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Recent Economic Developments in Germany, March-June 1964

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Summary

Business activity in Germany continued to expand and broaden during the spring as continued strong foreign demand has provided the basis for a renewed expansion of domestic investment.1/ In part, domestic demand--as indicated by the inflow of orders to industry--began to outpace the growth in foreign demand. So far, the supply situation has accommodated this growing demand without apparent strain, because of the existence of some spare capacity as well as of a cushion of finished goods inventories in certain sectors. But margins for further expansion on the supply side are narrowing, so that order books are lengthening, as are delivery periods in some industries. At some point this development may curtail the inflow of export orders, but at this stage the competitive position of German export industry is evidently still unimpaired.

Thus, although the upward price trend which became noticeable toward the end of last year has since continued, price increases have remained moderate, particularly when compared with those in neighboring countries. Wage advances were also moderate in the period under review, but increasing tightness in the labor market, rising consumer prices and continuing reports of widening profit margins are creating a climate for larger wage demands when major contracts expire this fall.

In its concern over possible inflationary dangers, the Government has been trying to develop new anti-cyclical fiscal powers and has also adopted a number of measures to encourage imports which become effective on July 1 of this year.

1/ For a review of earlier developments, see "Recent Economic Developments in Germany, January-March 1964," dated April 14, 1964.

The proposed 25 per cent withholding tax on income from fixed-interest investment accruing to nonresidents, announced in March, has effectively stopped inflows of capital into the bond market, and has in fact caused some withdrawal of funds. As a result, the D-mark weakened in foreign exchange markets in April and May, official reserves declined somewhat and a balance of payments deficit was recorded in April. However, renewed revaluation rumors caused speculative inflows into Germany at the beginning of June, which caused official reserves to rise $132 million in the first 15 days of June. An immediate effect of the proposed withholding tax was an upward movement in long-term interest rates, marking the end of any further attempts to lower the level of German interest rates level. An additional effect has been the development of an active market in foreign bonds denominated in D-marks during May and early June. Since these bonds are not subject to the proposed withholding tax, foreign demand has been heavy and Germany is emerging as a financial intermediary channelling foreign funds from investors to borrowers.

<u>Demand and output continue to expand</u>

The improving domestic investment climate, initially attributable to the continuing growth of foreign demand, has recently had a more important influence on the expansion of domestic demand than in previous periods. In fact, new orders received from domestic customers in March-April were 3.5 per cent above January-February, while foreign orders were actually 2.1 per cent lower. (See Table 1.) On a year-to-year basis, domestic orders in April were up 21.0 per cent, and foreign orders 17.2 per cent. These substantial growth rates indicate the strength of the current upswing.

Table 1. Germany: New Orders Received by Industry, 1962-April 1964
(Index numbers, 1954 turnover = 100; seasonally adjusted)

1962	All industries1/	Domestic orders	Foreign orders	Basic industries	Capital goods	Consumer goods
January	208	201	244	190	256	169
April	209	200	243	185	263	159
July	205	200	228	182	251	174
October	215	207	252	197	256	180
1963						
January	207	197	254	184	253	177
April	220	205	297	194	271	179
July	224	210	301	196	290	174
October	240	225	317	214	298	192
1964						
January	238	216	312	217	291	192
February	251	233	340	221	310	200
March	236	217	290	208	284	181
April2/	265	248	348	242	322	206

1/ Excludes mining, construction, food and power.
2/ Preliminary.
Source: Bundesbank, Monthly Report.

The rise in domestic orders reflected primarily the brisk expansion in the construction and capital goods sectors; orders to basic industries, which depend largely upon construction activity, rose by 24.7 per cent between April 1963 and April 1964, while orders to the capital goods industry were up 18.8 per cent. While investment demand is still heavily concentrated on capital deepening projects (because of the increasing labor shortage), the generally favorable business climate is also encouraging additions to plant, particularly in the more rapidly expanding industries such as automobiles, chemicals and electro-technical products. This demand, added to the continued large building programs of public authorities, is putting renewed strains on the building sector.

So far, the expansion in demand has been met by remarkably elastic supply conditions, reflecting in part the existence of unused capacities, particularly in the investment goods sector, and in part finished goods inventories which could be drawn down. But resource margins are shrinking rapidly, even though increases in output per man-hour continue large. During the first four months of 1964 industrial output has averaged approximately 10 per cent above the corresponding 1963 period. (See Table 2.) Part of this year-to-year increase, of course, reflected the low output levels of 1963 because of the bad weather, but a large part reflected the more efficient use of the industrial apparatus.

Table 2. Germany: Industrial Production, 1962-April 1964
(Index numbers, 1950 = 100; seasonally adjusted)

1962	All industries	Basic & producer goods	Capital goods	Consumer goods	Food beverages & tobacco	Building
January	268	277	369	224	223	266
April	274	287	373	229	237	261
July	278	298	376	235	233	274
October	282	300	384	238	235	284
1963						
January	270	280	364	229	231	169
April	284	302	381	235	246	290
July	289	308	383	241	254	311
October	300	326	396	251	249	307
1964						
January	305	334	404	249	261	316
February	300	329	405	246	248	270
March 1/	307	337	412	256	251	311
April 1/	295	333	390	243	242	270

1/ Preliminary.
Source: Bundesbank, Monthly Report.

With output no longer keeping pace with the order inflow, order backlogs have been lengthening. Industrial orders exceeded deliveries by 6 per cent during the first quarter of 1964, whereas they had been roughly equal during the last quarter of 1963. Backlogs grew particularly fast in the engineering and the basic industries, and delivery periods consequently lengthened. This development may well work toward bringing better balance to the demand-supply situation by deterring some foreign demand and stimulating some imports. However, resources are also pressed in most of Germany's major trading partners, and German industry, despite tighter supply conditions, may retain a competitive advantage in this respect.

Labor market very tight

As before, the tight labor situation is still the principal limit to expansion on the supply side. During April and May unemployment was down to 0.6 per cent of the labor force--about the same as in the preceding year--but job vacancies increased and in May there were five vacancies for each person unemployed. Labor difficulties are also becoming more pressing because the numbers of new entrants into the labor force is being curtailed by the introduction of a ninth compulsory year of schooling in some areas.

On the other hand, labor market tightness was relieved to some extent by an increase in the foreign labor force; at the end of March 1964, 830,000 foreigners were employed in Germany, about 100,000 more than in the preceding year. However, foreign workers are becoming increasingly difficult to recruit, particularly since skilled and semi-skilled labor from Italy now also is becoming scarce in Italy, a major source of labor reserves in past years.

Prices trend upwards

The combination of buoyant demand and the approach of full capacity utilization has begun to push prices upward, particularly in areas where price increases had been held back by lagging demand. With the change in the demand situation, past as well as current cost increases can more easily be passed forward in price increases.

Some upward price tendency was noticeable for investment goods. Price concessions were reported for this sector because of lagging demand earlier in 1963, and the price index was stable through most of the year; but between January and

April 1964, producer prices for investment goods rose by 0.4 per cent with increases recorded in each month. (See Table 3.) Producer prices for industrial products in general were up 0.4 per cent between January and April and 1.2 per cent between April 1963 and April 1964. Export prices, which were relatively stable during 1963, began rising toward the end of the year and in April 1964 were 3.4 per cent above the preceding year's level. With import prices also moving up, the terms of trade changed only very little. Consumer prices also continued to trend upward, in part because of seasonally higher food prices, the shortage of meat and the continuing increase in prices for services.

Table 3. Germany: Prices and Wages, January 1963 - April 1964
(Index numbers, 1958 = 100)

	1963				1964			
	Jan.	April	July	Oct.	Jan.	Feb.	March	April a/
Producer Prices								
Total industrial products	103.5	103.5	103.4	103.9	104.3	104.4	104.5	10[illegible]
Investment goods b/	107.3	107.2	107.3	107.4	107.5	107.6	107.8	107.9
Consumer goods b/	106.0	106.6	107.1	107.5	108.5	108.7	108.9	109.1
Consumer Prices								
General index	111.1	112.8	111.6	112.1	114.0	114.2	114.4	114.6
Food	111.0	114.1	110.3	110.1	113.6	113.7	113.9	114.1
Export Prices								
General index	100.4	100.4	100.6	100.8	102.2	102.7	103.1	103.8
Investment goods b/	107.0	107.3	107.8	108.0	110.2	110.2	110.3	c/
Consumer goods b/	101.2	101.2	101.1	101.5	101.7	101.6	101.6	c/
Import Prices								
General index	95.6	95.7	94.7	96.2	96.9	97.3	97.8	98.7
Investment goods b/	97.4	97.7	97.9	98.3	101.5	101.4	101.4	c/
Consumer goods b/	94.5	94.8	94.6	94.5	94.3	94.0	93.8	c/
Earnings								
Average hourly earnings in industry d/	145.8	147.3	151.6	154.1	156.4	158.1	c/	

a/ Preliminary.
b/ Grouped according to end-use of goods.
c/ Not available.
d/ Published February, May, August, and November only.

Source: Statistisches Bundesamt, _Wirtschaft und Statistik_.

Despite labor shortages, wages continued to rise only moderately. Average hourly earnings in industry rose at an annual rate of 6.6 per cent between November 1963 and January 1964, or by slightly less than the 7.3 per cent recorded during 1963. However, the moderate wage development largely reflects the fact that most major wage contracts are not due to expire until fall. There is a general feeling that the favorable business climate, the labor shortages and the retail price increases could be strong enough by the fall to put an end to the moderate trend in wages.

Government concern over inflationary pressures

The Government has expressed increasing concern over the inflationary pressures which are developing in the economy now that domestic demand has joined export demand as a major expansionary force. In the light of recent developments, official estimates of the rate of growth of real gross national product for 1964 have been revised up from 4.5 per cent to 5 - 5.5 per cent. But the authorities feel that the cyclical expansion carries an inherent threat of unfavorable price developments, particularly if other countries should prove unsuccessful in their stabilization efforts. Because of this threat, the Government is moving ahead on two fronts: in adopting unilateral tariff cuts and in asking for new anti-cyclical powers, particularly in the fiscal field.

Measures to stimulate imports

The authorities are working on the assumption that exports will continue to expand and that imports will not be able to keep pace unless measures are taken to stimulate them. Thus, Germany would continue to supply resources abroad at a time when its own resources are severely taxed and domestic demand is rising. This in turn would lead to an intensification of inflationary pressures.

On June 25 the Government obtained parliamentary approval of a number of measures designed to stimulate imports in order to bring about a better current account balance. These measures, which become effective on July 1, are:

a. A unilateral reduction by 50 per cent of intra-EEC duties on most industrial and some agricultural items, and a 25 per cent reduction in duties on certain other industrial items. This measure advances the effective date of most of the EEC tariff reductions scheduled for January 1965 and January 1966. Based on 1961 trade figures, these reductions affect about 10 per cent of German imports.

b. A unilateral reduction, to the level of the Common External Tariff, of duties on industrial items currently above this level; and a reduction of some duties on agricultural products originating outside the Common Market to, or toward, the Common External Tariff. On the basis of 1961 trade returns, about 1 per cent of German imports would be affected by this measure.

It is estimated that these tariff reductions would involve a customs revenue loss of about DM 300 million--possibly somewhat more--per year; customs receipts totalled DM 3,640 in 1963. Because of the limited nature of the reductions, it is not expected that these measures will have a significant effect in reducing Germany's trade surplus. The German Government has also proposed to the EEC Council that the Common External Tariff be reduced by 25 per cent, as an advance action in the Kennedy Round of GATT negotiations. This proposal has not been enthusiastically received.

Proposed fiscal measures

More important than the Government's tariff proposals, however, is the recent announcement that the increase in expenditures in the 1965 budget will be held to 5 per cent. This is in line with the general EEC recommendations to member countries to limit growth in budgetary expenditures to 5 per cent per annum in order to hold down inflationary pressures emanating from the public sector. This would also be in line with the recent emphasis on fiscal measures in anti-cyclical policy which prompted the Government to ask for new powers in this field. Government officials have been trying to work out an anti-cyclical fiscal policy, particularly in the field of public investment expenditures, and are particularly pleased about an agreement reached with the Laender to follow a more coordinated expenditure policy.

It is likely that the Federal budget will be somewhat more restrictive in 1964 than was estimated earlier. With the upward revision of the GNP estimate, tax receipts in 1964 should also increase, so that borrowing requirements may turn out to be somewhat less than anticipated. This faster growth in revenues also makes it more likely that the proposed reduction in income tax rates scheduled for January 1, 1965, and estimated to amount to DM 3 billion annual rate would be more than offset by rising revenues.

Securities markets under pressure

Heavy financing requirements of public authorities are becoming increasingly difficult to cover in the long-term securities market. The threat of the proposed 25 per cent withholding tax on income from German fixed interest securities accruing to nonresidents has effectively stopped capital inflows into such securities. Although this tax remains only a threat with delays in the passage of legislation, it has led to net sales by foreign interests. As a result, bond yields have been under continuous upward pressure since the announcement of the tax proposal in March. The yield on a representative Federal Railways bond rose from 5.84 per cent in March to 6.14 per cent at the end of April and to 6.29 per cent on June 5, indicating an end to any further attempts to bring German interest rates down.

Although bond yields remained under pressure, there were some signs that the bond market was adjusting to the withdrawal of foreign funds and to other effects of policy uncertainties. But this steadying of the market was possible only because new domestic offerings were carefully limited and because the Bundesbank gave considerable support to Federal issues. Thus, on May 20 a DM 300 million Federal loan (issued again with a 6 per cent coupon) was sold entirely to domestic customers, but only because of substantial purchases of outstanding bonds by the Bundesbank. Because of the persistent need to support the Government bond market, the Central Bank Council of the Bundesbank has reportedly decided that new issues should be most carefully timed; and the expected announcement of a new DM 250 million issue by the Federal Railways and a DM 200 million Federal Postal System loan has apparently been postponed.

A major repercussion of the withholding tax proposal has been the emergence of Germany as an important financial intermediary, with funds from foreign investors being channelled into foreign bonds through the D-mark. Because foreign bonds denominated in D-marks are not subject to the proposed tax, they have been in heavy demand by foreign interests, who reportedly have been switching out of German Federal bonds into foreign bonds. The active foreign demand for such bonds points up international confidence in the D-mark in preference to other currencies.

The weak tone prevailing in the bond market also spread to the stock market, despite continued favorable business news. Largely as a result of sales by foreigners, stock prices declined by 8 per cent between April 6, when they reached their 1964 high, and June 5th. The weakness in the market makes the placing of new stock offerings unfavorable just at a time when companies have been planning to turn to the market for the financing of large capital investment plans.

Despite reports of private as well as public bodies increasingly turning to the banking system for their financing requirements, latest statistics have not shown large increases in credit extended by the banking system. First-quarter credit extensions were only fractionally above the preceding year's level, when demand for credit was unusually low because of the abnormally severe winter slowdown (See Table 4). Credit extensions to the private sector actually were below the first quarter 1963 level. Deposits received from domestic customers, on the other hand, were well above that level. As a result, the gap between credit extensions and deposits received narrowed considerably.

Table 4. Germany: Change in Selected Bank Statistics 1962--March 1964
(billion DM)

	1962		1963		First qtr.	
	1st half	2nd half	1st half	2nd half	1963	1964
Credit extended to domestic customers 1/						
Private sector	9.1	9.8	9.6	9.5	3.5	2.2
Public sector	1.0	1.4	1.5	3.1	1.0	1.6
foreign customers	0.8	0.8	0.6	0.3	0.2	0.4
Purchases of securities	2.7	0.6	2.6	1.5	1.7	2.0
Total	13.6	12.6	14.3	14.4	6.4	6.8
Deposits received from domestic customers 1/						
Private sector	4.4	9.5	4.1	12.8	0.5	1.1
Public sector	2.4	3.4	0.8	3.8	-0.8	-0.6
foreign customers	-0.3	0.6	-0.5	0.7	-0.6	-0.8
Sale of bank bonds	3.8	2.8	4.3	4.0	2.5	3.3
Other	1.9	-2.3	3.3	-2.1	2.4	2.2
Total	12.2	14.0	12.0	19.2	4.0	5.2
Balance credit extensions less deposits received	+1.4	-1.4	+2.3	-4.8	+2.4	+1.6
Commercial banks' foreign exchange assets	+1.3	-1.6	+1.1	-0.8	+0.9	+0.9
Borrowings at Bundesbank	0.2	0.6	1.2	-1.5	0.6	1.1

1/ Non-bank sector

Source: Deutsches Institut fuer Wirtschaftsforsching, Wochenboricht No. 23, 1964; Bundesbank Monthly Report.

D-mark eases in April-May, strengthens in June

With the stoppage of foreign capital inflows and the possible withdrawal of some funds and continued money exports by commercial banks, demand for the D-mark eased temporarily in foreign exchange markets. Quotations moved down from 25.167 U.S. cents at the beginning of March to 25.155 cents in mid-April. (See Table 5). After mid-April, the forward premium on the D-mark began to narrow and at the beginning of May it equalled the preferential rate of 0.5 per cent per annum offered by the Bundesbank for investment in U.S. Treasury bills, eliminating the incentive for commercial banks to avail themselves of this facility.

At the end of May, however, the spot rate moved up to 25.168 U.S. cents while the forward premium on the DM widened to 0.9 per cent per annum under the influence of new speculative demand for the DM. The speculative flows were touched off by renewed discussions centering on exchange rate changes ranging from a widening of the margins around parity to a revaluation. Speculative movements were intensified by a statement by Economics Minister Schmuecker on May 31 in which he maintained that the stabilization measures thus far taken by the Federal Government could only buy time and that in the long-run it would not be possible to operate a system of fixed exchange rates if some countries did not exercise greater financial restraint. Immediate denials by the Ministry that this did not mean that the Government was contemplating revaluation did little to stop the speculative flows.

Table 5. Germany: Exchange Rate and Forward Rate in U.S. Cents per DM and Per Cent per Annum 1963-June 1964

Par Value	25.000
Upper Limit	25.188
Lower Limit	25.875

		Spot Rate[1/]	Forward Rate[2/]
1963	Jan.-March	24.991	+0.3%
	April-June	25.085	-0.1%
	July-Sept.	25.110	+0.2%
	Oct.-Dec.	25.152	-0.2%
1965	Jan.-March	25.160	+0.9%

			Spot Rate	Forward Rate
1964	March	6	25.167	+0.8%
		20	25.161	+0.9%
	April	3	25.162	+0.9%
		17	25.155	+0.7%
	May	1	25.161	+0.5%
		8	25.158	+0.5%
		15	25.157	+0.5%
		22	25.160	+0.4%
		29	25.164	+0.4%
	June	5	25.169	+0.7%
		12	25.166	+0.9%

1/ Noon buying rates.

2/ Quarterly and monthly data averages of Friday quotations.

Source: Federal Reserve Board.

Official reserves fluctuate

Official reserves in April and May declined by $193 million (See Table 6). This decline was largely due to the sale of U.S. dollars by the Bundesbank to the commercial banks for investment in U.S. Treasury bills, but in May such investments became unprofitable. But the official reserves then rose by $132 million in the first fifteen days of June when rumors of a revaluation of the D-mark produced a heavy return flow of funds to Germany.

Table 6. Germany: Changes in Reserve Position 1963-May 1964
(in millions of U.S. dollars)

	Jan.-Dec. 1963	1963 I	1963 II	1963 III	1963 IV	1964 April	1964 May	1964 June
A. Bundesbank gold and foreign exchange								
Gold	164	69	5	8	82	107	10	11
Foreign exchange	491	-70	248	163	150	-253	-57	121
Total	655	- 1	253	171	232	-146	-47	132
B. Drawing rights on IMF	35	2	---	25	8	- 6	a/	75
C. Commercial banks foreign exchange	73	223	56	62	-268	88	a/	a/
Total A through C	763	224	309	258	- 28	-64	a/	a/

a/ Not available.

Source: IMF, International Financial Statistics; Bundesbank, Monthly Report.

Trade surplus continues large

The trade surplus, on a customs basis, continued to increase during the first four months of 1964, when it reached an annual rate of DM 10 billion ($2.5 billion) as compared with DM 6 billion ($1.5 billion) registered for the year 1963 (See Table 7). However, the March-April surpluses were well below surpluses of the previous four months as imports began to outpace the rise in deliveries abroad.

The lengthening of foreign order books continues to attest to strong demand for German exports and to the prospect of continued large export surpluses.

Table 7. Germany: Merchandise Trade, 1962-April 1964
(seasonally adjusted, monthly averages, in billions of DM)

	Exports	Imports	Industrial goods Imports	Trade Balance
1962				
I	4.31	a/ 4.07	a/ 2.91	a/ .24
II	4.40	a/ 4.06	a/ 2.80	a/ .34
III	4.43	4.16	3.00	.27
IV	4.37	4.11	3.13	.26
1963				
I	4.40	4.10	3.11	.30
II	4.84	4.40	3.33	.44
III	4.99	4.63	3.41	.36
IV	5.01	4.16	3.21	.85
1964				
I	5.29	4.42	3.39	.87
January	5.40	4.61	3.43	.79
February	5.51	4.28	3.45	1.23
March	4.97	4.36	3.28	.61
April 1/	5.63	5.00	3.80	.63

a/ Change in import accounting procedure raised imports for the first quarter, 1962 by DM 0.124 billion (monthly rate) and those for April by a negligible amount.

1/ Preliminary.

Source: Bundesbank, Monthly Report.

The broadening of the export expansion to all areas continued in the first quarter of 1964 (See Table 8). Year-to-year increases in exports to other EEC countries remained substantial, but the very large growth rates in exports to France and Italy tapered off somewhat. However, exports to the Netherlands and the United Kingdom, both of which are expanding imports rapidly, continued to show increasingly larger growth rates than during 1963. Most importantly, however, year-to-year increases in exports to countries outside Europe and North America are also widening, indicating that strong demand for German goods in European countries is not impeding its sales efforts in other regions, which again are being able to expand their foreign purchases.

Table 8. Germany: Changes in Foreign Trade by Region

	Percentage Change from preceding year				Jan.-March
	1963			1964	1963
	Jan.-June	July-Sept.	Oct.-Dec.	Jan.-March	(DM mns.)
Exports to:					
EEC	+10.8%	+23.7%	+36.0%	+24.3%	6.188
France	+14.6	+16.6	+26.4	+23.9	1.786
Italy	+27.3	+42.3	+44.8	+13.0	1.335
EFTA	+ 4.6	+ 5.0	+ 6.2	+15.4	4.405
U.K.	+10.8	+ 2.1	+30.0	+30.1	.688
North America	+ 4.7	+10.5	+ 9.3	+25.1	1.240
U.S.	+ 8.4	+10.0	+ 8.7	+22.9	1.117
Eastern bloc	-13.4	- 2.6	-28.0	+35.4	.489
Other countries	- 2.2	+ 4.5	+15.5	+17.2	---
Total exports	+ 4.6	+11.6	+18.7	+20.5	15.559
Imports from:					
EEC	+ 6.2	+10.1	+11.8	+ 9.9	4.500
France	+ 3.3	+15.1	- 3.1	+15.8	1.414
Italy	- 1.8	- 3.0	+ 2.5	- 1.0	.883
EFTA	+ 3.4	+ 5.4	+ 1.9	+ 9.9	2.639
U.K.	+10.0	+11.2	- 8.1	+ 7.6	.631
North America	+15.9	+ 9.3	- 0.8	- 2.2	2.071
U.S.	+20.9	+10.6	- 0.1	- 3.6	1.930
Eastern bloc	- 4.2	+ 6.2	+ 1.2	+ 2.5	.523
Other countries	- 4.6	+ 7.0	+ 8.5	+13.4	---
Total imports	+ 3.9	+ 8.1	+ 6.5	+ 8.4	13.177

Source: Bundesbank, Monthly Report.

Balance of payments deficit in April

In April, the continuing large trade surplus was not sufficient to offset large Government payments abroad and, with the cessation of long-term inflow, Germany had a balance of payments deficit of DM 280 million ($70 million). The

April deficit reduced the surplus for the first four months of 1964 to DM 1,054 million ($254 million), which was still slightly above the DM 973 million surplus recorded in the first four months of 1963. However, there was a large structural shift in the composition of the surplus over the year: the current-account balance about doubled from DM 1,411 million in 1963 to DM 2,954 in 1964, while the capital account balance of DM 526 million during the first four months of 1964 was only about one third of the DM 1,666 million capital inflow recorded during the corresponding period last year.