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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.**

The downturn in economic activity that many observers had feared after the turmoil in share and foreign exchange markets in October 1987 did not materialise in the Federal Republic of Germany or elsewhere. Output increased further in the winter half-year of 1987-88, albeit more slowly. Households' demand continued to expand briskly, but investors held back from placing orders for the time being. The continued rise in output in the first quarter of this year was due partly to the extremely mild weather. This effect was also evident in the labour market; the number of persons in employment again rose rather more quickly and the seasonally adjusted unemployment total declined slightly, against the trend that has prevailed for more than a year.

Real merchandise exports continued to stimulate output even after the stock market upset of last October, expanding vigorously until the turn of the year. The effects of the further appreciation of the Deutsche Mark had not yet had time to emerge. The main factor behind the revival of exports in the autumn was the marked increase in demand in the industrialised countries, especially in Western Europe, in the second half of last year. German exports also benefited from the pick-up in imports by OPEC countries, probably mainly because of the recovery in oil revenues last year. Foreign suppliers were able further to increase their share of the expanding domestic German market, partly owing to

exchange-rate-induced shifts in competitiveness. Since real merchandise imports rose more rapidly than exports, the surplus contracted further. Nevertheless, the nominal trade surplus again increased owing to the further improvement in the terms of trade.

Private consumption increased at an annual rate of around 3 % from the third quarter of 1987 to the first quarter of this year. Since it accounts for a large proportion of overall demand, consumption was thus the main motor of economic activity. The expansion in consumption stemmed from an acceleration in the rise in disposable incomes, due primarily to the fact that the second stage of the tax reduction came into force at the beginning of the year. As before, consumer prices remained more or less stable in the winter half-year; in March they were only slightly above their autumn level and about 1 % higher than a year earlier. One factor in this stability was the fact that import prices remained static even after the turn of the year.

Investment in machinery and equipment continued to stagnate during the six months of the winter. The most recent trend of orders and survey data on investment plans suggest that the propensity to invest was less seriously impaired by the stock market events of the last few months of 1987 than many had feared. Domestic capital goods orders recently returned to the level recorded before the upheaval in the financial markets. Despite generally thin order books in the construction industry, building activity increased strongly in the second half of 1987 because the industry was able to make up for output lost earlier in the year owing to bad weather. In the first few months of this year building work has benefited from the extremely mild weather. After

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approximate adjustment to take account of these distortions the trend was slightly upwards.

The abatement of the hectic conditions in the share and foreign exchange markets and the improvement in foreign demand for German goods strengthened confidence in a continuing increase in overall production. Cyclical conditions broadly justify positive expectations for the remainder of this year. However, it should not be forgotten that the continued instability of the world economy creates considerable risks. The following assumptions are made in this connection: demand and output in the industrialised countries will increase further, although more slowly than last winter; the price of crude oil will remain around \$16-17 a barrel and the world market prices of industrial raw materials will rise much less than in the past; bearing in mind the dollar exchange rate, the Deutsche Bundesbank will not alter its policy; the growth in the money supply M3 will overshoot the target range; capital market interest rates will rise only marginally; the dollar/DM exchange rate will continue to fluctuate between DM 1.60 and 1.70; central rates within the European Monetary System will be realigned by enough more or less to offset inflation differentials; the Government will adhere to the fiscal policy traced out by budget plans and measures that have already been taken; settlements in the remainder of the wage round will be similar to those already agreed.

The main stimulus to German exports for the rest of the year will come from the continued, though slower economic growth in industrialised countries. There will be an increase in deliveries to these countries, although it will be dampened by the repercussions of the appreciation of the D-Mark against the dollar. German exporters are likely to lose further market share to suppliers from the dollar area. Since overall demand in Germany will continue to expand at more or less the same pace and the impact of the fall in import prices as a result of the appreciation of the D-Mark will still be felt for some time, imports will continue to rise briskly in the remainder of the year. They will again grow significantly faster than exports. At the same time, the deficit on services will increase further, primarily on account of foreign travel. The real contribution of the external sector will therefore again decline.

As in the last two years, private consumption will generate strong stimuli to economic activity in 1988. The main contributory factors this year are the entry into force of the second part of the 1986/88 tax reduction and the bringing forward of some of the provisions of the 1990 tax reform. Total net wages and salaries will increase by 3.5 %, a faster rate than last year, although

gross incomes will rise more slowly owing to a slightly more pronounced decline in the volume of work performed and lower increases in standard wages, since the agreements on further reductions in working hours generally led to lower settlements. Households' disposable incomes should increase by 4.5 % overall, compared with 3.8 % last year. The slightly higher growth in incomes in comparison with 1987 will be trimmed back, however, by a slight acceleration in consumer price inflation. Purchasing power will increase by 3 %, no more than the rate recorded last year. Households will probably increase their consumption in the same proportion.

Domestic economic conditions point to a further expansion in investment; domestic demand, especially private consumption, is on a clear rising trend. In view of the 1990 tax reform, investors can expect this to continue. Capacity utilisation rates are relatively high and returns on fixed assets have recovered in recent years. There are serious risks hanging over foreign trade, however. The combination of unpredictable future developments in the world economy, exchange rate uncertainty, the danger of increasing protectionism and the simmering debt crisis has made enterprises more cautious in their investment decisions. They will therefore allow a larger margin for risk in their investment calculations than hitherto. In these circumstances the propensity to invest will remain relatively weak.

At the beginning of 1988 building activity was less hampered by the weather than is usual at this time of year. The seasonally adjusted level is therefore higher than normal and cannot be maintained for the remainder of the year, although for several months the underlying trend in the building industry has once again been upwards. Demand for commercial construction has expanded very strongly in the last few months and signs of improvement have emerged in residential construction. Here demand has been on an upward trend since the beginning of last year and the demand for new building has now also picked up. Public building contracts are likely to decline, mainly owing to the tight financial situation of many local authorities. This prediction makes allowance for the relatively strong demand for subsidised loans from the Reconstruction Loan Corporation under last December's "Measures to strengthen growth". The reduction in Federal Government funds for municipal building projects is also having a dampening effect.

The underlying rate of growth in national product will be between 1½ and 2 % and will work out at around 2 %

ECONOMIC TRENDS

The Most Important Data of the National Accounts of the FR Germany Forecasts for the Year 1988

	1986 ¹	1987 ¹	1988 ²	1987		1988	
	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	1.0	0.7	0.5	0.9	0.5	0.5	0.5
Working time (per working day)	-0.8	-1.0	-1.0	-1.0	-1.0	-0.5	-1.0
Working days ³	0.0	0.2	0.5	0.0	0.4	0.5	0
Total work done, per calendar month	0.2	-0.1	0	-0.1	-0.1	0.5	-0.5
Productivity ⁴	2.4	1.9	2	1.6	2.2	2.5	2
Gross Domestic Product at 1980 prices	2.6	1.8	2	1.5	2.1	3	1.5
Appropriation of the National Product — at current prices — Change in % compared with the preceding year							
Private consumption	3.8	3.7	4.5	2.8	4.5	5	4
Government consumption	4.5	3.8	3	3.9	3.7	3	3.5
Investment in fixed assets	4.4	3.1	3.5	2.1	3.9	5	2.5
Equipment	4.9	4.5	3.5	3.5	5.4	2.5	5
Buildings	4.1	2.0	3.5	1.0	2.8	7.5	0.5
Exports	-1.6	0.0	4.5	-2.7	2.8	6	3
Imports	-7.6	0.5	6	-4.7	5.8	7.5	4.5
Gross National Product	5.6	3.8	3.5	4.2	3.5	4	3
— at 1980 prices — Change in % compared with the preceding year							
Private consumption	4.3	3.1	3	2.6	3.5	4	2.5
Government consumption	2.4	1.6	1.5	1.8	1.3	1.5	1.5
Investment in fixed assets	3.1	1.7	2	0.8	2.5	3.5	0.5
Equipment	4.1	4.0	2	3.2	4.7	1	3
Buildings	2.4	0.1	1.5	-0.9	0.9	5.5	-1.5
Exports	-0.2	0.8	3	-1.1	2.7	4.5	1.5
Imports	3.7	4.8	5	3.4	6.1	6.5	3.5
Gross National Product	2.5	1.7	2	1.4	2.0	3	1.5
Price Level of National Expenditure (1980 = 100) Change in % compared with the preceding year							
Private consumption	-0.5	0.6	1	0.2	0.9	1	1.5
Government consumption	2.1	2.2	1.5	2.1	2.4	1.5	1.5
Equipment	0.8	0.5	1.5	0.3	0.7	1	1.5
Buildings	1.6	1.9	2	2.0	1.8	2	2
Exports	-1.5	-0.8	1	-1.6	0.1	1.5	1
Imports	-10.9	-4.1	1	-7.8	-0.2	1	1.5
Gross National Product	3.1	2.1	1.5	2.8	1.5	1.5	1.5
Origin and Distribution of Income Change in % compared with the preceding year							
Gross income from employment ⁵	5.1	3.8	3.5	3.9	3.6	4	3
Gross wages and salaries total	5.0	3.8	3.5	4.0	3.7	3.5	3
Ditto per employed person	3.8	3.0	3	2.9	3.1	3.5	2.5
Net wages and salaries total	5.4	2.6	3.5	2.9	2.4	4	3
Gross income from entrepreneurship and property	9.7	4.0	3.5	5.6	2.4	6	1
Net income from entrepreneurship and property	11.1	5.4	3.5	8.7	2.5	6	1.5
Disposable income of private households	4.7	3.8	4.5	3.5	4.1	5	4

¹Based on data from the Federal Statistical Office (cf. Wirtschaft und Statistik, No. 3/1988) and own calculations.

²Own forecasts; rates of change for 1988 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.

on an annual average basis. The growth in overall production later in the year will stimulate only a modest additional demand for labour. Employment will again increase only in the services sector and will contract further in manufacturing and construction. The labour force will increase by 120,000 in 1988; this is a smaller growth than in previous years, but since the year-on-year rise in demand for labour will slow down more markedly, unemployment will rise by an estimated 50,000 to 2.28 million. Consumer prices will rise more quickly during the remainder of the year. Import prices cannot be expected to have any further appreciable price-dampening effects this year, so that the rise in domestic costs will once again have a stronger influence on the behaviour of prices.

Even after six years of economic expansion there is no sign of a downturn. Contrary to earlier expectations, the cyclical expansion in demand and output has been weak in Germany and in most other industrialised countries. At no time has there been the strong expansion particularly of investments, characteristic of previous upswings and whose subsequent easing would regularly lead to the downturn. Nor has there been that acceleration in cost and price increases that would eventually oblige the authorities to adopt a restrictive monetary policy. These two factors suggest that the expansionary phase will continue into 1989. Nevertheless, there are grounds for believing that the pace of economic growth, which is already unsatisfactory, will slow down noticeably during next year, possibly to the point of stagnation. The most important factor is the fiscal policy now taking shape. It has been decided to bring the withholding tax on investment income into effect on 1st January 1989 and the Government intends to increase consumption taxes.

It must also be feared that contribution rates for unemployment insurance will be raised. Fiscal policy must be considered contractionary even if one bears in mind that the effects of this year's income tax reduction will extend into next year. A slight course adjustment in monetary policy is to be expected. The Bundesbank will continue to watch the dollar/DM exchange rate, but the slight slowdown in money supply growth that is expected to materialise next year in major industrial countries, especially the USA, will give the Bundesbank scope to produce the same effect in Germany. Monetary policy will therefore generate no stimulus to economic activity. A change in the broad direction of incomes policy is unlikely, particularly since wage settlements for 1989 have already been reached in some major industries.

The external conditions affecting economic activity in Germany will probably not worsen significantly; the expansion in demand and output in the industrial countries is expected to slow down only slightly. On the basis of the assumptions underlying this report, particularly those relating to economic policy at home and abroad, the external value of the D-Mark will not change substantially. In view of these considerations and assumptions, overall output is expected to continue to rise at a much slower pace in 1989. The rate of growth of real GNP is likely to be between 1 and 1½ %. The dampening effect will come mainly from private consumption, which is expected to increase at only about half this year's rate. That being the case, employment will barely increase in 1989 and the number of unemployed will show a further slight rise. Consumer price inflation will accelerate, mainly because the external sector will no longer have a significant dampening effect and at least part of the increase in consumption taxes will be passed on to consumers.

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

Raw Materials and Groups of Materials	1987		1988					
	AA ²	April	January	February	March	April	29. 4.	13. 5.
Total index	149.2 ^p	147.8 ^p	152.3 ^p	148.3 ^p	142.7 ^p	152.9 ^p	153.3 ^p	149.7 ^p
Total, excl. energy raw materials	123.8	119.5	143.7	140.6	143.9	148.3	146.3	151.1
Food, tropical beverages	91.2	89.6	103.0	101.7	100.0	101.2	100.0	102.5
Industrial raw materials	148.6	142.3	174.6	170.2	177.4	184.2	181.7	188.1
Agricultural raw materials	167.1	163.3	187.6	185.3	189.8	200.6	201.7	197.8
Non-ferrous metals	150.3	133.4	199.4	187.2	201.6	205.9	198.8	227.5
Energy raw materials	164.0 ^p	164.3 ^p	157.4 ^p	152.7 ^p	141.9 ^p	155.6 ^p	157.4 ^p	148.9 ^p

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