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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

Since the spring there has again been a definite upward economic trend in the Federal Republic of Germany. The setback in demand and production, which began in autumn last year – triggered by the substantial changes in price and exchange rate relationships and the friction of associated adjustments – and which considerably reduced the expectations of businesses and private households, has thus been overcome. The decisive factor for the economic upturn was the fact that there was no further appreciation of the D-mark on foreign exchange markets, this leading to a decrease in uncertainty among investors and consumers.

The only slight changes in exchange rates, the renewed cyclical upturn of Western European economies, and the improved revenue situation of oil and gas exporting countries meant that there was no further decrease in merchandise exports but, rather, a renewed increase. The recovery of demand and production was also accompanied by a quite substantial renewed increase in merchandise imports, which had begun to slow down at the beginning of the year. A further contributory factor in this context was the continuing influence of the preceding reduction in import prices caused by exchange rate developments. Although there was virtually no further decrease in the real merchandise trade surplus, its decline on an annual basis will again be just as substantial as in the previous year, probably almost 1% in terms of the national product. As the terms of trade are again improving clearly on an annual average, there will only be a slight decrease in the surplus on the balance of trade. At roughly DM 75 billion the surplus on current account will be only approx. DM 5 billion lower than in 1986.

Noticeable stimuli for the economy have meanwhile been emanating again from private consumption, which had contracted markedly at the beginning of the year following the advanced purchasing of low-emission

vehicles in order to qualify for tax benefits. There has been a particular increase in demand for passenger cars as well as electrical appliances and furniture. Consumption was stimulated by a brisk increase in incomes; furthermore, households have been saving a lower share of their income than before. As regards consumer prices, the cessation of price reductions induced by lower energy prices and exchange rate developments again led to a growing influence of domestic factors. Prices have increased at an annual rate of roughly 1% since the beginning of the year. For the year as a whole consumer prices will probably be 0.5% up on the previous year. Investments in machinery and equipment are still marked by considerable fluctuations, which conceal the basic trend. If these are ironed out the result is an annual rate of increase of roughly 4% in this field, somewhat weaker than during the initial years of the economic upswing since 1982. Building investments have so far clearly failed in all fields to come up to the expectations expressed in the spring report. Although they increased again following the weather-induced setback during the first few months of the year they have so far been unable to reach the level recorded during the corresponding period last year. The most unfavourable development has been in residential building.

All in all, final demand has again increased at a swift pace since the spring. Furthermore, businesses have built up inventories. There was a fairly substantial expansion of the gross domestic product. As production fell at the beginning of the year the computed increase for 1987 as a whole is only 1¾%. The recovery of production has hardly been reflected in the labour market situation. Although there was a renewed increase in the number of employed persons, the rate of increase was much lower than in the winter six months. By the end of 1987 there will be only 80,000 more employed persons than one year previously. As the demand for labour increased more slowly than the potential labour force and as job-seekers who have not registered at employment offices (hidden reserve) are still looking for work the number of unemployed persons has again increased during the course of the year. At the

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 1987 and for the Year 1988

	1986 ¹	1987 ²	1988 ²	1987		1988	
	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	1.0	0.5	0.5	0.8	0.5	0.5	0.5
Working time (per working day)	-0.8	-1	-0.5	-1.0	-1	-0.5	-1
Working days ³	0.0	0	0.5	0.0	0.5	0.5	0
Total work done, per calendar month	0.2	0	0	-0.2	0	0.5	-0.5
Productivity ⁴	2.4	2	2	1.7	2	2	2
Gross Domestic Product at 1980 prices	2.6	1¾	2	1.5	2	2	1.5
Appropriation of the National Product							
- at current prices -							
Change in % compared with the preceding year							
Private consumption	3.8	3.5	5	2.6	4.5	5	5
Government consumption	4.4	4.5	4	4.0	4.5	4	4
Investment in fixed assets	4.4	2.5	4.5	1.4	3.5	5	3.5
Equipment	4.9	5	5.5	3.5	6	4	7
Buildings	4.1	1	3	-0.2	2	6	1
Exports	-1.6	-0.5	5.5	-2.9	1.5	6	4.5
Imports	-7.6	-0.5	8	-5.0	4.5	9	7.5
Gross National Product	5.6	4	4	4.4	3.5	4	4
- at 1980 prices -							
Change in % compared with the preceding year							
Private consumption	4.3	3	3	2.4	3	3.5	2.5
Government consumption	2.3	2	1.5	1.8	2	2	1.5
Investment in fixed assets	3.1	1	2	0.2	2	3	1.5
Equipment	4.1	4	3.5	3.2	5	2	5
Buildings	2.4	-1	1	-2.1	0	3.5	-1
Exports	-0.2	0	3.5	-1.3	1.5	4.5	2.5
Imports	3.5	4	5	3.1	4.5	6	4.5
Gross National Product	2.5	1¾	2	1.5	2	2	1.5
Price Level of National Expenditure (1980 = 100)							
Change in % compared with the preceding year							
Private consumption	-0.5	0.5	2	0.2	1	1.5	2
Government consumption	2.1	2.5	2.5	2.2	2.5	2	2.5
Equipment	0.8	0.5	2	0.3	1	1.5	2
Buildings	1.6	2	2	1.9	2	2	2
Exports	-1.5	-1	1.5	-1.6	0	1.5	2
Imports	-10.7	-4	3	-7.9	0	2.5	3
Gross National Product	3.1	2	2	2.8	1.5	1.5	2
Origin and Distribution of Income							
Change in % compared with the preceding year							
Gross income from employment ⁵	5.0	4	4	3.9	3.5	4	3.5
Gross wages and salaries total	5.0	3.5	4	3.9	3.5	4	3.5
Ditto per employed person	3.8	3	3.5	2.9	3	3.5	3
Net wages and salaries total	5.3	2.5	4	2.7	2	4	3.5
Gross income from entrepreneurship and property	9.8	5	3.5	6.7	3.5	4	3
Net income from entrepreneurship and property	11.3	6.5	4	9.6	3.5	4	3.5
Disposable income of private households	4.6	3.5	4.5	3.3	3.5	4.5	5

¹Based on data from the Federal Statistical Office (cf. Wirtschaft und Statistik, No. 9/1987) 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.

end of the year there will probably be 80,000 more unemployed persons than one year before and on an annual average the figure will be roughly just as high as in 1986.

There has been a renewed consolidation of the expansionary forces since the spring. Apart from domestic demand foreign demand also is again contributing to stimulating the economic upturn. The conditions for a continuation of this upward trend next year, therefore, would also seem favourable. However, the worldwide turbulences on financial markets, which encroached upon the stock markets in the Federal Republic of Germany, have produced new risks. If the collapse of share prices heralds or triggers a worldwide economic recession, the Federal Republic of Germany would be unable to escape the implications. The institutes participating in the compilation of this report, however, do not feel that this is the case. In view of the foreseeable course of economic policy in major countries they feel that an enduring worldwide crisis of confidence will probably be averted. After weighing up all the arguments, therefore, they have reached the conclusion that a continuation of the economic upswing in the Federal Republic of Germany at roughly the hitherto moderate pace is more probable even after the recent stock market turbulences than a substantial slackening of expansion or even an economic setback. Nevertheless, it is possible that the turbulences at the stock exchanges will have an impact on economic activity in the Federal Republic of Germany, either because of increased uncertainty regarding the disposition of funds or because of the narrowing of financial margins as a result of the loss of financial assets and the growing difficulties involved in issuing new shares. An effort has been made via cautious estimates to take these possibilities into account in the forecast. Nevertheless, under the present circumstances there are a number of considerable risks involved in the forecast.

The forecast is as usual based on a number of assumptions. The most important of these are: The increase of demand and production in industrialised countries will continue at its previously moderate pace. During the course of the coming year world trade will expand at a similar rate as this year, namely at a current rate of between 3 and 4 %. The price of crude oil will maintain a level of roughly \$ 18 per barrel. There will only be a slight increase in prices on the international markets for industrial raw materials. Monetary policy will remain primarily geared to keeping the dollar exchange rate stable. The growth of the money supply will only gradually be restrained. Capital-market interest rates

will increase slightly. Under these circumstances the exchange rate of the D-mark against the dollar will change to roughly the same extent as the inflationary differential between the Federal Republic of Germany and the USA. An adjustment of the central rates in the European Monetary System (EMS) will be effected during the course of next year, roughly compensating for the differences in inflation rates. Partly due to the worsened financial situation caused by tax cuts, public spending will increase to a lesser extent than this year. The second stage of the Tax Reduction Act 1986/1988 together with the measures agreed in anticipation of the tax reform in 1990 will provide total tax relief of roughly DM 11 billion in 1988. Wage settlements for 1988 have already been laid down in three-year contracts for several important sectors. The figures agreed on in these contracts will probably serve as a yardstick for agreements in other sectors. The increase in wages and salaries, therefore, will resemble this year's figure.

The development of exports will again be determined to a greater extent by improvements in economic activity in the importing countries. However, as a result of the previous change in the exchange rate of the D-mark a renewed but limited decline in German suppliers' share of their markets seems likely. All in all, a further increase in exports can be expected next year, even though this will not be substantial. This will once more lead to a shift in weight between the factors upholding expansion in 1988. Foreign demand will grow again while the increase in real domestic demand will be slightly less than in 1987; this is because stockbuilding no longer contributes to the increase. The situation is reversed in the case of the effects of the terms of trade on real income; the deterioration in the terms of trade will now slightly slow down the increase in real income in the Federal Republic. The tax relief in 1988, however, by and large fills the "gap". In 1988 too, therefore, overall demand will be stimulated by fiscal policy.

Real private consumption will probably increase in 1988 at a similar rate to that in the current year. The forecast rate of increase of 3 % means that, as in 1987, real private consumption will expand faster than the national product. Assuming largely unchanged increases in negotiated standard wage rates there will be an accelerated increase in the net wages and salaries total as a result of tax relief, even though the number of employed persons will increase at a slower rate than before. The disposable income of private households will probably increase in 1988 by a good 4.5 % following a figure of 3.5 % this year. The extent to which nominal private consumption increases depends on the savings behaviour of households. A largely

unchanged savings ratio is assumed in the forecast, i.e. the increase in nominal private consumption is expected to equal the increase in disposable income. The resultant acceleration of consumption growth in nominal terms, however, is not fully reflected in real consumption due to the higher rate of increase for consumer prices in comparison with 1987.

Domestic orders for capital goods have been increasing for some time and there has been a marked increase in imports of capital goods. In view of the generally favourable conditions for investment these trends can be expected to continue. If – as assumed – there are no lasting turbulences on the stock exchanges and foreign exchange markets the external economic conditions may, on the whole, be regarded as positive. This will lead to further improvement in the sales and profit expectations of export-orientated firms. On balance a more favourable trend seems improbable in the case of the domestic economic environment. Via tax relief at the beginning of 1988 fiscal policy provides stimuli for demand and also improves the conditions for growth in the medium term; these, however, are inadequate for a far-reaching enhancement of the propensity to invest. At a rate of 3 to 4 % the increase in real investments in machinery and equipment will probably be unsatisfactory next year, too.

The trend of demand for construction work does not indicate a noticeable increase in building investments for 1988. Residential building remains a "split sector". An increase in maintenance and modernisation work on buildings will probably compare with a further decrease in new housing construction activities. Under these circumstances it is currently unclear whether on the whole there will be a renewed increase in residential building investments. Incomplete information on the demand for fitting-out work is one major reason why it is difficult to make a reliable quantitative forecast. Following stagnation on an annual average for this year there will probably be a slight decline in public building

investments in 1988. The trend will continue to be more favourable in the case of industrial building, even though a particularly dynamic development seems unlikely here, too. An at most slight increase seems likely for building investments as a whole in 1988. As shown by the overestimation of expansionary forces in the spring report the forecasting risks in the field of building investments are at present particularly great.

Overall production in 1988 will probably increase by roughly 2 %. The pace of growth will thus lag behind the trend of recent years. There are no indications yet of any noticeable change of pace during the course of the year. Under these circumstances the increase in the number of employed persons in the course of the year 1988 will not be much greater than in 1987. On an annual average, however, the increase will be only half as great as in 1987. As in the course of the year the potential labour force will show a similar increase as the number of employed persons, the unemployment figure will stagnate. On an annual average, however, there will be 40,000 more unemployed persons than in 1987.

Imports will probably expand much faster in 1988 than in the current year, probably by 5 %. There will be a further reduction in net exports in real terms, although this will not be as pronounced as in 1987. As there will be a further deterioration in the terms of trade for the Federal Republic of Germany the external economic adjustment will be reflected for the first time also in the net export figure at current prices. It will fall by approx. DM 10 billion. The surplus on current account will probably decrease by roughly the same extent. At a level of DM 65 billion, however, it will still be very high. The slight increase in import prices will continue in 1988. Unit labour costs will only increase at the same rate as in the past, food is unlikely to become more expensive, and competition will remain tough. For these reasons the increase in the consumer price level will accelerate only slightly. On an annual average consumer prices will be just under 2 % higher than this year.

HWHA Index of World Market Prices of Raw Materials¹

(1975=100)

Raw Materials and Groups of Materials	1986		1987					
	AA ²	October	July	August	September	October	30. 10.	13. 11.
Total index	143.2 ^p	129.7 ^p	148.5 ^p	148.9 ^p	149.9 ^p	151.6 ^p	151.9 ^p	154.0 ^p
Total, excl. energy raw materials	116.1	114.9	121.8	122.7	125.0	129.0	129.4	134.4
Food, tropical beverages	107.1	101.2	87.6	86.1	89.2	92.8	93.2	94.6
Industrial raw materials	122.9	125.4	147.9	150.6	152.2	156.6	156.9	164.7
Agricultural raw materials	131.0	137.4	170.6	172.6	173.5	174.0	174.4	176.7
Non-ferrous metals	124.3	122.1	148.5	153.0	154.5	163.6	163.5	185.2
Energy raw materials	159.1 ^p	138.3 ^p	164.1 ^p	164.2 ^p	164.5 ^p	164.8 ^p	165.1 ^p	165.4 ^p

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