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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.**

Owing to the economic upheaval in Germany since unification, the Federal Republic has so far been a special case with regard to economic developments in the industrialized countries. The shift in demand from east to west generated a boom in the old Länder, but conversely prompted a drastic drop in production in the new. This has of course had repercussions beyond unified Germany. The gap between the income fed by official transfer payments and the much lower production in east Germany was partly bridged by drawing more on foreign resources. Weak export demand attending a slackening world economy and at the same time the competitive pressure from the elastic supply of goods from abroad countered the trend towards overheating in west Germany. At the same time, increased demand in Germany as a result of unification acted as a tangible stimulus to the economies of major trading partners.

The economic decline in east Germany would appear to have stopped. After a renewed, marked drop in the first quarter of 1991, overall production has evidently recovered somewhat in the course of the year. Turnover, net output and orders received in manufacturing over recent months point to a more stable trend. Altogether, production in trade, transport and in services ought not to have declined any further in the summer half-year. In construction, there are even indications that there has been a continuous upward trend since spring. All in all, it looks as if overall production bottomed out about a year after the introduction of the monetary, economic and social union, at an estimated one-third below its level in the first half of 1990, in industry as much as two-thirds. The number of gainfully employed in east Germany has continued to go down substantially right up to the present. The figure was nearly ten million at the end of 1989 and has probably fallen by almost three and a half million since then, which is

a measure of the depth of the transformation process in east Germany connected with the change-over of the economic system.

There is, however, no reason for resignation. The economic and social transformation in east Germany is profound and, of their nature, decline and renewal do not occur simultaneously. The households massively geared their expenditure at once to western goods, which forced companies to drastically cut down on their production and workforce. The collapse of trade with the countries of the former CMEA, prompted by the switch to convertible currencies at the beginning of the year, also dampened demand. All this must be grasped as part of the process of transformation and is an adjustment response to the new conditions now prevailing in east Germany and in the countries of eastern and central Europe. It takes time to set up new structures and a similar plummeting of demand would also have triggered a massive drop in production and employment in any Western economy. In east Germany, though, it was not just a matter of a negative demand shock. The preconditions for an effective market-driven economic system were almost utterly lacking. Unmistakeable progress has meanwhile been achieved here.

Now that aggregate production has recovered slightly in the summer half-year, there are signs of a resurgence, which ought to gain impetus in the course of next year. The uptrend is based on several sources. First, the decline in those branches bound to contract under free market conditions has slowed down considerably and is less of an impediment to the incipient overall growth in others. On top of this, the overall conditions have improved. Without question, the multiple constraints which at the outset severely inhibited the development of enterprises and the process of reorganization have eased, which has encouraged the readiness to invest and the will to set up enterprises. The Treuhandanstalt has helped recovery by privatizing companies. Finally, the sizable transfer payments to east Germany are taking effect and instigated

*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.

an expansion in production, particularly in construction and allied areas. Next year, overall production ought to be some one-tenth higher than in this, where the level has probably been about a quarter below that of 1990. It is still unclear whether the economy has now been ignited for a sustained period of growth: too many activities have been initiated by government spending, too many obstacles have still not been surmounted, too many companies in the hands of the Treuhandanstalt are obviously unable to find the path to competitiveness and too many wage claims are being enforced which are overstressing the capacity of the east German economy.

The number of jobless has risen considerably in the course of this year, but the September figure of 1.03 million falls noticeably short of the level widely feared. The unemployment trend is not a measure of the actual decline in competitive jobs in east Germany. Much labour is engaged in short-time work, in job creation schemes, in further training or employment institutions, has been given early retirement or commutes to work in west Germany. Unemployment will probably go on rising until mid-1992. A surge is likely soon, mainly because the companies in the hands of the Treuhandanstalt evidently want to dismiss many employees before the end of 1991. This will release a large number of workers who are presently working short-time. There is hope that the labour market will stabilize in the summer half-year of 1992.

The forces for growth in west Germany have been waning since spring. There are a number of different reasons for this change in trend. As early as the summer of last year demand abroad for German products began to slacken as a result of the economic downturn in most of Germany's trading partners. Domestic orders have also been on the decline since around the turn of the year. This is probably attributable both to dwindling foreign trade and to the high interest rates in conjunction with worsening earnings expectations. High interest rates are also the main reason for receding demand in construction. Since

the middle of the year, tax increases have also been inhibiting growth, particularly private consumption. This has been offset by the expansive impulses generated by east German demand, i.e. in effect by fiscal policy. This dynamic has obscured the restraining effects of both world economic trends and monetary policy for some time, but it can no longer do this as growth in demand from east Germany – which is at a high level – is flagging. Deviating from the general weakening of the expansionary forces, orders received from abroad have made a marked recovery in recent months. This turn for the better is clearly associated with the trend reversal in world-wide economic activity. During the phase in which economic expansion was slowing down more and more, the increase in prices strengthened considerably primarily as a late result of the boom, to which fiscal policy and, earlier, monetary policy contributed. The departure from a moderate course in wage policy has also helped to push prices up on the cost side.

The economic expansion in west Germany has probably largely come to a standstill since the middle of the year. From the current standpoint, there is little to indicate that this stagnation will give rise to a recession. There might be a danger of this occurring if wage agreements are reached in next year's negotiations that prompt the off-evoked conflict with monetary policy, which is potential-oriented. We have not assumed such a development here. Rather, our forecast is based on the premise that there will be a change in wages policy towards much lower negotiated increases. Overall production should rise again early next year in response to rising exports. The expiry of the solidarity surtax on 1 July 1992 and buying in anticipation of higher value added tax as of 1 January 1993 will also have a stimulating effect, especially on private consumption. From the demand side, the economic slowdown is conducive to restabilizing prices, although experience shows that the delay between cause and effect is always comparatively long. Owing to the slower productivity growth attending a phase of weak economic

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activity, the costs side, on the contrary, will at first exert increased pressure on prices. Altogether, this means that prices will continue to rise quite forcefully well into next year.

The forecast for 1992 is based on a number of assumptions. The economic upturn in the trading partner countries continues at a moderate pace. The oil price keeps to some US\$ 20 a barrel. The price level on world markets for industrial raw materials in dollars goes up slightly. The high demand in east Germany grows only little. Wage agreements in 1992 stay noticeably below the rates for this year (at some 5%). Monetary policy retains its present potential-oriented course; the monetary reins are not tightened. The budget plans and measures agreed on so far are implemented; we assume no new major initiative, here. There is no notable change in the interest level on the capital market and the real external value of the D-Mark.

The reviving world economy augurs well for German exports. The international competitiveness of German suppliers ought not to alter much given that monetary

relations in the EMS are unlikely to change. Exports will be stimulated all the more by the world economic recovery as west German firms will again turn their attention more to foreign markets as demand wanes in east Germany. The overall conditions for investment have worsened. Orders in hand are still quite high and delivery times have shortened only little, so that investment growth has simply slowed down so far, but the investment climate is likely to deteriorate further. The current increase in real investment in machinery and equipment will drop back tangibly to recover in the second half of next year, partly due to stronger stimulus from abroad. High interest rates, poor earnings prospects, lower growth in real income and the government's financial problems will result in weaker demand in west Germany's building sector. Private consumption will expand comparatively slowly next year.

Overall production will stagnate until around the end of the year, after which it should revive in response to demand from abroad. Due to slower demand growth and a lower utilization of capacity in industry, imports will only go up slightly at first. Not until during the course of next year will they receive fresh impetus from the economy. The

Key Data of the Forecast for West Germany

	1990	1991 ¹	1992 ¹	1990	1991 ¹	1992 ¹
	Absolute figures			% change on previous year		
Real gross national product ² (DM bn.)	2 138.7	2 210	2 250	4.5	3.5	2
Domestic demand, in real terms ² (DM bn.)	2 082.7	2 150	2 195	5.0	3.5	2
Aggregate demand in real terms ^{2,3} (DM bn.)	2 926.8	3 095	3 190	6.4	6	3
Gainfully employed ⁴ (1,000 persons)	25 470	26 260	26 600	3.3	3	1.5
Unemployed (1,000 persons)	1 883	1 700	1 700	-7.6	-9.7	0
Rate of unemployment ⁵ (%)	7.0	6.2	6.1	-	-	-
Consumer prices ⁶	107.3	111.0	115.5	2.6	3.5	4

¹Forecast by the participating institutes in rounded figures. ²At 1985 prices. ³Domestic demand and exports. ⁴Domestic gainfully employed. ⁵Related to labour force (employed and unemployed). ⁶Price index for private consumption.

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

	West Germany			East Germany			Federal Republic of Germany		
	1990	1991 ¹	1992 ¹	1990	1991 ¹	1992 ¹	1990	1991 ¹	1992 ¹
Employed wage and salary earners ² (1,000 persons)	25 470	26 260	26 600	8 530	6 560	5 510	34 000	32 820	32 110
Unemployed (1,000 persons)	1 883	1 700	1 700	240	950	1 400	2 123	2 650	3 100
Short-time workers (1,000 persons)	55	130	150	758	1 630	750	813	1 760	900
Net. gov. financial investment ³ (DM bn.)	-	-	-	-	-	-	-80.4	-90	-95
Balance on current account ⁴ (DM bn.)	-	-	-	-	-	-	77.4	-35	-25

¹Forecast by the participating institutes; forecast figures for east Germany on the basis of data from the Federal Statistical Office for the second half of 1990 and an empirically grounded model calculation by the Deutsches Institut für Wirtschaftsforschung. Rounded figures. ²Domestic employed. ³As defined in the national accounts. ⁴As defined in the balance of payments statistics.

current lull in the economy will gradually curb the growth in demand for labour. Unlike earlier phases of economic weakness, however, employment will continue to rise, substantially in fact. Owing to the invariably delayed reaction to the business cycle, the weaker upward trend in employment will probably continue throughout next year. The labour force will grow much less than in 1991 and unemployment ought to remain more or less unchanged in the course of 1992.

One year after unification, there are increasing signs that the rift in production levels between the two parts of Germany has stopped widening. After a short break, the upward trend in west Germany will continue at a moderate pace. In east Germany overall production will gradually recover, following the stabilization in the second and third quarters. This will not, however, be the signal for an explosive resurgence of growth with the east German economy rapidly catching up on the west. The recovery of production is starting at a low level and while some branches expand the decline in others will continue. Also, the main impetus behind production stems from the state. The foundations for a robust, self-sustaining growth, though, have still not been laid.

Typical of the upheaval in the new Länder is the decoupling of income and production trends: income is still far higher than production. The standard of living of east German households has much improved since unification. Nominal household income – with lower employment and greater short-time working and unemployment – has on average increased thanks to rises in wages and pensions and the introduction of numerous social benefits. In real terms, too, households are better off than before unification. Altogether, real disposable income per capita in east Germany in 1992 should average about a quarter higher than prior to unification.

Income in east Germany is at present under the sway of a wages policy aiming at the rapid alignment of the east German wage level with that of west Germany. This strategy is rapidly pushing up labour costs which in turn exerts even more pressure on the existing east German companies to adjust. With low competitiveness, they cannot pass on wage rises in the form of higher prices. Quite the reverse, to uphold market shares and in particular to tap new markets, prices will in many cases have to be cut. Where product quality is too low for a company to survive on the market, lowering prices will in many cases help little to increase sales opportunities. Money spent on higher wages, though, cannot at the same time be invested in improving product quality. Rising wages in east Germany make for a corresponding expansion of the volume of wage substitute payments and subsidies flowing into the new Länder. The risks involved in such a development are obvious. Sustained, massive subsidies for private consumption in east Germany can ultimately only be paid for by raising taxes, which for their part could again cause distribution conflicts in west Germany. There is, therefore, a danger of a wages-prices-subsidies-taxes spiral undermining the economic basis for east German recovery.

The sudden import pull from the new Länder triggered by unification has been key to this year's rapid switch in Germany's current account from a surplus to a deficit. Despite east Germany's absorption of resources, though, this deficit will lessen slightly next year. On the one hand, special factors will cease to apply, such as payments to other countries in connection with the Gulf War. On the other, the economic gap between Germany and other countries is shifting, with German exports to major trading partners on the increase again. Nevertheless, there is unlikely to be a fundamental reversal in the foreign trade situation in the medium term.

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

Raw Materials and Groups of Materials	1990		1991					
	AA ²	October	July	August	Sept.	October	1. 11.	15. 11.
Total index	185.7	245.6	158.1	159.8	163.8	171.6	174.0	169.0
Total, excl. energy raw materials	150.8	152.6	131.5	130.2	132.6	133.7	133.7	134.1
Food, tropical beverages	94.7	90.5	86.3	87.9	90.8	90.1	90.8	90.0
Industrial raw materials	193.6	200.0	165.9	162.5	164.4	167.0	166.4	167.7
Agricultural raw materials	210.8	214.5	174.8	164.1	165.0	170.2	168.8	169.2
Non-ferrous metals	201.9	208.6	169.8	168.1	170.8	170.6	171.1	173.6
Energy raw materials	206.0	299.8	173.6	177.1	182.1	193.8	197.5	189.4

¹ On dollar basis. ² Annual Average.