L.5.2 RFD 607

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Recent Economic Developments in Germany, May-December 1966

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At the beginning of 1967, economic trends in Germany continued to point clearly downward. However, the business climate had shifted to a much more optimistic one than had prevailed in late 1966. On the psychological side, the replacement of the Erhard by the Kiesinger Government ended a period of broadening political and economic uncertainty. The new Government appears to have won both the confidence of business and labor and the cooperation of the central bank. On the economic side, reflationary measures agreed on by the new Government will hopefully give direct support to industrial output fairly quickly. Increased government spending is mainly concentrated on investment projects requiring little or no lead-time, and accelerated depreciation allowances (applicable on plant and equipment ordered or purchased between January 20 and October 31, 1967) should have an appreciable stimulative effect on investment spending, at least according to past experience. These fiscal measures are being supported by the central bank's shift to an expansionary policy as evidenced by the recent two-stage reductions in minimum reserve requirements (by a total of 19 per cent) and in the discount rate (by 1 percentage point). Given the confidence of business in the new Government's ability--and willingness--to cope with the economic situation, these policy actions combined with the continued stimulus

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N.B. For a review of developments in the first part of 1966 see "Recent Economic Developments in Germany, January-April," dated July 14, 1966.

provided by foreign demand should induce a definite improvement in private domestic demand later in the year. However for the next few months, as the effect of these stimuli is still working its way through the economy, major economic indicators--such as production and employment--are expected to decline somewhat further from their year-end levels.

The economy's position at the end of the year

The slowdown in economic activity, which first became noticeable in the spring of 1966, developed unexpectedly rapidly in the second half of the year. Private investment demand had begun to slow in 1965 as the earlier investment boom peaked out but over-all demand continued to be supported by strongly rising private consumption, public sector spending, and foreign demand. During the second half of 1966, however, the slowdown spread throughout the domestic economy. The weakness of private investment demand became more marked and there was an actual reduction in the level of fixed investment expenditures toward the end of the year. (See Table 1.) This fall-off in private investment demand was reinforced by a weakening of government demand as the liquidity squeeze began to affect government finances increasingly severely. Furthermore in late 1966, inventories probably were being run off and the growth of private consumption demand also slowed noticeably.

Private consumption grew more slowly because disposable incomes rose at a reduced rate as wage increases moderated and unemployment rose. At first, a declining rate of savings cushioned the slowdown in private spending; but the savings rate began to rise again toward the end of the year. Consequently in the second half of the year, foreign demand was the only clearly expansionary force in the economy. Despite its strong growth, however, this stimulus was not sufficient to rekindle business investment or offset slowing domestic demand.

Table 1. Germany: Gross National Product 1965 and 1966
(percentage changes over previous year, in current prices)

	1965	1966 p/	1966 e/ I	II	III p/	IV p/
Consumption	10.2	7.3	10.3	7.9	6.7	4.6
Private	9.5	7.0	11.1	7.5	6.5	4.2
Public	12.7	7.9	8.2	9.8	8.1	5.9
Gross Fixed Investment	9.4	3.0	11.6	4.8	0.3	-0.1
Plant	5.5	4.4	16.1	4.6	0.5	0.0
Equipment	13.8	2.0	8.0	5.0	0.0	-2.0
Capital Investment and Inventories	9.7	-1.5	n.a.	n.a.	n.a.	n.a.
Net Foreign Contribution						
Exports	9.1	12.6	9.0	13.0	16.0	14.0
Imports	17.5	4.5	12.0	5.0	1.5	2.0
Gross National Product (current prices)	8.5	6.4	8.5	6.8	6.0	4.6
Price Deflator	3.8	3.5	4.0	3.7	3.3	3.4
Gross National Product (real)	4.5	2.7	4.5	3.1	2.7	1.2

p/ Preliminary.
e/ Quarterly GNP figures are partly estimated and may not add to totals.
n.a. Not available.
Sources: Annual figures from Federal Statistical Office; quarterly estimates from IFO Institut, Munich and Deutsches Institut für Wirtschaftsforschung, Berlin.

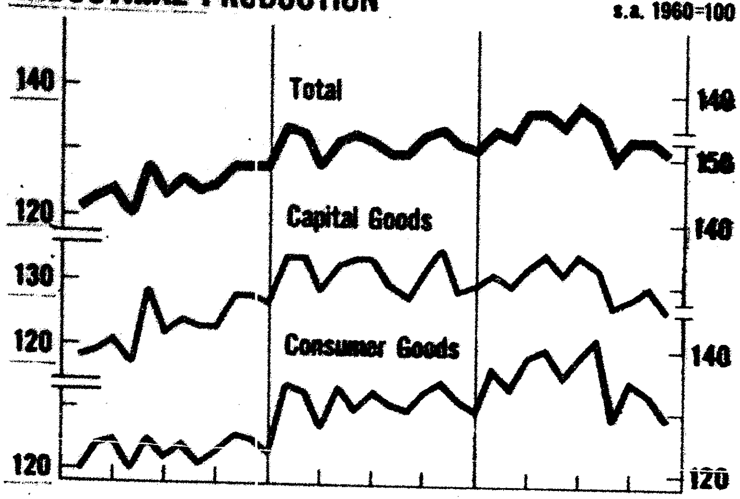
By year-end, therefore, major economic indicators pointed to a further weakening in the economy. Gross national product (in real terms) was still rising in the second half of 1966, but industrial output had begun to decline in July. Production averaged 2.6 per cent lower in the second half than in the first half of the year. (See Chart.) Heavy order backlogs helped to keep deliveries at high levels but, with lagging order inflows, backlogs declined from about 3.2 months equivalent of output in December 1965 to 2.6 months by December 1966. (See Chart.) The fall-off in demand was particularly marked in the construction, steel, and electrical equipment industries as well as in the soft goods industries. Only the basic goods sector, which includes such growth industries as chemicals and plastics, continued to perform reasonably well.

In these circumstances, wholesale and export prices leveled off after the spring. (See Chart.) But the biggest market swing was to be found in the weakening of demand for labor. Following years of over-full employment which necessitated massive inflows of foreign labor, the demand for labor eased markedly. Job vacancies declined and, for the first time in years, did not exceed the number of unemployed; unemployment rose from 1.2 per cent in January 1966 to 2.9 per cent of the working force (on an unadjusted basis) in January 1967 despite much larger than seasonal lay-offs of foreign workers late in the year.

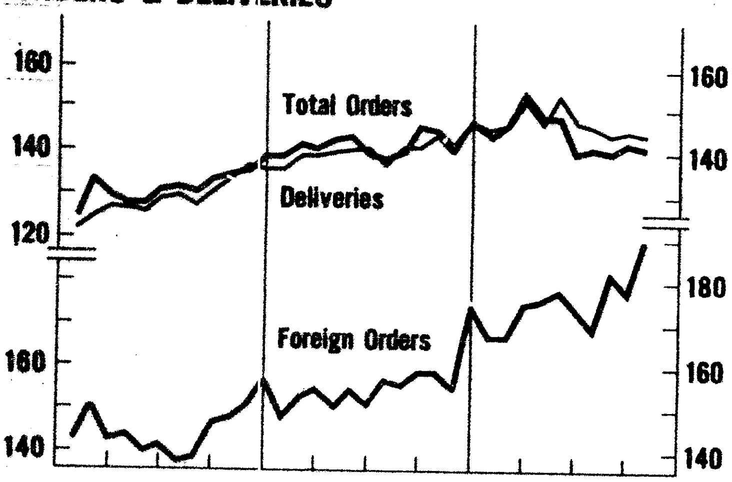
At year-end, the demand outlook suggested further declines in industrial output and concommitant rises in unemployment. Private industrial investment spending was expected to decline 12 per cent

GERMANY

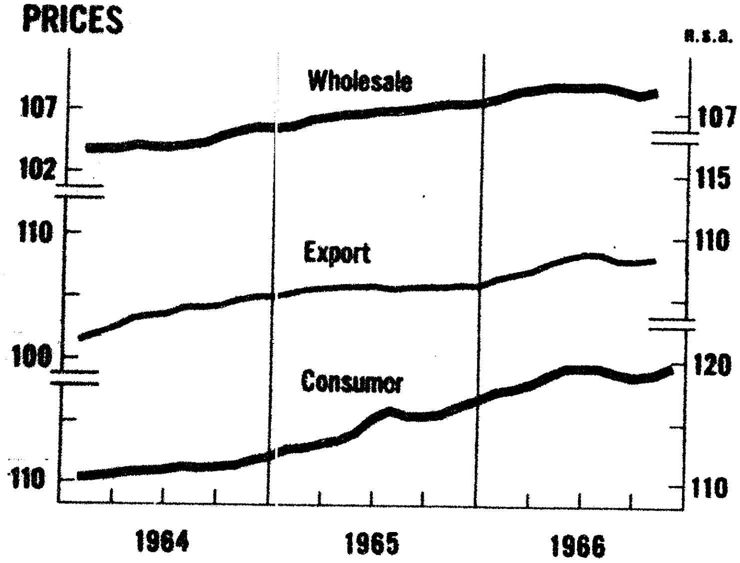
INDUSTRIAL PRODUCTION



ORDERS & DELIVERIES



PRICES



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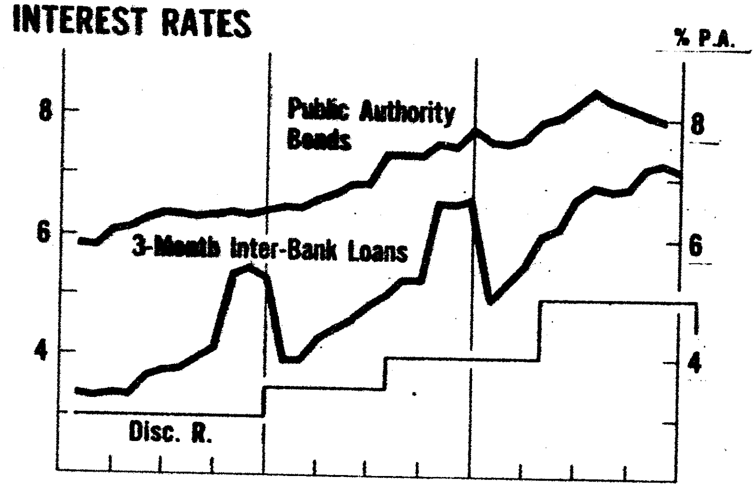
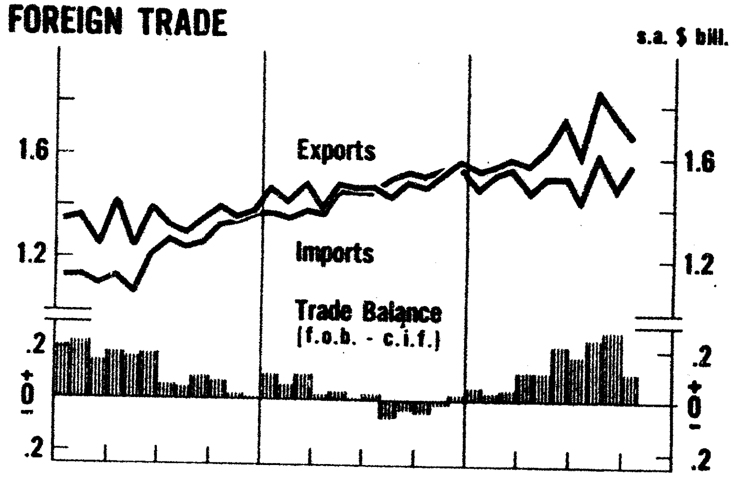
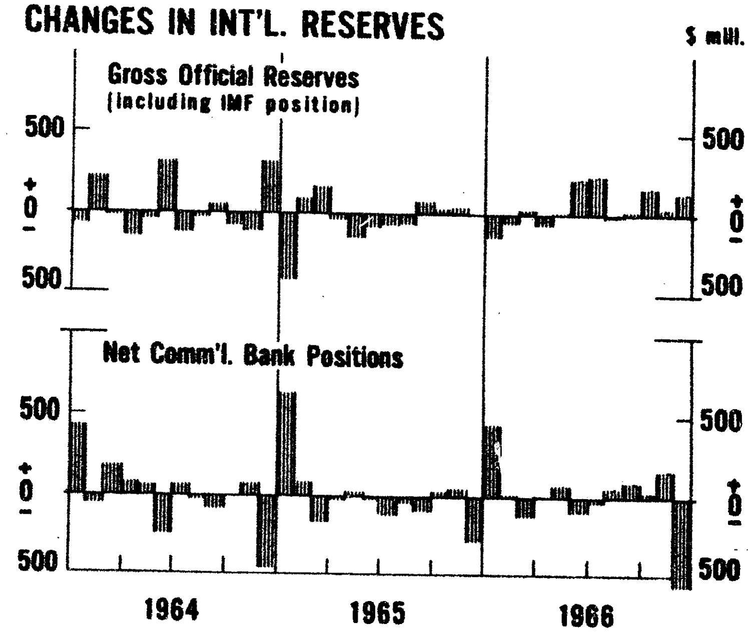


FOREIGN TRADE



CHANGES IN INT'L. RESERVES



in 1967, compared to a September estimate of an 8-10 per cent decline. With private consumption demand also expected to continue to slow down, a revival of economic activity in 1967 depended mainly upon fiscal and monetary action.

Expansionary fiscal policy for 1967

Against this general economic background, the German authorities reached agreement upon a series of measures to ease credit and upon a strongly expansionary budget for 1967. The Kiesinger Government's budget is probably, in fact, more expansionary than the Erhard budget proposals (the final stumbling block that led to the breakup of the CDU/CSU--FDP coalition) had been. However, the Kiesinger Government managed to shape its budget proposals in such a way that they not only met the legal requirement of "balance" on the ordinary (largely consumption) account, but were also better tailored than earlier proposals to meet the current requirement of a revival of economic activity. Bundesbank officials, who had been highly critical of the Erhard proposals, greeted the new budget with public statements of endorsement and cooperation, in part because downtrends had become much clearer as the year-end approached.

The 1967 budget estimates propose an expenditure increase of DM 6.6 billion, or 9.5 per cent, over actual 1966 outlays; this compares with expenditure rises of 5.3, 6.0 and 9.3 per cent respectively in 1964, 1965 and 1966. (See Table 2.) However, the actual expansionary

Table 2. Germany: Federal Budget 1964-1967[a]
(DM billion)

	1964	1965	1966	1967 High Employment	1967 Actual
Receipts	58.1	61.9	67.4	72.7	70.2-71.0
Expenditures	60.3	63.9	69.9	76.5[b]	76.5
Deficit	2.2	2.0	2.5	3.8	5.5--6.3

a/ 1964-66: Final expenditures and receipts.
1967: Budget proposals, January 1967.

b/ The DM 2.5 billion "contingency" budget is included also in the "high employment" figure because it represents only a shift from scheduled consumption to investment expenditures. Total outlays have remained unaffected.

stimulus is probably somewhat greater than indicated by the budgeted rise in expenditures. First, budget proposals have generally tended to underestimate actual expenditure levels; for example, in 1966 actual expenditures exceeded budget estimates by DM 1 billion. The fact that the Government is committed to an expansionary spending policy supports the likelihood that 1967 expenditures again will exceed estimates by substantial amounts. Second, a greater proportion of expenditures than in previous years is to go for investment outlays. In fact, the entire DM 2.5 billion "contingency" budget constitutes a shift from consumption expenditure proposals in the earlier Erhard budget to investment projects in the current budget. Since such expenditures are assumed to have a larger impact on economic activity--through the multiplier/accelerator effect--than do consumption expenditures, an additional expansionary stimulus is expected from this structural shift in the expenditure pattern. Third, a greater than usual proportion of budget expenditures is to be financed by short-term borrowing.

Perhaps most significant is the move toward contra-cyclical budgeting which the new proposals represent. On the revenue side, certain tax privileges are being reduced and tax collections are being accelerated in order to meet the legal requirement that the "ordinary" budget be balanced. But in reality this requirement is being by-passed by the fact that revenue estimates are based on non-cyclical economic growth assumptions. This technique marks a notable departure from previous German budget procedure. The budget estimates assumed a growth in GNP of 5.1 per cent (in current prices) in 1967 over 1966, while latest estimates indicate a probable growth of only 3.5--4 per cent, thus a shortfall of at least DM 900 million can be anticipated on this basis alone. An additional DM 900 million shortfall is already certain because lower-than-expected growth in 1966 has reduced the income base below that upon which 1967 revenues were calculated.

Total revenues, as estimated in the budget, are to rise by DM 5.3 billion, or DM 1.3 billion less than expenditures, resulting in a "high employment" deficit of that amount. If 1966 is taken as a year of relatively high employment, the change in deficit or fiscal stimulus not due to declining economic activity amounts also to DM 1.3 billion. The actual deficit is anticipated to be somewhere in the neighborhood of DM 5-1/2--6-1/4 billion. The Bundesbank has given its approval to this "high employment" budgeting procedure and has promised assistance in financing any shortfall in tax receipts because of the lagging domestic growth as well as in financing the contingency budget. Recent Bundesbank measures to relax monetary policy have already significantly improved the financing climate of credit markets.

Improvement in trade accounts leads to balance of payments surplus

Aside from overt central bank policy actions, one of the most important factors improving the liquidity position of the German economy has been the re-emergence of a growing balance of payments surplus as of mid-1966. The chief factor accounting for the shift to surplus in Germany's payments position was the marked improvement in the trade account.

The weakening of demand in Germany during the course of 1966 reacted upon the country's trade position in two ways. The growth of imports fell from the exceptionally high annual rate of 19.5 per cent realized in 1965, when demand pressures were at their peak, to only 3.2 per cent in 1966. At the same time, export growth accelerated from an annual rate of roughly 10 per cent realized in the previous three years to 12.5 per cent in 1966. (See Chart.) As a result, the German trade surplus grew by $1.69 billion in 1966 to reach $1.99 billion, its highest level in the post-war period.

Efforts by German producers to maintain output contributed to the export growth last year, but the main explanatory factor was rapidly expanding demand in the markets of major trading partners.

Gains were particularly large in sales to Italy, France, the United States and Canada. Continued rapid growth of exports is expected by the German authorities for 1967. Rapid demand growth in foreign markets probably will be a less important factor than in 1966, but improved competitiveness should be of greater importance. On the price side, domestic price rises have moderated and German exporters may shave margins additionally in efforts to promote exports; furthermore, the smaller wage increases already signaled for this year should make it easier than in past years to maintain or cut price levels. On the supply side, more resources should be available to supply foreign demand.

The lagging growth of imports can be attributed not only to the marked slackening of domestic demand but also to certain special factors. Government (primarily military) and food imports fell off noticeably in 1966, unrelated to business developments. But movements in German imports have also been closely related to cyclical changes. Between late 1963 and the first half of 1965, industrial capacity utilization was pushed close to effective limits and the private sector's marginal propensity to import rose from 7.9 per cent to 30.1 per cent. After mid-1965, when final demand began to grow more slowly and the rate of capacity utilization declined, the marginal propensity to import fell rapidly to an estimated 15 per cent by the second quarter of 1966.

Within the industrial goods category, imports of finished goods--particularly those for further processing--showed the greatest tendency to decline during 1966; imports of raw materials also grew much more slowly over the course of the year. Import trends in both these categories tended to confirm other indications of downward inventory adjustments and possibly reflected smaller direct investment inflows.

At $1.0 billion, the total inflow of private capital in 1966 was only moderately below the 1965 volume of $1.2 billion. (See Table 3.) However, there was considerable change in the composition of the inflow resulting from the stringent credit conditions in Germany, the U.S. voluntary credit restraint program, and later, the weakening of demand in Germany.

Tending to reduce net capital imports was an increase in German purchases of foreign securities, reflecting the unsettled conditions in the German stock and bond markets. There was also a cut in the inflow of direct investment capital, largely it would seem the result of the U.S. balance of payments program and the tightening of credit in international financial markets. But German firms which had previously relied heavily on this form of financing now had to seek alternative sources. With credit tightening in Germany, firms turned to the Euro-dollar market. This probably was particularly true for German-based subsidiaries of American firms who did not have established credit lines with German banks. As a result, the rise in short-term foreign borrowing by German firms largely offset the decline in import credits following the fall-off in import growth. Consequently, total short-term capital inflows in 1966--at $669 million almost equaled the 1965 inflow.

Table 3. Germany: Balance of Payments, 1965-1966
(millions of dollars)

	1965	1966	1966 I	1966 II	1966 III	1966 IV
1. Goods & Services:						
Trade Balance	301	1,988	211	344	564	869
Services	- 354	- 434	- 77	-117	-182	- 58
Total	- 53	1,554	134	227	382	811
2. Official Payments:						
Donations[1]	-1,465	-1,467	-389	-351	-334	-393
Long-Term Capital	- 436	- 563	- 37	-376	- 37	-113
Short-Term Capital	296	361	- 21	419	3	- 42
Total	-1,605	-1,669	-447	-308	-368	-548
3. Private Capital:						
Securities Transactions						
Foreign Purchases[2]	199	170	16	177	- 13	- 10
German Purchases[3]	- 262	- 337	- 93	-167	- 30	- 47
Other Long-Term	590	523	209	112	122	80
Short-Term	195	430	124	99	201	6
Errors & Ommissions	479	239	183	101	57	-101
Total	1,201	1,025	439	322	337	- 72
Surplus or Deficit (-)	- 457	910	126	241	351	191

Financed By:

	1965	1966	1966 I	1966 II	1966 III	1966 IV
1. Commercial Banks' Net Foreign Exchange Positions (increase -)	- 38	- 97	-348	2	-117	367
2. Debt Prepayment	--	- 236	--	- 40	--	-196
3. Reserve Movements						
Drawing Rights on IMF (increase -)	- 163	- 181	- 24	-118	--	- 39
Bundesbank Liabilities	41	23	43	- 41	26	- 5
Gold & Foreign Exchange (increase -)	617	- 419	203	- 44	-260	-318
Total	495	- 577	222	-203	-234	-362
Total Financing	457	- 910	-126	-241	-351	-191

1/ Includes remittances of foreign workers.
2/ Foreign purchases of German securities.
3/ German purchases of foreign securities.
Source: Bundesbank.

By the beginning of 1967, easing credit conditions in Germany and the weakened state of aggregate demand had led to some tapering off of financing credits. However, this decline may be at least partly offset by a reflow of German security capital as long-term financial markets in Germany continue to strengthen.

The re-emergence of the German balance of payments surplus led to an increase in the Bundesbank's aggregate foreign asset position from $7.4 billion at the end of 1965 to $8.0 billion at the end of 1966. This increase represented slightly over half the balance of payments surplus. Some $500 million accruing to Germany were financed by debt prepayments and advance payments for military purchases.

Official gross foreign exchange holdings rose $537 million to $2.5 billion in 1966; holdings of U.S. dollars rose $785 million to $2.1 billion. Bundesbank holdings of gold declined from $4.4 billion to $4.3 billion because of payments in connection with the increase in Germany's IMF subscription from $788 million to $1,200 million.

Net foreign exchange positions of commercial banks showed a modest improvement since banks turned over a large part of their foreign exchange gains to the central bank to acquire DM.

Financial markets ease

The re-emergence of surpluses in the balance of payments beginning in the second quarter of 1966 added substantially to the liquidity position of the German economy after mid-1966. At the same time, the general economic slowdown and borrowing restraint on the part of the public authorities led to a gradual slowing in the expansion of demand for funds. Consequently, stringency on financial markets began to ease from August onward and--apart from a seasonal tightening in September and again towards the end of the year--interest rates declined from the near record peaks reached in July. (See Chart.)

The easing of credit conditions was most marked in the bond market. Between July and the end of January, yields on outstanding 6 per cent public authority bonds declined by 110 basis points to 7.33 per cent, a level somewhat below the 7.59 per cent recorded in January 1966. Some of the recent firming of the market has been caused by speculation about the removal of the 25 per cent withholding tax on yields of bonds held by non-residents.[1/] The issue ban on new public authority bonds, which had been in effect since May 1966, was lifted in January 1967. Public authority access to the market will continue to be rationed. But first tests of the absorptive capacity of the market were encouraging. In January, two new 7 per cent issues totaling DM 150 million, both having a yield to maturity of 7.61 per cent, were immediately oversubscribed and bond prices firmed further in February despite the announcement of two more public authority issues in coming weeks.

By mid-1966, the Bundesbank had ceased to tighten monetary restrictions. At first, the authorities merely allowed the operation of market factors to add to bank liquidity. No active steps to ease

1/ Although the new Government did originally propose such a move, it seems currently to be less in favor of doing so, particularly now that financial markets are generally gaining strength under the stimulus of an easier central bank credit policy. The Bundesbank, for its part, is firmly opposed to the removal of the coupon tax.

credit were taken until the end of 1966 because of concern about the wage and the budget outlook. Following favorable developments in the wage sector, a further marked weakening of the demand situation and the new Government's budget decisions, the Bundesbank proceeded to take a number of moves at the end of the year which marked a reversal in monetary policy:

a. In early January, a 9 per cent reduction in minimum reserve requirements on domestic time and sight deposits, which had originally been announced as a year-end measure for December only, was extended indefinitely; this action freed an estimated DM 900 million of bank reserves.

b. Effective February 1, minimum reserve requirements on foreign liabilities were brought down from the legal maximum (to which they had been raised on April 1, 1964), to the same level as rates applying to domestic liabilities.1/

c. Effective January 6, the discount rate was lowered from 5 to 4-1/2 per cent and the lombard rate from 6-1/4 to 5-1/2 per cent.

d. Bundesbank selling rates on open market paper were reduced by a total of 1 percentage point between December 30 and February 17.

1/ Earlier, effective January 1, banks had been directed to calculate reserve requirements on foreign liabilities on a gross rather than net basis. The restrictive impact of this measure was more than offset by the reduction of reserve requirements on foreign liabilities.

e. Effective February 17, the discount rate was lowered from 4-1/2 to 4 per cent and there was a 10 per cent reduction of minimum reserve ratios which freed some DM 1.7 billion of bank funds.

The measures affecting foreign liabilities reversed earlier actions designed to stem the net flow of funds into Germany. The latest action, which releases about $425 million of bank funds at a time when demand for loanable funds is falling, may provide some incentive for German firms to borrow at home in order to repay costly short-term foreign credits brought in last year.

On the domestic side, this relaxation of credit policies should further ease the credit market and, hopefully, contribute to a revival of business activity.