STANDARD & POOR'S

CREDITWEEK®

INTERNATIONAL

THE AUTHORITY ON CREDIT QUALITY NOVEMBER 7, 1994

KOHL FACES ECONOMIC CHALLENGES AFTER SLIM VICTORY

Chancellor Helmut Kohl's narrow victory in Germany's Oct. 16, parliamentary elections will make the task of turning the country's economy around and putting the government's fiscal house in order more difficult but not impossible, according to S&P analysts who follow the Federal Republic and German industry.

The governing coalition of the conservative Christian Democratic Union/Christian Social Union (CDU/CSU) and the liberal Free Democratic Party (FDP) emerged with a majority of 10 in the 672-seat parliament (Bundestag), a sharp drop from 1990's election results, when the ruling coalition won 134 more seats than the opposition *(see chart on next page)*. The 41.5% vote for the CDU/CSU was the lowest since the first post-war elections in 1949. Although far less than its 1990 total of 11%, the FDP, with 6.9% of the vote, managed to achieve the 5% minimum needed to get into parliament.

The slim 10-seat advantage Mr. Kohl has to work with is not necessarily a disaster in the relatively stable German political environment. Two former SPD-led governments, Helmut Schmidt's (1976-1980) and Willy Brandt's (1969-1972) coalitions, survived with 10- and 12- seat majorities, respectively. However, the CDU/CSU-FDP coalition has been showing signs of strain and, given the difficult agenda ahead, particularly on the economic and budget fronts, it may be forced to make substantial compromises to survive until the next scheduled election in four years.

"The narrowness of the coalition's majority may force the chancellor to proceed with caution on contentious issues such as fiscal tightening, social security reform, and the question of European economic and monetary union," says Wolfgang Meyer-Parpart, the head of S&P's Frankfurt office. Mr. Kohl has been one of Europe's leading advocates of economic and monetary union and he undoubtedly will continue to play a critical role in the run-up to 1999, Mr. Meyer-Parpart stresses. However, with German voters increasingly skeptical about the benefits of deepening European integration and wary of the plan for economic and monetary union set forth by the Maastricht Treaty, Mr. Kohl may be less vocal on these issues.

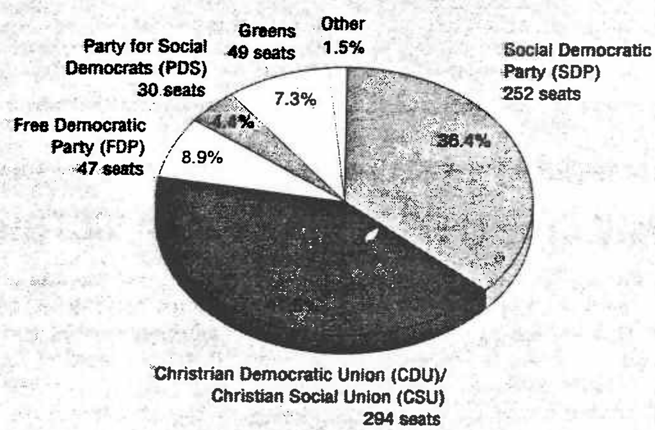
"Mr. Kohl's freedom of maneuver in fiscal policy will also be more limited," says Mr. Meyer-Parpart. Continued high unemployment in eastern Germany contributed to the coalition's diminished showing in those states and to the resurgence of the former Communists, the Party of Democratic Socialism (PDS), which won al- ▶

most 20% of the vote there. The gap in living standards between eastern and western Germany remains wide, and the government will no doubt be forced to continue to spend large sums of money to narrow it.

The government's plan to cut social spending may be made more difficult with the opposition now commanding nearly as many votes in the Bundestag and controlling the Bundesrat, with its veto power over budget legislation that affects the German states (Laender) directly. Initiatives such as limiting unemployment benefits to two years will clearly have more of an impact on the constituents of the SPD and PDS and therefore are very likely to be opposed by the two parties.

In addition, the government's proposed 7.5% personal income tax-surcharge, which it hopes to enact to pay for the soaring costs of unification, undoubtedly will be strongly opposed by SPD, as the party made taxation a top issue during the campaign, saying it would scrap the 7.5% tax surcharge in favor of a 10% charge on the top 20% income earners.

GERMAN ELECTION RESULTS



Source: Official election results.

ECONOMY ON THE REBOUND

The CDU/CSU-FDP's come-from-behind victory—it trailed by as much as 5% in opinion polls earlier in the year—can be attributed in part to the German economy's recovery from its most severe recession since World War II. Economists have predicted the German economy will grow as much as 3.5% in 1995, following a strong 2.5%-2.7% this year. Corporate profits have begun to rebound, with those of the 30 companies that constitute Germany's most widely watched stock index, the DAX index, projected to jump 70% in 1994 and perhaps another 40% in 1995. The recession Germany suffered through after the unification consumption and investment stimulus lost steam in 1991 shook the confidence of a country that was accustomed to rising living standards. More than a million jobs were lost as German GDP fell 2% during the year-and-a-half economic downturn.

On the other-hand, the recession forced Germans to deal with underlying structural and competitive disadvantages, the most severe being the country's high labor costs. In 1993, for example, unit labor costs in the automotive industry, Germany's leading exporter, were 20%-30% higher than those in Japan, the U.S., and France. Likewise, "The German chemical industry has the highest labor costs of any industrial country involved in the industry," according to Christian Wenk, an associate director in S&P's London office who follows German chemical companies. Chemical industry labor costs in Germany are "two-thirds higher than those in the U.S. and the U.K., and one-fourth higher than those in Japan," says Mr. Wenk.

German industry responded to its labor cost disadvantage by cutting jobs, with big companies such as Daimler-Benz AG, Volkswagen AG, and BASF AG letting tens of thousands of workers go. Daimler-Benz, for example, was able to cut costs by US$2.4 billion in 1993 thanks, in large part, to the company's ongoing work force reduction, which will total 20% by the end of 1994, says Edward Lawrence, an analyst in S&P's International Finance Department.

PRODUCTIVITY, PROFITS IMPROVE

In addition to job cuts, which have put downward pressure on wages and benefits, more flexible work schedules and pay structures have started to improve labor costs, which could decline by as much as 5% this year. Average productivity in the chemical industry, for example, rose significantly in the first half of 1994, according to Mr. Wenk. The benefits of increased productivity were immediately evident, as the big four German chemical companies had strong first-half increases in pretax profits, ranging from 41% and 39% for BASF and Hoechst AG, to 24% and 11% for Bayer/AG and Henkel KGaA, respectively, adds Mr. Wenk.

"The German defense and aerospace industry has also undergone significant restructuring to be more competitive, prompted not only by the recession, but also by cuts in defense spending," notes Mr. Lawrence. Deutsche Aerospace AG alone cut 8% of its workforce in 1993 and is committed to cutting an additional 10,300 jobs and closing six plants by 1996. There also has been an increase in European cross-border collaboration, with Deutsche Aerospace having taken equity stakes in several European aerospace consortiums.

"To keep the recovery on track as well as lay the foundation for future growth, the government will need to press ahead with structural reform of the economy," says Konrad Reuss, an associate director in S&P's International Public Finance Group. This includes tax reform of both personal income and corporate taxes; social security reform, as the costs of the welfare state have been rising steeply; and deregulation, as the German economy is the most heavily regulated in the developed world. According to Mr. Wenk, the chemical industry alone is governed by more than 2,000 laws, including stringent environmental regulations that add significantly to production costs.

However, some structural problems, such as the strength of the deutsche mark (DM), are impossible to solve. Consequently, some German industries have begun to invest heavily outside the country. Most prominent among this group are the automakers, with BMW and Mercedes Benz building plants in the U.S., and chemical companies, which are making substantial investments in Asia. The German government's challenge, given that the trend of locating manufacturing facilities outside Germany is likely to accelerate, is to keep the value-added high tech industries in the country, says Mr. Wenk.

"The government also needs to focus its attention on getting the country's fiscal house in order," Mr. Reuss emphasizes. Despite this year's faster-than-expected recovery, public spending as a percentage of GDP will be 5% higher than it was prior to unification, with total public debt now over 60% of GDP. And public debt has doubled since 1990, with interest payments alone now gobbling up 25% of available tax revenues each year. "It is very clear how Germany got into this debt hole," Mr. Reuss says. "Not only has the government been hit by the massive costs of unification, with around DM150 billion going to the east each year for new infrastructure, pensions, and unemployment benefits, but also by a revenue squeeze as a result of the just-ended recession." Mr. Reuss indicated that the reelected government will have to make further cuts in spending, including welfare benefits, and may be forced to raise taxes once again.

The German financial markets' favorable response to Mr. Kohl's victory reflects a belief that the government will be able to move forward with its economic and fiscal policies. The bond market soared and the DM hit a two-year high against the dollar, as investors anticipated progress in reducing the budget as well as continued low inflation.

"If the government does in fact practice the sound fiscal and monetary policy that it promised during the parliamentary campaign, then there may be room to decouple German interest rates from the international markets, including the U.S. market," says Mr. Meyer-Parpart.

Mark Goebel (212) 208-1951