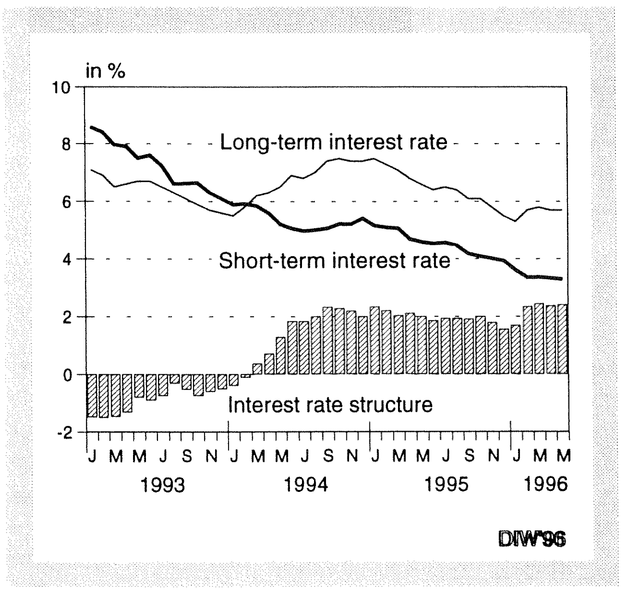
Economic Trends 1996/97: Germany: Meagre Growth

The German economy suffered a major setback during the winter months. The growth process came to a standstill after just one and a half years. To this extent Germany has performed even worse than the other west European countries. This is largely due to the appreciation effect, which was stronger in Germany than elsewhere and hit its exports to a more than proportional extent. This, in turn, had a negative knock-on effect on investment. Particularly worrying is the fact that even six years after economic unification the east German economy – which is still far from able to stand on its own feet – has not been spared by the cyclical reverse. The cyclical problems are now exacerbating the extreme structural problems, so that a process of self-sustained growth enabling the region to catch up with western Germany appears further away than ever.

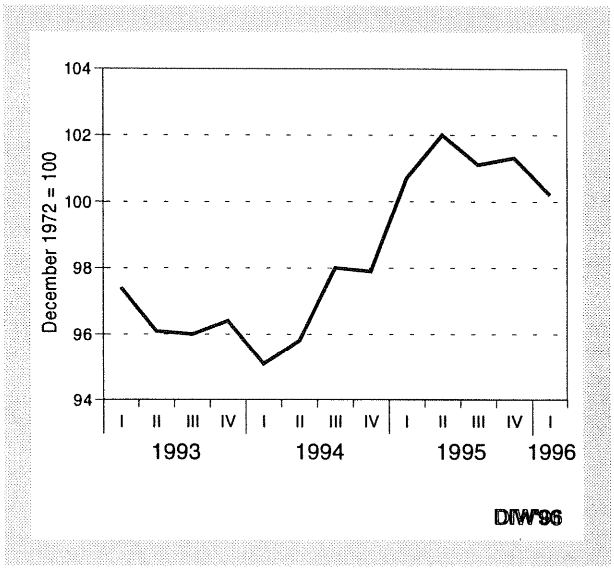
The cyclical reverse was not unexpected. It is a consequence of the global rise in interest rates in 1994 and the sharp real appreciation of the D-Mark that lasted until the first quarter of 1995 (cf. figures 1 and 2). The poor output results during the winter months are largely due to investment activity. Foreign trade, too, has failed to provide an expansionary impulse in real terms. Only private consumer spending and public current spending served to underpin effective demand. Private consumption was stimulated by the fiscal policy measures that came into force at the start of the year (exemption of earnings up to minimum subsistence level from taxation and the rise in child benefit).

Figure 1
Interest Rates



Source: German Bundesbank.

Figure 2
Real External value of the D-Mark[1)]



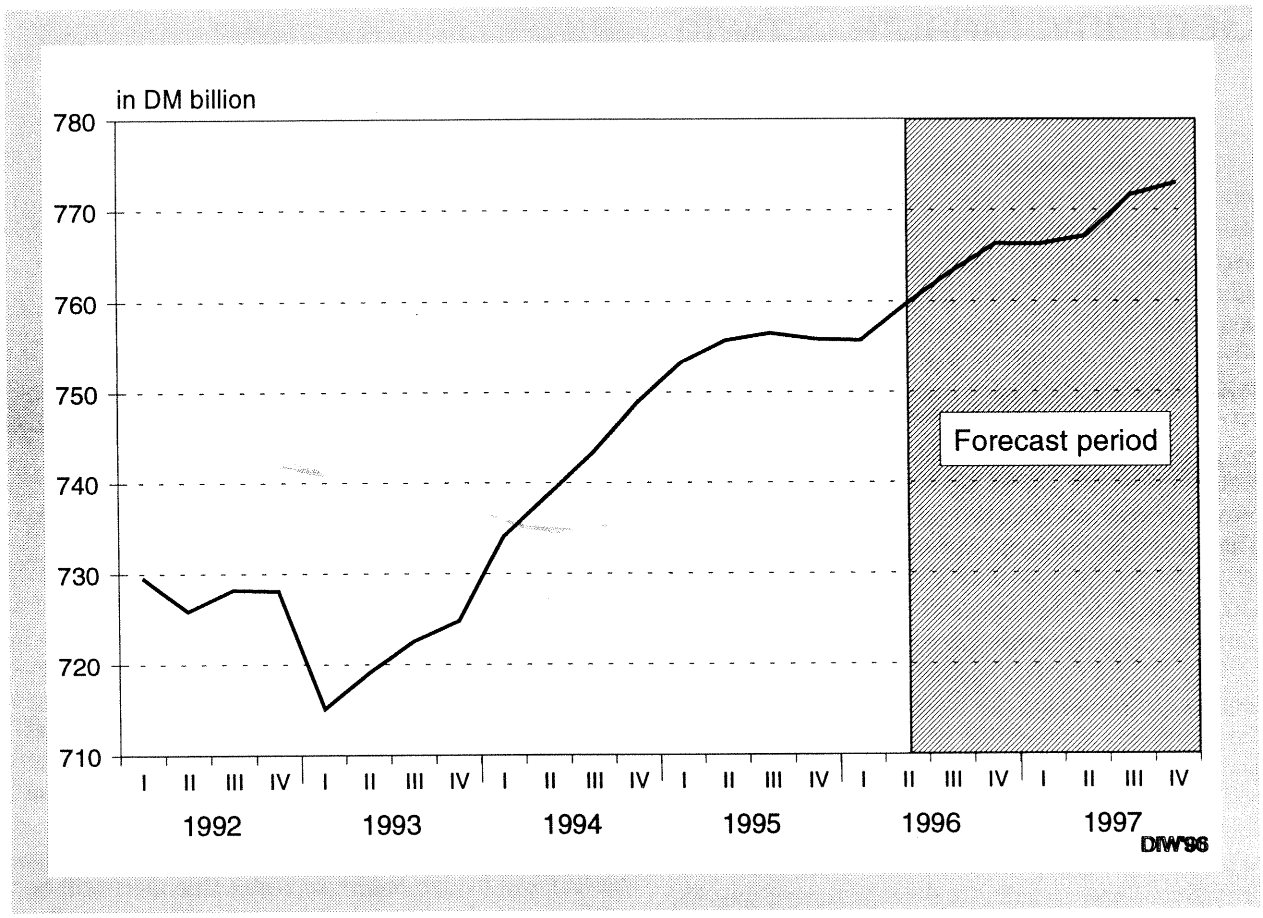
1) Compared to 18 industrialised countries; quarterly figures based on consumer prices.
Sources: German Bundesbank; DIW calculations.

Although the trend of incoming industrial orders, particularly foreign orders, indicates that there will be no further decline in total output in the coming months, it would be presumptuous to see the slight improvement in incoming orders as auguring a lasting upturn (cf. figures 4 and 5). The German economy is still a long way away from this point as there are currently no indications from where strong impulses to underpin such a development could come.

This year real GDP in Germany is set to grow by slightly more than half a percentage point. Even this rate can only be achieved if output recovers in the second half of the year (cf. figure 3). In eastern Germany the real growth rate is likely to slow to 2%; for west Germany a rate of half a percent is estimated. Even next year the German economy as a whole is expected to grow only very moderately. According to the DIW's estimates GDP growth will reach just 1 to 1.5%, whereby for the first time the rate in east Germany will actually be lower than in the west of the country. Thus – for the time being at least – the catching-up process in east Germany will have come to a standstill.

Private consumption will exert a restrictive influence. Neither wage nor transfer income trends offer grounds for expecting a significant expansion. The efforts being made by the government to consolidate its

Figure 3
Germany's Real GDP[1)]



1) Quarterly figures; adjusted for seasonal deviations and the number of working days using the Berlin Method (BV4), at 1991 prices.
Sources: Federal Statistical Office; DIW calculations.

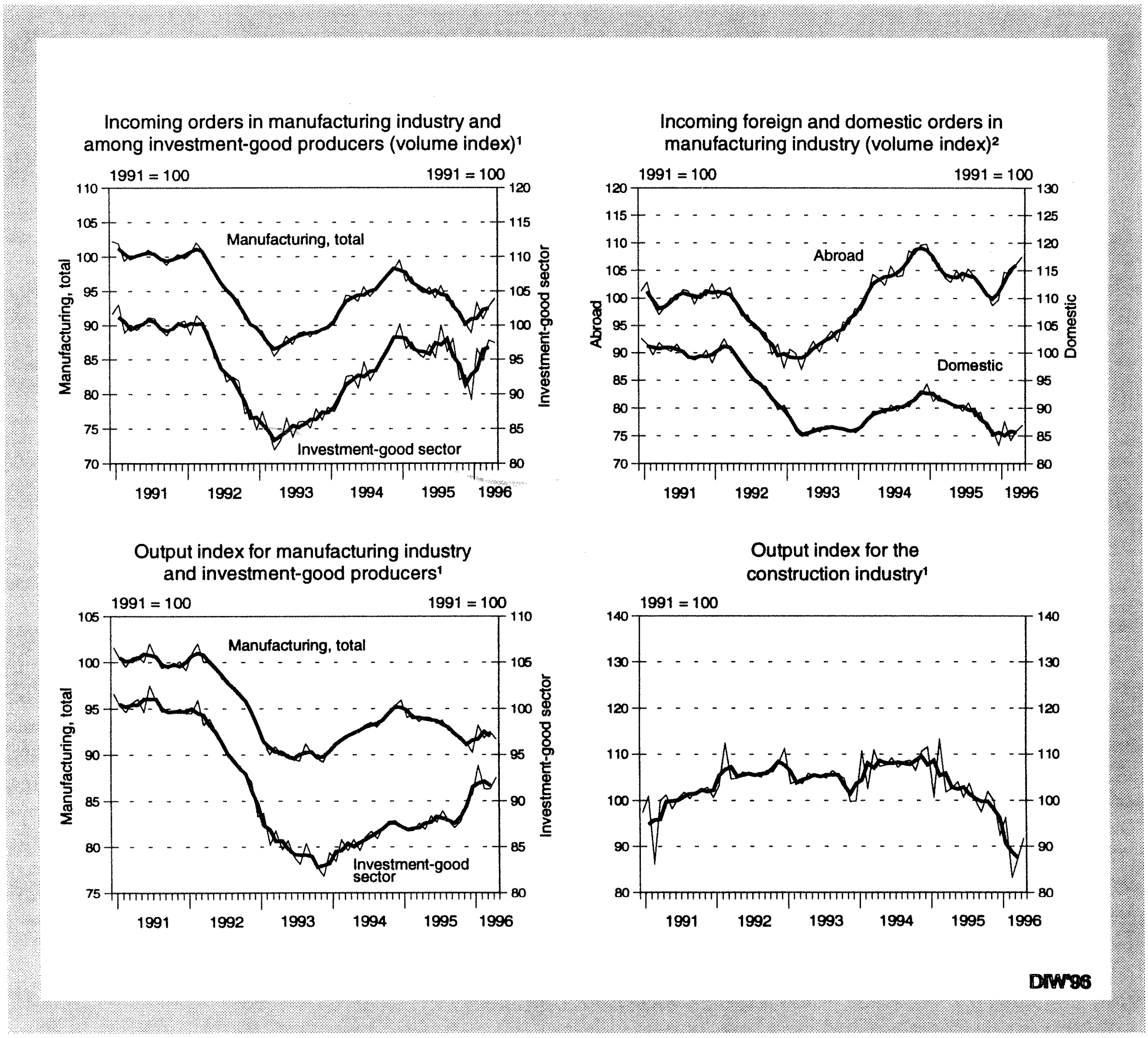
fiscal position will also exert a restrictive impact. In real terms private consumption will expand by just 1%; government current spending excluding transfers ("government consumption") will actually contract. Incoming orders from abroad, on the other hand, give grounds for optimism that exports will pick up in the coming months. Due to the renewed decline in the external value of the D-Mark, the international competitiveness of German firms has improved in terms of unit labour costs. The prognosis assumes that the real external value of the D-Mark remains constant, so that export activity will not be restricted from this quarter. In 1997, too, strong export growth to the Asian-Pacific area and to central and eastern Europe can be expected; prospects are also favourable on the US market. However, the vast majority of German goods are exported to the EU countries, where the weakness of economic growth means that exports are unlikely to expand to any great extent. In the prognosis for 1997 exports are expected to expand in real terms by 5%: this is an optimistic view. In view of the weakness of domestic economic expansion, import growth will remain modest. Net exports will again increase, leading to a renewed surplus in real terms.

Investment dynamic lacking

As far as investment in machinery and equipment is concerned, the current framework of conditions is ambivalent. At just under 85%, corporate capacity utilisation does not indicate the existence of supply bottlenecks that might induce firms to expand their capital stock in the short term. What is decisive is how firms evaluate their sales prospects. The volume index of domestic orders in German manufacturing industry as a whole suggests no improvement in the current state of affairs.

Expected developments with regard to mass income offer no prospects of a rise in private consumption such as to require an extension of the capital stock. On the

Figure 4
West Germany's Economic Trends

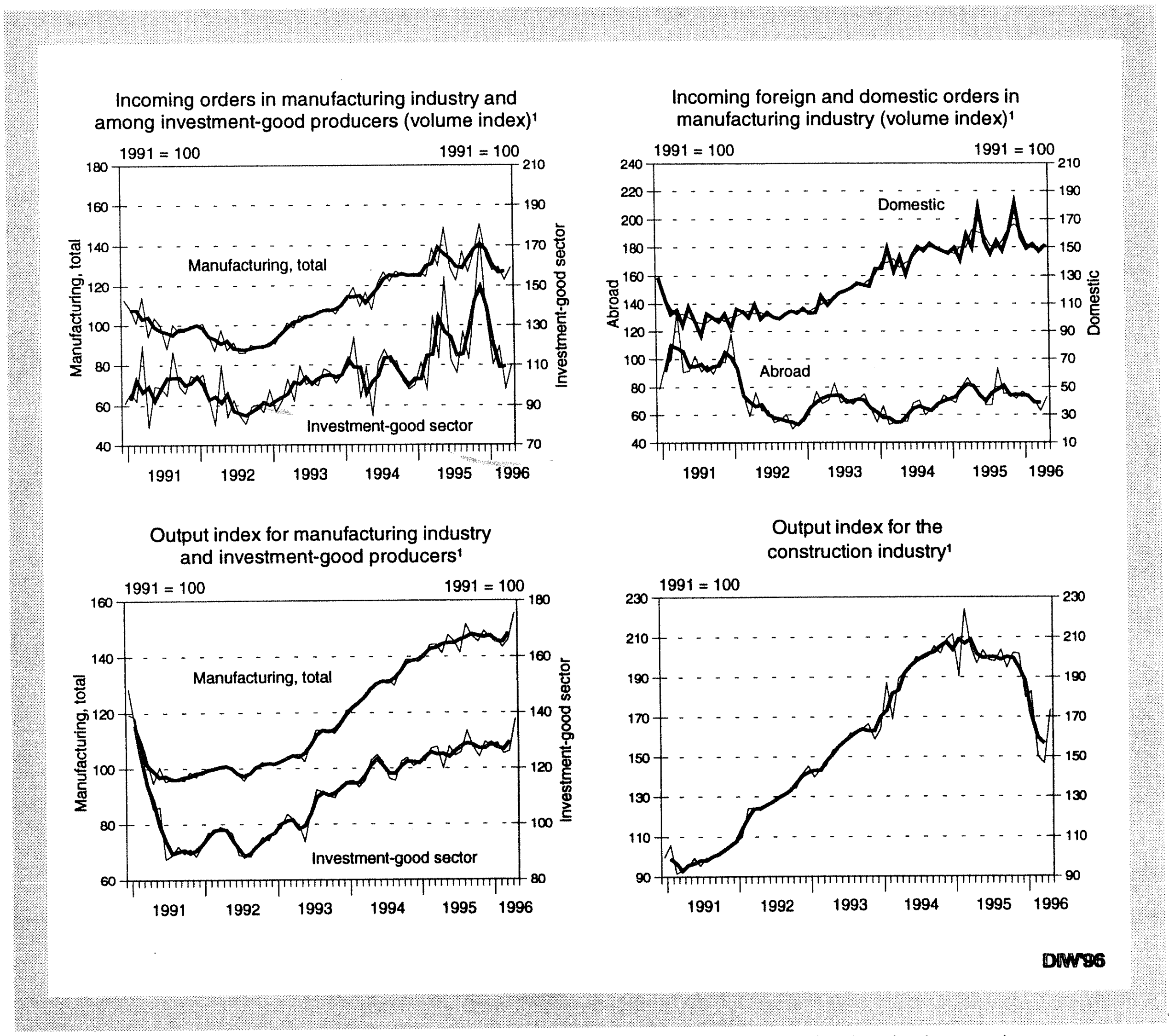


1) Figures adjusted for seasonal deviations and the number of working days using the Berlin Method (BV4) and moving three-month average.
Sources: Federal Statistical Office; DIW calculations.

other hand moderate wage trends imply an easing of the burden of unit wage costs. Even so, for as long as output fails to pick up more substantially and the scope for price increases remains limited, expectations concerning unit profit prospects will not improve to the extent that a marked pick-up in investment in machinery and equipment will materialise in the coming year (cf. figure 6). An additional obstacle to a broad-based and lasting improvement in European – and thus also in German – investment activity is the relatively high level of real interest rates. All these factors suggest that investment in machinery and equipment will only accelerate – slightly – until the end of the current year. Due to the weakness of recent quarters, however, the figure for investment growth 1996 on annual averages will be just 1%, whereas for 1997 an annual average increase of 4% is to be expected.

Real west German investment in buildings will decline in the current year (-3½%) and in east Germany it will expand only modestly compared with recent growth rates (1%); overall a contraction of 2½% will be recorded for 1996. In 1997 investment in buildings is

Figure 5
East Germany's Economic Trends



1) Figures adjusted for seasonal deviations and the number of working days using the Berlin Method (BV3) and moving three-month average.
Sources: Federal Statistical Office; DIW calculations.

expected to stagnate. The contraction in eastern Germany (-4½%) will be more or less offset by growth in west Germany (2%).

Particularly in east Germany the weakening of construction demand is a problem of major macroeconomic importance. The productive capacity and jobs created since 1991 in the construction industry and branches dependent on construction are now being lost again; structural unemployment will increase in this sector, too, unless countermeasures are taken. The scope for policy action is extremely limited, however. West-east transfers can only be increased – if at all – to a limited extent and it would not be advisable to grant renewed tax concessions to private investors.

Economic policy considerations

The very modest rates of economic growth destroy any hope of a major turnaround on the labour market. Under the framework of macroeconomic conditions sketched out above, registered unemployment will rise further, reaching above 4 million (annual average) in the current year, compared with 3.6 million in 1995 (cf. table 1).

Table 1
Federal Republic of Germany: Key Forecast Figures

	Federal Republic of Germany			West Germany			East Germany		
	1995	1996	1997	1995	1996	1997	1995	1996	1997
Gross domestic product[1] (% change on the previous year)	1.9	0.5	1.5	1.6	0.5	1.5	5.6	2.0	1.0
Employment[2] (in 000s)	34 864	34 535	34 450	28 458	28 160	28 100	6 406	6 375	6 345
Unemployment (in 000s)	3 612	3 930	4 015	2 565	2 760	2 810	1 047	1 170	1 210
Unemployment rate[3] (in %)	9.4	10.2	10.4	8.3	8.9	9.1	14.0	15.5	16.0
Consumer prices[4] (% change on the previous year)	2.0	1.5	1.5	1.8	1.5	1.5	2.1	2.0	1.5
Public sector's financial balance[5] (DM billion)	–122.7	–136.0	–122.5	–	–	–	–	–	–
Balance of payments[6] (DM billion)	–24.9	–20.8	–7.5	–	–	–	–	–	–

1) At 1991 prices. — 2) Domestic employment. — 3) Germany: unemployed as a percentage of the national working population (employed and unemployed). West and east Germany: unemployed as a percentage of the domestic working population (employed and unemployed). — 4) West and east Germany: price index of cost-of-living of all private households, Germany: price index of private consumption. — 5) National accounts definition. 1995 excl. the revenue arising out of the assumption of the capital held by the Deutsche Kreditbank (DM 5.6 billion) and the debts incurred by the Treuhandanstalt (DM 204.6 billion) and excl. the debt incurred by the east German housing sector (DM 30 billion) assumed by the Erblastentilgungsfonds. — 6) On balance of payments statistics definition.
Sources: Federal Statistical Office; German Bundesbank; Federal Labour Office; DIW calculations, 1996 and 1997 DIW forecast, forecast figures rounded..

Lasting employment growth is only possible if firms enjoy favourable conditions for investment over an extended period. Consequently, the prime task for economic policy makers is to set the course for a lasting economic upturn. They will only be able to perform this task successfully if collective pay bargaining and monetary and fiscal policy are coordinated and deployed in a consistent manner. This must build on a prejudice-free analysis of Germany's macroeconomic problems, i.e. of developments on both the supply and the demand side of the economy.

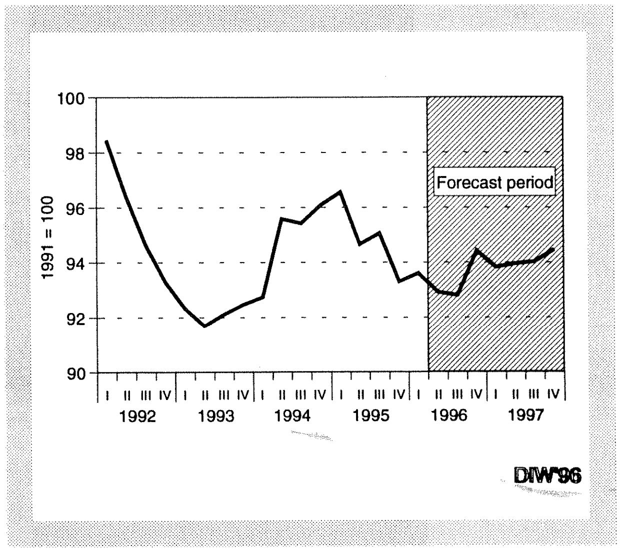
The federal government´s "Programme for more Growth and Employment" is not adequate to this task as it is oriented one-sidedly to the supply side. According to the logic of this programme, if labour costs and corporate taxation and other charges are reduced it will be more profitable for firms to take on additional labour. Yet this overlooks the fact that stable demand trends are a necessary precondition if improvements on the supply side are to be realised. This precondition is currently not being met. This implies the danger that such a programme will fail to make an impact on the economy.

Wages and salaries

It is a widely held view that it is the wage level that, in the final analysis, determines the employment level. The current debate on indirect labour costs also creates the impression that lower wage costs – in real terms – would directly lead to positive employment effects because the price of labour falls and thus the demand for labour increases. This view is incomplete, however, as it fails to take account of the interrelationships between

Figure 6

Index of Unit Profit in the German Producing Sector[1)]



1) Index of the producer prices in the manufacturing sector (1991=100) in relation to unit labour costs (gross income from employment to gross value added at 1991 prices), adjusted for seasonal deviations and working days using the Berlin Method (BV4).

Sources: Federal Statistical Office; German Bundesbank; DIW calculations.

goods, capital and labour markets, which in the final analysis serve to determine the real wage.

By itself nominal wage trends are indeterminate in their effects on the real sphere: the profitability of investment and thus employment on the one hand and real purchasing power on the other. The question as to their impact on real wages cannot be answered a priori, just as nominal wage trends alone do not determine the level of profits in an economy. The role of collective wage bargaining is, rather, that of a nominal anchor, on which economic agents should base their calculations. Collective wage bargainers can have no interest in a conflict with monetary policy. Experience has shown that the central bank will induce a "stabilisation recession", thus deciding the conflict in favour of price stability. To this extent wage negotiators are well advised to avoid risking an inflationary acceleration during the upturn and thus avoiding an ex post "correction" of wage agreements by the monetary authorities.

There is currently no danger of an inflationary acceleration. Equally unlikely is the risk of falling nominal wages and the resulting destabilisation of expectations. Although the wage settlement in the metal sector reached last year when many prognoses – including that of the federal government – were decidedly optimistic, was clearly too high, the majority of collective agreements for 1996, most of which run well into the coming year, were extremely moderate. Thus the collective bargaining system has established the preconditions for an inflation-free upturn.

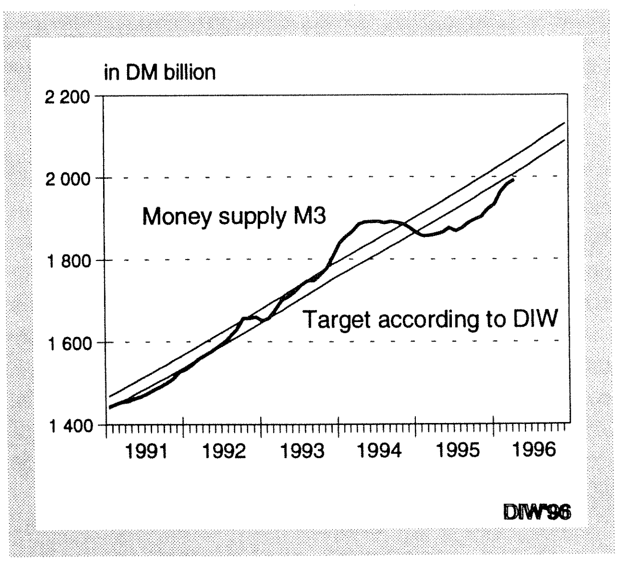
Monetary policy

Currently the nominal capital market interest rate in Germany is, at 5¾ %, low in both historical terms and in comparison with other countries. Also low, however, are the current and expected rates of inflation: the real rate of interest is currently of the order of 4%. Although this rate is in line with the long-term average, this average was – in terms of economic growth – itself too high; all the more so in a period of cyclical weakening in which, according to the Bundesbank, "relatively low interest rates" are appropriate in the context of stable money supply trends[1] (cf. figure 7).

It is undisputed that a lower real rate of interest would stimulate economic growth. The Bundesbank should attempt to bring this about by cutting short-term interest rates further. The Bundesbank, too, takes the view that there is further scope for interest rate cuts. The question is whether the monetary authorities can bring about constant, or even declining, capital market rates in Germany in the face of the trend towards rising capital market rates emanating from the USA. With

Figure 7

Money Supply M3 and Target according to DIW[1)]



1) Unitl the end of 1993: +7%, +6% onwards.

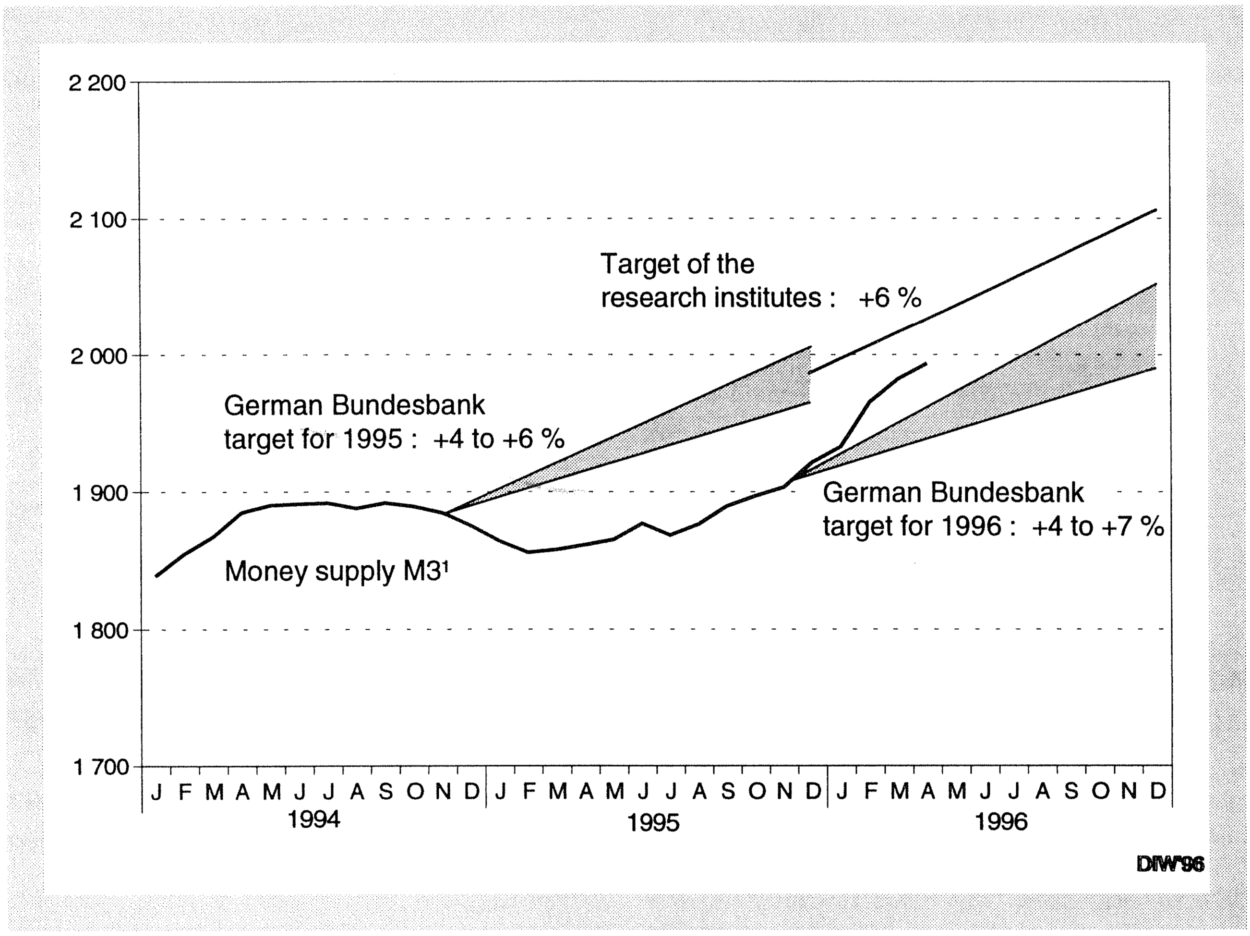
Sources: German Bundesbank; DIW calculations.

1 German Bundesbank, *Geschäftsbericht* 1995, p. 29.

Figure 8

M3[1)] in Germany – Actual and Targeted

DM billion



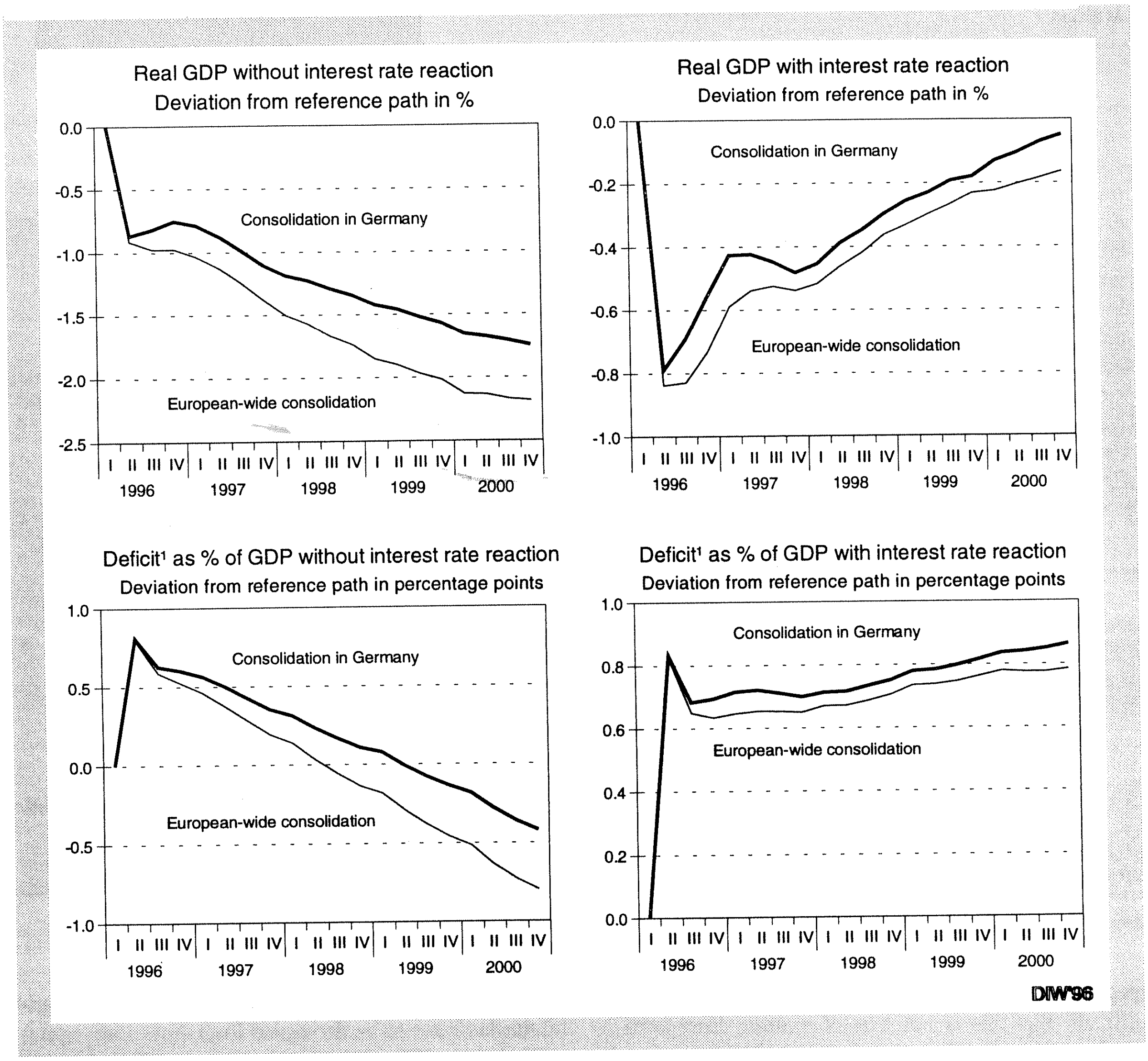
1) Monthly average; seasonally adjusted.

Sources: German Bundesbank; DIW calculations.

respect to Germany alone this is indeed likely to prove difficult. But this is not true of western Europe as a whole, whose weight on the global capital market is greater than that of the USA; even the smaller group of countries participating – in the form of coordinated monetary policies – in the exchange rate mechanism of the EMS has a substantial influence. If the majority of west European countries were to decide to decouple themselves from the rising interest rates emanating from the USA – where such a move is appropriate – they could throw their weight on the global capital market into the balance in the form of a joint interest rate cut. This would put pressure on the international interest rate level. But this would not be enough. What is the point of flexible exchange rates between the US-dollar and the west European currencies? Firstly, of course, in order to protect a country from undesirable price changes in other countries. Secondly, though, flexible exchange rates should also be used to enable west European capital market rates to be decoupled from American capital market rates. Why did this not occur in 1994 when US capital market rates rose – for reasons that were justified in domestic economic terms – pushing west European rates up, although this was not in accordance with European economic requirements? The reason is probably resignation on the part of the Bundesbank, which after May 1994 abandoned the attempt to cut its central bank rates and so detach Europe from rising American rates, a step that was subsequently followed by all the other west European central banks. Inevitably this gave rise to the impression that a decoupling of European and American capital market rates was in principle impossible.

Now that there is no danger of inflation, the Bundesbank should certainly attempt to prevent US rates pushing up those in Europe. In terms of both economic

Figure 9
Simulations of the Effects of Fiscal Consolidation Programmes in Germany



1) A positive (negative) value implies a lower (higher) deficit compared to the reference path.
Sources: Oxford Economic Forecasting Model; DIW calculations.

growth and employment the US economy is in a completely different situation to that in Europe. If European monetary policy is not decoupled, the growth process will in all probability once more come to an end far too quickly.

Fiscal policy

The economic reverse has destroyed the hope that fiscal policy would be able to reduce budget deficits within a short space of time. Despite a restrictive spending policy, the combined budget deficit of local, state and central government and the social insurance institutions is expected to rise by DM 13 billion[2] this year to DM 136 billion (according to national accounting definitions).

Next year the overall budget deficit is expected to narrow by DM 13 billion. A deficit of DM 123 billion – 3.4% of nominal GDP – would mean that Germany

[2] For the purposes of this calculation the 1995 deficit was adjusted to take account of special factors (cf. Table 1).

would fail to meet the criterion of 3% set out in the Maastricht Treaty. These figures assume even tighter restrictions on spending. The estimates take into account the fiscal effects of the recent austerity package on public budgets and the government's taxation policy changes that come into force in 1997.

Even after six years, German fiscal policy has still not fully recovered from unification. Indeed, fiscal policy has, if anything, become even more hectic. This is due not merely to the fact that Germany, of all countries, is in danger of failing to meet the fiscal policy criteria stipulated by the Maastricht Treaty. There is a lack of a clear fiscal policy concept to solve the range of problems it faces. The most visible sign of this is the fact that ambitious targets have repeatedly been set, whereby it soon becomes apparent that they cannot be achieved. Discussion focuses all too seldom on the reasons behind these undesirable developments. The central problem is the deep economic and employment crisis: ever fewer employees are having to provide for ever more recipients of transfer income. On top of this come the burdens arising out of the need to finance German unification. Besides this, wage and salary earners are making an ever increasing contribution to overall tax revenue, whereas profits and income from capital have declined significantly in importance as a source of tax revenue.

This makes it all the more urgent for fiscal policy that the framework of macroeconomic conditions improves and a lasting upturn gets under way. For it is only then that the problems can be resolved. The grave problems in east Germany cannot be readily solved without an upturn in west Germany. A turn for the better is all the more likely the more the economy receives support from fiscal policy. Yet for some considerable time now the fiscal policy stance has been oriented precisely towards the reverse, the prime aim being to limit the budget deficits by cutting back spending – particularly on social security and investment. Yet this strategy has quite clearly failed, as the deficits have not been reduced. But even this has not led to calls for a policy change; instead the austerity strategy is being tightened further.

The DIW doubts whether such an approach can prove successful in the prevailing situation, as it serves not to strengthen, but to weaken, economic activity. Government demand will be reduced and/or those suffering an additional burden (for instance those suffering from cuts in unemployment benefit and minimum social security benefit) will be forced to cut back their demand for goods and services. Reduced spending by economic agents automatically leads to reduced income, demand losses and deteriorating profitability expectations in other areas of the economy, whereby due to the multiplier effect the impact is exacerbated and the overall effect is greater than the initial impulse. This is all the more true given that such a strategy is being pursued not only in Germany, but throughout Europe. This is shown by simulation models calculated by the DIW (cf. figure 9). The models simulate the impact of a cut in government spending equal to 1% of GDP. In the first instance this measure is assumed to have been implemented in Germany alone; in a second variant it is postulated that the leading EU countries implement a package of cuts of the same order of magnitude.[3] In another scenario the monetary authorities seek to stimulate private demand by means of interest rate cuts and thus to offset the reduction in government demand. The results of the simulations show that an austerity programme of the order of magnitude indicated leads year by year to growth losses in Germany. After five years GDP is 2% below the reference value.

Economic stagnation is an unsuitable context for an attempt to consolidate government budgets. There is the very real danger that consolidation efforts will actually manoeuvre the economy into a recession. Restrictive policy action in a stagnation phase ultimately generates the very reverse of the aims of the policy. Consequently the fiscal authorities should at least attempt to meet cyclically induced cuts in revenue and increased spending via higher public borrowing.

Given the weakness of effective demand, fiscal policy must play a more offensive role. First and foremost capital spending policies require urgent revision. Public budgets must make greater resources available for public investment. This is particularly true in east Germany. The federal government would also be well-advised to refrain from implementing the planned cuts in social spending and in particular from postponing the increase in child benefit. Secondly, taxation policy should accord priority to bolstering mass purchasing power. Germany's Stability and Growth Law provides for a fixed-term cut in income tax. Given, however, that it is already planned to cut the solidarity surcharge on income tax by one percentage point (to 6.5%) on 1 January, 1997 (and by a further percentage point in 1998), it would seem politic to bring this measure forward, rather than recourse to the Stability and Growth Law. This demand boost is far from sufficient, however. In cyclical terms it would be appropriate to at least halve the surcharge in one step, reducing the tax burden on private households and firms by DM 14 billion. Of course such an approach only makes sense if at the same time steps are taken to ensure that the transfers to east Germany are not cut. Given the economic setback there they are

[3] It was assumed that this step was taken by France, Italy, Great Britain, Spain and the Netherlands, Germany's five most important trading partners in Europe.

more urgent than ever.

Incorporating fiscal policy in the economic and employment measures required clearly means that initially the budget deficits will be greater than they would have been had a rigorous austerity policy been pursued. This would be likely to change, however, if, as sketched above, policy coordination succeeded in leading the economy out of the doldrums. Just how difficult this task is can be seen from the simple fact that in the past unemployment was only reduced in a lasting manner in periods in which real GDP growth was substantial – i.e. significantly in excess of 2% – over an extended period.

The DIW is aware of the fact that the high level of outstanding government debt restricts the degree of freedom for fiscal policy action. Even so, the alternative – a strict austerity strategy – involves greater risks for the economy. This is all the more the case if the restrictive fiscal policy is pursued not only in Germany, but at European level. If consolidation is successfully achieved in the upturn, the scope for fiscal policy action will expand once more. This requires, however, that policy makers then pursue a rigorous policy and refrain from spending the additional revenue generated by the cyclical upturn.

An argument that is frequently brought against higher budget deficits is that they prevent interest rates on capital markets from falling. This is indeed the case, but it is all too often overlooked that a reduction in the budget deficit, to the extent that it results from spending cuts or tax increases, inevitably withdraws resources from the business sector and thus reduces profits. In cases where productive capacity is underutilised this aspect almost certainly plays a far greater role than the potential decline in interest rates.

'Arbeitskreis Konjunktur' in the DIW
(Study Group 'Business Cycle')