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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 German economy is in the midst of a vigorous upswing. With real GNP rising at a current rate of around 3%, the increase in economic activity this year resembles the early phase of the growth period that has now lasted for six years. The five economic research institutes responsible for the joint economic report did not share the widespread fears that the stock market crash of October 1987 would lead to an economic setback in 1988; last autumn they forecast that the upswing would continue. They greatly underestimated its strength, however, and indeed it has also proved much stronger than they predicted in their spring forecast. Underestimating the forces of expansion has been a worldwide phenomenon, with forecasts being revised steadily upwards everywhere. It is reasonable to suppose that the reasons for the error are more or less the same in all countries. Undoubtedly the primary factor that has been underestimated is the effect of the monetary expansion over the last three years. Further stimulus came from the central banks' policy of reducing interest rates in the wake of the stock market crash. Some of the effects of the dramatic fall in oil prices in 1986 probably also took longer to emerge than had been expected. Years of efforts to create conditions more conducive to growth by means of economic and fiscal measures and, partly in response to this, wage restraint have contributed to the faster growth in economic activity and not least to the revival in investment. The

combination of these factors has produced an upswing that is now affecting overall demand across the board: consumption, exports, investment in machinery and equipment as well as capital spending on new construction.

It is still very difficult to make an accurate assessment of the performance of individual demand components and the interaction between them owing to the incomplete recording of foreign trade flows in the first few months of this year; this also affects the calculation of investment in machinery and equipment and the change in stocks. Export demand quickly provided renewed stimulus to strengthen the upswing. Contrary to fears that the stock market crash would seriously dampen economic growth in the industrialised countries, the pace of the expansion has accelerated further during the winter half-year. Real merchandise exports will increase by 5½% in 1988, considerably faster than real domestic demand. Real merchandise imports are also rising quickly, and are likely to be between 7 and 8% higher than last year. Nevertheless, there are indications that the balance of payments on current account will record a slightly larger surplus than in 1987.

Households' demand also came under the influence of favourable factors, chief among these being the rise in disposable incomes as a result of the second stage of the tax reform; because of the tax reduction, the slowdown in the growth in employees' gross incomes did not work through to net earnings. The increase in consumer spending was only marginally slower than the

* The 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 1988 and for the Year 1989

	1987 ¹	1988 ¹	1989 ²	1988		1989	
	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	0.5	0.5	0.5	0.5	0.5	0.5
Working time (per working day)	-1.0	0	-1	0.3	-0.5	-1	-1
Working days ³	0.2	0.5	0	0.7	0	0	-0.5
Total work done, per calendar month	-0.1	0.5	-1	1.5	-0.5	-0.5	-1
Productivity ⁴	2.0	2.5	2.5	2.3	3	2.5	2.5
Gross Domestic Product at 1980 prices	1.9	3.5	2	3.9	3	2	1.5
Appropriation of the National Product							
- at current prices -							
Change in % compared with the preceding year							
Private consumption	4.1	4.5	4.5	4.4	4	5.5	4
Government consumption	3.8	3	1	3.1	3.5	2	0.5
Investment in fixed assets	3.1	7	6	9.1	5.5	4	7.5
Equipment	4.5	6.5	7.5	5.2	7.5	7	7.5
Buildings	2.1	7.5	4.5	12.1	3.5	1.5	7.5
Exports	0.0	7	6.5	7.7	7	8	5
Imports	0.7	7	6.5	7.8	6.5	7.5	5.5
Gross National Product	3.9	5	4	5.6	4.5	4.5	4
- at 1980 prices -							
Change in % compared with the preceding year							
Private consumption	3.5	3	2	3.2	3	2.5	1
Government consumption	1.6	2	0	1.9	1.5	0.5	-0.5
Investment in fixed assets	1.8	5.5	3.5	7.9	3.5	1.5	5
Equipment	4.0	5.5	5	4.6	6	4.5	5.5
Buildings	0.2	5.5	2.5	10.4	1.5	-0.5	5
Exports	0.8	5	4	5.4	4.5	5.5	3
Imports	4.9	6.5	4	7.8	5	4	3.5
Gross National Product	1.8	3.5	2	3.9	3	2	1.5
Price Level of National Expenditure (1980 = 100)							
Change in % compared with the preceding year							
Private consumption	0.5	1.5	2.5	1.2	1.5	2.5	2.5
Government consumption	2.2	1.5	1	1.2	1.5	1.5	1
Equipment	0.5	1	2	0.5	1.5	2	2
Buildings	1.9	2	2.5	1.5	2	2.5	2.5
Exports	-0.8	2	2	1.6	2	2.5	2
Imports	-4.1	0.5	2.5	0.0	1.5	3	2
Gross National Product	2.0	1.5	2	1.6	2	2	2
Origin and Distribution of Income							
Change in % compared with the preceding year							
Gross income from employment ⁵	3.9	4	3	4.0	3.5	3	3
Gross wages and salaries total	3.9	3.5	3.5	3.9	3.5	3.5	3.5
Ditto per employed person	3.0	3	2.5	3.3	3	2.5	2.5
Net wages and salaries total	2.8	4	2.5	4.1	3.5	2.5	2.5
Gross income from entrepreneurship and property	4.0	9	4	10.3	7.5	5	3.5
Net income from entrepreneurship and property	5.5	9.5	3.5	10.2	8.5	4.5	2.5
Disposable income of private households	4.2	4	3.5	3.8	4.5	4.5	3

¹Based on data from the Federal Statistical Office (cf. Wirtschaft und Statistik, No. 9/1988) 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.

growth in incomes. Investment in machinery and equipment has risen much more steeply than had been expected at the beginning of the year. The wait-and-see attitude that had been feared a year ago in reaction to the turbulence in the stock exchanges did not materialise. World economic activity did not suffer a setback and the exchange rate of the D-Mark did not remain at the high level seen at the turn of the year; sales and profit expectations strengthened accordingly. The rise in capacity utilisation prompted firms to make expansion plans. In addition, borrowing terms remained favourable. Real building investment has also contributed significantly to the rise in overall demand and output this year. The surge in output in the early part of 1988 as a result of the mild weather was not offset by a corresponding decline later in the year.

The rise in total output was accompanied by a slight acceleration in the growth in employment. By the end of the year 150,000 more persons will be employed than at the end of 1987, a rise of 0.6%. However, developments in the labour market are also being influenced by the continued steady growth in the labour force, owing partly to the immigration of Germans from Eastern Europe. At the end of the year the number of persons unemployed will therefore be hardly lower than a year before. The rate of price increases remained relatively slow, although it has accelerated slightly during the year.

The expansion in economic activity will continue next year, though it will probably lose some of its impetus and will no longer outpace the growth in productive capacity. Both the foreign sector and economic policy are likely to have a dampening effect, and the expansion will be further weakened by cyclical factors, such as a reduction in stock-building. The present forecast is based on the following assumptions: demand and output in the industrialised countries will continue to increase appreciably, but not as vigorously as in the past; the price of crude oil will settle at around \$ 15 a barrel; the world market prices of industrial raw materials will decline slightly; as in other major countries, Germany's monetary policy will slowly curb the growth in the money supply, entailing a slight rise in interest rates; real exchange rates will remain broadly unchanged; the main thrust of fiscal policy is directed towards restoring sound public finances, as reflected in plans to increase revenues and reduce expenditure; negotiated hourly wage rates will rise rather more quickly than this year.

The expansion in exports will slow down somewhat in response to the slight weakening of the growth in economic activity abroad. However, the slowdown should be less pronounced than that in world trade,

since investment activity abroad will remain brisk. In addition, the burden caused by the sharp appreciation of the D-Mark against the dollar is gradually easing. The rise in shipments to Western European industrialised countries, which take around 70% of German exports, will slow down a little as economic expansion in Western Europe slackens. Exports to the USA will probably grow only slightly. Overall, real merchandise exports are likely to rise by 4.5% next year, after increasing by 5.5% this. With the slowdown in macro-economic expansion, imports will also slacken, especially those of consumer goods. In the figures for 1989 as a whole, the percentage rate of growth in imports will be as high as that in exports, but since exports far exceed imports the export surplus will continue to rise in volume terms. Despite a slight deterioration in the terms of trade, the trade surplus will again increase. Although the deficit on services is still rising, the current account surplus will also be higher than a year earlier.

By contrast with this year, when the second stage of the tax reductions is having an expansionary impact, next year fiscal policy will be distinctly deflationary. In particular, the planned increases in excise duties and in taxes on diesel cars and non-life insurance will boost revenue by DM 9½ billion, including the VAT effect, and the introduction of withholding tax on interest income will bring in around DM 4 billion in additional funds. Receipts from income tax will also show a larger increase owing to tax progression. Government expenditure will increase by 2½%, less than the growth in nominal national product; the slowdown is attributable primarily to the planned structural reform of the health sector. Capital expenditure by the public sector will also be expanded less rapidly, partly in anticipation of the contraction in revenues expected in 1990 when the third stage of the tax reform becomes effective. Only part of the Federal financial assistance for structurally weak Länder is likely to lead to additional expenditure, since some of the projects would have been undertaken in any case. The total public sector deficit will decline sharply in 1989, contracting by almost DM 30 billion to around DM 15 billion.

The rise in total gross wages and salaries will be slightly lower next year than in 1988. For around half of the work force the cash component of the contractual wage increases will be smaller than this year owing to the agreed reduction in working hours; the shortening of working hours will probably be offset only partly by an increase in employment. Since the tax progression will take its full effect again, net incomes will rise by even less than gross incomes, despite a reduction in contributions to compulsory health insurance. Transfer

payments to households will also increase more slowly owing to cuts in social security benefits and the raising of pensioners' health insurance contributions. Disposable incomes should rise by around 3½% overall, half a percentage point less than this year. Past experience suggests that households will react to the slower increase in real disposable incomes by saving less. Other pointers in this direction are the fact that further reductions in income tax are due to take effect in 1990 and that the reform of compulsory health insurance will oblige contributors to pay for many medicaments, medical appliances and aids themselves. Viewed as a whole, the savings ratio is likely to decline by almost one percentage point.

Investment in machinery and equipment will continue to rise, although not at quite such a rapid pace as this year. The expansionary effects of monetary and fiscal policy in 1987-88 are gradually tailing off and the growth in export demand is slackening somewhat, but high capacity utilisation rates in many industries foretell a further appreciable increase in investment, particularly as the tax reductions due to come into effect in 1990 will boost demand and widen the scope for self-financing. The underlying trend in building investment continues to be upwards, but the pace is likely to slacken in the coming year. As with machinery and equipment, a further vigorous increase can be expected in commercial construction, although here too the rate of growth will be slightly slower. Having brought projects forward to this year, the Federal Postal Administration is planning a smaller increase in investment. A sharp slowdown in the growth in public-sector construction is to be expected, although the Structural Assistance Programme should provide some stimulus. Only in residential construction will the vigorous expansion continue. Real incomes have risen appreciably in recent

years. The expectation of a renewed rise in prices and interest rates also makes the early implementation of building projects seem advisable. Moreover, the faster increase in rents has improved yields in the private residential rented sector and created new incentives. The house-building programme for immigrants of German origin can also be expected to stimulate activity.

As the growth in total output slows down, so too will the increase in employment, with a rise of little more than 100,000 next year. As before, the main provider of new jobs will be the private services sector, whereas few posts will be created in the public sector or in manufacturing, despite the agreements on shorter working hours. The labour force is expected to increase by a further 200,000 persons next year, divided almost equally between Germans (including immigrants from Eastern Europe) and foreigners. In these circumstances, the unemployment total will rise by around 100,000 in the course of 1989. On an annual average basis it is likely to be approximately 50,000 higher than in 1988, at 2.3 million.

Theoretically, the increase in excise duties due to come into force in 1989 should raise consumer prices by ¾%, but it is unlikely to be passed on immediately or in full in all cases. The tax effect on the level of consumer prices is therefore estimated at 0.6% in 1989. If the tax increase is excluded, the rise in prices will probably work out at 2%, approximately equal to the rise in overall unit labour costs and import prices together. The prices of services will again increase by more than the average next year, partly on account of the increase in postal charges and the substantial rise in rents. However, the prices of foodstuffs will increase very little, given the abundant supply. Overall, consumer price inflation in 1989 will probably average around 2½%.

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

Raw Materials and Groups of Materials	1987		1988					
	AA ²	October	July	August	September	October	4. 11.	18. 11.
Total index ^P	149.2	151.6	142.7	140.4	133.6	130.5	132.4	132.1
Total, excl. energy raw materials	123.8	129.0	153.5	149.5	147.2	150.7	155.2	153.9
Food, tropical beverages	91.2	92.8	119.8	112.0	111.5	110.6	109.8	108.3
Industrial raw materials	148.6	156.6	179.1	178.1	174.4	181.2	189.8	188.6
Agricultural raw materials	167.1	174.0	194.3	192.4	182.6	185.0	189.9	189.2
Non-ferrous metals	150.3	163.6	205.6	205.3	207.8	226.5	245.0	241.2
Energy raw materials ^P	164.0	164.8	136.4	135.2	125.7	118.7	119.1	119.3

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