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Eckhardt Wohlers*

Germany: Gradual Revival in Domestic Demand

The economic recovery in Germany is still narrowly based. The main problem continues to be the unsatisfactory situation in the labour market. What is the outlook for next year? What problems may arise in the run-up to EMU?

With monetary and world economic conditions continuing to be favourable, economic activity in Germany began to pick up again in the spring of this year after a brief pause in the autumn of 1996. Total demand and output are increasing, and the business climate and business expectations have improved perceptibly, especially in Western Germany (see Figure 1). The recovery is still narrowly based, however. It continues to be fuelled primarily by exports, which have been rising strongly for a year (see Figure 2), thanks primarily to the brisk cyclical expansion in the industrial countries and the noticeable improvement in international competitiveness as a result of the large real depreciation of the Deutsche Mark in the last eighteen months.

Contrasting Economic Trends

Domestic demand remained weak overall. Firms' decisions regarding stock levels are clearly again having a stimulatory effect, as indicated by the significant expansion in production by manufacturers of intermediate inputs in the first half of the year, and investment in plant and equipment also edged upwards in response to good expectations regarding exports and a marked improvement in profits, but private consumption is sluggish in view of the small increase in incomes and continuing adverse developments on the employment front.

In the construction industry, factors tending to depress activity continue to have the upper hand, despite the stimulus of low interest rates and the squeeze on prices, so that building investment declined overall, although there was perceptible growth in some branches, such as the construction of owner-occupied homes. The structural adjustment taking place in apartment block construction, where earnings prospects have dimmed considerably as a

result of the progressive slackening of demand in the housing market and the curtailment of state subsidies, is having a particularly adverse effect. In industrial construction, the propensity to invest is being damped by the continued existence of idle capacity and the reluctance of firms to invest in machinery and equipment, while in the public works sector it is being checked by the tightness of government finances. The impact of the structural problems in the construction industry is particularly severe in Eastern Germany because of the industry's size in relation to total output in that part of the country; here the stimulus from the improvement in cyclical conditions, which led to a pronounced rise in the inflow of orders and production in manufacturing industry, was largely cancelled out by the downturn in the construction sector.

Investment continues to be the main weak point in the current recovery. Although corporate profitability has improved markedly and sales prospects have brightened perceptively, especially in the export sector, firms are being cautious about increasing investment in machinery and equipment. The crisis in construction has undoubtedly been a contributory factor, causing the industry to cut back severely on investment of late. The much greater reluctance of large internationally operating enterprises to undertake domestic investment points to location problems.¹ However, the rather high level of uncertainty at present is also playing an important role; as econometric models show, it is having a significant effect on investment decisions.²

There is uncertainty about the durability of the recovery, but especially about future fiscal policy. The

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¹ See Günter Weinert, Eckhardt Wohlers: Verhalten aufwärts – Die Lage der Weltwirtschaft und der deutschen Wirtschaft am Jahresbeginn 1997, HWWA Report No. 161, 1997, pp. 45 ff.

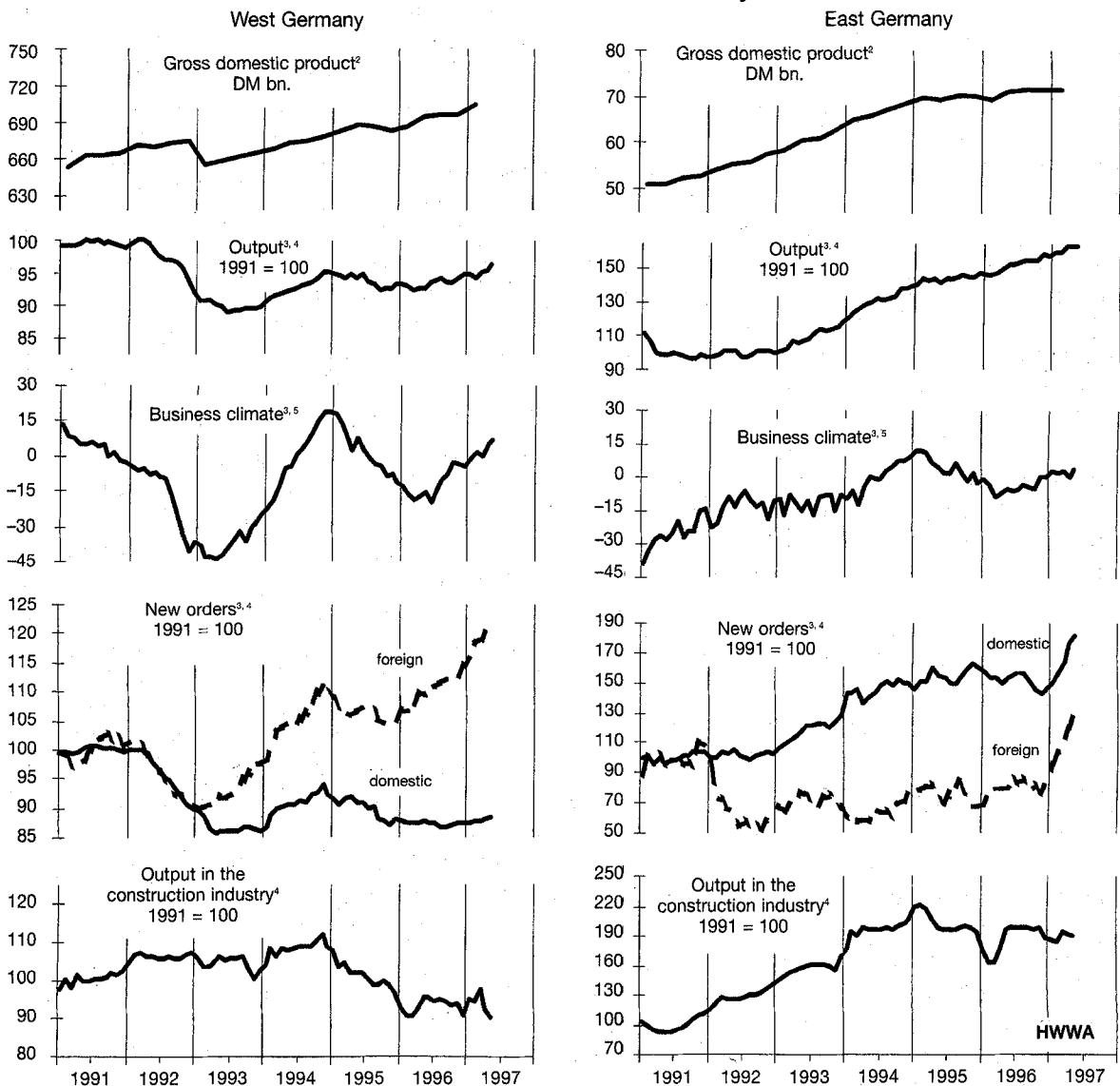
² See Wilhelm Mailand: Einfluß von Unsicherheit auf die Ausrüstungsinvestitionen, in: WIRTSCHAFTSDIENST, Vol. 77 (1997), No. 5, pp. 296 ff.

Federal Government has initiated a series of reform proposals, but since many of them require Opposition approval, it is not yet possible to foresee the final outcome. The paralysis of economic policy is an important reason for the slowness of the recovery in activity.

Although demand and output have now been rising for a year, the underlying employment trend continued to be downwards until the spring. The slight rise more recently was due mainly to special factors, as was the fall at the turn of the year; e.g. the low acceptance and

use of the amended bad weather payments in the construction industry led to an increase in temporary lay-offs.³ The number of unemployed again rose substantially in the spring, but here too special factors were partly responsible. For example, in both Western and Eastern Germany the curtailment of labour market measures again caused more people to register as unemployed, so that previously concealed unemployment became overt. The continued unfavourable situation in the labour market is partly a consequence of the adjustment crisis in the con-

Figure 1
Economic Indicators for Germany¹



¹ Seasonally adjusted using method ASA II (HWWA-version). ² At 1991 prices, quarterly values. ³ Manufacturing industry. ⁴ Three-month moving averages. ⁵ Balance of firms' positive and negative reports.

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

struction industry: in Western Germany almost 30% of the fall in employment since the end of 1995 has been attributable to the problems in the building industry, while in Eastern Germany the figure is around 25%.

There is nevertheless a glimmer of hope in the labour market as well. The slowdown in the fall in employment in manufacturing indicates that the wave of rationalisation triggered by the shock of wage growth and currency appreciation in the spring of 1995 is tailing off; the substantial fall in the DM exchange rate since then and the much more moderate wage increases point to the same conclusion. Moreover, surveys by the ifo-Institut⁴ show that the number of firms planning to shed staff has fallen considerably. Finally, the number of persons joining the unemployment register, which is a more immediate indicator of redundancies than the total number of unemployed and generally reacts more quickly than the latter, has been falling for some months. All this suggests that the recovery is gradually spreading to the labour market.

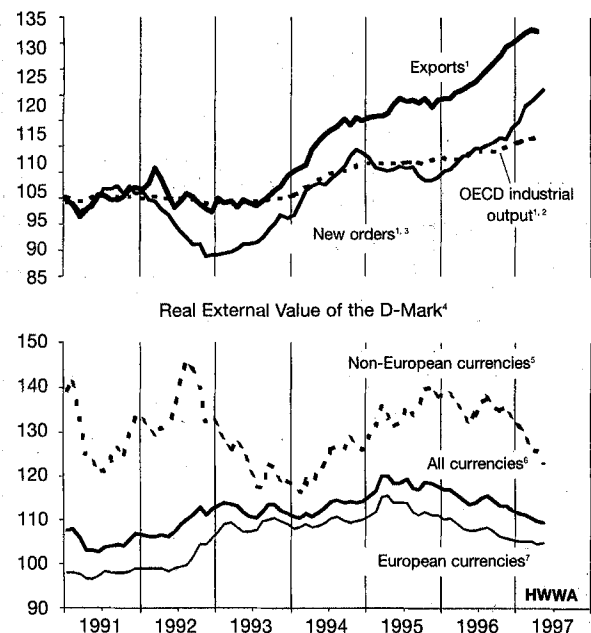
In view of the favourable monetary conditions, there is a justified prospect that the recovery in activity in the industrial countries will continue. In most European countries fiscal policy is aimed to a greater or lesser extent towards budget consolidation and is damping demand in the short term, but monetary policy is generating tangible stimulus, which will determine developments for some time to come because of its lagged effect. The same goes for Japan; only in the USA has there been a slight tightening of the monetary reins. Short-term interest rates have fallen to a very low level in most countries, as have capital market rates.

In view of the largely unstrained development and the tranquillity on the price front, there is little at present that would warrant a change in monetary policy and a raising of short-term interest rates, at least in Europe. Obviously, as economic activity strengthens and capacity utilisation rises it cannot be ruled out that the Bundesbank, and possibly other European central banks following in its wake, will give an interest rate signal in order to emphasise its determination to safeguard stability; this is all the

more likely the more fiscal policy strays from the consolidation course. A slight interest rate increase of this kind is unlikely to come before 1998, however.

Against this background, there is also only a small chance of a lasting change in the interest rate trend in the capital market. It is true that the strengthening of economic activity in Europe and Japan will also lead to an increase in capital demand on the part of private investors, but this will be counteracted by governments' continuing efforts to reduce their budget deficits. Moreover, the slight increase in US interest rates in the spring in an attempt to take the heat out of the expansion will also tend to dampen demand for capital. If the American economy continues to grow more rapidly than productive potential, however, the Federal Reserve is likely to make further interest rate changes before the end of the year. If so, rate increases would probably also occur at the longer end and could spill over to Europe because of the interdependence of interest rates, possibly endangering the continuation of the European recovery. However, the forecast does not take account of this possibility.

Figure 2
Indicators of Foreign Trade



³ See the assessment of the economic situation by the following members of the Association of German Economic Research Institutes: Deutsches Institut für Wirtschaftsforschung, Berlin (Institut für Konjunkturforschung); HWWA-Institut für Wirtschaftsforschung, Hamburg; ifo-Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Institut für Wirtschaftsforschung Halle; Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen: Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Frühjahr 1997, Essen, Berlin 1997, p. 23.

⁴ Ifo-Konjunkturtest: Sonderfragen zur Arbeitskräftenachfrage.

¹ Three-month moving averages, seasonally adjusted using ASA II (HWWA version), 1991 = 100. ² As an indicator of world economic activity. ³ Foreign orders received by manufacturing industry. ⁴ Based on consumer prices, 1985 = 100. ⁵ Against the Japanese yen, the Canadian dollar and the US dollar. ⁶ Against the currencies of 18 industrial countries. ⁷ Against the currencies of 15 European countries.

Sources: Deutsche Bundesbank; OECD; Statistisches Bundesamt; own calculations.

ECONOMIC TRENDS

The risks in connection with European economic and monetary union (EMU) are difficult to assess. The decisions as to the starting date, the size and composition of the group of participating countries and the procedure for determining conversion rates will be taken in the spring of 1998. All of these aspects have far-reaching consequences for the formation of expectations in the financial and foreign exchange markets and hence also for important economic factors such as interest rates and exchange rates. Until now, much pointed to Stage 3 beginning on time with a large group of participants. Almost all the candidate countries comply with the reference values for the inflation and interest rate criteria, and most of them will at least come very close to meeting the budget criterion.⁵ Most countries still greatly exceed the reference value for government debt, but clearly no-one now considers this to be an obstacle to participation.

With the change in government in France, uncertainty as to whether EMU would start on time and about the group of countries that will participate increased again. Caught between short-term employment objectives and strict compliance with the

criteria, the French Government will, in case of doubt, argue for a "more flexible" interpretation of the budget criterion instead of tightening its consolidation measures; other countries could follow suit. Although this reduces the danger that the recovery in Europe will be further undermined by more budget cuts, it fuels doubts about the durability of stabilisation efforts and hence ultimately about the solidity of the euro. The depreciation of the Deutsche Mark and the currencies of other potential EMU member countries in the last few months, not only against the US dollar but also against the pound sterling, undoubtedly reflects a degree of scepticism about the stability of the common currency.

Despite these imponderables, for the purposes of the forecast it is assumed that the EMU will begin on time with a large group of participating countries and that the size and composition of the group will not give the financial markets any great surprises, so that no additional market turbulence is to be expected on that score. It is also assumed that a degree of mistrust of the euro will cause the currencies of potential member countries to depreciate again slightly against third currencies such as the US dollar. A further assumption is that when the decision on the group of participants is taken the currency conversion procedure will also be laid down and credibly

⁵ See Die Lage der Weltwirtschaft und der deutschen Wirtschaft im Frühjahr 1997, op. cit., pp. 3 f.

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 ¹ (% change on previous year)	1.9	1.4	2 ¹ / ₄	2 ³ / ₄	1.6	1.3	2 ¹ / ₄	2 ³ / ₄	5.3	2.0	2.5	3.0
Private consumption	1.8	1.3	1.0	2.0	-	-	-	-	-	-	-	-
Government consumption	2.0	2.4	1.5	1.0	-	-	-	-	-	-	-	-
Plant and equipment	2.0	2.4	4.5	6.5	-	-	-	-	-	-	-	-
Buildings	1.2	-2.7	-0.5	0.5	-	-	-	-	-	-	-	-
Domestic demand	2.1	0.8	1.5	2.5	-	-	-	-	-	-	-	-
Exports	5.9	4.9	8.0	6.5	-	-	-	-	-	-	-	-
Imports	6.4	2.6	5.0	5.5	-	-	-	-	-	-	-	-
Gainfully employed ² (% change on previous year)	-0.3	-1.2	-1.0	0.5	-0.6	-1.0	-1.0	0.5	1.1	-1.7	-2.5	0.0
Unemployed (1000 persons)	3612	3965	4325	4225	2565	2796	3025	2925	1047	1169	1300	1300
Rate of unemployment ³ (in %)	9.4	10.3	11.3	11.0	8.3	9.0	9.7	9.4	14.1	15.7	17.6	17.6
Consumer prices ⁴ (% change on previous year)	1.8	1.5	1.5	1.5	1.7	1.4	1.5	1.5	1.0	2.2	1 ¹ / ₄	1 ¹ / ₄
Public sector borrowing requirement ⁵ (in % of GDP)	-3.5	-3.8	-3.2	-2.5	-	-	-	-	-	-	-	-
Balance on current account ⁶ (DM bn)	-33.8	-20.9	-10.0	0.0	-	-	-	-	-	-	-	-

¹ At 1991 prices. ² Domestic gainfully employed. ³ 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). ⁴ Price index for the cost of living of all private households. ⁵ 1995 excluding as expenditure debts taken over from the Treuhandanstalt and east German housing companies and excluding as income the capital taken over from the Deutsche Kreditbank. ⁶ As defined in the balance of payments statistics.

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

presented, so that no further major shifts between EMU currencies will occur.⁶ Finally, it is assumed that any differences in short-term interest rates that remain after the procedure has been decided will quickly disappear and that adjustment will to a great extent take the form of rate reductions in "high-interest-rate" countries.⁷

Continued Expansion in Activity

In these circumstances, the economic recovery in Europe will continue in the run-up to EMU; the picture in non-European countries is similar. In Germany exports will continue to bolster activity because of the favourable world economic environment. In addition, the exchange-rate-related improvement in international competitiveness will have an impact for some time yet, and the D-Mark can be expected to show a further slight weakening against third currencies. Exports will therefore continue to grow strongly (see Table 1); Germany's share of world trade will expand further.

Domestic demand will also generate increasing stimulus, so that the revival in activity will broaden. Expenditure on machinery and equipment will rise in response to the favourable economic climate. Sales prospects will therefore continue to brighten, profitability will improve further as a result of far-reaching rationalisation, moderate wage growth and productivity gains associated with rising capacity utilisation, and low interest rates will make investment in capital goods increasingly attractive by comparison with financial investment. A lasting improvement in the political setting is not likely in the foreseeable future, however; uncertainty about the progress of important reform proposals and the fiscal policy stance will continue to place a perceptible damper on investment.

Private consumption will initially continue to be affected by the unfavourable labour market conditions, but it should grow more rapidly again next year as activity strengthens and the employment situation gradually improves. The construction industry, on the other hand, will remain in the doldrums. The situation in residential construction and public works, in particular, will improve only slowly, so that building investment will trail far behind developments in the economy as a whole. In view of

the structural constraints in the building sector and the burdens imposed by fiscal policy, economic activity in Germany will still not reach a particularly rapid rate of growth; real GDP will increase by about 2 $\frac{1}{4}$ % this year and by 2 $\frac{3}{4}$ % in 1998. In these circumstances, a lasting improvement in the labour market cannot be expected. Nevertheless, employment should stop falling in the second half of this year and increase slightly in 1998. On an annual average, however, the number of persons in employment will again be significantly lower this year than in 1996. The number of unemployed will be well over 4.3 million and still significantly above 4 million in 1998.

The economy of Eastern Germany is also benefiting from the improvement in economic conditions, but the adjustment problems in the construction industry are still having a severe impact here; the resulting damping effects are difficult to offset because of the weakness of other branches of activity. Real GDP growth in Eastern Germany will therefore initially be barely higher than in the West, and the labour market situation is likely to deteriorate further, albeit only slightly. In these circumstances, an appreciable reduction in transfers to the new Länder is hardly feasible, particularly as for the most part they finance statutory social benefits. Reactivating the catching-up process will require not only a tightening-up of promotional measures and more efficient use of the funds available but also a temporary increase in resources; however, this would have to be accompanied by wage restraint.

In view of the moderate pace of the expansion and the continuing high level of unemployment, it will hardly be possible for Germany to achieve the reference value for the EMU budget criterion, despite the expenditure cuts that have been introduced. On the assumptions on which the forecast is based, the state's borrowing requirement according to the relevant national accounts definition will amount to 3.2% of gross domestic product this year; a further reduction of DM 7 billion would be necessary to bring it down to the reference value of 3.0%. Not until next year would the deficit fall significantly below the reference value, to 2 $\frac{1}{4}$ %. In calculating the budget deficit, it is assumed that the fiscal measures that have already been decided - amendments to the employment promotion law and to the statutory health insurance scheme, among other things - will be carried out as planned. It is also assumed that the measures contained in the 1998 Tax Law and passed by the Finance Committee of the Bundestag - including the reduction in the "solidarity surtax" and

⁶ If used correctly, both the central rate procedure and the average rate procedure (calculation of the conversion rate as the average over several years) are appropriate means of preventing speculation against individual currencies.

⁷ For the reasoning, see Eckhardt Wohlers: German Economy Without Momentum, in: INTERECONOMICS, Vol. 32 (1977), No. 2, p.103.

the bringing-forward of part of the tax reform to 1998 – will be implemented in their present form; if so, the reduction in taxes next year will be considerably less than originally planned. Finally, it is assumed that the profits transferred by the Bundesbank to the Federal Government will be much larger in 1998 than this year as a result of a revaluation of the foreign exchange reserves.

In assessing the budget deficit figures, however, it must be borne in mind that the margin of uncertainty is particularly wide at present. For example, there are

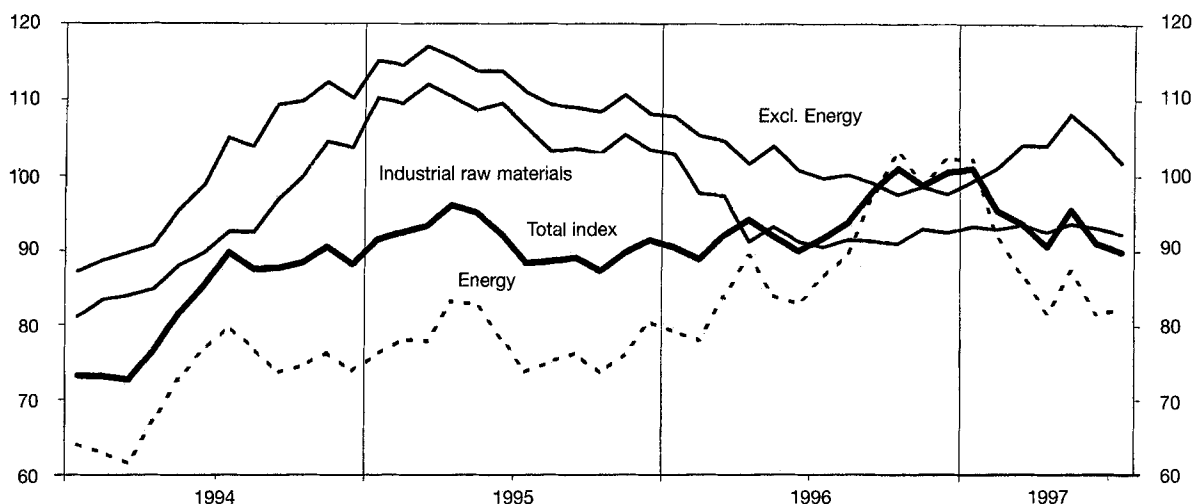
⁸ See Konjunkturschlaglicht: Steuerschätzung erneut ungünstiger, in: Wirtschaftsdienst, Vol. 77 (1997), No. 6, p. 359.

⁹ The fiscal aggregates will probably be calculated on the basis of the definition in the 2nd edition of the ESA (European System of Integrated Economic Accounts). Until now the definition was only recommended and was not used in the German national accounts. In the ESA, among other things, the treatment of investment by state hospitals is partly different to that adopted for the German national accounts, producing a slightly lower figure for state expenditure.

considerable problems in estimating revenue, as the relationship between tax receipts and macro-economic developments has been seriously upset by the many tax changes of recent years and the measures to promote the development of Eastern Germany,⁸ and it is possible that some expenditure will be postponed until the beginning of 1998. Moreover, the demand to revalue the foreign exchange reserves has shown that the German Federal Government is not averse to “creative accounting” either. Finally, it should also be borne in mind that the calculation of the budget deficit for the purposes of the EMU decision will probably be based on a method that differs slightly from the one used hitherto in official statistics (and here too), and which would produce a slightly lower figure for the borrowing requirement.⁹ According to the “harmonised” definition, the budget deficit could possibly still come within the reference value.

HWWA Index of World Market Prices of Raw Materials¹

(1990 = 100)



Raw Materials and Groups of Materials ¹	1996	Jan. 97	Feb. 97	March 97	April 97	May 97	June 97	July 97 ²
Total Index	94.3 (3.3)	101.0 (11.6)	95.4 (7.3)	93.6 (1.6)	90.6 (-3.8)	95.5 (3.8)	91.1 (1.1)	89.9
Total excl. energy	101.4 (-9.6)	99.3 (-8.0)	101.1 (-4.1)	104.1 (-0.6)	104.1 (2.4)	108.1 (3.9)	105.4 (4.5)	101.8
Food, tropical beverages	124.6 (-2.1)	117.0 (-4.5)	125.2 (-2.3)	135.3 (7.1)	138.3 (4.3)	151.0 (11.1)	141.7 (9.8)	130.0
Industrial raw materials	93.7 (-12.6)	93.3 (-9.3)	93.0 (-4.9)	93.5 (-4.0)	92.6 (1.4)	93.7 (0.4)	93.1 (2.0)	92.3
Agricultural raw materials	96.0 (-13.8)	94.6 (-12.9)	93.2 (-6.2)	92.9 (-5.5)	93.0 (5.6)	92.7 (1.8)	92.2 (-0.6)	91.4
Non-ferrous metals	88.0 (-15.8)	90.3 (-4.2)	91.4 (-3.0)	93.7 (-1.6)	90.2 (-5.0)	94.3 (-1.6)	93.5 (8.5)	92.1
Energy	89.7 (15.5)	102.2 (29.0)	91.7 (17.3)	86.9 (3.5)	81.8 (-8.4)	87.3 (3.8)	81.8 (-1.5)	82.2

¹ On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change. ² Up to and incl. 28th July.