sharper among large firms, accounting for one third of manufacturing jobs, than among small companies.<sup>3</sup> Evidently, large firms responded to the intensification of international competition by transferring production abroad as well as by forcing the pace of rationalisation and by reducing their labour forces.

<sup>3</sup> The results of the IAB business panel indicate that this tendency continued in 1995; cf. Arbeitsmarkt 1995, Amtliche Nachrichten der Bundesanstalt für Arbeit, Vol. 44, June 1996, p. 32.

### Underlying Conditions Remain Favourable

The renewed stagnation of the economy towards the end of 1996 shows that the situation continues to be precarious. It should, however, be viewed as a short-term pause for breath in a process of recovery which is, however, proceeding only slowly. Supporting this interpretation, alongside the clear improvement in the business climate since the end of last year, is the fact that monetary conditions are favourable: interest rates are low and the D-Mark revaluation of Spring 1995 has been reversed; the real external value of the D-Mark has now fallen back to the level of autumn 1992. A number of factors have actually shown partial improvement compared with our last forecast at the beginning of the year.<sup>4</sup> Long-term interest rates have reached a new low (cf. Figure 2). In addition, the D-Mark has weakened further against the Dollar, though this will add to inflationary pressures.

The underlying economic environment will for the time being remain favourable in Germany as it will in most of the other industrialised countries. The underlying conditions for future price trends in western Europe – and in Japan too – can be expected to remain calm: capacity utilisation is increasing only gradually, wage rates are rising at a moderate pace, held back by high unemployment, and there is relatively little inflationary pressure coming from international commodity markets. As a result, there is no need for action in the sphere of monetary policy. Thus there appears to be little likelihood in the short term of a change of course in Germany and most other industrialised countries.

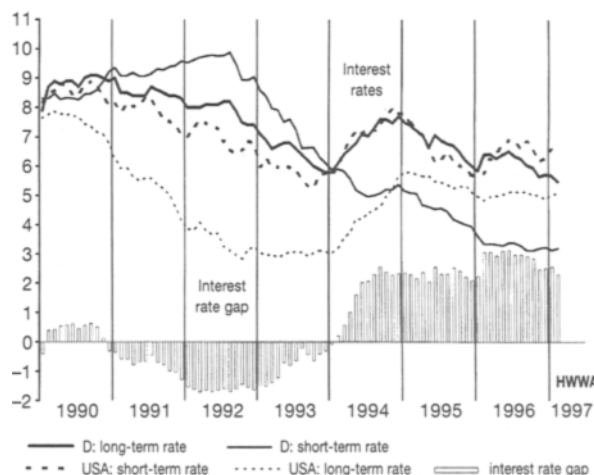
Against this background, there is also little reason to expect a radical change in interest rates on capital markets, especially as a number of countries in Europe are reducing their government deficits under the pressure of Maastricht. Under these conditions, and with an underlying assumption of growing cyclical convergence in the major countries,<sup>5</sup> major changes in currency relationships should not, in general, be expected. The forecast is thus based on the assumption that there will at least this year be no major shift in the structure of exchange rates in Europe. It is further assumed that the dollar will on average main-

tain the level it has reached after its show of strength in recent months – a movement which should be seen primarily as a normalisation of its value. For all that, with Maastricht in the foreground, considerable risks remain.

Developments in the USA represent one source of uncertainty. After six years of upswing, capacity is heavily utilised, and the unemployment rate, at barely 5½%, has by American standards been very low for some while.<sup>6</sup> At the same time, wage and price increases have so far remained moderate. Most recently, however, there have been indications of an acceleration in the rate of wage rises. If this trend takes hold, the Federal Reserve might very soon raise short-term interest rates a little to underline its determination to secure stability. Any such hike should not, however, have any great impact on interest rate trends on the capital market.

The favourable monetary framework should mean that the economies of the industrialised countries remain on an upward path. On the other hand, offsetting the positive monetary background, fiscal policy this year, in Europe at least, will act as a restraining influence as the potential candidates for membership of the European Monetary Union (EMU) strive to meet the reference values of the Maastricht budgetary criteria. Most European countries have

**Figure 2**  
Development of Short-term and Long-term  
Interest Rates  
(Germany and USA)



Short-term rates: Germany = Three-month funds, USA = Treasury bills. Long term rates: Germany = Public sector loans with remaining term of 8-15 years, USA = Public sector loans with remaining term of 10 years, January 1997: 1st to 24th of month. Interest rate gap: difference between short-term and long-term interest rates in Germany.

Sources: Deutsche Bundesbank; own calculations.

<sup>4</sup> See Günter Weinert, Eckhardt Wohlers: Verhalten aufwärts – Die Lage der Weltwirtschaft und der deutschen Wirtschaft am Jahresbeginn 1997, HWWA-Report No. 161, Hamburg 1997, p. 34 ff.

<sup>5</sup> Ibid, p. 21 ff.

<sup>6</sup> See Christiane Brück: Arbeitslosigkeit und Inflationsrisiken in den USA – Zur Lage der NAIRU, in: Wirtschaftsdienst, Vol. 77 (1997), No. 2, pp. 111 ff.

recently been working towards budgetary consolidation without, however, impairing the renewed upturn in economic activity. It should also be remembered that the measures proposed in budget plans will not impact fully on demand and that some represent, to a certain extent, financial "window-dressing".<sup>7</sup> All in all, the measures taken so far, so long as they are not significantly intensified, should not jeopardise the continuation of economic expansion in Europe.

### Expansion at a Moderate Pace

In view of the favourable external economic environment and the favourable monetary framework, economic recovery should continue in Germany as elsewhere. With demand and production continuing to grow in the industrialised countries and in view of the sizeable improvement in Germany's international competitiveness in the wake of the D-Mark's depreciation, exports will remain a prop for the economy. The propensity to invest should also be stronger. Sales prospects at home and abroad will become more favourable; there will be further improvement in company earnings. These will benefit from rationalisation achieved in the last few years, from productivity gains linked to higher capacity utilisation and from moderate wage increases, even though these will be partly offset by significantly

higher, government-induced non-wage labour costs. With interest rates low, investment in capital assets will become more attractive relative to financial investment.

There is still a lack of certainty over the future course of fiscal policy, if only because important reform projects like the planned tax reform still have to clear parliamentary hurdles. This will continue to burden the investment climate for the time being. In addition, there are still reservations regarding wage policy. Under these circumstances, investment activity will not display any great dynamism. Capital investment is expected to grow by about 5% in 1997. In the construction industry, on the other hand, no turning point is foreseen for this year; a slight improvement in west Germany will be offset by a clear downturn in east Germany, not least due to the halving of special depreciation allowances for residential building. With incomes growing only slowly and unemployment remaining high, private consumption can hardly be expected to provide any impetus.

All in all, therefore, the economy in Germany will show little dynamism again this year. Gross domestic product in real terms will grow about 2.5%,<sup>8</sup> up from 1.4% last year (cf. Table 1). In these circumstances, no clear improvement of the situation on the labour

<sup>7</sup> See Günter Weinert, Eckhardt Wohlers, op.cit., p. 20.

<sup>8</sup> Forecasts carried out in parallel using the HWWA national accounts-based econometric model come to the same result.

**Table 1**  
**Key Data of the Forecast for the Federal Republic of Germany**

	Germany				West Germany				East Germany			
	1995	1996	1997	1998	1995	1996	1997	1998	1995	1996	1997	1998
Gross domestic product <sup>1</sup> (% change on previous year)	1.9	1.4	2½	3	1.6	1.3	2½	2½	5.3	2.0	2½	4
Gainfully employed <sup>2</sup> (% change on previous year)	-0.3	-1.1	-½	½	-0.6	-1.1	-½	½	1.1	-1.5	-1½	0
Unemployed (1000 persons)	3612	3965	4150	4050	2565	2796	2900	2800	1047	1169	1250	1250
Rate of unemployment <sup>3</sup> (in %)	9.4	10.3	10.8	10.6	8.3	9.0	9.4	9.1	14.1	15.7	16.8	16.8
Consumer prices <sup>4</sup> (% change on previous year)	1.8	1.5	1¾	1¾	1.7	1.4	1¾	1¾	2.1	2.2	1¾	1¾
Public sector borrowing requirement <sup>5</sup> (in % of GDP)	-3.5	-3.9	-3¼	- <sup>a</sup>	-	-	-	-	-	-	-	-
Balance on current account <sup>6</sup> (DM bn)	29.9	-26.6	-20	-15	-	-	-	-	-	-	-	-

<sup>1</sup> In 1991 prices. – <sup>2</sup> Domestic gainfully employed. – <sup>3</sup> Unemployed as a percentage of the resident labour force (place of residence concept); west and east Germany: unemployed as a percentage of the labour force within the region (place of employment concept). – <sup>4</sup> Price index for the cost of living of all private households. – <sup>5</sup> 1995 excluding as expenditure debts taken over from the Treuhandanstalt und east German housing companies and excluding as income the capital taken over from the Deutsche Kreditbank. – <sup>6</sup> As defined in the balance of payments statistics. – <sup>a</sup> Due to the uncertainties over fiscal policy plans, a forecast of the deficit ratio is currently too precarious.

Sources: Statistisches Bundesamt; Deutsche Bundesbank; Bundesanstalt für Arbeit. 1997 und 1988; HWWA-Forecast, rounded figures.

market can be expected. Though numbers may rise slightly during the year, the average number of those in employment will fall again somewhat in 1997; unemployment will rise to nearly 4.2 million. Under these conditions, no significant strengthening of the catch-up process in east Germany is in sight. Real gross domestic product will not rise much more strongly than in west Germany; on balance over the year, the situation on the labour market will worsen further.

### Substantial Forecasting Uncertainty

Forecasts going beyond the current year are particularly uncertain at present. In the first half of 1998, the die will be cast for EMU, and at that point at the latest the decisions which have been taken will have an impact – and possibly a substantial one – on key factors for the economic environment, such as interest and exchange rates. In normal circumstances, demand and production react to changes in these factors only after some delay, but short-term, noticeable effects on economic developments in 1998 could result from changes in expectations.

On a strict interpretation of the Maastricht Treaty, few countries will fulfil the membership criteria for EMU. From this point of view, a delay in the launch of the European Monetary Union seems possible. Germany, too, risks failing to meet the reference values for the budgetary criteria, in spite of the budgetary measures that have been introduced. On the basis of the assumptions underlying the forecast, the 1997 budget deficit – 3¼% of nominal gross domestic product – will breach the 3% reference value, and the criterion relating to total debt will also be slightly exceeded.<sup>9</sup> Rather than delaying the starting date, it is more likely that for political reasons the criteria will be interpreted “loosely”, even if this has been vehemently denied to date. This applies particularly to the budgetary criteria, for which the

Maastricht Treaty allows a certain amount of room for interpretation, but it may also apply to the requirement for two-year participation in the exchange rate mechanism of the European Monetary System. To that extent, there are strong grounds for believing that EMU will start on schedule and with a large group of participants; in that case, the founder members would include Italy which has made major efforts to meet the required qualifications. The extensive convergence of long-term interest rates indicates that this is also how financial markets view the prospects.

In order to avoid presenting a broader target for speculation, the conversion rate at which individual currencies join EMU should be set at the latest at the same time as decisions are made about which countries will participate. Alternatives for the conversion rate could be the central EMS rate or an average derived from market rates in the years leading up to the launch of EMU.<sup>10</sup> So long as the chosen method is credibly presented, speculative “attacks” on individual currencies in the period remaining before the start of EMU would seem to have little chance of success. If the averaging procedure is used – rather than EMS central rates – the conversion rate on entry would only be finally established on the starting date, leaving some scope for speculation. But that scope becomes narrower the closer the starting date comes.<sup>11</sup> On the other hand, the exchange rates between “ins” and “outs” could be subject to wider fluctuation.

Once the founding membership and the procedure for establishing conversion rates are fixed, interest rate differentials between future participants – these are still significant particularly at the short end – will tend to narrow even before the start of EMU.<sup>12</sup> In which direction the gap will be closed is, a priori, an open question. But there are grounds for believing that higher rates will tend to descend towards lower – German – levels. Because of high unemployment, the “high-yield” countries will be tempted to loosen the monetary reins to provide a boost to their domestic economies. Any negative impact on prices would take time to come through, would be spread across the whole EMU group and would thus be borne by all participants.<sup>13</sup> Due to its asymmetrical impact, there would thus be little incentive in the “low-yield” countries to counter such behaviour by raising their interest rates. For this reason alone, a more intensive monetary policy cooperation in the EU is necessary. The prospects for long-term interest rates are uncertain. If the Euro is viewed in capital markets as a weak currency, leading to expectations of higher

<sup>9</sup> See Günter Weinert, Eckhardt Wohlers, *op. cit.*, p. 52.

<sup>10</sup> See Arbeitsgemeinschaft der wirtschaftswissenschaftlichen Forschungsinstitute: *Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Herbst 1996*, Berlin, Oktober 1996, p. 34 f.

<sup>11</sup> Even taking a reference period of two years, now under discussion, the weighting accorded to ex-post values would dominate, so that the central rate would in substantial measure be “pre-determined”. The closer the starting date comes, the larger the number of ex-post values, thus making the average ever more calculable, giving ever less scope for speculation.

<sup>12</sup> On the other hand, the interest rate gap between “ins” and “outs” is likely to widen.

<sup>13</sup> Similar points are made by Joachim Scheide, Ralph Solven: *Auf dem Weg zum Euro – Szenario für Zinsen, Wechselkurse und Konjunktur*, Kieler Diskussionsbeiträge No. 292, February 1997, p. 12 ff.

inflation, which could be boosted by a lax monetary stance in the "high yield" countries, then a rise in rates in the "low-yield" countries could also be on the cards.

### Prospects for Further Recovery

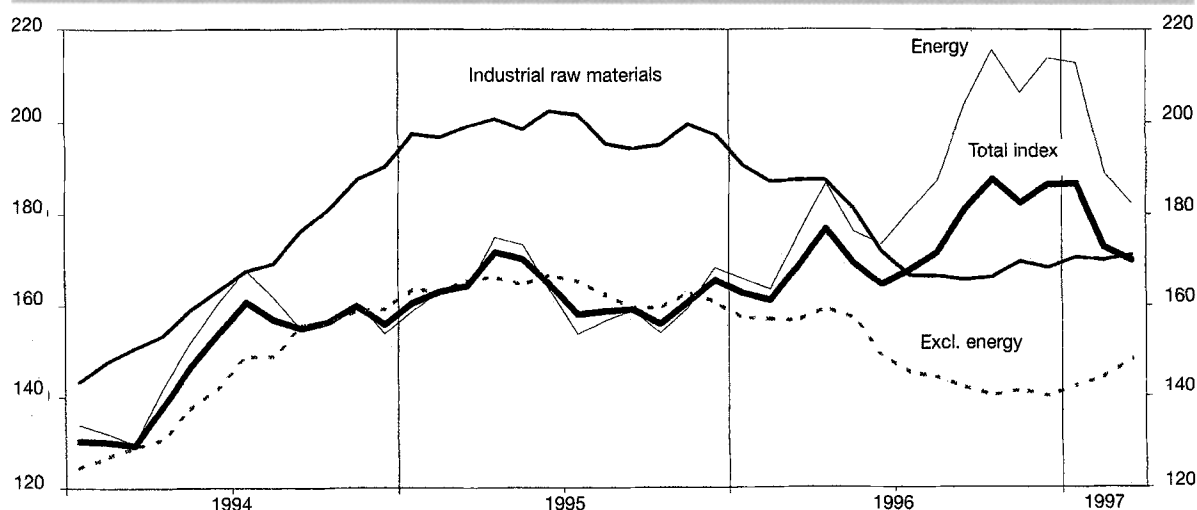
In view of all these imponderables, forecasts for 1998 can do no more than provide pointers and orders of magnitude; that is how the data in Table 1 should be read. They are based on the assumption that EMU will start on schedule with a large group of participants, whose size and composition corresponds with the prevailing expectations of the financial markets at the time, and that there will be a slight firming of interest rates at the long end in Germany when the EMU decision is made. The forecast for Germany is in addition made considerably more precarious by the uncertainties over the future course of fiscal policy. Parts of the proposed reforms must

first clear parliamentary hurdles, and it cannot be predicted what compromises will be struck in the end. This applies not least to the reform of the tax system; it is assumed here that the reform of the tax system will be implemented as now envisaged by the government and that the solidarity surcharge will be reduced in 1998.

Based on these assumptions, it is likely that the economic recovery will continue in 1998 and will become more broadly based. Real gross domestic product could grow by about 3%; capacity utilisation should move towards long-term average rates. But little easing of the situation on the labour market is to be expected. The number of those in employment will rise a little, but the number of unemployed is unlikely to fall below the 4-million mark. This means that the government's goal of halving unemployment by the year 2000 is no longer achievable.

**HWWA-Index of World Market Prices of Raw Materials<sup>1</sup>**

(1975 = 100)



Raw Materials and Groups of Materials <sup>2</sup>	1996	Sep. 96	Oct. 96	Nov. 96	Dec. 96	Jan. 97	Feb. 97	March 97
Total Index	173.3 (6.5)	181.0 (13.7)	187.7 (20.3)	182.4 (13.5)	186.5 (12.8)	186.8 (14.9)	172.7 (7.3)	169.8 (0.7)
Total, excl. energy raw materials	149.2 (-8.6)	142.1 (-10.9)	140.1 (-12.1)	141.3 (-13.1)	140.0 (-12.9)	142.4 (-9.4)	144.3 (-8.1)	148.4 (-5.3)
Food, tropical beverages	114.3 (-2.7)	111.3 (-2.1)	105.9 (-5.9)	104.3 (-8.8)	102.9 (-8.6)	105.4 (-6.8)	110.7 (-5.7)	118.6 (2.2)
Industrial raw materials	175.7 (-11.3)	165.5 (-14.8)	166.1 (-14.9)	169.6 (-15.1)	168.2 (-14.7)	170.6 (-10.6)	169.9 (-9.2)	171.1 (-8.8)
Agricultural raw materials	187.5 (-12.3)	177.2 (-14.3)	180.2 (-15.0)	179.3 (-17.3)	176.7 (-17.8)	176.0 (-16.2)	173.7 (-14.5)	172.3 (-14.7)
Non-ferrous metals	176.8 (-15.6)	159.2 (-23.5)	157.2 (-21.9)	170.8 (-19.0)	172.2 (-17.1)	181.1 (-6.0)	183.1 (-3.6)	187.1 (-2.6)
Energy raw materials	187.4 (15.4)	203.7 (28.1)	215.5 (39.9)	206.4 (29.4)	213.7 (27.1)	212.8 (28.4)	189.3 (15.9)	182.3 (3.9)

<sup>1</sup> On a dollar basis. <sup>2</sup> Averages for the period; figures in brackets: percentage year-on-year change.