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The Economic Situation in the Federal Republic of Germany

In its latest joint report on the economic situation the Association of German Economic Research Institutes reaches the following conclusions, presented here in an abridged form.¹

The general economic situation in the Federal Republic of Germany is still characterised by an underlying upward trend. The increase in overall production was again primarily sustained by foreign demand; domestic demand, on the other hand, increased only slightly. The strength of foreign demand is not only due to the improvement of economic activity worldwide but also to the depreciation of the D-mark in real terms, which has substantially reduced the price of goods and services from the Federal Republic of Germany on export markets. A major reason for the weakness of domestic demand is the fact that the economic policy setting has not yet been improved enough to enable businesses to create a sufficiently large number of profitable jobs. It is difficult to determine the intensity of economic recovery during the winter six months, as well as during the preceding period; special determinant factors have once again distorted developments. There was virtually no increase in the number of employed persons during this period. The seasonally adjusted number of unemployed persons remained at its high level of 2¼ million.

Merchandise exports have been expanding strongly now for two years. The slowdown during the first few months of 1985 was merely a reflex response to the previous surge of activity in this field caused by the stepping up of deliveries postponed on account of industrial action. There was still a marked increase in orders from abroad. Yet again, demand centred on capital goods. Due to the accelerated increase in merchandise imports since the beginning of the year the merchandise trade surplus did not increase any more in real terms. In nominal terms, there was a noticeable

decline in the balance-of-trade surplus on account of the deterioration in the terms of trade.

Investments in fixed assets have been growing now for over two years, although there have been considerable fluctuations. The level of investments was exaggerated at the end of 1984 by efforts to catch up on shortfalls caused by industrial action. Investments in fixed assets, therefore, probably did not increase any further at the beginning of 1985; indeed, they may well have declined. The upturn in investment activity has not yet been really incisive. One main reason for this is that it has not affected many fields outside of the manufacturing sector. The situation has continued to deteriorate in the building sector. Residential building orders have been decreasing for almost two years. The situation in the industrial building sector is comparatively favourable. Although building activities here picked up towards the end of last year, this was only because of the expiry of the qualification deadline for the government's investment allowance for industrial buildings and because weather conditions only prevented building activity to a slight extent in all sectors. At the beginning of 1985 the severe winter produced a production setback.

Along with the disposable real incomes of private households, private consumption increased only slightly. At the beginning of this year the adverse effect of the weather on employment led to high income losses; these losses could not be compensated for by increased payments of unemployment benefit and bad-weather money. In addition, the purchasing power of private households was reduced by the temporary increase in inflation; this was primarily caused by the soaring dollar and weather-induced price increases for food and fuels, i. e. to temporary influences. Furthermore, uncertainty with regard to the tax treatment of vehicles in connection with the intended

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.

reduction of toxic vehicle fumes caused many households to postpone the purchase of a new vehicle.

As always, this forecast is based on a number of assumptions. World trade will continue to expand at a current annual rate of 5 %. During the course of the year the dollar's annual average exchange rate will figure at slightly below DM 3. There will be an appreciation in the value of the D-mark against most partner currencies in the European Monetary System later on in the year. The price level on international markets of industrial raw materials and oil on a dollar basis will hardly change. Fiscal policy will move along the lines set out in the 1985 budgetary plans. No new measures will be introduced this year to influence the course of general economic development. The first stage of the tax reform planned for 1986 will be adopted by parliament in its already announced form. The Bundesbank will continue the course it has recently been pursuing, i. e. it will extend the money supply by about 5 %. The decrease in borrowing by the housing sector and the expected appreciation of the D-mark will lead to slightly falling interest rates. The wage agreements yet to be concluded this year will be marked by wage rates which by and large correspond to those negotiated so far.

The continuing economic expansion in the industrialised countries and the German lead with regard to the price competitiveness of its suppliers, a result of the pronounced depreciation of the D-mark in real terms, means that exports will continue to expand during the course of the year. Foreign demand, therefore, will again be much more expansive than domestic demand. Since economic expansion has slowed down in the United States exports to this area will increase less markedly during the course of the year than before. Exports to European industrialised countries, on the other hand, are likely to witness greater expansion, since the economic recovery in these countries will continue and the competitiveness of German suppliers is still improving. As investments have picked up almost everywhere, there will be a particularly clear increase in the exports of capital goods.

Among the components of domestic demand it is investments in fixed assets which will increase most. A steady increase in the propensity to invest can be expected during the course of the year. Business earnings will again increase, albeit to a lesser extent than over the past two years. Interest rates will probably continue to fall, thus increasing the attractiveness of physical assets in comparison to financial assets. Sales prospects for industry will continue to look good. In particular, order books will fill up and capacity utilisation

will be extended in the capital goods sector. There has been an upward revision of investment plans in the manufacturing sector. However, it remains to be seen whether the exchange-rate induced risks associated with sales abroad have been adequately taken into account. On the whole, investment activity is still dynamic, even though stimulating economic policy measures have been discontinued. However, the momentum is mainly limited to the manufacturing sector; what is more, the share of investments designed to create new jobs is still low.

The downward trend in demand for construction work over the past two years will continue to determine developments in the building industry during the course of the year. However, the situation does vary from one building sector to the next. Demand for residential building has dropped substantially. A rapid reversal of this trend is unlikely. Although mortgage rates are likely to fall, they will still remain relatively high. The real income levels of private households will increase only slightly. Many building projects will probably be postponed with an eye to the planned "Law to Reregulate Tax Assistance for Owner-Used Residential Property", which provides for larger depreciation amounts and a greater child component as of 1987. The number of unfinished building projects has decreased considerably and is now lower than its lowest level recorded so far in 1983. The volume of residential building can be expected to decrease on average by about 6 % during 1985. The prospects are somewhat better for industrial building, where orders are increasing. The recovery in fixed assets investments means that in many cases additional building projects are required, although not to the same degree as before. The currently marked increase in investments by the Bundespost (Federal Post Office) and the Bundesbahn (Federal Railways), which involve substantial construction work, have a supportive effect here. Industrial building investments will probably increase slightly during the course of the year; however, on an annual average they will be roughly 2 % down on last year's level, in which investment was pushed up by efforts to qualify for the government's investment allowance. There will be a relatively favourable development in the field of public building investments. Investments in real terms here can be expected to increase slightly on an annual average for the first time since 1980.

The development of incomes is unlikely to improve the conditions for an increase in private consumption during the course of the year. There will be a slightly greater increase in the gross incomes of employees,

ECONOMIC TRENDS

The Most Important Data of the National Accounts of the FR Germany

Forecast for 1985

	1983 ¹	1984 ¹	1985 ²	1984		1985	
	Years			1 st hf. yr. ¹	2 nd hf. yr. ¹	1 st hf. yr. ²	2 nd hf. yr. ²
Origin of National Product, in real terms							
Change in % compared with the preceding year							
Number of employed	-1.6	-0.2	0	-0.3	-0.1	0	0.5
Working time (per working day)	-0.1	0.1	-0.5	-0.3	0.5	0	-1
Working days ³	0.1	-0.2	-0.5	0.4	-0.8	-1	0.5
Total work done, per calendar month	-1.6	-0.3	-0.5	-0.2	-0.5	-1	-0.5
Productivity ⁴	2.7	2.9	3	2.5	3.3	3.5	2.5
Gross Domestic Product at prices of 1976	1.0	2.6	2.5	2.3	2.8	2.5	2
Appropriation of the National Product							
- at current prices -							
Change in % compared with the preceding year							
Private consumption	4.1	3.2	4	3.6	2.9	3.5	4.5
Government consumption	3.0	4.2	4.5	4.1	4.3	5	4
Investment in fixed assets	4.8	3.2	2.5	3.3	3.0	2	2.5
Equipment	8.5	1.9	9	-1.1	4.4	11.5	7.5
Buildings	2.5	4.0	-2	6.3	2.1	-3.5	-0.5
Exports	0.2	11.1	12.5	8.5	13.5	13	11.5
Imports	0.1	9.9	9.5	11.4	8.5	9	10
Gross National Product	4.6	4.6	4.5	4.3	4.8	4.5	4.5
- at prices of 1976 -							
Change in % compared with the preceding year							
Private consumption	1.1	0.6	1	0.6	0.6	0.5	1.5
Government consumption	0.2	2.0	1.5	1.3	2.7	2	1.5
Investment in fixed assets	3.1	1.3	1	0.8	1.6	1	1
Equipment	6.1	0.4	7	-2.6	2.8	9.5	5
Buildings	0.9	1.9	-3	3.4	0.7	-4.5	-2
Exports	-1.3	7.9	8.5	5.6	10.2	9.5	7.5
Imports	0.5	5.7	5	6.8	4.6	4.5	6
Gross National Product	1.3	2.6	2.5	2.3	2.9	2.5	2
Price Level of National Expenditure (1976 = 100)							
Change in % compared with the preceding year							
Private consumption	2.9	2.6	2.5	3.0	2.3	2.5	2.5
Government consumption	2.8	2.2	3	2.8	1.5	3	2.5
Equipment	2.3	1.5	2	1.5	1.5	2	2
Buildings	1.6	2.0	1	2.8	1.4	1	1.5
Exports	1.5	2.9	3.5	2.7	3.0	3.5	4
Imports	-0.4	4.0	4.5	4.3	3.7	4.5	4
Gross National Product	3.2	1.9	2	2.0	1.8	2	2.5
Origin and Distribution of Income							
Change in % compared with the preceding year							
Gross income from employment ⁵	2.1	3.0	4	3.1	2.8	3.5	5
Gross wages and salaries total	1.6	2.8	4	3.1	2.5	3	4.5
ditto per employed person	3.4	3.0	3.5	3.4	2.7	3	4.5
Net wages and salaries total	0.7	1.4	2.5	1.6	1.3	2	3
Gross income from entrepreneurship and property	10.5	9.1	6	5.8	12.0	8.5	4
Net income from entrepreneurship and property	13.1	9.3	6.5	4.8	13.3	9.5	4
Disposable income of private households	2.3	3.4	4	3.4	3.5	4	4

¹Based on data from the Federal Statistical Office (cf. Wirtschaft und Statistik, No. 3/1985) and own calculations.

²Own forecasts; rates of change rounded off.

³Only half of the change of the number of working days has been allowed for.

⁴Real Gross Domestic Product per hour worked.

⁵Including employers' social security contributions.

ECONOMIC TRENDS

primarily due to wage settlements which are higher than those agreed upon last year. The net income increases will be about one-and-a-half percentage points lower than the gross increases, one reason being the increase in social insurance contributions. An increased growth in transfer incomes can be expected, mainly as a result of the fact that a growing number of employees are taking advantage of early retirement provisions. On the whole, disposable income in 1985 will increase by about 4 % in nominal terms and just under 1.5 % in real terms. A more or less unchanged savings ratio can be expected this year. Although the increase in mass incomes, the fact that lower amounts have been released from premium savings agreements, and the increase in precautionary savings in the face of greater uncertainty concerning the state pension scheme would suggest an increased savings ratio, these tendencies are by and large offset by the falling interest rates, which will reduce the willingness to form financial assets and increase the propensity to incur debts. In this situation, real private consumption will again increase only moderately in 1985.

In accordance with this forecast, real GNP will, as in the previous year, increase by about 2½ %. The production growth rate will be clearly above-average in manufacturing industry, but there will be a drop in the building industry. The utilisation of the economy's overall productive capacity, which is still characterised by weak growth, will increase only slightly. Any attempt to forecast developments in the field of employment this year must take into account the effects of the new regulations on working time. Although the official reduction of working time will also lead to the taking on of additional labour, its impact will by and large be cushioned by increased rationalisation and the more efficient use of manpower. In addition, there will, at least temporarily, be more overtime. The total number of employees in 1985 will probably exceed the previous year's level by approx. 50,000. The increase in the

number of gainfully employable persons will be reduced by the earlier retirement of many employees and the low demographically induced increase. Nevertheless, it is still likely to be greater than the increase in the number of employed persons. The number of registered unemployed persons, therefore, will on average be somewhat greater this year than in 1984.

Imports will increase markedly, but not as strongly as exports. This already results from the fact that the favourable competitive position of German suppliers has a stimulating effect on exports. Due to various overhangs at the beginning of this year the average annual increases will differ to a greater degree than the current rates of increase. This would suggest a considerable increase in the export surplus. Although, despite the expected improvement during the course of the year, the terms of trade this year will generally be somewhat less favourable than in 1984, the surplus in the balance of trade can be expected to increase from DM 54 billion to approx. DM 75 billion. There will probably be no decrease in the deficit on the services balance and that of transfer payments will again increase. The current account surplus, therefore, will increase less than the balance of trade improves. It will probably figure at around DM 30 to 35 billion.

During the course of the year the factors which led to accelerated inflation during the winter six months will no longer apply. In all probability, the prices for seasonal products will again decrease. Due to the weakening of the dollar, the price of those imports invoiced in dollars will not increase so rapidly. Further progress on the path towards stabilising prices will, among other things, be made more difficult by unit labour costs, which are again increasing. The potential-oriented monetary policy and relatively weak demand will strongly limit the scope for price increases. Consumer prices in 1985 will probably increase, as in the previous year, by an average of 2½ %.

HWWA Index of World Market Prices of Raw Materials¹ (1975=100)

Raw Materials and Groups of Materials	1984		1985					
	AA ²	December	January	February	March	April	10.5.	24.5.
Total index	205.0	201.1	200.7	197.7	197.0	198.1	197.8	197.3
Total, excl. energy raw materials	125.1	115.0	114.1	114.1	112.6	115.0	114.4	112.9
Food, tropical beverages	122.7	111.9	112.6	111.4	111.3	110.7	108.2	105.7
Industrial raw materials	126.9	117.4	115.2	116.1	113.5	118.4	119.0	118.4
Agricultural raw materials	128.6	115.9	111.9	112.0	106.9	109.8	111.4	111.8
Non-ferrous metals	135.8	127.8	129.9	131.6	131.2	137.9	140.5	137.1
Energy raw materials	251.7	251.4	251.3	246.6	246.2	246.6	246.5	246.6

¹ On dollar basis. - ² Annual Average. For the method of computation of the HWWA Index cf. INTERECONOMICS No. 5, 1980, p. 261 ff.