

Hamburg Institute of International Economics (HWWA) (Ed.)

**Article — Digitized Version**

## The economic situation in the Federal Republic of Germany

Intereconomics

*Suggested Citation:* Hamburg Institute of International Economics (HWWA) (Ed.) (1987) : The economic situation in the Federal Republic of Germany, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 22, Iss. 3, pp. 157-160, <https://doi.org/10.1007/BF02932238>

This Version is available at:

<https://hdl.handle.net/10419/140082>

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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.<sup>1</sup>**

Following its brisk development during the summer the economic upswing in the Federal Republic of Germany began to slow down in the autumn of 1986. The national product even fell at the beginning of 1987, although this was partly due to unfavourable weather conditions. The main reason for the flagging economy were the retardant influences of external economic factors. Their extent was greater than had been assumed in autumn by the institutes compiling this report. This was not only due to the – contrary to assumptions – initially still continuing appreciation of the D-mark, especially against the dollar, but also to the fact that the exchange rate changes had greater retardant effects on exports and investments than originally forecast. Private consumption, on the other hand, has continued to shore up the economy. Despite the decline in production the increase in the number of employed persons has continued, albeit at a slower pace. As the restraining effects of the drop in import prices gradually diminished consumer prices, which had fallen during the course of 1986, again increased slightly.

The decrease in demand and production during the winter six months does not mark the start of a cyclical downswing. This assessment is based on the fact that the cyclical upswing has been moderate during recent years, that bottlenecks accompanied by an inflationary acceleration of cost and price increases did not occur, and that monetary policy in particular is pursuing an expansionary course. Rather, the weakness results from substantial changes in price and exchange rate relationships, changes to which the West German

economy has to adjust. The pace and the extent of D-mark appreciation caused considerable uncertainty in industry about the future development of the economy. This apparently induced many businesses to cancel planned investments. As in the case of most businesses the cancellation of investments is not a way to respond to growing foreign competition it may be expected that many of these investments have only been postponed and will soon materialise. The adjustment to the altered external economic environment is not yet concluded. However, in view of experience during similar developments in the past the retardant effects can already be expected to recede noticeably this year.

The domestic conditions for a continuation of the cyclical upswing continue to be favourable. Expansionary monetary policy provides substantial stimuli to the real economy and the sales and profit expectations of the domestically-oriented businesses are still good. Besides, the reduction in the price of heating fuels will also only start affecting the incomes and purchasing power of part of the private households this year. The combined impact of a decrease in adverse influences from abroad and fairly favourable domestic conditions will probably already lead to a renewed cyclical increase in overall demand and production in the spring. There are a number of risks involved in this forecast, however, especially since it is based on assumptions which are relatively uncertain, particularly that relating to the development of the D-mark against the dollar.

These are the most important assumptions: The upward trend for demand and production in industrialised countries will continue. World trade will expand during the course of the year at about the same pace as in the previous year. On an annual average the price of oil will tend to be slightly lower than the price

<sup>1</sup> Participating institutes: Deutsches Institut für Wirtschaftsforschung (DIW), Berlin; HWWA-Institut für Wirtschaftsforschung-Hamburg; Ifo-Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel (IfW); Rheinisch-Westfälisches Institut für Wirtschaftsforschung (RWI), Essen. The following article presents the views of the majority of participating institutes (HWWA, IfW, RWI). The DIW and Ifo institutes expressed their more sceptical assessment in a dissenting opinion.

envisaged by the OPEC of \$ 18 per barrel. Prices on the international markets for industrial raw materials will more or less remain at their current level. The dollar exchange rate will stay at around DM 1.80; the central rates in the European Monetary System will remain unchanged. Irrespective of the revenue decrease expected in comparison with the last tax estimate, public spending will be raised by the planned amount. Countercyclical policy measures are not expected. The Deutsche Bundesbank will stick to its present course. The central bank money supply will tend to expand above the target funnel of 3 to 6 %. Wage settlements will be only slightly lower than last year. Agreements on a reduction in working time will be negotiated in important sectors; however, these will not take effect before next year. Industrial disputes leading to noticeable production shortfalls are not expected.

Exports will again be the economy's weak point this year. Nevertheless, there is reason to expect that the decline in exports will soon come to a standstill and that it will be replaced later on in the year by a slight increase. In the industrialised countries economic development will be marked by a somewhat more pronounced upward trend than during the winter half-year. Furthermore, there will be a gradual abatement of the retardant effects of the D-mark appreciation. The combination of both these factors would indicate a renewed slight increase in exports to the industrialised countries. This particularly applies to exports to Western European countries. Exports to North America will continue to fall, but probably not so markedly as they have done so far. Exports to oil-exporting developing countries are now expected to decrease much more slowly than hitherto. Many of these countries have by and large completed the adjustment of imports to revenue losses, and their earnings have been increasing again since last autumn. All in all, the increase in merchandise exports in the second half of the year will be lower than the previous decrease; for the year as a whole, therefore, exports will be somewhat lower than in the previous year.

During the current year substantial stimuli to economic activity are again expected to emanate from private consumption. The increase of 4 % in disposable incomes will only be slightly less than the corresponding figure last year. In the case of wage and salary earners the increase will be markedly lower than in the previous year due to the fact that employment will rise at a slower pace, the increase of negotiated standard wage rates will be slightly lower and tax progression will again take full effect. The influence of these factors, however, will probably be offset by the fact that self-employed persons' drawings, which only increased slightly last

year, will again increase more noticeably. Transfer incomes as a whole will expand at a similar extent, pensions much faster, as in the previous year. Private households are expected to spend a greater share of their income on consumption than in the previous year. After savings probably increased to a greater extent than planned last year in connection with the unexpected reduction in the price of oil some of this income is likely to be channelled into spending this year. As the overall increase in prices will keep within narrow limits, the increase in private consumption in real terms will probably be similar to that in 1986.

Following the weather-induced setback during the first few months of the year the recovery in the building industry will continue. Prospects, however, are no longer quite as good as they were in autumn; the number of new orders in the winter six months at any rate clearly decreased. Nevertheless, businesses currently have a considerable order backlog. A marked increase in building investments can be expected at least for this year. This particularly applies to industrial building investments, where the increase will again be slightly higher than in the previous year. Together with the Federal Railways and the Federal Post Office the trade and services sectors, which benefit from the continuing expansion of domestic demand, are likely to appreciably expand their building investments. Although public building investments will not increase to the same extent as last year the increase will nonetheless still be considerable. One reason for this increase is the fact that the stimuli from the Federal Government's urban development promotion programme will be greater than last year. For the first time since 1984 an increase can again be expected in residential building activities, although this will only be slight. In terms of the general trend this is still very much a "split sector". The recovery in the field of new housing construction is confined to single-family houses. This reflects the effects of the "historically" low mortgage interest rates and the still fairly favourable income expectations. Investments in the construction of residential flats, on the other hand, will continue to decline. The development in the field of modernisation and maintenance, where measures now account for over a third of total housing construction investments, will be much more favourable than in the field of new housing construction.

The conditions for investments in machinery and equipment will again improve during the course of the year. The uncertainties and burdens associated with the appreciation of the D-mark will gradually diminish, and there will be a slight increase in external demand. Export-oriented firms, therefore, will view their sales and

## ECONOMIC TRENDS

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

Forecasts for the Year 1987

	1985 <sup>1</sup>	1986 <sup>1</sup>	1987 <sup>2</sup>	1986		1987	
	Years			1 <sup>st</sup> hf. yr. <sup>1</sup>	2 <sup>nd</sup> hf. yr. <sup>1</sup>	1 <sup>st</sup> hf. yr. <sup>2</sup>	2 <sup>nd</sup> hf. yr. <sup>2</sup>
<b>Origin of National Product, in real terms</b>							
Change in % compared with the preceding year							
Number of employed	0.7	1.0	0.5	1.0	1.0	1	0.5
Working time (per working day)	-0.6	-0.8	-1	-0.9	-0.8	-1	-1
Working days <sup>3</sup>	-0.3	0.0	0	-0.1	0.2	0	0.5
Total work done, per calendar month	-0.2	0.2	0	0.0	0.4	0	0
Productivity <sup>4</sup>	2.8	2.3	2	2.7	1.9	1.5	2.5
Gross Domestic Product at 1980 prices	2.6	2.5	2	2.7	2.3	1.5	2.5
<b>Appropriation of the National Product</b>							
– at current prices –							
Change in % compared with the preceding year							
Private consumption	3.9	3.8	4.5	4.2	3.4	4	5.5
Government consumption	4.4	4.8	4.5	4.7	4.8	4.5	4.5
Investment in fixed assets	1.3	4.6	5.5	5.2	4.2	4	7
Equipment	11.8	5.4	5.5	8.2	3.2	3	7.5
Buildings	-5.3	4.0	5.5	2.9	4.9	4.5	6.5
Exports	10.1	-1.9	-1	-0.6	-3.3	-2.5	1
Imports	6.9	-8.0	1	-6.7	-9.4	-3.5	6
Gross National Product	4.8	5.5	4	5.7	5.4	4	4
– at 1980 prices –							
Change in % compared with the preceding year							
Private consumption	1.8	4.2	4	4.5	4.0	4	4.5
Government consumption	2.2	2.5	2.5	2.5	2.6	2.5	2.5
Investment in fixed assets	-0.3	3.3	3.5	3.8	2.8	2	5
Equipment	9.4	4.6	4	7.4	2.4	1.5	5.5
Buildings	-6.2	2.3	3.5	1.3	3.1	2.5	4.5
Exports	7.3	-0.5	-0.5	0.3	-1.2	-1.5	0.5
Imports	4.7	3.2	4	3.2	3.2	3.5	4.5
Gross National Product	2.5	2.4	2	2.5	2.3	1.5	2.5
<b>Price Level of National Expenditure (1980 = 100)</b>							
Change in % compared with the preceding year							
Private consumption	2.1	-0.4	0.5	-0.3	-0.6	0	1
Government consumption	2.2	2.2	2	2.2	2.2	2	2
Equipment	2.3	0.8	1.5	0.8	0.8	1.5	2
Buildings	0.9	1.7	2	1.6	1.7	2	2.5
Exports	2.6	-1.5	-0.5	-0.9	-2.1	-1.5	0.5
Imports	2.1	-10.9	-2.5	-9.6	-12.2	-7	1.5
Gross National Product	2.2	3.1	2	3.1	3.0	2.5	1.5
<b>Origin and Distribution of Income</b>							
Change in % compared with the preceding year							
Gross income from employment <sup>5</sup>	3.8	5.0	4.5	5.0	5.0	4.5	4
Gross wages and salaries total	3.7	5.0	4.5	5.0	5.0	4.5	4
Ditto per employed person	2.9	3.8	3.5	3.9	3.8	3.5	3.5
Net wages and salaries total	2.3	5.3	3	5.2	5.4	3.5	3
Gross income from entrepreneurship and property	9.0	9.5	3.5	10.2	8.8	3	4
Net income from entrepreneurship and property	8.4	10.9	4.5	11.1	10.7	4	4.5
Disposable income of private households	3.9	4.4	4	4.2	4.6	4	4

<sup>1</sup>Based on data from the Federal Statistical Office (cf. Wirtschaft und Statistik, No. 3/1987) and own calculations

<sup>2</sup>Own forecasts; rates of change for 1987 rounded off.

<sup>3</sup>Only half of the change of the number of working days has been allowed for.

<sup>4</sup>Real Gross Domestic Product per hour worked.

<sup>5</sup>Including employers' social security contributions.

profit prospects less sceptically than in the winter six months. There was a further substantial drop in interest rates during the first few months of the year. In view of the continuingly buoyant expansion in private consumption and the brisk building activities the profits and profit expectations of domestically-oriented firms continue to be favourable. The average returns on physical assets still considerably exceed those on financial assets. All this indicates that investments in machinery and equipment will soon pick up, especially since investments can also be expected which had been postponed during recent months because of the extreme uncertainty concerning the further development of exchange rates.

Following the decline in the winter six months overall production will again increase markedly. There will be a considerable expansion in the second quarter of 1987 not only because production will be carried out which had to be postponed during the first few months of the year due to unfavourable weather conditions, but also because the economy's expansionary forces will have regained momentum. During the second half of the year backlog effects will probably contribute to a relatively powerful overall economic expansion; domestic demand will continue to be the primary motor of activity. Due to the low initial level, however, the increase in the national product will probably be only about 2% on an annual average; the forecasts of the individual institutes differ gradually on this point. There will be a much greater increase in imports than in the supply of goods from domestic production. The appreciation of the D-mark will facilitate penetration into the domestic market by foreign suppliers, especially those from the dollar area. Since merchandise imports will increase substantially in real terms while exports experience a slight decrease the surplus in visible trade will decrease considerably – as was already the case last year. As a result of a further improvement in the terms of trade on

an annual average, however, the balance at current prices will decrease to a lesser extent. The surplus on the balance of trade will probably be about DM 100 billion and on the current account a good DM 60 billion.

The renewed expansion of overall production will be accompanied by an increase in the demand for labour. This increase, however, will be lower than last year. The negotiated reduction in weekly working time, which has, or will, become effective in a number of sectors, will hardly lead to new hirings to any noticeable extent. Altogether, the number of employed persons will increase by roughly 150,000 during the course of the year and exceed the previous year's figure on an annual average by approx. 200,000. The private service industry and the public sector, in the latter case also within the framework of job creation measures, will account for the lion's share of the employment increase. There will only be a slight drop in the number of registered unemployed persons, especially since the potential labour force will again increase at a slightly faster pace and job-seekers who have not registered at employment offices (hidden reserve) will continue to move into the labour market.

The price-curbing effects of the reduction of import prices will continue to abate. In the meantime, the adjustment of the gas and long-distance heating prices to the decreased fuel oil prices has been completed. The development of consumer prices, therefore, will once again largely be determined by domestic costs, which are expected to rise between 2 and 2.5% this year. It is doubtful whether the increase in costs can be passed on *in toto* to consumer level. Although the monetary framework has been generously defined the scope for passing on cost increases will probably be kept within relatively narrow limits by demand and competition. During the course of the year the consumer prices will at most increase by 2% and be about 0.5% higher on an annual average than in 1986.

#### HWHA Index of World Market Prices of Raw Materials<sup>1</sup> (1975=100)

Raw Materials and Groups of Materials	1986		1987					
	AA <sup>2</sup>	December	January	February	March	April	24. 4.	8. 5.
Total index . . . . .	143.2 <sup>P</sup>	130.2 <sup>P</sup>	145.1 <sup>P</sup>	146.4 <sup>P</sup>	146.8 <sup>P</sup>	147.8 <sup>P</sup>	148.1 <sup>P</sup>	148.7 <sup>P</sup>
Total, excl. energy raw materials . . . . .	116.1	112.7	114.0	116.1	117.9	119.5	120.4	121.9
Food, tropical beverages . . . . .	107.1	93.8	91.9	91.2	88.3	89.6	91.0	92.9
Industrial raw materials . . . . .	122.9	127.0	130.8	135.1	138.8	142.3	142.8	143.9
Agricultural raw materials . . . . .	131.0	140.3	146.9	152.3	156.4	163.3	165.1	166.5
Non-ferrous metals . . . . .	124.3	123.0	124.1	126.9	131.9	133.4	131.7	139.5
Energy raw materials . . . . .	159.1 <sup>P</sup>	140.4 <sup>P</sup>	163.3 <sup>P</sup>	164.1 <sup>P</sup>	164.1 <sup>P</sup>	164.3 <sup>P</sup>	164.3 <sup>P</sup>	164.4 <sup>P</sup>

<sup>1</sup> On dollar basis. - <sup>2</sup> Annual Average. - <sup>P</sup> Provisional (due to incomplete data on oil prices).