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The Economic Situation in 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.**

There is a pronounced dichotomy in the united German economy. In the west, the cyclical expansion has continued at an unabated speed. The utilization of productive capacity, already very high, has risen even further. There are considerably more employed persons and the number of jobless has declined noticeably despite the substantial increase in the labour force due to the influx of East Germans and ethnic Germans from East European countries. In east Germany the decline in overall production has accelerated drastically after the monetary, economic and social union entered into force on 1 July this year. The introduction of the D-mark suddenly exposed firms to competition, forcing many of them either to curb or close down production. An added factor is that the elimination of central planning has meant that supply links were abruptly severed, which has also impeded production. In August, industrial output attained only about half of the previous year's level. Both unemployment and the number of short-time workers have risen sharply, though not as rapidly recently as in the two months immediately after completion of the union.

The German economic research institutes had forecast this split development in their report of last spring, although they underestimated the dynamic of the upswing in west Germany and the speed and depth of the economic decline in east Germany. The two are closely related to one another. In contrast to the assumptions made in the report, private household income in east Germany has not dropped in spite of the rapid rise in unemployment and short-time working; on the contrary it has risen. Prior to, and especially after, the introduction of the D-mark in east Germany, wages rose both in individual firms and as a result of collective wage agreements. Old age pensions

were also raised considerably via legal regulation. Also, the conversion of bank accounts resulted in larger D-mark assets than at first assumed. Households had much higher D-mark sums from current income and savings at their disposal than had been anticipated and a much greater share of this money is evidently being spent on west German and other western goods in general than expected. The surge in consumer demand from east Germany has given the west German economy an impetus in excess of expectations. This stimulus has had an immediate impact on the retail sector and above all on the consumer goods industries, and an indirect effect on other sectors. It has given a boost to the domestic buoyant forces, which are the key to the continued upward trend.

In west Germany the increase in prices and costs has accelerated only slightly, particularly in comparison to previous boom phases, although recently the high rise in oil prices has led to a sharp increase in the price level. We anticipate that the oil price will gradually decline, while remaining well above the level prior to the Gulf crisis. We do not expect this to act as a serious impediment to economic activity either in Germany or the other industrialized countries, assuming of course that employers and labour accept as inevitable the loss in purchasing power entailed in more costly oil and the resultant general price rise. The continuation of the upswing could be jeopardized by an inappropriate reaction on the part of employers and unions which could trigger a price-wage-price spiral. Another danger is the possibility that the oil price could turn out to be substantially higher than assumed here. The domestic propellant forces could then be weakened considerably. A restrictive response by monetary policy to higher oil prices could worsen the pressure unnecessarily.

The economy in west Germany is in any case less robust than might appear from the present trend in demand and production. Long-term interest has attained quite a high

* Participating institutes: Deutsches Institut für Wirtschaftsforschung, Berlin; HWVA-Institut für Wirtschaftsforschung-Hamburg; Ifo-Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen.

level, making the financing of real investment more costly and financial investment more attractive. As early as mid 1988 monetary policy shifted from an expansionary course to an – over the medium-term – neutral course geared to growth in production potential. Fiscal policy is the foremost driving force of the economy, although the stimulating impacts of the tax cuts from the beginning of the year would seem to be gradually waning. This indicates that investment and consumption are slowly losing momentum. This ought to be offset by positive demand effects emanating from east Germany. Public authorities in west Germany have earmarked large funds for private households and public budgets in the new Länder which are slowly making themselves felt on the spending front. There are, however, retarding effects connected with the raising of these funds, regardless of whether they are financed via the capital market or via taxes. This poses a threat to the business outlook.

Public finances in west Germany and in east Germany are heavily influenced by the fiscal consequences of the process of unification. Transfer payments to the former GDR take up a sizable portion of public spending in west Germany. The payments stem from Federal funds – largely from the three supplementary budgets – and from the German Unity Fund. From the latter DM 22 billion are to be made available this year and DM 27 billion from the supplementary budgets, nearly DM 50 billion in all. Next year these payments taken altogether will increase to between DM 70 and DM 75 billion, a good DM 25 billion of which will go towards financing unemployment in east Germany and DM 10 billion to help pay for old age pensions. DM 35 billion will be appropriated from the German Unity Fund.

As a whole, government expenditure in the territory of the former Federal Republic of Germany should increase by about 8% next year, after an increase of nearly 10% this year. Excluding the payments to the new Länder, the estimated rise is 6% (1990: 5%). Adjusted for these payments, expenditure will in both years expand somewhat more slowly than nominal national product (7 1/2% and 6 1/2%) but much more rapidly than in past years. All the major items of public expenditure, public consumption, current transfer payments and government investment contribute to this larger increase. Particularly sizable in both years will be the rise in welfare spending, because the supplementary benefit rates have been raised as of mid 1990 and the number of claimants is still on the increase. Further contributing factors to the rise in current transfer payments are the adjustment of old-age pensions to general income trends and the continued rise in the number of pensioners. The estimated spending on government consumption is based on the premise that wage agreements in the public services can only be partially divorced from rises in other sectors while the number of new hirings is kept within narrow limits. On balance, personnel costs will go up by a good 5%. Current material expenses, however, will increase more markedly. The inclusion of the risk of invalidity in statutory medical insurance will raise expenditure while the cuts in military procurement will have a dampening effect. Public investment spending will slow down with hardly a plus in real terms. Interest payments, in contrast, will shoot up fast due to the rapid increase in new public borrowing at persistently high capital market interest rates. Government revenue in the former Federal Republic of Germany will go up by 6% in 1991, with an actual plus of only 3 1/2% in 1990 due to the tax cuts.

PUBLICATIONS OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

Benu Varman

CAPITAL FLIGHT

A Critique of Concepts and Measures

Large octavo,
176 pages, 1989,
price paperbound DM 48,-
ISBN 3-87895-380-1

The term "capital flight" is not clearly defined and is applied to a variety of concepts. Estimations of the amount of flight capital, which influence international banks, decisions regarding credits and the economic policies of the countries involved, are correspondingly imprecise. Benu Varman's book was written as a Ph. D. thesis at the University of Kiel. It deals both theoretically and empirically with the phenomenon of capital flight from developing countries and comes to completely new definitions and information. It received the "Erich Schneider Price 1989" for its outstanding quality.

VERLAG WELTARCHIV GMBH – HAMBURG

ECONOMIC TRENDS

The creation of federal structures in the former GDR is accompanied by radical changes in public tasks and spheres of competence. There will be drastic staff cuts in the public services in which, comparatively speaking, far more people were employed than in the west German administrative apparatus. Public employees made redundant will receive compensation to the value of 70% of their last pay for a period of six months. In the first half of 1991, about half a million people are likely to be receiving this redundancy pay. Public investments in east Germany will at first lag well behind demand expectations. These investments will probably grow in the course of 1991 thanks to improvements in the funding of local government as a result of structural aid from the new Länder and the Federal Government.

There has been a steep rise in social security payments in east Germany since the economic and monetary union to pay for the sizable costs of unemployment and short-time working. In 1991, expenditure by the east German unemployment insurance will go up to approximately DM 30 billion (1990: DM 10 billion). With the planned further

increases in pensions, expenditure will expand here too, which will mean another deficit (DM 3½ billion) in the pension budget. Other social security payments in east Germany are also likely to rise considerably, because benefit payments are being introduced that were unknown in the former GDR or had been effected in kind. As of 1 July value added tax, special consumer taxes and, until the end of 1990 in simplified form, wage tax are being levied in the territory of the former GDR. Up to the end of 1990, businesses will be required to pay flat-rate levies instead of a tax on earnings. Unlike west Germany, the main pillar of the fiscal system for the foreseeable future will be indirect taxation. Owing to the relatively high blanket deductions and allowances income and property tax will not provide much revenue. All in all a cash tax revenue of a good DM 40 billion can be expected for 1991 (second half of 1990: DM 17 billion).

The public sector (central, regional and local authorities and social insurance) as defined in the national accounts will record a deficit of some DM 70 billion for both parts of Germany together in 1990. In the coming year the public

Key Data of the Forecast for West Germany

| | 1989 | 1990 ¹ | 1991 ¹ | 1989 | 1990 ¹ | 1991 ¹ |
|--|------------------|-------------------|-------------------|---------------------------|-------------------|-------------------|
| | Absolute figures | | | % change on previous year | | |
| Real gross national product (DM bn.) | 1 766.0 | 1 838 | 1 885 | 3.9 | 4 | 2.5 |
| Domestic demand, in real terms (DM bn.) | 1 693.4 | 1 768.5 | 1 819 | 2.7 | 4.5 | 3 |
| Aggregate demand in real terms ² (DM bn.) | 2 342.5 | 2 472.5 | 2 578 | 5.0 | 5.5 | 4.5 |
| Gainfully Employed ³ (1,000 persons) | 27 635 | 28 320 | 28 800 | 1.4 | 2.5 | 1.5 |
| Unemployed (1,000 persons) | 2 038 | 1 900 | 2 000 | . | . | . |
| Rate of unemployment ⁴ (%) | 7.6 | 7.0 | 7.0 | . | . | . |
| Consumer prices ⁵ | . | . | . | 3.2 | 2.5 | 4 |

¹ Forecast by the participating institutes in rounded figures. ² Domestic demand and exports. ³ Domestic gainfully employed. ⁴ Related to labour force (employed and unemployed). ⁵ Price index for private consumption.

Key Data of the Forecast for the Federal Republic of Germany (as a whole)¹

| | West Germany | | East Germany | | Federal Republic of Germany | |
|---|--------------|--------|--------------|-------|-----------------------------|--------|
| | 1990 | 1991 | 1990 | 1991 | 1990 | 1991 |
| Employed wage and salary earners ² (1,000 persons) | 25 360 | 25 860 | 8 420 | 6 500 | 33 780 | 32 360 |
| Unemployed (1,000 persons) | 1 900 | 2 000 | 250 | 1 400 | 2 150 | 3 400 |
| Short-time workers (1,000 persons) | 60 | 80 | 830 | 1 750 | 890 | 1 830 |
| Net. gov. financial investment ³ (DM bn.) | -58 | -83 | -14 | -8 | -71 | -90 |
| Balance on current account ³ (DM bn.) | 110 | 93 | -52 | -77 | 58 | 16 |

¹ Forecast by the participating institutes; forecast figures for east Germany on the basis of the findings of an empirically grounded model calculation for 1989 by the Deutsches Institut für Wirtschaftsforschung. Rounded figures. ² Domestic employed. ³ As defined in the national accounts.

sector deficit will amount to some DM 90 billion. Within the public sector the social insurance institutions in west Germany will achieve surpluses of about DM 20 billion in both years. The deficit incurred by the public sector in west Germany – including the German Unity Fund and other transfers payments to east Germany – will go up from DM 77 billion in 1990 to DM 105 billion. If the calculation is based on the definitions used in the financial statistics, the public sector deficit – including the Unity Fund – in west Germany will amount to DM 85 billion for 1990 and about DM 115 billion for 1991. If we include the public budgets in the territory of the former GDR – excluding the Treuhand trust body – the net overall public sector borrowing needs will amount to nearly DM 100 billion in the current year and more than DM 120 billion in the next. Since, though, the surpluses from west German social insurance provide funds for the capital market, the effective government borrowing requirements in 1991 will in fact be the above mentioned DM 90 billion calculated in national accounting terms. All figures specified here must be seen under the proviso that the forecasting of economic and social developments is presently subject to a particularly high degree of uncertainty.

In the coming year the economic expansion in Germany will slow down. Taking east and west Germany together, real gross national product should rise by some 1½%. This figure for Germany as a whole, however, is a poor reflection of the trends that are likely to manifest themselves in western Germany on the one hand and eastern Germany on the other. In west Germany the forces propelling the upswing will slacken distinctly, though this will be obscured to a large degree by the boost in demand engendered by the spending in east Germany on west German consumer and, increasingly, capital goods. In east Germany the downward trend in the economy will continue well into 1991. Real gross national product in the coming year ought to average some 10% less, after having dropped by about one sixth this year. This decline is not the result of a cyclical drop in demand; it is the effect of the

process of structural adjustment which the economy in eastern Germany is undergoing. This process first means the continued curtailment of production for which there is no longer a demand. However, new manufacturing capacity and businesses can be expected increasingly to be set up. Underlying the continued sharp fall in gross national product in east Germany in 1991 will thus be a decline in overall production in the first half of the year followed by a tangible increase.

Concomitant to the divergent developments in production in west and east Germany, the trends on the labour market will also run in opposite directions. The large reduction of one and a half million in the number of employed in Germany as whole (annual average for 1991 as compared with 1990) is an aggregate effect of the, albeit cyclically weakened, employment increase in the west and the dramatic decline due to structural shrinkage in the east. Similarly, the sharp rise in the unemployment rate in Germany as a whole to an annual average of almost 10% in 1991 (1990: 6%) can be attributed almost wholly to the loss of jobs in east Germany. While a distinct improvement can be expected here for the latter part of the coming year, however, the slowdown of cyclical forces in west Germany will probably cause a rise in unemployment. The development of the economy in east Germany will require a net influx of real resources over a long period, the bulk of which will have to come from west Germany. This process is already well underway in the current year. Whereas real exports from east Germany are likely to expand little in 1991, imports will increase by one fifth; imports from west Germany in particular will expand powerfully. Due to the high utilization of capacity there, additional supplies will not be possible without considerable additional imports. Increased real absorption in Germany will be reflected in rapidly rising imports both this year and next. The all-German current account surplus will diminish markedly. This development means that the German economy will be generating strong economic impulses to its trading partners.

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

| Raw Materials and Groups of Materials | 1989 | | 1990 | | | | | |
|---|-----------------|-------|-------|-------|-------|-------|-------|--------|
| | AA ² | Oct. | July | Aug. | Sept. | Oct. | 2.11. | 16.11. |
| Total index | 158.0 | 159.9 | 157.2 | 204.5 | 236.8 | 245.6 | 240.5 | 213.1 |
| Total, excl. energy raw materials | 150.7 | 145.4 | 151.9 | 156.1 | 156.6 | 152.6 | 151.5 | 150.4 |
| Food, tropical beverages | 104.3 | 95.2 | 93.9 | 92.4 | 91.9 | 90.5 | 89.7 | 88.9 |
| Industrial raw materials | 186.0 | 183.6 | 196.0 | 204.7 | 205.8 | 200.0 | 198.5 | 197.2 |
| Agricultural raw materials | 191.3 | 191.8 | 208.0 | 216.7 | 216.1 | 214.5 | 216.8 | 216.9 |
| Non-ferrous metals | 223.5 | 216.9 | 207.2 | 219.6 | 226.4 | 208.6 | 200.4 | 195.6 |
| Energy raw materials | 162.3 | 168.4 | 160.3 | 232.7 | 283.7 | 299.8 | 292.4 | 249.8 |

¹ On dollar basis. ² Annual Average.