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Article — Digitized Version

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Intereconomics

*Suggested Citation:* Hamburg Institute of International Economics (HWWA) (Ed.) (1990) : The economic situation in the Federal Republic of Germany, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 25, Iss. 3, pp. 157-160, <https://doi.org/10.1007/BF02924799>

This Version is available at:

<https://hdl.handle.net/10419/140245>

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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 upswing in the Federal Republic of Germany strengthened further in 1989. Both demand and production increased distinctly in the winter six months. This meant an accelerated increase in the demand for labour. The number of employed grew by circa 350,000 from the autumn of last year to spring 1990, compared to an increase of 100,000 in the preceding six months; unemployment fell markedly. Following the opening-up of the GDR there was a considerable flow of migrants into the Federal Republic in the winter six months, which together with the flow of ethnic Germans from other Eastern European countries meant the greatest increase in the population of the Federal Republic since the fifties. The direct effects of this on demand were already noticeable by the turn of the year. Expenditure by the immigrants, who as a result of their high initial requirements save at most a small part of their income, probably made an important contribution to the lively upswing of consumption.

The migrants from the GDR and Eastern Europe meant a considerable increase in the supply of labour. Strains on the labour market therefore remained within limits compared to earlier booms. Workers from the GDR in particular probably helped to reduce personnel bottlenecks in enterprises. At all events, following the turn of the year the number of vacant jobs fell together with the clearly accelerated growth of employment. Although overall capacity utilisation has reached a high level, the upward pressure of consumer prices as a whole did not become stronger. The current rate in the first months of 1990 was around 3%. The intention of the Federal Government to form an economic and monetary union with the GDR gave rise to fears both at home and abroad that this would trigger an accelerated rise in prices due to a strong, sudden increase in demand. It was also expected that the reconstruction of

the East German economy would require a high amount of capital. This did not remain without effect on the capital market. The average current yield on public sector bonds rose temporarily to over 9%, thus reaching its highest level for seven years, but later weakened again somewhat. On exchange markets the D-Mark still tended to be on the strong side.

With the slowing-down of business activity abroad – not least as a result of monetary policy – there are signs of a diminished rise in foreign demand for the West German economy. In addition, the higher interest rates lead one to expect a slower expansion of domestic demand. Furthermore, following the tax reduction at the beginning of 1990 there are no expansive stimuli contained in fiscal policy for 1991. All of these factors would have resulted in a marked slowing-down of the rate of expansion of the economy, especially in 1991. The formation of the economic and monetary union with the GDR will now change this picture, however, both already in the current year and, more strongly, in the coming year. The extent of the changes can be quantified only very roughly. Firstly, there are still considerable uncertainties as to the modalities and the time-table of the economic and monetary union. Secondly, there are uncertainties as to how economic actors in the GDR will behave under conditions which are completely new to them. There is no historical precedent for the supersession of a centrally planned economy with a non-convertible currency by a market economy with the parallel introduction of a fully convertible currency. A glance at the experience of the economic and monetary reform in West Germany in 1948 shows that the changeover to a market economy even under difficult initial conditions can very rapidly set free enormous forces, but there are also important differences between the present situation and that of 1948.

The political decision in favour of an economic, monetary and social union between the Federal Republic and the GDR has been taken. A far-reaching

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\* 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. The report was concluded in early April.

economic unification of the two Germanies is a transitional stage on the path to complete political unification. The task now is to prepare economic integration within a short space of time in such a way that the economy of the GDR with the changeover to the new system has a chance to catch up rapidly with the Federal Republic via a spurt in growth. Only a clear perspective in this direction can put a stop to East Germany's bleeding to death via the loss of qualified workers and thus to the collapse of its economy. Economic activity in the GDR is taking place largely without legal regulation. There are already indications that obligatory dues are not being paid and that the state, in order to maintain its functioning, is falling back to a considerable extent on lending from the central bank. Together with the large losses of workers since the borders were opened, this is leading to an accelerating process of economic decline, which itself drastically worsens the starting conditions of the GDR within the economic and monetary union. Great haste is thus required in the negotiations between the two German governments.

Due to the high mobility of labour in the GDR, the opening-up of the borders requires a complete renunciation of its traditional economic system. The perspective of a monetary union in the near future has not modified the necessity of this, but rather has made the bringing into line of the GDR's economic system with that of Western Europe even more urgent. The central points for an economic reform are: price formation, wage determination, freedom of contract and company constitution, the tax system, a two-tier banking system, social insurance, competition law and property laws. In the current discussion on the modalities of the monetary union the impression arises that with the conversion of stocks the flow variables expressed in monetary units (income, pensions, rents, debt service) would also be fixed definitively. This is a misleading outlook, however. A genuine conversion only takes place for monetary stocks. Flow variables are only affected by the exchange of one currency for another in as far as the contracting parties concerned feel themselves bound to honour current contracts. In the case of an upheaval of the dimensions of that in the GDR, contracts relating to current transactions will certainly have to be replaced by new contracts conforming to market principles within a brief period of time.

In the case of the planned monetary union between the Federal Republic of Germany and the GDR it must first be decided how high the initial allocation to the GDR of DM central bank money should be in order to meet cash requirements and reserve requirements for the

initial stock of deposit money (sight deposits). Private households, enterprises and the state require an initial allocation of money to be able to conduct the necessary transactions in the early days and weeks, in which many of them will not yet achieve an (adequate) income or receipts. The size of this additional supply of money should be based on expected income and turnover in the territory of the GDR. Nobody can say today with certainty how high the gross national product in the GDR after the currency reform will be. This depends above all on the competitiveness of the GDR, which will be determined primarily by the speed and intensity with which reforms are carried out and by the level of costs which crystallizes in this process. The calculations here are based on a gross national product of DM 300 billion, but the degree of uncertainty is very high. If it is assumed that in the GDR the relationship between nominal gross national product and the money supply M1 (cash plus sight deposits) will be similar to that in the Federal Republic (approx. 6:1), the necessary initial allocation to non-banks in the GDR of M1 money supply will be approx. DM 50 billion.

If, in addition, the apportionment of the M1 money supply between cash and sight deposits in the Federal Republic is taken as a basis, cash requirements would be about DM 15 billion. The amount of deposit money (sight deposits) required at the beginning of the monetary union would thus probably be around DM 35 billion. If banks in the GDR – like those in the Federal Republic – were required to hold minimum reserves, their initial central bank money requirements would be approx. DM 5 billion. Including cash requirements, an initial allocation of central bank money to the GDR of about DM 20 billion for transaction purposes would have to be calculated. This would mean an increase of around 9% compared to stocks of DM central bank money in the Federal Republic, which probably reach DM 220 billion in mid-1990. The M1 money supply, presumably around DM 430 billion in mid-1990, would increase only slightly more strongly (by 11½%). An expansion in money stocks of this size can hardly seriously prejudice the stability of the value of money. An error margin of 30 percent in the calculation of the required size of the initial allocation of money is equivalent to no more than 3% of total money stocks.

It continues to be uncertain what shape the reforms in the GDR will take, what the actual modalities of the monetary union will be and how all this will affect the behaviour of consumers and savers in the GDR following monetary unity. This is the reason why the uncertainty as to the effects on the West German economy is so great. In this situation a forecast such as

that being made here should not be overvalued. In order to get to grips approximately with the possible effects of economic and monetary unity on economic trends in the Federal Republic, the following assumptions were made: monetary unity will be realised in the summer of 1990; at the same time there will be a radical economic reform in the GDR. Further, two variants are considered regarding the conversion of accounts, the level of wages and pensions, and savings behaviour. In the first variant, GDR households have quite a high nominal income at their disposal, of which they spend a relatively large part on goods from the West. In addition, they spend a considerable part of their savings. In the other variant nominal disposable incomes are lower and it is assumed that there is no net spending of savings.

When calculating the effects of demand on the Federal Republic the following must be taken into consideration: a part of the demand will be served directly from abroad; the goods produced in the Federal Republic contain a high share of imports; a considerable amount of private and public capital flows from the Federal Republic into the GDR and this in turn has effects on the demand for capital goods in the Federal Republic; demand in the GDR leads in part to the crowding-out of West German exports to other countries and of direct investments there; to a certain extent there is a displacement of investment and production out of the Federal Republic and into the GDR. All in all, in the case of the first variant, there could be in the space of one year an additional surge of demand in West Germany to the tune of DM 50 billion. That would, in the final analysis, mean an increase in gross national product, measured against the situation of no monetary

union, of approx. two percentage points. In the GDR unemployment would be relatively high due to the presumably higher pressure of labour costs and the resulting lower competitiveness. In the case of the second variant, the net demand effect for the Federal Republic would only be about half as large. In the GDR unemployment would be considerably less, since more enterprises would be competitive. This forecast is based on a middle variant, according to which in the Federal Republic in the first year following the establishment of economic and monetary unity there would altogether be an additional demand spurt from the GDR to the tune of DM 35 to 40 billion, of which by far the larger part would not come into effect until 1991.

The following assumptions were also made: the expansion of real world trade will slow down somewhat in the course of the current year; raw materials prices will fall slightly further; the price of oil will remain at \$ 18 per barrel; in real terms the external value of the D-Mark will stay constant; monetary policy will succeed in adjusting trends in the level and expansionary path of the volume of money to the production potential in the extended D-Mark area; increases in negotiated wage rates will be somewhat higher than last year; possible agreements on shorter working hours will not take effect until 1991. Fiscal policy has provided strong stimuli to economic activity and growth in the current year via tax reductions. Possible fiscal policy measures for the GDR going beyond the supplementary Federal budget which has already been passed are assumed to have only slight effects in the current year. On the further assumption that additional borrowing for the GDR will remain within relatively narrow limits and that rises in

**Table 1**  
**Benchmark Data for the Forecast for the Federal Republic of Germany**

	Absolute values				Changes over the previous year in %			
	1987	1988	1989	1990 <sup>1</sup>	1987	1988	1989	1990 <sup>1</sup>
Gross national product, real (DM bn)	1641.9	1701.8	1769.2	835.5	1.7	3.6	4.0	3¼
Domestic demand, real (DM bn)	1591.6	1650.9	1696.5	1762.5	2.9	3.7	2.8	4.0
Total demand, real (DM bn) <sup>2</sup>	2142.1	2233.3	2339.6	2452.5	2.4	4.3	4.8	5.0
No. of employed (1000s) <sup>3</sup>	27157	27354	27729	28200	0.7	0.7	1.4	1.5
Unemployed (1000s)	2229	2242	2038	1950	•	•	•	•
Unemployment rate (%) <sup>4</sup>	8.5	8.4	7.6	7.2	•	•	•	•
Consumer prices <sup>5</sup>	•	•	•	•	0.6	1.2	3.1	3.0
Balance on current account (DM bn) <sup>6</sup>	81.2	85.3	99.1	100	•	•	•	•
Net state financial investment (DM bn) <sup>7</sup>	-37.1	-45.2	4.9	-20	•	•	•	•

<sup>1</sup> Estimated by the participating institutes; rounded off.

<sup>2</sup> Domestic demand plus exports.

<sup>3</sup> Residents; the results of the 1987 population and place of work census have been included in the calculation.

<sup>4</sup> As a percentage of the workforce (employed plus unemployed); based on the results of the population census.

<sup>5</sup> Price level of private consumption.

<sup>6</sup> Balance of payments statistics.

<sup>7</sup> National accounts concept.

costs and prices will accelerate only slightly, the level of interest rates on the capital market will not show any remarkable change. Under these conditions the economic expansion in the Federal Republic will continue in the current year with virtually undiminished force (cf. Table 1).

Economic trends in 1991 will depend strongly on the effects of the economic and monetary union with the GDR. International trends, on the other hand, will have relatively little impact. Monetary policy in the Federal Republic is more likely to have dampening effects. It is hardly likely to pull the reins tighter since the upward pressure of costs and prices will remain relatively moderate throughout 1990, but the tightening which has already taken place will continue to show an effect for some time. Fiscal policy is not likely to stimulate economic activity much. Following the tax reductions of 1990, in the coming year tax progression will again take effect; stimuli resulting from additional public expenditure in connection with the economic union will probably remain relatively limited at first. It is assumed here that the Federal Republic will be faced in 1991 with fairly great expenditure for the initial funding of unemployment insurance in the GDR. Unemployment there will presumably rise markedly at first because in uncompetitive branches jobs will be lost more rapidly than new ones can be created in other branches and in new enterprises. It is presumed that approx. DM 10 billion from public funds in the Federal Republic will be spent on infrastructural investment in 1991; considerably greater expenditure would only be to be expected if it were possible to reduce the lengthy times required for planning. Deliveries of consumer goods will probably rapidly achieve a considerable volume. In order to come to a conception of orders of magnitude, it was necessary to make numerous assumptions regarding politically determined data, market reactions

and behavioural patterns of private households in the GDR. These included in particular conversion rates for savings accounts, the level of pensions and of unemployment benefits, the level of wages and prices, savings behaviour and the structure of demand.

Although as a whole only slight stimuli will come from monetary policy and fiscal policy as well as from economic trends abroad, economic activity in the Federal Republic will continue to expand strongly in the coming year. The determining factor for this is the considerable boost to demand which is to be expected from the GDR. Consumers there will with certainty demand goods and services from the Federal Republic in large quantities. In addition, investments in the GDR, whether from local enterprises, from West German ones or from enterprises in other Western countries, will increase strongly. This leads to the expectation of substantially greater deliveries of capital goods from the Federal Republic to the GDR. For these reasons, employment, income, consumption and also investments in the Federal Republic will continue to show a lively growth. Altogether the increase in the national product in the coming year will probably reach approximately the result expected for 1990 and thus be of an order of magnitude of 1½ percentage points higher than it would be without the economic and monetary union. The resulting additional government receipts will probably be of about the same size as the additional expenditure for the GDR assumed here. The total public deficit in the Federal Republic in 1991 would therefore be of a similar size to that of this year. Due to the level of capacity utilisation achieved, imports will increase strongly; this will affect economic trends abroad, particularly in Western Europe. Under these circumstances the danger will probably diminish that increasing domestic strains will lead to an accelerated rise in costs and prices.

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

Raw Materials and Groups of Materials	1989		1990					
	AA <sup>2</sup>	December	January	February	March	April	4.5.	18.5.
Total index . . . . .	158.0	163.3	168.0	166.1	161.7	155.4	151.7	158.9
Total, excl. energy raw materials . . . .	150.7	142.9	144.1	145.5	149.5	151.7	152.5	152.7
Food, tropical beverages . . . . .	104.3	94.2	95.8	96.3	98.3	100.5	101.2	100.7
Industrial raw materials . . . . .	186.0	179.9	180.8	183.0	188.5	190.7	191.6	192.4
Agricultural raw materials . . . . .	191.3	198.2	203.3	206.9	205.6	209.2	209.5	210.6
Non-ferrous metals . . . . .	223.5	189.7	182.8	182.3	204.0	204.7	205.0	203.4
Energy raw materials . . . . .	162.3	175.2	181.9	178.0	168.8	157.6	151.2	162.5

<sup>1</sup> On dollar basis. - <sup>2</sup> Annual Average.