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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 abridged form:**

In its seventh growth year, the economy of the Federal Republic of Germany is expanding rapidly. The sizable anticipated annual average rise in gross domestic product of 3.5% is on a level with last year. The increase in gross national product is about half a percentage point higher than in 1988 at some 4%, due to the volatile growth of investment income from abroad. At a current annual rate of a comfortable 3%, the expansion of overall production exceeds the rate of growth in production capacity. Delivery periods and order backlogs have lengthened in general with individual production bottlenecks inhibiting further growth in some areas. Business firms have increasingly expanded employment, and despite persistently high unemployment a shortage of manpower is making itself clearly felt on the labour market, particularly with regard to skilled workers. Despite marked strains on the economy, the price and cost upswell which has attended similar boom periods in the past is not as yet discernible.

The powerful upswing especially in Western Europe, the major market for West German exports, has boosted demand for export goods substantially. Furthermore, growth in these countries has been spurred on by investment, which has particularly favoured German exporters, whose range of products has an above average capital goods component. Another contributory factor has been the improved competitiveness of German business, because in real terms the D-Mark

has depreciated noticeably against the US dollar and because there has also been a decline in the real external value of the D-Mark within the European Monetary System (EMS). Real merchandise imports have risen rapidly, though less so than real exports, so that real net exports rose by a large margin.

This year's developments in domestic demand have not been uniform. As in the other West European countries, vigorous investment has been based to a large extent on endogenous forces unleashed when the cyclical increase in production is constrained by limited capacity, threatening to cause bottlenecks. The surge in orders from abroad has certainly given an impetus to German businesses' propensity to invest, which has probably also increased as compared with previous years due to improved supply conditions and the higher anticipated long-term returns. The construction industry is undergoing a pronounced expansion. In residential construction, commercial and industrial building and in the public sector, production and demand are rising at a brisk pace. Real demand of private households has risen little. Disposable income has gone up somewhat more than last year, but real purchasing power has strengthened only slightly due to a much higher rise in consumer prices this year. Private households' propensity to consume remains high, though, as demonstrated by the high propensity to borrow and the decline in the savings ratio since the end of last year by about one percentage point.

After this year's lively growth, the upswing will slow down in 1990. Firstly, the economy of the Federal Republic of Germany will not be able to cut itself off from global economic trends: climbing rates of interest

* 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.

worldwide will deter businesses from investing in real capital and the Federal Republic of Germany as one of the largest exporters of capital goods, will be affected by this more than the average. Secondly, due to tighter monetary controls, the expansion of demand for capital goods is slowing down. The forces for growth will shift. In response to the tax reform, private consumption will act as a stimulus, but this will not suffice to fully offset the overall loss of momentum. Capacity utilisation will, however, remain high and employment will go up at roughly the same rate as this year, though unemployment is unlikely to go down noticeably, as the labour force is growing even more rapidly. Although prices will tend to increase more rapidly, the rate of inflation – the effect of consumer tax having disappeared – will not on an annual average exceed this year's. Real GNP will rise by 3%.

This forecast is based on the following assumption. Demand and production in the industrialized countries will increase more slowly than until now. The speed of expansion in world trade will slacken off markedly. Owing to weaker demand in the industrialized countries, raw materials prices will drop slightly in the course of the year; the price of oil will keep to 17 to 18 dollars per barrel. The exchange rate of the D-Mark will stay as it is in real terms, accounting for the possibility of a small realignment in the European Monetary System or, alternatively, a slight strengthening against the US dollar. Monetary policy will manage to keep the M3 increase in the money supply to around 5%. The Bundesbank will not tolerate a lower rate of expansion, even if it would mean a downward adjustment of interest rates. Wages will stay in line with the agreements of past years; a slightly higher rise in standard hourly wages is assumed than hitherto. The fiscus will accept the revenue losses incurred through the tax reform without cutting spending; owing to increased revenue arising from the upswing and less expenditure, the finances of regional/ local authorities will be better than originally expected. Under these conditions, the economy will continue to grow at a slower rate. This forecast is however beset with considerable uncertainty. Without question, the probability of a slowing-down in the rate of expansion has increased with the renewed rise in interest rates this year and the increase once again in capacity utilization, but even so, a different development cannot be excluded.

It is, for example, conceivable that in major European countries the momentum for growth will be strong enough to prevail over the retarding forces on the monetary side. If firms' profit expectations remain high, even the present rate of interest will not provide any

greater incentive to invest in securities. It is impossible to assess this precisely, because developments in this area cannot be clearly demarcated and predicted in the same way as demand complexes like private consumption. Here, we are dealing with the internal dynamics of a market process, which itself generates employment and earnings opportunities. This process will also be affected by anticipated political changes, such as the completion of the European single market, whose significance cannot be measured. Arguing against a scenario of continuingly vigorous growth, however, is that it is unimaginable without increasing scarcities on commodity and capital markets and the greater price increases this would entail. This would however – especially in the Federal Republic of Germany – put even more pressure on interest rates, thus making for a more pessimistic outlook beyond the immediate short term.

It is also possible that the internal dynamic of the upswing has been generally overestimated and the tightening of the monetary reins, begun one and a half years ago, underestimated, particularly as monetary policy worldwide is moving in this direction and may have a cumulative inhibiting effect. In this case, investment in Europe would slow down more conspicuously, which in turn would hit exports, and thus the investment of exporters in the Federal Republic of Germany, particularly hard. Another possibility is that the persistent high foreign trade surpluses will prompt reactions in economic policy and incite turbulence on the financial and foreign exchange markets, in the course of which the D-Mark will strengthen appreciably. Controverting a recession scenario are, however, not only the favourable initial situation of the German economy but also the fact that a clear reduction in profit margins, which in the past was typical for the last boom phase, is not within sight. Next year, too, cost trends will probably affect the profit expectations of businesses little. Also, the exchange relations in the EMS, within whose economic area most of Germany's export business is done, appear quite stable in view of the partners' readiness to adjust to the economic policy of the Federal Republic.

Bearing in mind all these imponderables, the institutes consider the middle variant outlined at the beginning to be the most probable. Clearly, in this forecast, too, growth is expected to lessen not only quantitatively but also qualitatively. The slackening-off of investment impairs the prospects of sustained vigorous growth, as fewer resources will be deployed to expand capacity. The latest crash on the stock exchanges, only two years after the turbulence on the financial markets in

ECONOMIC TRENDS

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

Forecasts for the 2nd Half Year 1989 and the Year 1990

	1988 ¹	1989 ¹	1990 ²	1989		1990	
	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	0.6	1.5	1	1.2	1.5	1	1
Working time (per working day)	-0.3	-1	-1	-0.6	-1	-1	-0.5
Working days ³	0.3	0	0	0.2	-0.5	0	0
Total work done, per calendar month	0.6	0.5	0	0.8	-0.5	0	0.5
Productivity ⁴	3.1	3	2.5	3.2	3.5	2.5	3
Gross Domestic Product at 1980 prices	3.7	3.5	3	4.0	3	2.5	3
Appropriation of the National Product							
– at current prices –							
Change in % compared with the preceding year							
Private consumption	4.0	5	6.5	5.2	5	6	6.5
Government consumption	3.7	2	3.5	2.4	1.5	4	3.5
Investment in fixed assets	7.5	11	8.5	12.3	10	7	10
Equipment	8.4	13	9.5	13.1	12.5	10.5	9
Buildings	6.7	9.5	7.5	11.7	7.5	4.5	10.5
Exports	7.7	15	8.5	16.0	14	9	7.5
Imports	7.8	13.5	9.5	14.1	12.5	10	8.5
Gross National Product	5.2	6.5	6	7.0	6	5.5	6.5
– at 1980 prices –							
Change in % compared with the preceding year							
Private consumption	2.7	2	3.5	1.7	2	3	3.5
Government consumption	2.2	-0.5	1.5	0.1	-0.5	1.5	1.5
Investment in fixed assets	5.9	7.5	4.5	9.2	6	3	5.5
Equipment	7.5	10	6	10.6	9.5	7	5
Buildings	4.7	6	3	8.2	3.5	0	5.5
Exports	5.8	11.5	5.5	12.5	11	6	5
Imports	6.3	7.5	6	7.6	7	7	5
Gross National Product	3.6	4	3	4.6	3.5	2.5	3.5
Price Level of National Expenditure (1980 = 100)							
Change in % compared with the preceding year							
Private consumption	1.2	3.5	3	3.4	3.5	2.5	3
Government consumption	1.4	2	2	2.3	2	2	2
Equipment	0.8	2.5	3.5	2.3	3	3.5	3.5
Buildings	1.9	3.5	4.5	3.3	4	4.5	4.5
Exports	1.8	3	2.5	3.1	3	3	2.5
Imports	1.5	5.5	3	6.1	5	3	3.5
Gross National Product	1.5	2.5	3	2.3	2.5	3	3
Origin and Distribution of Income							
Change in % compared with the preceding year							
Gross income from employment ⁵	3.9	4.5	5	4.5	5	5	5.5
Gross wages and salaries total	3.9	5	5.5	4.7	5	5	6
Ditto per employed person	3.1	3.5	4	3.3	3.5	4	4.5
Net wages and salaries total	4.2	4	8.5	3.5	4	7.5	9
Gross income from entrepreneurship and property	8.7	9.5	7.5	11.0	8.5	7	8.5
Net income from entrepreneurship and property	8.8	8.5	10	9.2	7.5	9.5	10
Disposable income of private households	4.3	4.5	7	4.8	4.5	6.5	7.5

¹Based on data from the Federal Statistical Office (cf. Wirtschaft und Statistik, No. 9/1989) 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.

October 1987, casts doubts on the generally optimistic expectations of the present appraisal. It is worth recalling that the scepticism as to future continued growth voiced two years ago – not shared by the institutes – proved unfounded, partly because monetary policy responded promptly. Similar fears today would seem even less warranted: the international economic environment is under less strain than in 1987 and the forces for growth are more resilient than at that time. Furthermore, based on the experience of 1987, the market participants can rely on the institutions of monetary policy taking appropriate action to stabilize the financial sector by providing short-term liquidity.

Real visible exports will go on rising appreciably next year, although the upward trend in foreign demand will flatten out noticeably with the more restrained growth in the industrialized countries. The external value of the D-Mark may be expected to keep more or less constant, which means that international competitiveness will continue at its present favourable level for some time longer. The increase in exports will continue to be buoyed by investment activity in neighbouring European countries. Growth of real merchandise imports in 1990 will slightly exceed that of exports, though export surpluses, which rose very tangibly in 1989, will hardly contract at all. The current account surplus in 1990 will in fact probably be somewhat higher than this year.

Unlike other demand aggregates, private consumption will increase more steeply, the decisive factor being the accelerated expansion in real disposable income resulting from the sizable relief provided by the tax reform. Gross pay will likely increase by 5½%, assuming that pay rises not already set as part of agreements will range between 5% and 5½%.

Agreements on a further reduction of working hours will presumably not enter into force until 1991. An 8½% rise in net pay is forecast. Accounting for the continued steep rise in distributed profits and unearned income, the disposable incomes of private households are likely to rise by some 7%. Real income will go up by a good 4%.

With high capacity utilization and good profit prospects, businesses will be prepared to expand their holdings of real capital. Foreign demand will increase more slowly but, thanks to the tax reform, sales prospects at home will improve, particularly in the consumer goods sector. The imminent completion of the European single market will also help stabilize the propensity to invest. On the other hand, higher interest rates will tend to make investment in real capital less attractive compared to less risky financial assets. In all, we can expect further, albeit less vigorous, investment growth.

The upturn in the construction industry will persist into next year. This is indicated by the upsurge in demand, the substantial rise in orders and various promotion schemes, which are not confined to residential building. However, trends in the different segments will probably now again diverge more from one another. In the short and medium term, a considerable increase in residential building is also indicated due to the unexpectedly large influx of immigrants of German descent from the GDR and Eastern Europe, the growing number of one person households and the positive developments in real income over recent years, which will make for a tangible upturn in the demand for housing. Investment in construction as a whole will keep to its lively upward trend. Average annual growth will however be well below that for 1989 with its exceptionally mild winter.

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

Raw Materials and Groups of Materials	1988		1989					
	AA ²	October	July	August	September	October	3. 11.	17. 11.
Total index	143.4	130.5	156.3	151.8	155.8	159.9	159.8	158.0
Total, excl. energy raw materials	150.2	150.7	147.2	146.6	145.2	145.4	144.7	144.0
Food, tropical beverages	108.6	110.6	102.7	96.7	96.3	95.2	96.2	96.9
Industrial raw materials	181.8	181.2	181.1	184.6	182.5	183.6	181.6	179.9
Agricultural raw materials	191.6	185.0	189.8	191.6	190.1	191.8	195.6	194.7
Non-ferrous metals	216.4	226.5	205.6	219.8	219.1	216.9	202.5	198.3
Energy raw materials	139.5	118.7	161.6	154.8	162.0	168.4	168.7	166.1

¹ On dollar basis. - ² Annual Average.