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The Economic Situation in the Federal Republic of Germany

In its latest joint assessment of the economic situation the Association of German Economic Research Institutes reaches the following conclusions, which are presented here in an abridged form¹.

The cyclical upswing in the Federal Republic of Germany which began in the middle of 1978 continued in the spring and summer of 1979 with almost undiminished strength and even spread over a wider field. The notable increase of the entrepreneurs' propensity to invest contributed most markedly to the strengthening of the forces making for a cyclical upsurge. Higher capacity utilization and improved sales and profit expectations lessened the risk involved in new investments while the conditions for financing them were at first favourable. Although, in distinction from previous uptrend phases, rationalization remained the foremost motive, investments on extension of production and on manufacture of new products were more recently playing a greater role. The building investments experienced an exceptionally strong rise, after their fall due to the weather at the beginning of the year. The real demand appears however to have passed its peak in the summer. Only the industrial building contracts increased until recently – an indication that industry is again willing to invest more in plant extensions. The weakening of demand will at first have no effect on the level of production as the building industry can fall back on well-filled order books.

The export trade did more to sustain the uptrend than it had done in the two preceding years. The goods

exports rose much faster in real terms during the second quarter of 1979 and still moved up very strongly after the middle of the year. The increase of exports mostly reflects the economic revival in the industrial countries of Western Europe. Since the flow of foreign orders has been less favourable of late, it is however to be expected that the rise of exports will slow down noticeably in the coming months already. The imports have been rising faster since the middle of the year – after a temporary abatement of their expansion – owing to the strong advance of the overall demand in the Federal Republic. In the near future the increase of imports must be expected to slow somewhat as industrial production will not continue to move ahead at such a rapid pace and inventory accumulation will also proceed less strongly.

The Federal Republic has in the current year moved much closer to its high employment target. In the third quarter about 400,000 more people were in employment than a year earlier. The number of part-timers has risen markedly and that of trainees even more. The substantial extension of employment and tax cuts have brought about appreciable income increases for wage and salary earners' households against a background of moderate pay increases. The disposable income of private households expanded at first substantially as income transfer payments were also increased by a number of measures (higher social insurance pensions and child allowances) and the favourable trend of profits led to greater profit withdrawals. The savings ratio tended downward and private consumption grew rapidly, in nominal and real

¹ Participating institutes: Deutsches Institut für Wirtschaftsforschung, Berlin; HWWA-Institut für Wirtschaftsforschung, Hamburg; Ifo-Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen. The Institut für Weltwirtschaft has presented its more sceptical appraisal in a minority report.

terms, up to the middle of the year. Later the expansion of consumption slackened distinctly. The main reason for this trend was the faster surge of consumer prices. As far as prices are concerned, the climate has been deteriorating for about a year already, mainly because the domestic money supply was at first very plentiful and imports have become extremely dearer. To these factors must be added the cumulation of administrative price rises at the beginning of the year and the raising of the value-added tax at the middle of 1979.

Some of the influences which made a crucial contribution to the strong expansion in the current year – such as extensive tax relief, substantial inventory replenishment and the favourable economic conditions abroad – will no longer operate next year. Slower growth of demand and production is thus indicated but its extent and duration will depend in no small measure on the economic policy and on the attitude of employers and trade unions. The forecast offered here depends, as always, on certain assumptions. The assessment for 1980 is weighed by especially great uncertainties, if for no other reason, because the international reactions to the latest oil price hike cannot yet be fully appraised. Moreover, the further developments in the field of crude oil supplies and prices are uncertain. Our forecast is based on the following assumptions: The cyclical trend in other countries follows the course described in the first part of this report. Economic growth is abating but the upward trend is maintained in most countries. Oil supplies remain sufficient; the world market prices for oil do not rise significantly faster than those for industrial products. It is an aim of fiscal policy not to let the deficit increase further; the tax cuts envisaged by the Government for 1981 will not be carried into effect earlier. The monetary policy adheres to the concept of a potential-oriented control of money supply, thus providing once more greater scope for monetary expansion than in recent months. The wage increases do not deviate too far from those agreed upon in 1979.

The distinct slowdown of the cyclical expansion in Western Europe and Japan and the recession in the USA will damp the advance of goods exports perceptibly. These influences are however likely to weaken later in 1980 as some measure of cyclical recovery may be anticipated, at least in the USA. Besides, the deliveries to the oil-exporting states will – after having declined – rise by a not inconsiderable margin as a result of their high revenues. The exports to the Soviet Union and China may be counted upon to increase further, the more so as the import capacity of the Soviet Union has expanded thanks to dearer crude

oil and gold and China is opening her market wider to products from the Western world. The exports of goods will, all in all, rise by 4.5 % – considerably more slowly than in 1979. This will probably affect those basic materials in particular the export demand for which had been raised to excess by precautionary purchases. The transition from strong to moderate economic growth will be reflected by the goods imports. The change will show most markedly in the imports of industrial primary products and less so in those of finished products. In view of the risks faced in the supply of mineral oils the inventories, which have been much replenished in the meantime, will not be reduced; the imports will thus increase in line with current requirements, and this means much more slowly than this year.

The demand of private households will in 1980 grow less vigorously than this year, mainly because, after the relief in the last two years, the progressive tax rates will once more have their full effect on the incomes. In spite of larger wage increases than this year the total gross wages and salaries will not rise faster. The stronger advance of the hourly earnings will be more than offset by a decline of the number of hours worked; short-time working will spread again and the workforce will rise more slowly than in the previous year. The transferred incomes – social insurance pensions and benefits – will also increase more slowly, mainly because the children's allowance will not be raised next year and the social insurance pensions' increment will be slightly smaller. Seeing that profit withdrawals will likewise probably increase more slowly as the trend of profits is no longer quite so favourable, the total disposable income of private households must be expected to grow at a lower rate than in the current year. Since the private households this year financed part of their additional expenditure on heating at the expense of their savings, it is unlikely that the savings rate will decline further in the coming year. Expenditure on private consumption will rather expand parallel to disposable incomes and this means also somewhat more slowly than this year.

That the trend of final demand will no longer be as favourable as it has been will undoubtedly have a damping effect on the investment propensity. There are however a number of factors which suggest that it will prove fairly resistant to retarding influences. The enterprises are at present well cushioned financially, and the profit trend will according to the forecast not greatly worsen in 1980. A cautiously optimistic investment forecast is also supported by the fact that,

in distinction from previous uptrend phases, the investments on capacity extensions are this time playing a subordinate role. For this reason it need not be assumed that these investments will suffer as big a decline as usually in a downtrend phase. Finally, it has to be borne in mind that the big rise of oil prices will have not only moderating but stimulatory effects on investments. All in all, the equipment investments may be expected to increase further although not as fast as in the current year.

In the building market the decline of demand will at first lessen the imbalance of supply and demand and take the wind out of the sails of the price-cost surge. The building production on the other hand will be sustained by high order books far into the next year. The decline of orders will check the increase in bare construction operations and perhaps later lead here to a decline; the finishing trades will increase their operations further within their capacity limits. The demand will be stimulated by measures against heat losses. There will be shifts in demand and production not only between bare construction and finishing but also between residential, public and industrial building. If the situation in the building market eases as foreseen, the upsurge of prices is likely to abate in this area next year.

Overall production in the economy will temporarily rise more slowly but there is little danger of its sliding into a recession. This assessment is based, above all, on the fact that the investment propensity is holding up well and the trend of exports, stock-building and private consumption will be only temporarily

moderately affected. The adverse effect of the crisis of oil prices on the economic trend later in 1980 will be slight only. Besides, the tax relief envisaged for early 1981 is likely to have a positive influence on the economic climate. The growth rate of the real national product will decline from a good 4 % this year to 2.5 % next year. The repercussions on the labour market will be relatively small. While the demand for labour will decline temporarily, there will be no significant dismissals. Adjustments will in the main take the form of less overtime and more short-time working and of vacancies not being immediately filled. The number of unemployed will clearly reflect the change in the labour situation. The yearly average unemployment rate will be only slightly higher because 1980 will open with a low seasonally-adjusted unemployment figure – far below the 1979 average.

The effect of the setback to the stabilization of the price level will be felt far into the next year: The rise of the raw material prices has not yet worked through to all manufacturing stages. As productivity increases by a smaller margin, wage costs and thus prices will come under heavier upward pressure. No slowdown of the price surge can therefore be expected until later in the year when the raw material prices will work in the same direction, for in view of the world-wide cooling of the economic climate it is unlikely that they will advance further. Another factor, on the consumer level, is that a further increase of the value-added tax and a similar cumulation of administrative price rises is not imminent. Nevertheless the cost of living index will rise in 1980 as much as it did in 1979 on an average.

Index Numbers of World Market Prices of Foodstuffs and Industrial Raw Materials

Index and commodity group	1978	1979					
	October	January	April	July	October	Nov. 2	Nov. 16
HWHA-Index*(1952-1956=100) . . .	334.1	339.3	362.6	406.4	431.9	431.5	440.4
Foodstuffs	254.8	245.8	248.9	291.0	301.2	302.6	310.5
Raw materials other than foodstuffs . . .	372.8	384.4	417.3	462.0	494.9	493.7	502.9
Fuels	564.8	585.6	641.5	738.4	824.4	824.2	834.2
Raw materials for consumer goods . .	210.3	213.4	225.4	243.1	237.4	237.6	245.2
Raw materials for capital goods . . .	288.7	298.2	322.2	332.6	338.3	335.1	344.8
Reuter's Index (18. 9. 1931 = 100) . . .	1517.4	1499.1	1551.0	1569.2	1658.3	1687.1	1694.7
Moody's Index (31. 12. 1931 = 100) . .	974.9	992.7	1048.0	1084.2	1151.0	1126.6	1154.6

*Index compiled by the Hamburg Institute for International Economics. On dollar-basis.