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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

After slackening off during the winter six months the economic upswing in the Federal Republic of Germany recuperated during the summer. Since then demand and production have been increasing at a considerable rate again. The once again long and severe winter was not the only reason for the temporary weakness. Delays in the shift of expansionary forces from foreign to domestic demand were more significant in this respect. Incisive changes in key economic parameters apparently led to uncertainty and a wait-and-see approach. The basic upward trend only managed to reassert itself during the summer six months. As opposed to overall production, the number of employed persons during the course of 1986 consistently revealed an upward trend. The latest figures show that the total number of employed persons was 280,000 up on the corresponding figure one year ago. The number of unemployed persons has dropped for the first time during this economic upswing; the unemployment figure in autumn was approx. 100,000 lower than one year previously.

Merchandise exports were retarded by a number of factors during 1986, their upward movement coming to a standstill. The increase in the external value of the D-mark against the dollar has made life much more difficult for exports to the dollar area. A flagging world economy during the first six months of 1986 also exerted a restraining influence. Oil-exporting countries speedily responded to revenue losses by further reducing demand. The trend in merchandise imports was determined by the expansion of demand and production in the Federal Republic of Germany. Additional imports of oil products above and beyond the current demand level represented a determinant factor up until well into the summer months. Although in real terms the export

surplus continued to decrease, it increased again in nominal terms due to the marked improvement in the terms of trade.

Following a slack period at the beginning of the year private consumption has become the decisive motor of economic activity. The boost to purchasing power as a result of the drop in consumer prices and tax reductions was of key significance. The pronounced increase in real incomes prompted consumers to buy durable goods. The trend in consumer prices during 1986 was marked by the substantial drop in import prices, especially in the price of oil. The cost of living has fallen by almost 1 % since the beginning of the year. If the trend in prices had been solely determined by the increase in domestic prices and costs consumer prices would have probably been between 1.5 and 2 % higher than during the previous year.

For the first time in years there has been a clear upward trend in real gross fixed capital formation during 1986. This is mainly due to the trend reversal in the field of building investments. There has been a relatively brisk increase in public building since the winter break. The increased propensity of businesses to invest is reflected in the marked increase in industrial building investments. More and more building-intensive plant extension investments are being carried out. Investments in residential building, on the other hand, continued to decline. Investments in machinery and equipment continued to increase substantially during the course of 1986, albeit at an extremely fluctuating pace. The already favourable profit situation improved even more due to the reduction in the prices of imported raw materials and intermediate products. The in the meantime relatively high level of capacity utilisation in industry has been an increasingly significant factor for the stepped-up investment activity.

The prospects of a continuation of the economic upswing in the Federal Republic of Germany are good. The still substantial monetary expansion will continue to

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.

ECONOMIC TRENDS

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

Forecasts for the 2nd Half Year 1986 and for the Year 1987

	1985 ¹	1986 ²	1987 ²	1986		1987	
	Years			1 st hf. yr. ¹	2 nd hf. yr. ²	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	0.7	1.1	1.1	1.0	1.1	1.2	1.0
Working time (per working day)	-0.5	-0.8	-0.8	-0.7	-0.8	-0.8	-0.8
Working days ³	-0.3	0.0	0.2	-0.1	0.2	0.0	0.4
Total work done, per calendar month	-0.1	0.3	0.5	0.2	0.5	0.4	0.6
Productivity ⁴	2.7	2.5	2.5	2.5	2.5	2.5	2
Gross Domestic Product at prices of 1980	2.6	3	3	2.7	3	3	2.5
Appropriation of the National Product							
- at current prices -							
Change in % compared with the preceding year							
Private consumption	3.9	4	5.5	3.8	4.5	5.5	5
Government consumption	4.4	4.5	5	4.5	4.5	5	5
Investment in fixed assets	1.3	5.5	8	5.2	6	8.5	7
Equipment	11.8	9	9.5	8.6	10	10.5	9
Buildings	-5.3	3	6.5	2.7	3	7	5.5
Exports	10.1	-0.5	3.5	-0.6	-1	2	5
Imports	6.9	-6.5	6	-6.7	-6.5	3	9.5
Gross National Product	4.8	6.5	5	6.0	6.5	5.5	4.5
- at prices of 1980 -							
Change in % compared with the preceding year							
Private consumption	1.8	4.5	4	4.0	5	4.5	3
Government consumption	2.2	2	2	2.2	2	2	2
Investment in fixed assets	-0.3	4	5	3.8	4	6.5	4.5
Equipment	9.4	8	7.5	7.7	8.5	8.5	6.5
Buildings	-6.2	1	3.5	1.1	1	4.5	2.5
Exports	7.3	0.5	3	0.3	1	2	3.5
Imports	4.7	4.5	5.5	3.1	5.5	6	5
Gross National Product	2.5	3	3	2.5	3	3	2.5
Price Level of National Expenditure (1980 = 100)							
Change in % compared with the preceding year							
Private consumption	2.1	-0.5	1.5	-0.2	-0.5	1	2
Government consumption	2.2	2.5	3	2.2	2.5	3	3
Equipment	2.3	1	2	0.9	1	1.5	2.5
Buildings	0.9	2	2.5	1.6	2	2.5	2.5
Exports	2.6	-1.5	0.5	-0.8	-1.5	0	1.5
Imports	2.1	-10.5	0.5	-9.6	-11.5	-3	4
Gross National Product	2.2	3.5	2	3.4	3.5	2.5	2
Origin and Distribution of Income							
Change in % compared with the preceding year							
Gross income from employment ⁵	3.8	5	5	4.9	5.5	5.5	5
Gross wages and salaries total	3.7	5	5.5	4.9	5.5	5.5	5
Ditto per employed person	2.9	4	4	3.8	4.5	4	4
Net wages and salaries total	2.3	5.5	4	5.2	6	4	4
Gross income from entrepreneurship and property	8.8	12	4.5	12.1	11.5	7	2
Net income from entrepreneurship and property	8.6	13.5	4.5	13.4	14	8	2
Disposable income of private households	3.9	4.5	5	3.9	5	5	5

¹Based on data from the Federal Statistical Office (cf. Wirtschaft und Statistik, No. 9/1986) 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.

stimulate the economy, the considerable reduction in the price of oil will initially continue to have a bearing on real income levels and, what is more, the economy has developed a certain momentum of its own which will continue for a while. These various factors will suffice to ensure a continued upswing next year. Its intensity, however, can be expected to tail off during the course of the year, primarily due to the gradually diminishing influence of the oil-price factor. Admittedly, there are considerable uncertainties, above all concerning external economic developments. It is very difficult to predict how the process of adjustment taking place in many countries in the wake of the drop in the price of oil and the exchange rate of the dollar will affect the world economy and world trade in view of the unusually large changes in these parameters. International disagreement on appropriate economic policy measures leads to additional risks. Furthermore, it is difficult to forecast the extent and the course of the effects which the drastic decline of the D-mark/dollar exchange rate will have on German exports.

In spite of the uncertainties involved certain assumptions, and in some cases even pure guesses, have to be made. These are the most important ones: Demand and production in industrialised countries will continue to increase next year. The pace of this increase will slow down somewhat during the course of the year as the influence on real incomes of the lower price of oil gradually peters out. World trade will continue to expand only at a moderate pace, increasing by an annual average of roughly 4% in 1987. The price of oil on international markets will stay at around US \$ 15 per barrel. On the whole, the prices of industrial raw materials will not change noticeably. The D-mark/dollar exchange rate will fluctuate at roughly DM 2. The D-mark will remain unchanged vis-à-vis most European currencies. Fiscal policy will continue its course of clamping down on increased spending and a further consolidation of public finance. It is not assumed that new measures will be adopted. The central bank money supply will increase during 1987 by approx. 5% over its level (which will clearly exceed the target) at the end of 1986, i.e. much slower than it has done so far. The increase in the negotiated standard wage rates will be slightly higher next year than this year. There will be a further reduction in working time in some sectors. Noticeable production shortfalls due to industrial disputes are not expected.

The chances of an increase in German exports next year are relatively limited by the development of the world economy and world trade. Demand and production in the industrialised countries will only

increase at a moderate pace, probably slowing down somewhat during the course of the year. The adjustment to the changed D-mark/dollar exchange rate, which experience shows extends over a longer period, will have a retardant effect on German exports. On the whole, no more than a moderate increase can be expected in exports to industrialised countries. Exports to oil-importing developing countries will probably decrease even further. Most oil-exporting countries will have to cut back their imports even further due to their reduced oil revenue, although not to the extent they have done so far. Although, all in all, exports will move out of the stagnation zone they will only increase moderately.

Investment conditions will continue to be favourable next year. Once again there will be a relatively pronounced increase in domestic demand and a gradual recovery in foreign demand. Sales and profit expectations will on the whole remain positive. The capacity utilisation level of production plant will continue to be high and the extension motive will probably become even more significant. Increasing returns on physical assets and lower returns on financial assets have made investments in physical assets more profitable again. Profits will continue to increase, albeit not to the extent they have done so far. Despite a slight increase in interest rates the terms of financing will remain favourable. All in all, a marked increase in investments in machinery and equipment can again be expected during the course of the coming year. The pace of this increase, however, will probably slow down.

The recovery of demand in the building industry continues and there will be a slightly greater increase in building investments next year. For reasons similar to those outlined in the case of investments in machinery and equipment there will continue to be a pronounced increase in investments in industrial building. There will also be a clear increase in demand and production in the field of public building. The recovery in the residential building sector is sluggish, this sector experiencing a twofold development. Demand for owner-occupied houses is increasing, whereas demand for residential flats continues to fall. Demand for maintenance and modernisation work on buildings already standing is increasing more than demand for new housing construction. For the first time in several years there will again be a slight increase in residential building investments. This, however, is only a cyclical recovery and not a trend reversal.

Once again private consumption will contribute substantially towards the enhancement of overall demand next year. Its expansion, however, will lose

momentum as the impulses from the drop in the price of oil, from the reduction of import prices resulting from the D-mark appreciation against the dollar, and from tax cuts recede. Income from wages and salaries will probably increase to about the same extent as during 1986. The negotiated standard wage rates will be somewhat higher than during the last round of pay negotiations. Employment will continue to increase. The net wages and salaries total, however, will increase much less than this year, since tax progression will again take full effect. There will be a slightly accelerated increase of about 5% for the disposable incomes of private households. With consumer prices rising once again, however, there will be a much less pronounced increase in real incomes. It is doubtful, however, whether consumers will cut back their consumption accordingly. A great deal would suggest that they will lower their savings ratio instead.

The probable development of overall demand means that a further clear increase in overall production can be expected in 1987. This is likely to slow down during the course of the year, however, primarily as a result of the waning influences of the reduced price of oil and tax cuts. Very little would suggest that the economy's endogenous momentum will be powerful enough to prevent a tailing off of the cyclical upswing during the forecast period. Nevertheless, the rate of increase of GNP in real terms will probably be the same as it was in 1986, i.e. almost 3%. This results from the fact that the overhang at the end of this year will be higher than at the end of last year.

The tailing off of the increase in overall production will be accompanied by a slowdown in the increase in employment. Negotiated pay settlements and labour market policy measures, which will at least increase employment in the short term, will tend to counteract this development. The number of persons for which agreements will be reached on a reduction of working

time will be greater than in 1986. The increase in the number of parents taking advantage of the government-financed leave of absence to look after their babies up to the age of 10 months will lead to an additional demand for labour. Altogether, the number of employed persons will probably increase by almost 250,000 next year (1986: 300,000). The number of registered unemployed persons will decrease by almost 100,000. At the end of 1987 the seasonally adjusted number of unemployed persons will still be a good 2 million.

Merchandise imports will increase substantially, since the improved competitive position will continue to enable many foreign suppliers to gain greater shares of the market. In some branches of capital goods production this will be encouraged by domestic supply bottlenecks. As in 1986, the surplus in merchandise trade in real terms will decrease in 1987. During the year the terms of trade will also deteriorate. The combination of these two factors will also lead to a reduction in the balance of trade. At about DM 100 billion during the year as a whole, however, it will probably be only slightly lower than this year's figure. The current account surplus will fall by approx. DM 10 billion to roughly DM 60 billion.

The trend in consumer prices next year will only be favourably influenced to a slight degree by external factors. There will be some after-effects, however. The increase in the main cost factor, unit labour costs, though, will not nearly be offset any more by these influences. As in 1986, unit labour costs will increase by about 2.5% in 1987. In terms of the monetary preconditions there will be greater scope for passing the once again clearly increasing costs on to the prices. Conditions such as those typical for sellers' markets, however, will once again not generally prevail next year; bottlenecks will remain the exception. Under these circumstances the increase in prices will to begin with undoubtedly be kept to a minimum.

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

Raw Materials and Groups of Materials	1985		1986					
	AA ²	October	July	August	September	October	31.10.	14. 11.
Total index	197.3	195.6	115.1 ^p	125.1 ^p	133.4 ^p	129.7 ^p	129.0 ^p	129.2 ^p
Total, excl. energy raw materials	112.5	109.3	111.7	111.8	115.5	114.9	113.7	113.7
Food, tropical beverages	106.9	100.8	100.3	99.0	104.3	101.2	100.4	98.3
Industrial raw materials	116.8	115.8	120.4	121.6	124.0	125.4	123.8	125.5
Agricultural raw materials	112.4	114.3	130.0	131.2	133.9	137.4	136.0	138.3
Non-ferrous metals	131.5	127.2	121.1	120.5	124.1	122.1	120.5	121.2
Energy raw materials	246.7	246.0	117.1 ^p	132.8 ^p	143.8 ^p	138.3 ^p	138.0 ^p	138.2 ^p

¹ On dollar basis. - ² Annual Average. ^p Provisional (due to incomplete data on oil prices).