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German Economy in an Unfavourable Light

The German economy has weakened considerably since the middle of last year. What are the reasons for this development? Is the largest economy in the European Union heading for recession or is it no more than a temporary lull? What is the outlook for next year? What steps should economic policy take?

The half-life of economic forecasts is currently very short. Take for example Germany's economic research institutes which had, in their joint diagnosis published in April, already lowered their expectations for the country's economic growth to 2.1% for this year, only to ring in a new "reduction round" just two and a half months later. Unfavourable developments in the first six months of this year were the decisive factor behind the forecast adjustments. The economy weakened in the second half of the year 2000, and this weakness continued unabated into the current year. In the first quarter of this year, real gross domestic product increased at a rate which, at just under 1.5%, was little faster than in the second half of the year 2000, and – according to the X-12-ARIMA seasonal adjustment procedure used by the Federal Statistical Office[1] – domestic demand even declined. The available indicators point to a decidedly restrained development in the second quarter, too. The business climate in manufacturing industry has worsened, and the level of new orders has dropped in recent months. Given that aggregate utilisation of capacity has been falling for some time, the technical definition of a downturn has been met.

The reasons behind the appreciable economic slowdown are partly to be found in external influences, partly in the domestic economy. A not inconsiderable role has been played by the economic slide in the USA and the dampening influence this has had on the global economy. The secondary effects on the emerging economies of Asia and Latin America in particular have been substantial. The recovery process in these countries has suffered a significant setback, and real gross domestic product growth rates in both regions have contracted considerably since last autumn. German exports did not remain unaffected by all this. There has been a noticeable decline in new orders from abroad since the start of the year, and exports themselves have been in decline in recent months. In addition, the deterioration of export expectations has made a decisive contribution to the worsening business climate and to a more cautious disposition where intermediate products are concerned.

Rising Prices Weaken Domestic Demand

Domestic demand put the brakes on the economy even more strongly than export developments, with the renewed acceleration in price increases making a major difference this year. At the consumer level, the inflation rate rose from 2.2% in December 2000 to 3.5% in May this year. Household energy and food products in particular became considerably more expensive. However, there has also been a marked rise in the inflation rate excluding energy and seasonal

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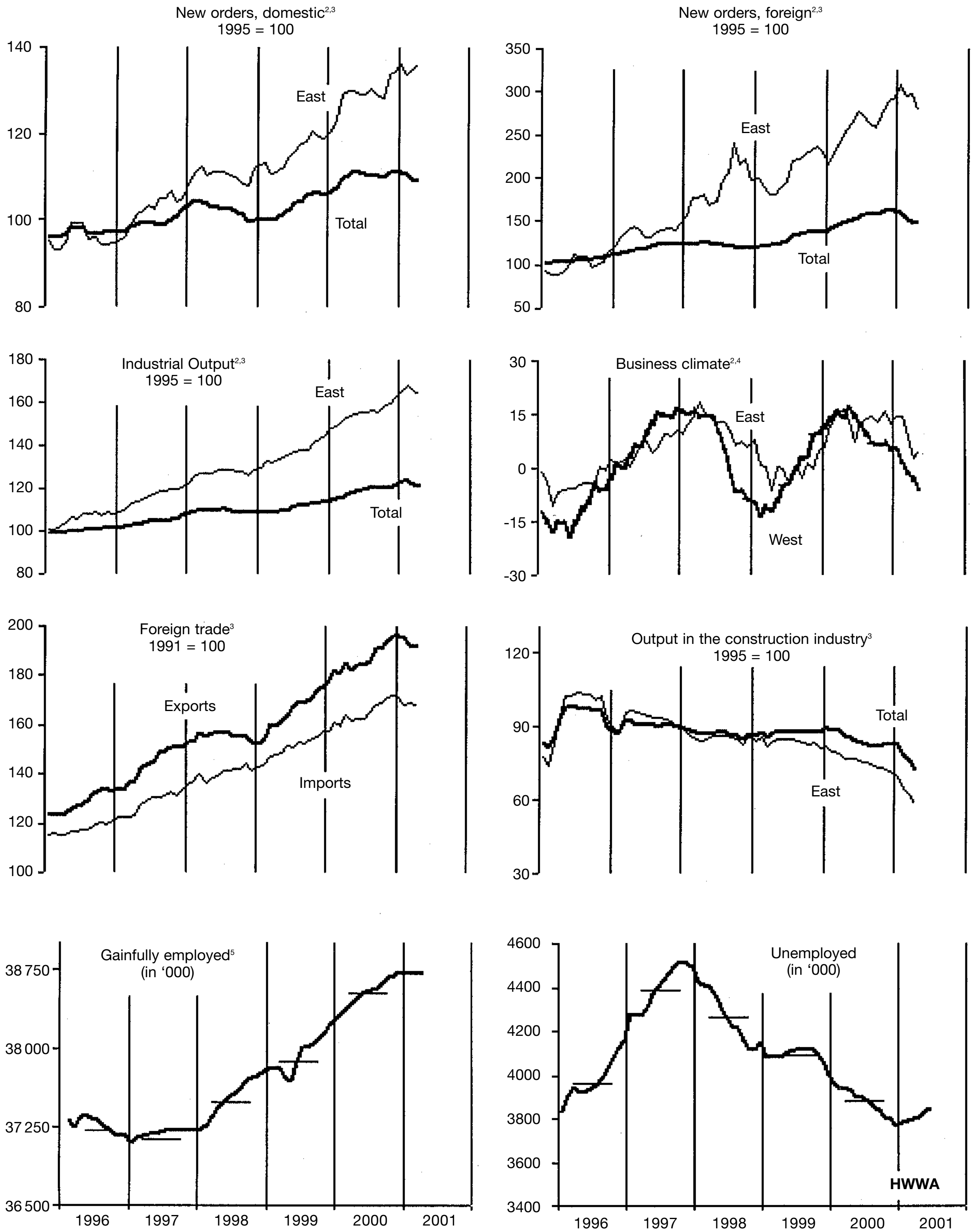
[1] The fact that the two seasonal adjustment procedures used by the Federal Statistical Office – Census X-12-ARIMA and BV4 – have come up with greatly differing results for the first quarter of this year makes it more difficult to judge the current economic situation. For example, X-12-ARIMA shows a drop in exports while BV 4 posts a significant increase. Domestic expenditure has fallen according to X-12-ARIMA, but merely stagnated according to BV 4.

Figure 1
Economic Indicators for Germany[1]



[1] Seasonally adjusted using the Census-X-11 method. [2] Manufacturing industry. [3] Three-month moving averages. [4] Balance of firms' positive and negative reports. [5] Place of residence concept. Seasonal adjustment according to the Census-X-11 method.

Sources: Statistisches Bundesamt; ifo Institute; HWWA calculations.

food products; in May it stood at 2.7%. This rate may, on the other hand, exaggerate the current price trend. The core rate[2] calculated by the HWWA to characterise underlying price developments is currently at 2½%.

This year's increase in price levels is also to a large extent due to external influences. The main factors behind the steep rise in the price of household energy and fuels were recent tensions in the international markets for oil products and the weak euro, but also the ongoing effects of last year's oil price rise, in particular the delayed adjustments to the prices of gas and district heat. The strong increase in food prices was primarily due to the livestock epidemics BSE and foot and mouth disease and to the changes in consumer behaviour they initiated. Domestic households have suffered an appreciable loss of purchasing power as a result of the accelerating rate of inflation – amounting to almost DM 5½ billion in the first quarter and probably even around DM 6 billion in the second quarter of this year. This was the primary reason why there was barely any increase in private consumption during the first months of the year in spite of the tax relief measures that came into force at the start of the year.

A further important reason for the marked weakness of domestic demand in the first quarter is to be found in the construction industry. The first three months of this year saw a drastic decline in the level of construction investments.[3] This development is largely determined by the residential building sector, where the decline – a drop of almost 7½% compared to the final quarter of 2000 – was twice as strong as in the rest of the industry. Although developments in the residential building sector are still strongly influenced by eastern Germany, there has also been an accelerated decline in investments in residential housing in western Germany. A common factor to both regions is that the construction of one and two-family houses, which had continued to expand markedly up to the beginning of last year and had been a mainstay of residential construction activities, has also been in decline since then. This is all the more surprising given that financing costs were relatively low and that the income expectations among private households were relatively good for much of last year; the prospect of tax reductions should really have provided further stimulus. It would appear that these factors, which used to be of major importance for private building activities, have for some time carried substantially less weight than before. There is one faint ray of hope, however. In the first months of this year, there has been an increase in the number of cases of building permission being granted – a forerunner indicator – both in the field of residential buildings and elsewhere in the construction industry.

The weakening economy is having an increasing effect on the labour market. The rise in employment came to a standstill in the first months of this year, and the number of unemployed has been rising again since the start of the year. In western Germany, where unemployment had continued to fall even during the winter slump of 1998/99, the number of unemployed has risen again for the first time in three years. In eastern Germany, where even last year's economic upturn failed to generate any significant improvement in the labour market, unemployment continues to stagnate at a high level.

All in all, the economic situation in Germany is decidedly delicate. The situation has similarities to that of mid-1999 when there had also been a marked weakening of the global economy in the wake of the financial crises in Asia, Russia and Latin America. The situation at that time was even worse than today in that there had been a marked drop in the level of industrial capacity utilisation which had fallen below the long-running trend. As early as the second half of 1999, however, with the global economy beginning to pick up, there was a significant recovery which quickly transformed into a strong upswing.

Little Stimulus from the World Economy

On closer examination, however, today's situation differs from that of two years ago in one very significant respect: when it comes to overcoming the current slump we cannot expect any great support from the global economy in the near future. In the USA, the economy has slowed down much further than was the case after the financial crises of 1997 and 1998. There has at least been a swift economic policy response: since the start of the year, the Fed has lowered its lending rates in a number of steps by a total of more than two percentage points, and fiscal policy has brought forward part of the planned tax cuts to this year. This will probably have strengthened confidence that the slump can be overcome fairly rapidly and will to a certain extent have defused the

[2] Cf. Jörg Hinze: Inflationsrate überzeichnet Preistendenz, in: Wirtschaftsdienst, Vol 80 (2000), No. 7, pp. 438-439.

[3] When considering the development of construction investments it is important to bear in mind that, due to weather-related problems with seasonal adjustment, the figures available for the winter months are subject to considerable uncertainties. In this respect, an exaggeration of the first quarter decline in construction investments cannot be ruled out.

problems resulting from the decline in asset prices and – in connection with this – from growing consolidation requirements on the part of many private households. This leads us to expect that the economy in the USA will pick up again in the second half of the year and gain momentum during the course of next year. The high growth rates of recent years will not, however, be achieved again in the foreseeable future. Thus, in contrast to the situation two years ago, the USA will hardly be in a position to take on the role of growth engine for the world economy. The stronger economy in the USA will nonetheless have a positive influence on developments in other regions, if only because the dampening effects currently felt will disappear. For next year in particular, a marked improvement can again be expected in the economic situation of the emerging economies not only of Asia, which has been additionally affected by the "normalisation" process in the so-called new economy, but also of Latin America. Developments in Asia continue to be restricted by the ongoing weakness of the Japanese economy, however.

In the euro area, the economy has also slowed down appreciably since last autumn – though not in the same measure as in Germany. Here too, there are similarities with the situation two years ago in that major reasons for the weaker economy are to be found in the field of foreign trade. However, the economic policy scenario is a different one. In mid-1999 – partly as a result of considerable interest rate reductions in many member countries prior to monetary union – monetary policy was the source of considerable stimulus for the economy, whereas fiscal policy had a restrictive effect due to the on-going consolidation efforts under way at the time. In the current period of economic weakness, it is much the reverse.

Even in the present economic policy scenario there is a justifiable hope that the current slump will be only temporary in nature and that the economy in the euro area will pick up again in the second half of the year. One reason is the fiscal policy stimulus in a number of member countries which, from a cyclical point of view, comes at just the right time. What is more, the dampening effects cause by last year's tightening of monetary policy are gradually beginning to fade. Also, monetary policy is currently charting a more or less neutral course; this is all the more so since the cut in interest rates in May.[4]

ECB in a Dilemma

In view of the weakness of the economy, calls for further interest rate cuts are growing louder. In terms of the two pillars on which the European Central Bank bases its monetary policy decisions, however, there is currently no scope for a further relaxation. While M3 expansion has slowed down appreciably this year, its rate of growth still remains above the reference value of 4½%. On the other hand it does appear that, even after the latest correction, this figure is still exaggerated by exceptional factors.[5] Nor does the second pillar – consisting of a bundle of relevant price development indicators – currently give any grounds for a relaxation of monetary policy. Inflation remains stubbornly above 2%, and will not fall below the target rate until some time during the course of next year – much later than had been expected until relatively recently. There is thus a greater risk that inflationary pressure may strengthen, not least as a result of secondary effects triggered by wage policy. On the other hand, the inflation rate has probably reached its zenith by now. Given the return to lower oil prices and with the secondary effects of the previous oil price increases ebbing away, inflation rates in the euro area will once again fall significantly in the coming months. Based on this consideration, the forecast assumes a further cut in interest rates of 25 basis points this summer.

The interest rate decision could also be influenced by the exchange rate of the euro. Any hopes of the euro strengthening as the respective spreads between growth and interest rates in the USA and the euro area narrow have not been realised.[6] While the exchange rate of the euro picked up temporarily around the turn of the year 2000/2001 when recessionary fears abounded in the USA and the Fed cut its interest rates, it has again lost ground in recent months despite the fact that real gross domestic product in the euro area has even increased at a somewhat stronger rate than in the USA and short-term interest rates are now even lower than in America. The ongoing weakness of the euro probably has something to do with the fact that inflation in the euro area accelerated faster than in the USA, so that the differences between the inflation rates diminished significantly. However, the euro's development this year probably also indicates that, in the longer term, a

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[4] In May, the main refinancing rate was reduced by 25 basis points to 4.5%.

[5] Cf. Deutsche Bundesbank: Die Wirtschaftslage in Deutschland im Frühjahr 2001, Monthly report May 2001, p. 18; further: Monetäre Entwicklung im Euro-Raum seit Beginn der EWU, Monthly report June 2001, pp. 42 ff.

[6] Cf. also Jörg Hinze: Weiterhin Inflationsrisiken, in: Wirtschaftsdienst, Vol 81 (2001), No. 6, p. 352.

greater growth potential continues to be perceived in the USA than in the euro area, and that it is considered more likely that the USA, rather than the EMU, will see a comparatively rapid end to the current slump. As a result, there is little indication of a sustained strengthening of the euro in the near future.

Restrained Recovery in the Second Half of the Year

Against this background, the German economy should stabilise in the second half of this year. Although cyclical expansion will be somewhat faster, utilisation of capacity will continue to fall at first. In other words, the downturn will merely decelerate, the output gap will expand further. Little stimulus can be expected of exports, which in the past two years were the driving force behind the country's economic upturn, if only because of the restrained developments in the regions outside Europe; moreover, the impulses generated by last year's depreciation of the euro are fading. On the other hand, domestic demand will pick up speed in the second half of the year. Private consumption will play a major role here, expanding at an accelerated rate as a number of factors – such as the easing of tension in the oil markets, the fact that the passing-on effects triggered by the previous oil price rise will have run their course, as well as the gradual disappearance of exceptional factors such as BSE and foot and mouth disease – combine to bring about a considerable decline in the rate of inflation. Towards the end of the year, moreover, a degree of stimulus should be provided by the introduction of euro coins and bank notes. This is due to the fact that certainly not all of the cash reserves held, for example, by private households in Germany – but also by households in many Central and Eastern European countries – will be converted into euros, but will, in part at least, be used to purchase consumer goods.

Next year will see Germany's economy gain momentum. Expansion will continue to be supported primarily by domestic demand and not least by private consumption. While fiscal policy stimulus is on the wane, the stimulus emanating from this year's relaxation of monetary policy will make itself increasingly felt in the year 2002. The economy will also be strengthened by a further decline in inflation. At 1.7%, the inflation rate will, on average, be back below the two per cent mark next year. As a result, private households' disposable income will, in real terms, tend to increase even somewhat faster next year than in 2001, despite the effects of the tax reform felt this year. Finally, exports will again benefit from the recovery of the world economy next year. However, they will not be able to match the high growth rates of recent years.

All in all, real gross domestic product can be expected to grow at around 2¼% in the year 2002, following a rate of 1.7% this year. The labour market situation will show little improvement as a result of the slump. Although the labour market, too, will again see a slight recovery in the second half of this year, there will be no more than a minor drop in the average number of people unemployed in Germany in 2001. The same applies to next year. The number of unemployed will not fall to anywhere near 3.5 million, the government's target for 2002.

Dismantling the state financial deficit will also be delayed by the economic slump. At 1.8% in relation to GDP it will remain well above the government's target mark of 1½% this year; it will fall no lower than 1.4% next year. However, this is no reason to resort to frantic actionism of any kind. It would, for example, be counterproductive in the current situation to initiate additional austerity measures in an attempt to force the deficit below 1½% of GDP in spite of everything. This would limit the effectiveness of the automatic stabilisers contained in the budget and place an additional burden on the economy. Conversely, however, it would be inappropriate to look for new measures to kick-start the economy. With the tax relief measures that came into force at the start of the year, the government has already – if unintentionally – taken considerable steps to support economic activity. Without the tax package – which involves tax relief for private households and companies amounting to DM 45 billion or 1.1% of gross domestic product – the downturn would be far more pronounced. Further measures are not appropriate, at least from a cyclical point of view. As far as growth aspects are concerned, however, the government still has to deliver. Deregulating the labour market, which is currently under discussion, or bringing forward the next stages of the tax reform would be meaningful measures for strengthening the forces of growth.

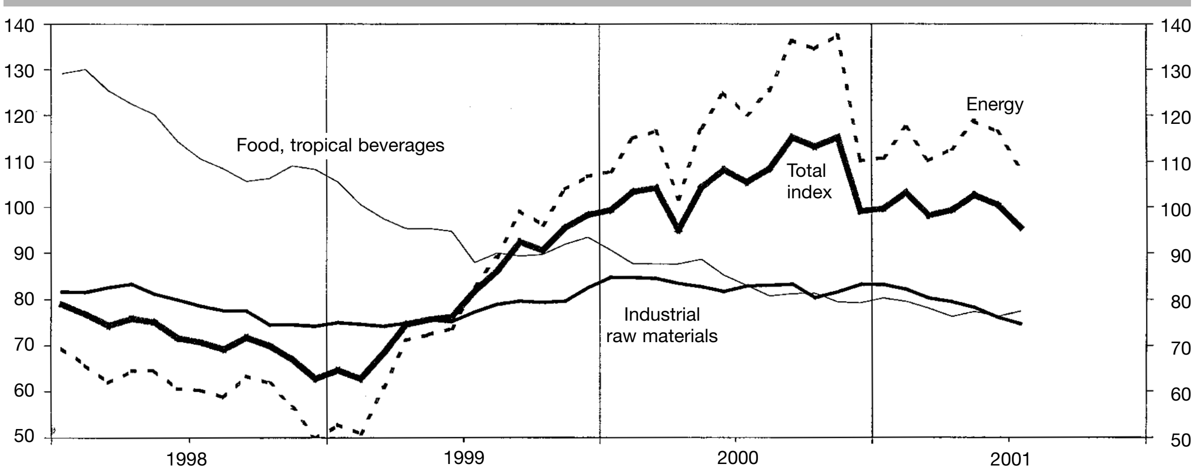
Forecast Risks

The forecast contains substantial risks. For example, the slump in the USA could drag on for longer than is assumed here. Given the substantial weight of the US economy, this would not be without consequences for other regions. Further risk factors are oil prices and the exchange rate of the euro. In this forecast it is assumed that the price of oil remains at the $ 25/barrel level. Higher oil prices – due to increased political tension in the Near East, for instance – could impede the rapid decline in inflation rates forecast here. The same is true of the euro, should it continue its weak trend. However, any rapid and vigorous appreciation of the euro – for example in connection with a recession in the USA – would not be unproblematical, because it would weaken the international competitiveness of products from the euro area and thus place an added burden on exports. This would, in the short term at least, more than offset the positive effects on price developments.

Finally, wage developments also carry a risk. Pay rises have been moderate in recent years, despite the acceleration of price increases caused by the rise in oil prices. Here it is assumed that the next round of pay settlements does not bring any significantly higher wage increases than the previous ones. This can be justified by the weak economy, the faltering labour market recovery, and not least by the expected marked drop in inflation rates. Recently however, calls for markedly higher wage increases in the next pay round have been growing louder. If this were to happen, it would not only jeopardise progress in the fight against unemployment, but would also have a considerable negative impact on the price climate in Germany. Moreover, any appreciable acceleration of wage increases in Germany could be regarded by the ECB as a signal of a growing risk of inflation, particularly if a wage policy of this kind were to find imitators in other member countries.

HWWA Index of World Market Prices of Raw Materials[1]

(1990 = 100)



Raw Materials and Groups of Materials	2000	Jan. 01	Feb. 01	Mar. 01	Apr.01	May 01	June 01	July 01[2]
Total Index	105.9 (31.5)	99.6 (0.3)	103.1 (–0.2)	98.1 (–5.8)	99.3 (4.6)	102.6 (-1.6)	100.5 (-7.1)	95.5 (-9.4)
Total, excl. energy	83.3 (2.3)	82.4 (–4.4)	81.4 (–4.6)	79.7 (–6.5)	78.6 (-6.9)	78.0 (-7.3)	76.1 (-7.8)	75.4 (-9.1)
Food, tropical beverages	84.3 (–10.5)	80.2 (–11.4)	79.5 (–9.2)	78.1 (–10.8)	76.2 (-13.0)	77.4 (-12.6)	76.2 (-10.5)	77.4 (-6.6)
Industrial raw materials	83.0 (7.5)	83.1 (–1.8)	82.1 (–3.0)	80.2 (–5.0)	79.5 (-4.7)	78.2 (-5.4)	76.1 (-6.9)	74.7 (-9.9)
Agricultural raw materials	81.9 (4.2)	82.8 (–0.7)	81.8 (–1.4)	80.3 (–3.7)	79.1 (-5.6)	75.9 (-6.8)	74.0 (-7.9)	72.9 (-10.7)
Non-ferrous metals	83.0 (15.5)	82.1 (–5.5)	81.0 (–6.8)	77.6 (–8.3)	76.4 (-4.6)	78.3 (-4.9)	74.6 (-7.8)	71.9 (-13.1)
Energy	120.6 (50.9)	110.8 (2.8)	117.3 (2.0)	110.1 (–5.5)	112.7 (10.9)	118.7 (1.1)	116.4 (-6.7)	108.7 (-9.5)

[1] On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.
[2] Up to and incl. 20th July.