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September 22, 1967

Rosemary A. Darlington

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Recent Economic Developments in Germany January-July 1967

This paper reflects the personal opinion of the author and must not be interpreted as representing the opinion of the Board of Governors

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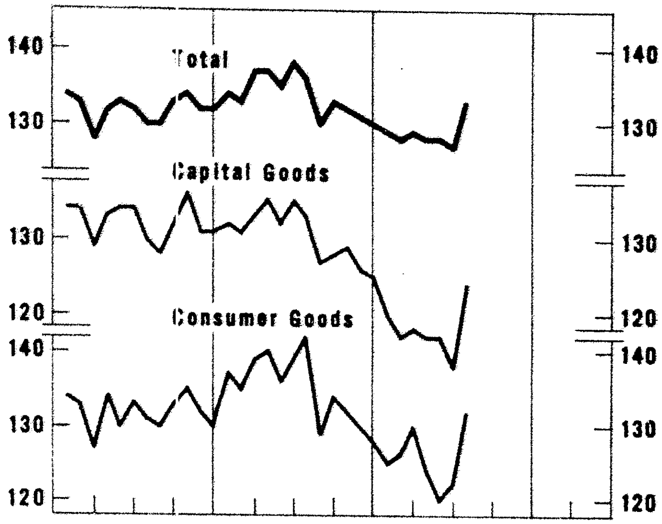
Recent Economic Developments in Germany
January - July 1967

In the spring the recession in Germany bottomed out, indicating that the authorities' attempts to revive the economy were beginning to make themselves felt. Since mid-year there have been indications that a recovery may be underway. Industrial production, which had declined 7.3 per cent from the high reached in June 1966, was virtually unchanged for four months beginning in February and rose appreciably in July. Seasonally adjusted unemployment, though remaining sizable by German standards, declined somewhat in June and remained at this level in July. Scattered evidence suggests that the phase of inventory liquidation may be coming to an end and some cautious rebuilding may be taking place. This possibility may help explain a more than seasonal increase in short-term credit extensions to the private sector in June. An improvement in business confidence has been reflected in a 19 per cent rise in the stock market during July and August.

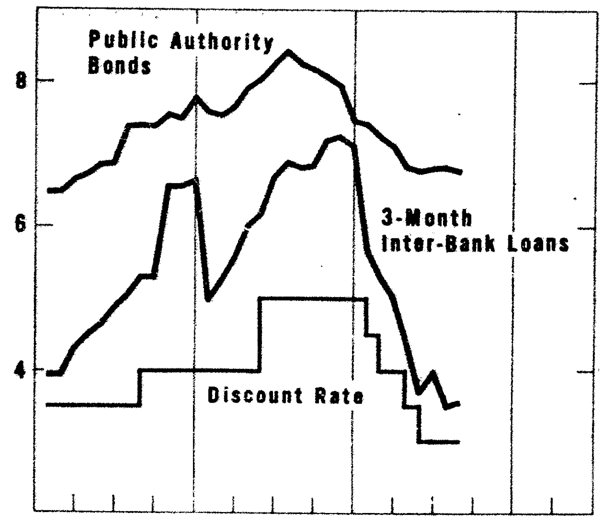
Despite these encouraging signs, it is still unlikely that private demand by itself will be strong enough to bring about the resumption of a sustained rate of growth and an acceptable rate of resource utilization. Recognizing this, the authorities have continued to take expansionary fiscal and monetary measures. Effective September 1, the Bundesbank lowered reserve requirements for the seventh time since December 1966, and the Government has made clear its intention to implement the second special investment budget authorized by Parliament in early September.

GERMANY

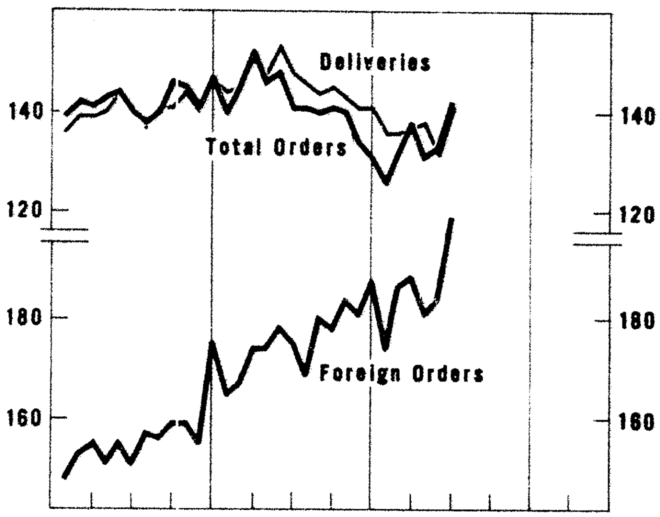
INDUSTRIAL PRODUCTION
s.a. 1960=100



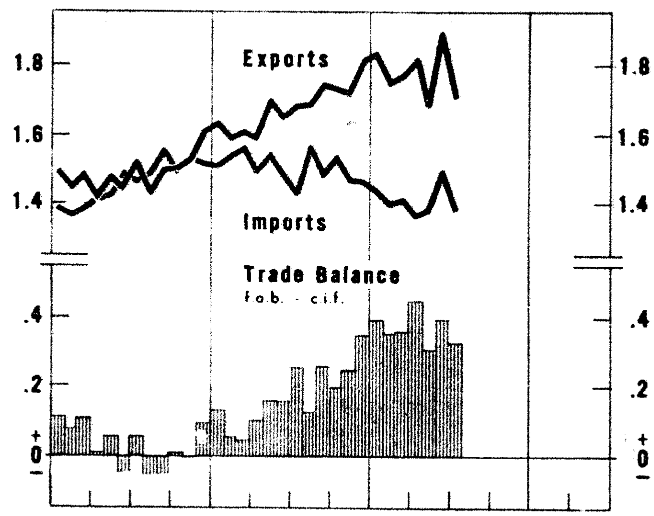
INTEREST RATES
% p.a.



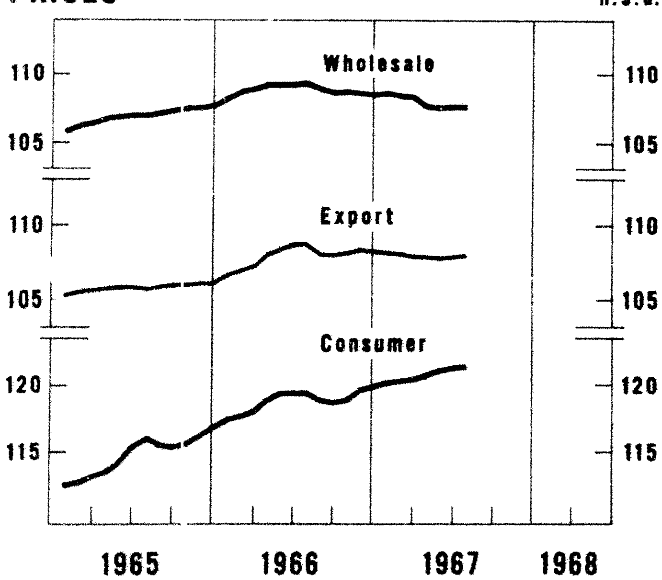
ORDERS & DELIVERIES



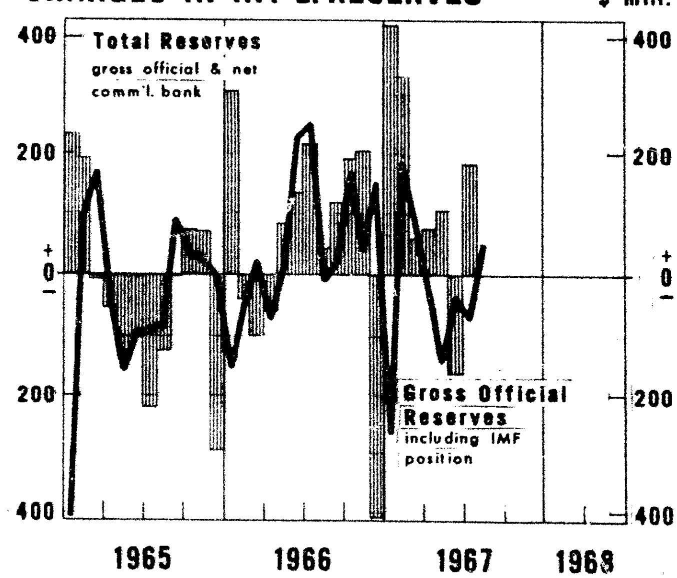
FOREIGN TRADE
s.a. $ bill.



PRICES
n.s.a.



CHANGES IN INT'L. RESERVES
$ mill.



The economic situation in the first half of the year--background to these measures--involved significant underemployment of resources. After years of over-full employment, unemployment rose to about 2 per cent of the labor force even after a reduction of 291,000 in the number of foreign workers employed in Germany (measured over the year ended in June). Industrial employment had fallen by June to 92 per cent of the year-earlier level. Furthermore, in the absence of adequate demand, the rate of capacity utilization by industry dropped to 77 per cent in the first and second quarters compared with 88 per cent in the first quarter of 1966 and a preferred rate of 90 per cent.

The major recessionary factor continued to be a pronounced downturn in private investment demand, which was only moderated by public investment spending. Total fixed investment was down 13.5 per cent in the second quarter from its high a year earlier. Furthermore, private consumption had practically ceased to grow by the second quarter as a result of curtailed growth of disposable incomes. By the second quarter, therefore, public consumption and exports were the only sectors where significant expansion took place. Over the past few months, however, expansion of export demand has slackened as a result of slowdowns in economic activity in some of Germany's important trading partners. Export expansion had earlier been the major factor offsetting the decline in aggregate domestic demand in Germany.

With expansionary impulses from this sector lessening and with no sign of upturn visible by early July, the Government announced a second investment budget.

The new investment budget, which amounts to DM 5.3 billion ($1.4 billion), is about double the size of the earlier one. Its announcement already appears to have had favorable psychological effects on business expectations and its real effects should begin to reach the economy in the next few months. It is hoped that the new govermental spending authority under this program can be translated into orders by mid-October. However, the placement of Federal orders under the first investment budget took almost five months until completion; placement of orders under the new program may be even more delayed since projects must be proposed, approved, and coordinated by three levels of government, not just one. Furthermore, the encouragement to invest which this program imparts to industry may take additional time to show up given the relatively high degree of unused capacity in industry presently.

Decline in aggregate demand

The fall in private investment demand continued through the first half of the year. Business spending on equipment is estimated to have been about 14 per cent below year earlier levels in the first quarter and 16 per cent lower in the second. Although exact data for business investment in plant is not available, expenditure of this type also showed a large year-to-year decline, reflecting the particularly strong decline of interest in capacity expansion. The overall reduction in gross fixed business investment in the first half of the year appears, therefore, to have been considerably larger than the 12 per cent decline forecast for 1967 on the basis of the Ifo Institute's April survey of business intentions. This fact suggests that the year-to-year rate of decline of private investment could be appreciably smaller in the second half of the year.

Business inventory policy in the first half of the year was highly cautious. Industry is reported to have held inventories at levels low even in the context of the depressed economic situation. This behavior was conditioned by uncertainty regarding the tax treatment inventories would receive when the changeover was made at the beginning of 1968 from a gross turnover to a net value-added tax system. The recent decision on the tax treatment of inventories may now reduce the cautiousness of business inventory behavior. In July, the Government proposed that inventories which were as high at the end of 1967 as their end-1966 levels would be credited with 85 per cent of the turnover tax already paid on them; inventories not meeting this criterion would be credited with only 70 per cent.[1] Perhaps as a result of this proposal, some inventory restocking has been noted

1/ The measure, as finally approved by Parliament on September 8, provides that all inventories will receive the higher tax credit.

recently. Results of recent consumer goods trade fairs suggest, however, that inventory policy remains cautious and that buying is still being done with an eye to carrying relatively low inventories over year-end.

Public investment spending was not able to offset the drop in business investment. (See Table 1.) In fact, in the first and second quarters total public expenditures for gross fixed investment declined, apparently as expenditure cuts ordained during the 1966 credit squeeze took effect before expenditures under Federal anti-cyclical programs could be realized.

The weakness in the investment sector communicated itself to other sectors of the economy via rising unemployment and a consequent drop in the growth of private disposable incomes. This led to a weakening of consumer demand which grew only 1.0 per cent in current prices by the second quarter, and probably not at all in real terms since the consumer price index in this period was 1.5 per cent higher than a year ago. (See Table 1.) The growth which did take place during the first half of the year was supported in substantial part by increased government transfer payments and by a reduction in private households' propensity to save. Whereas private households had increased their savings ratio from 11.4 per cent in the first half of 1966 to 11.8 per cent in the second, partly in reaction to the uncertainty of the economic situation, partly a return to trend,

Table 1. Germany: Gross National Product
(Percentage change over the previous year; current prices)

	1966				1967 p/	
	I	II	III	IV	I	II
Consumption	10.5	8.0	6.5	4.5	4.5	1.5
Private	10.5	7.5	6.5	4.0	3.5	1.0
Public	9.0	11.0	8.5	4.0	8.5	4.0
Gross fixed investment	10.5	4.0	1.0	- 2.0	- 9.0	-13.5
Plant	16.0	5.0	3.0	3.0	- 4.0	-11.0
Equipment	6.0	3.0	- 1.5	- 7.0	-13.0	-16.0
Net foreign contribution						
Exports	9.0	13.0	16.5	12.0	9.5	12.0
Imports	12.0	5.0	2.0	± 0	- 6.5	- 2.5
Gross National Product (current prices)	8.0	7.5	6.0	4.0	1.0	- 1.0
Price deflator	4.0	4.0	3.5	3.0	3.0	1.0
Gross National Product (real)	4.0	3.5	2.5	1.0	- 2.0	- 2.0

p/ Preliminary estimates.

Source: Deutsches Institut für Wirtschaftsforschung, Berlin.

the ratio was reduced to 11.4 per cent again in the first half of 1967[1/] as private households sought to maintain their expenditure patterns in the face of slower income growth.

The decline in aggregate demand in Germany has relieved the pressures which had built up behind wages and prices. The slack demand for labor has been reflected in more moderate wage increases and has reportedly led to improved worker performance and attitudes, for instance in the form of reduced absenteeism. These developments have been accompanied by more moderate price movements. Producer prices of industrial products have leveled off and in some instances actually declined. (See Chart). The rise in the consumer price index has also slowed markedly, rising 1.8 per cent on a year-to-year basis in January-June in contrast to a 4.2 per cent rise in the same period a year ago.

Ambivalent Federal Government fiscal policy

While the Federal Government has recently responded more actively to the serious weakening of private domestic demand, its use of stimulatory fiscal measures was not decisive earlier. After presenting the 1967 budget proposals and introducing the first contingency budget to stimulate the economy, the Government ordered Federal

1/ Based on estimates by the Deutsches Institut für Wirtschaftsforschung. Bundesbank estimates show the same movement, but more marked.

ministries to hold monthly current expenditures to 75 per cent of the 1966 average pending final parliamentary approval of the 1967 budget (finally obtained in June). Furthermore, the placement of orders under the contingency budget lagged and by mid-April, orders for only DM 400 million of the DM 2.5 billion total had been placed. On April 12, the Government issued an order rescinding the restrictions on current expenditures and accelerating the placement of orders.

The realized increase in Federal spending was not sufficient to offset spending cuts in the investment category by other levels of government. Consumption expenditures continue to grow substantially at all levels of government, largely reflecting staff and salary increases. However, expenditures and plans for investment were generally cut at lower government levels as these governments tried to find a way to adjust expenditures to currently-reduced incomes without raising borrowing and debt servicing burdens at this time. This motive led governments, particularly those at the community level, to make severe cuts in investment spending. Since communities in Germany normally account for more than two-thirds of total public investment in Germany,[1/] this cutback caused total public sector investment in the first half to decline slightly despite increased investment spending by other public bodies.

1/ At that level, community investments would have accounted for 3 per cent of German GNP in 1965.

The outlook for the remainder of the year was for more of the same. Budgetary difficulties and fear of increasing already substantial debt servicing burdens in the face of unfavorable revenue prospects led Länder and communities to retreat from the expansionary spending of last year and to cut expenditure plans for 1967. The Länder as a whole planned to increase total expenditures only 2.3 per cent in 1967 and, within this overall total, to cut investment spending 18 per cent. The Länder also sharply cut their grants and assistance to the communities this year. Since a substantial part of communities' revenues are obtained from Länder assistance, revenue expectations of the communities have been very seriously affected. Communities, therefore, planned to cut total expanditure by 1.5 per cent and investment by 13 per cent in 1967.

To combat the effects of these expenditure cuts, the Federal Government proposed a second investment program which would involve a total of DM 5.3 billion. In budget accounting terms, this program is completely separate from either the 1967 or 1968 budgets. The bulk of the funds would be spent on Länder and community investment projects, although there would also be some additional Federal investment. As well as financing its own projects, the Federal Government would help finance those of the Länder and communities, with local government expected to supply the remainder of the financing. (For details, see Table 2.) In all, this program foresees spending of DM 2.8 billion by Bonn, DM 2.0 billion by the Länder, and DM 500 million by the communities.

However, at the same time the Government announced expenditure cuts and tax increases for 1968 to keep the 1968 and future deficits within "reasonable" bounds. The main proposals include:

(1) an increase in the value-added tax from 10 to 11 per cent on July 1, 1968.

(2) a 3 per cent surtax on corporate incomes and on incomes of more than DM 16,000 in the case of single people or more than DM 32,000 in the case of married couples effective January 1, 1968.

(3) the withdrawal of preferential tax rates on profits of savings banks and credit cooperatives.

(4) a cut in defense expenditures.

(5) the reduction or cessation of Federal contributions to various social agencies, the introduction of income ceilings for recipients of certain social allowances, and an increase in employer and employee contributions to various social insurance funds over the next few years.

Over the next four years, these measures are expected to result in cumulative savings in expenditures of DM 30 billion and increased tax revenues of DM 14 billion.

Table 2. Second Investment Budget Proposal of The Federal Government
(DM billions)

Projects:	Source of Funds: Federal	Länder	Communities	Total
Federal	1.3	-	-	1.3
Länder	1.0	1.0	-	2.0
Communities	0.5	1.0	0.5	2.0
Total	2.8	2.0	0.5	5.3

Source: Finance Ministry.

The Government has, however, allowed room for the built-in stabilizers to work, thereby moderating the restrictive effects which would otherwise have occurred. Forward revenue estimates for this year and next are based on overly optimistic GNP growth assumptions. Consequently, the Government has already assumed a smaller deficit than is likely to occur. On balance, although the net effect of this package of measures would appear to be neutral or at most only slight expansionary, some real expansionary effect will probably result from the relative timing with which these measures are to be effected. The announcement of this program appears to have already had a favorable effect on business expectations.

<u>The Government's budget problem</u>

At the heart of this ambivalent fiscal program is the dilemma with which the Government finds itself confronted. On the one hand the new Government recognizes the need for contra-cyclical stimulation of the economy to move Germany out of the recession. The Government is faced, however, with a serious and deep-seated public mistrust of large public deficits. In fact, it was the inability of the Erhard Government to cope with the problem of threatening, large-scale deficits which led to the downfall of his Government. Movement toward reform of the budgetary situation has become perhaps the central issue determining public confidence.

The current budgetary problem has resulted from the underestimation of the implications for future budgets of past current expenditure commitments and from the reduced growth of revenues as a result of the economic slowdown. On the assumption that expenditures rose in accordance with legislation now on the books, and that GNP grew an average of 5 to 5-1/2 per cent per year (4 per cent in real terms) between 1968 and 1971 (in itself an optimistic assumption), the Finance Ministry has calculated that the Federal budget deficit would rise to:

DM 14.2 billion in 1968
DM 14.7 billion in 1969
DM 17.3 billion in 1970
DM 17.6 billion in 1971

In the postwar era budget deficits have never before reached DM 5 billion. Traditionally conservative public opinion in Germany would not tolerate deficits of this size. Furthermore, it would not be possible to finance such amounts on the limited German capital market, particularly in its current state of weakness.

The Government also came under pressure from the Bundesbank to revise its expenditure policies. In fact, the Bundesbank maintained a high degree of monetary stringency through 1966 in order to influence Government budgetary policy. Only after the Kiesinger Government took the first steps towards bringing the budget situation into line in January, did the Bundesbank begin an aggressive relaxation of its credit policies.

Expansive monetary policy encourages economic revival

German interest rates have fallen substantially in response to the expansive monetary policy introduced at the beginning of the year, though long-term rates remain relatively high. High short-term interest levels in foreign money markets have encouraged banks to place a large part of their liquidity gains abroad, thereby tending to set a "floor" to German rates. Short-term rates in Germany fell slightly more than 2 percentage points between January and August but in August remained an average of 50 basis points above the 3 per cent discount rate. (See Chart.) Beginning in July the Bundesbank attempted to limit the export of funds by increasing the exchange rate uncertainty, thereby forcing banks to take up forward cover and reducing the arbitrage incentive. These efforts seem, however, to have met with little success. Banks continued to export funds through August and domestic short-term rates remained close to July levels.

Easing in long-term markets was more limited than in short-term markets because borrowers--particularly those of the public sector--took advantage of improving credit availabilities to satisfy long-term financing requirements which had built up during last year's restriction of the capital market and to consolidate short-term credits. Average yields on 6 per cent public authority bonds therefore declined only 63 basis points between January and August, leveling off around the 6.8 per cent level as of May. (See Chart.) This yield actually understates the pressure bearing on the bond market since public authority access to the market is still strictly regulated, yet the Bundesbank (acting as agent for public authorities) has found it necessary on recent occasions to support bond prices. In a notable change of policy, the Bundesbank began purchasing bonds for its own account in September, introducing a significant improvement on the bond market.. Bond yields moved down to 6.7 per cent in the first few days of September.

Demand for bank funds has come primarily from the public sector. Outstanding loans to public authorities rose DM 4.8 billion during January-June, the greatest part of the increase taking place in the long-term category. This is almost twice as much as the DM 2.8 billion increase recorded during the same period last year. Lower interest rates and easy credit availability had little stimulative effect on private credit demand, however, given the performance of the economy in the first half of the year and the pessimistic outlook which prevailed until recently. Only in June did credit to the private sector grow by a significant amount. But for the first half of the year as a whole, new net credit extensions to the private sector fell back sharply from DM 12.7 billion in 1966 to DM 4.6 billion in the current year.

Large surplus in balance of payments

The depressed state of demand in Germany has encouraged the return of Germany's international payments balance to large surplus. The developing surplus began to take on substantial proportions in the second half of 1966 and the trend has continued in the current year. The substantially modified second quarter surplus is misleading since it resulted from a one month deficit in June, a development which has not been repeated. April and May recorded a total surplus of DM 779 million; July again showed a substantial surplus and August appears to have also. The overall German surplus amounted to DM 4.2 billion in January-May (DM 10.1 billion at an annual rate) in contrast to DM 985 million (DM 2.3 billion) during the same period of 1966.

The development of a surplus of this size has reflected mainly the expansion, as in past cycles, of Germany's normally substantial structural trade surplus.

Faced with inadequate domestic demand, German producers have concentrated increasingly on export sales in an effort to maintain production levels and income. As a consequence, exports accelerated appreciably until recently when flagging demand in trading partners led to a tapering off of German export growth. However, the more important contributor to Germany's greatly increased trade surplus has been the decline in imports accompanying the fall in domestic demand. Imports on a seasonally adjusted basis have declined since the first quarter of 1966; the rate of decline accelerated in the first quarter of 1967, moderating somewhat in the second quarter. (See Chart.) In the first half of 1967 imports were DM 2.5 billion less than in the first half of 1966, or only slightly more than the value of imports in the first half of 1965. Germany's trade surplus has consequently grown steadily since end 1965 and, on a balance of payments basis, totaled DM 8.8 billion in January-June compared to DM 2.2 billion in the same period last year. (See Table 3.)

Table 3. Germany: Balance of Payments, 1966-
Second Quarter 1967
(in millions of DM)

	1966 I	1966 II	1966 III	1966 IV	1967 I	1967 II
1. Goods and Services						
Trade balance	846	1,376	2,258	3,478	4,335	4,436
Services	- 331	- 402	- 621	88	- 159	- 447
Total	515	974	1,637	3,566	4,176	3,989
2. Official Payments						
Donations 1/	-1,686	-1,559	-1,440	-1,579	-1,473	-1,431
Long-term capital	- 147	-1,502	- 152	- 429	- 197	- 354
Short-term capital	- 56	1,665	- 42	- 192	- 332	- 284
Total	-1,889	-1,396	-1,632	-2,200	-2,002	-2,069
3. Private Capital						
Securities transactions						
Foreign purchases 2/	124	706	- 48	- 31	16	- 81
German purchases 3/	- 442	- 669	- 121	- 187	- 366	- 294
Other long-term	902	479	643	332	110	- 366
Short-term 4/	497	397	802	12	589	- 407
Errors and omissions	794	474	126	- 726	908	- 673
Total	1,875	1,387	1,402	- 600	1,257	-1,821
Surplus or deficit (-)	501	965	1,407	766	3,431	99
Financed by:						
1. Commercial banks' net foreign exchange assets (increase -)	-1,390	6	- 470	1,466	-3,277	- 981
2. Reserve movements						
Drawing rights on IMF (increase -)	- 94	- 471	- 2	- 156	- 12	676
Bundesbank liabilities	171	- 163	104	- 21	- 191	- 23
Gold and foreign exchange (increase -)	812	- 177	-1,039	-1,271	49	229
Total	889	- 811	- 937	-1,448	- 154	882
3. Debt Prepayments	-	- 160	-	- 784	-	-
4. Total financing	- 501	- 965	-1,407	- 766	-3,431	- 99

1/ Also includes foreign workers' remittances. 2/ Net foreign purchases of German securities. 3/ Net German purchases of foreign securities (minus). 4/ Excludes total net commercial bank foreign exchange holdings.
Source: Bundesbank.

The outflow of official payments and private capital helped to hold down the size of the overall payments surplus. The tendency towards increased net private capital outflows reflects the change in the credit situation in Germany that has taken place over the past year. Whereas last year German firms borrowed heavily abroad, particularly to obtain long-term funds during the domestic credit squeeze, firms this year have repaid loans. Furthermore, with the shift in the trade situation, import credits have dwindled while export credits have grown significantly. Net transactions in portfolio securities have also moved against Germany as foreigners have reduced their purchases of German securities while Germans have maintained their purchases of foreign securities.

The balance of payments surplus was reflected in large additions to commercial banks' net foreign positions. Commercial banks used funds accruing to them to invest in volume at short-term abroad, prompted by more attractive yields in U.K. and Euro-dollar markets and by insufficient credit demand at home. Recent Bundesbank attempts to eliminate the arbitrage spread and halt the outflow of funds do not seem to have succeeded, for banks continued to export funds through August. As a result of these outflows, the central bank showed no reserve accumulation in the first half of the year.

The marked disequilibrium in Germany's external position underscores the importance of reviving internal demand in that country through fiscal and monetary policies. Furthermore, to the extent that trade with Germany influences other European economies, renewed expansion in Germany would help to revive demand in those economies and encourage a general pick up in European economic growth.