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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.**

Just about two years after German economic union, the economies of west and east have stopped drifting apart. The transfer of financial capital, investment goods and human capital to the new Länder has increased and the goods and services markets are meshing ever more closely together. The boom in west Germany triggered by unification came to an end around the middle of last year and the economy has slackened noticeably. This weakness continues even though the latest figures would seem to indicate a certain stabilization, giving grounds for cautious optimism. A cumulative downtrend is unlikely, but cannot be excluded. Contrary to earlier expectations, the world economy has not yet started to recover. It looks as if this will not occur until later this year, and even then the pace will be moderate. On the domestic front, the pressure of labour costs has increased and monetary policy, partly in response to this, has tightened. All this is holding back the economy in west Germany and impeding the emergence of new forces for growth.

Further progress has been made in transforming the economies of the new Länder. The flow of investment from west to east has swelled. Despite improvements in individual branches, building, services and privatized industry in particular, one still cannot speak of a broad-based upswing. The structural problems at regional and sectoral level are grave and adjustment continues to be inhibited by many constraints. There are no discernible adjustment forces in most of the companies that have not

yet been privatized. There is still a broad rift between distributed income and own production in the new Länder which can only be bridged with massive government aid. As yet, there is no discernible endogenous growth process that could narrow this gap. Incomes in east Germany are still rising rapidly and because these rises are still not aligned to productivity, this increases the pressure of labour costs, discourages investment and inhibits the creation of new jobs. The only reason why unemployment has not risen far more sharply is the extensive labour policy measures adopted.

East Germany

In east Germany overall production for the first quarter of 1992 has probably risen little above that for the summer of last year. Unmistakable successes have been achieved in transforming many branches of the economy, but many others are still registering stagnation and decline. The proliferation of private companies in east Germany and the pace at which this is occurring point to a gradually accelerating expansion in production. It is likely that it will become increasingly evident already during the course of 1992 that the economy in east Germany has left the recession behind and is on the way to recovery. The situation on the labour market has, however, continued to deteriorate.

Though manufacturing has since the summer of 1991 as a whole registered a modest upward trend, production and orders received have been quite unstable. Production has increased relatively vigorously in sectors allied to the building industry, which have benefited from the demand pull in construction. Altogether, in spite of the slight upward trends, which also took place in some sectors not linked to

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building, such as engineering and electrical engineering, manufacturing still faces serious adjustment challenges. In the building industry, the manifold and extensive government programmes to improve infrastructure, renovate residential property and promote private enterprise are taking effect. Taken together, trade, transport and private services have also registered an upturn since the spring of 1991.

In 1991, real disposable household incomes averaged some 12% above 1990, which has meant a robust increase in private consumption, despite an incipient normalization of the propensity to save. A smaller increase can be expected this year. Wage rates are rising rapidly though, at about 20% in the course of the year, they are rising definitely more slowly than in 1991. In contrast, the number of employed is at present declining comparatively little. Altogether, disposable income will be about one-fifth above the 1991 level. Price rises during the course of the year will be less than in 1991, even if, as is assumed here, rents are raised again and other administered prices go up. Real disposable household income in 1992 will average a good 7% above that in 1991. Private consumption can be expected to exceed last year's figure by 3% to 4%.

Investment swelled considerably last year, on the part both of private west German firms, which have invested particularly in machinery and equipment, as well as of government, which has channelled funds largely into construction. Business investment will also expand markedly this year. The major impulses will again be coming from west Germany. According to surveys and projections by the Ifo Institute, a figure of some DM 45 billion could be achieved, a considerable rise on the DM 26 billion recorded for 1991. Capital formation by east German firms is likely to remain very low. Aggregate public investment in east Germany in 1992 will amount to some DM 20 billion, after DM 13 billion in 1991. As a whole, combined private and public investment in east Germany will reach some DM 90 billion this year. Nevertheless, even this sizable investment will not suffice for an adjustment process which will be able within a reasonable span of time to create employment for an adequately large number of people at the same market wage level as in the west.

The forceful expansion in public and private building investment was already reflected in a noticeable increase in production in the course of last year and influenced allied sectors of industry and crafts. While activities in public works last year already exceeded the previous year's level, commercial and industrial building only started to expand as the year progressed. Modernization and renovation of residential property developed in a similar way during the year. A surge in production can be

expected in these areas for 1992, especially in the public sector. Residential building, however, will – at best – stagnate in the course of the year.

The trends in east German foreign trade clearly reflect the adjustment dictates imposed on firms by the world market and the collapse of the traditional export markets in Eastern Europe. The value of exports last year averaged 50% below that for 1990, and of those to the former European state-trading nations, as much as 60%. The slight revival of exports during the latter half of 1991 is largely attributable to government-backed guarantees for exports to Eastern Europe. It is doubtful whether these exports can be sustained at the present volume. As production gains momentum in the privatized and new companies, sales to Western countries will expand to more than offset renewed losses in trade with Eastern Europe.

For 1992, there are indications of an expansion in overall production in east Germany which will gradually become stronger and to which industry will make a tangible contribution in the second half. The privatized and new businesses in industry will in the course of the coming year gradually begin to noticeably prevail over the old ones and production will start up in plant that is now in the planning, installation or conversion phase. We estimate growth in gross domestic product in east Germany for this year of 7% and approximately double that rate for the next. More jobs are still being lost than created in east Germany and the number of employed is diminishing; the growth in aggregate production during this year will do little to alter this. The worst of the recession on the labour market will not be passed until sometime next year.

West Germany

After the boom unleashed by unification, west Germany's economy has been in decline since the summer of last year. The transfer of goods into the new Länder has increased little above the high level already achieved, so the economy has received few impulses from there. Economic policy has at the same time had an inhibiting effect: taxes and other contributions have been raised, some for a limited period, some with no time limit, and monetary policy has adopted a quite restrictive course to counter inflationary expectations. West Germany's economy has now been pulled fully into the wake of the prolonged slackness of economic activity prevailing abroad. To a certain extent, though, the slowdown can also be seen as a normalization following the preceding boom. The utilization of capacity has declined tangibly since its high in autumn of 1990; but it is on average still satisfactory. While there was a clear economic downswing

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in the second half of 1991, the upward trend of prices strengthened. The main reasons are the increases in indirect taxes and administered prices, a poor harvest for seasonal crops and also the persistent rise in rents. On the other hand, due to the weakness of the economy producers have not managed to pass on higher labour costs in full via higher prices.

Now that the exceptional forces that boosted production in the first quarter have abated, the inhibiting factors will again prevail for the time being. The world economy will be slow to gain momentum and interest rates in west Germany will remain high for the present. In view of these risks, the current wage round is of key importance. Only if both sides clearly signal their readiness to shoulder the burden of German unification without generating inflation,

can we expect to overcome the present recession quickly. If a part of the wage rises could be paid in the form of one-off payments, as is now being tentatively practised by the banks and has been repeatedly advocated by the economic institutes, this would pave the way for lower permanent costs and lessen the danger of higher wages being passed on in full in the form of higher prices.

The forecast is based on a number of assumptions that are mostly the outcome of projections, but in some cases they are merely estimates. The assumptions are as follows: The world economy will come out of recession and expand at a moderate pace. The oil price will change little in the course of the year; other raw materials prices will go up slightly. Demand from east Germany will rise only slightly in the course of the year. Effective pay rises in this

Key Data of the Forecast for West Germany

	1990	1991	1992 ¹	1990	1991	1992 ¹
	Absolute figures			% change on previous year		
Real gross national product ² (DM bn.)	2 138.7	2 205.9	2 228.5	4.5	3.1	1
Domestic demand, in real terms ² (DM bn.)	2 072.0	2 134.8	2 160	4.5	3.0	1
Aggregate demand in real terms ^{2,3} (DM bn.)	2 924.6	3 090.5	3 147.5	6.3	5.7	2
Gainfully employed ⁴ (1,000 persons)	28 433	29 173	29 400	2.9	2.6	1
Unemployed (1,000 persons)	1 883	1 689	1 780	-7.6	-10.3	5.5
Rate of unemployment ⁵ (%)	6.2	5.5	5.8			
Consumer prices ⁶ (1985 = 100)	107.3	111.1	115.3	2.6	3.6	3 ³ / ₄

¹Forecast by the participating institutes in rounded figures. ²At 1985 prices. ³Domestic demand and exports. ⁴Domestic gainfully employed.

⁵Related to civil labour force (employed and unemployed). ⁶Price index for private consumption.

Sources: Statistisches Bundesamt; own calculations.

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

	West Germany			East Germany			Federal Republic of Germany		
	1990	1991	1992 ¹	1990	1991	1992 ¹	1990	1991	1992 ¹
Gross national product ² (% change on previous year)	4.5	3.1	1	-14.4	-30.3	10.5	2.6	0.2	1.5
Gainfully employed ³ (1,000 persons)	28 433	29 173	29 400	8 855	7 166	6 125	37 288	36 339	35 525
Unemployed (1,000 persons)	1 883	1 689	1 780	240	913	1 350	2 123	2 602	3 150
Rate of unemployment ⁴ (%)	6.2	5.5	5.8	-	11.3	18.1	-	6.7	8.1
Consumer prices ⁵ (% change on previous year)	2.6	3.6	3 ³ / ₄	0.2	13.6	12	2.3	4.7	5
Net gov. financial investment ⁶ (DM bn.)	-	-	-	-	-	-	-	-94.4	-102
Balance on current account ⁷ (DM bn.)	-	-	-	-	-	-	79.4	-34.3	-17

¹Forecast by the participating institutes in rounded figures. ²At 1985 prices for west Germany; at 1991 prices for east Germany and the Federal Republic. ³Domestic gainfully employed. ⁴Related to civil labour force (employed and unemployed). ⁵Price index for private consumption. ⁶As defined in the national accounts. ⁷As defined in the balance of payments statistics.

Sources: Statistisches Bundesamt; own calculations.

year's wage round will be around 6%; the linear rise in wages will be lower. No far-reaching fiscal policy measures will be taken to consolidate government finances; the measures already planned will be implemented. Monetary policy will allow an increase in the M3 money supply at the upper limit of the target corridor of 3.5% to 5.5%. Interest rate cuts on the market will be underpinned by base rate cuts by the Bundesbank. Later in the year interest rates on the capital market will diminish as interest rates tend to decline worldwide and the domestic price upswell abates. The real external value of the D-mark will not alter significantly.

West German exports will benefit from the world recovery. Owing to the comparatively high wage agreements by international standards last year and this, the price competitiveness of German suppliers has deteriorated somewhat, but this will not be enough to undermine the strong market position German exporters have established over the years, particularly in investment goods. After the stagnation in the winter half-year, exports in the course of the year expand on a par with world trade, averaging a 3½% growth rate for the year as a whole.

The overall slump has a particularly marked effect on demand for investment goods. The propensity to invest has been noticeably subdued since the middle of last year, because the profit/interest ratio has been worsening increasingly. Investors will regain their confidence as soon as interest rates begin to go down and demand revives, initially from abroad. Overall though, investment can only be expected to stagnate in 1992. Growth in the building sector will be curbed by the weak economy and high interest rates. Developments in the various sectors will differ greatly however. After a brief respite, demand in residential building has revived recently. Commercial and industrial building is hampered by the poor sales and earnings expectations of businesses. Public works will

decline again this year. The main reason for this is the priority the Federal Government accords investment in east Germany. At 1½% in all, real building investment in 1992 will expand far more slowly than last year (4.1%).

Private consumption will buoy the economy this year. With wage rises lower and employment trends weaker than last year, the disposable income of private households will not expand much below the 1991 rate, mainly because certain fiscal burdens have been removed. The rise in real income, however, will be heavily offset well into the year by the forceful price rises, which will not begin to slow down until the second half. An added factor are the base effects, which will also put a brake on the rate of growth as compared with the previous year. Altogether, real disposable income for the year as a whole will rise by some 1%. The savings ratio ought not to change much at first. We can expect a decline in the second half-year, as households will advance their purchases of consumer durables in anticipation of the increase in value added tax at the beginning of 1993. All in all, private consumption will record a 1% to 1½% growth rate this year.

For the rest of the year, overall production in west Germany can be expected to achieve moderate growth, largely due to increasing demand from abroad and expanding private consumption. The demand for additional labour will decline markedly in the course of the year. Due to the overhang at the beginning of the year, though, the number of employed will still on average be nearly a quarter of a million or almost 1% higher. A mere 50,000 more people are likely to find new jobs during the year, however. The increase in the labour force, which reached almost 800,000 last year, will decline on average in 1992 to somewhat over 500,000. Given these supply and demand trends on the labour market, the annual average number of registered unemployed will rise slightly.

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

Raw Materials and Groups of Materials	1991		1992					
	AA ²	December	January	February	March	April	24. 4.	8. 5.
Total index	161.8	153.6	150.7	151.3	151.1	157.8	156.1	161.1
Total, excl. energy raw materials	136.4	133.2	132.8	130.8	131.3	132.3	132.3	132.7
Food, tropical beverages	89.0	92.0	92.3	90.4	90.4	89.3	89.1	88.5
Industrial raw materials	172.5	164.5	163.7	161.6	162.4	165.1	165.3	166.4
Agricultural raw materials	182.0	167.6	167.1	165.0	166.2	171.7	172.1	173.8
Non-ferrous metals	174.5	164.9	163.3	168.5	170.7	171.8	171.9	172.2
Energy raw materials	176.6	165.5	161.2	163.2	162.6	172.7	169.9	177.6

¹ On dollar basis. ² Annual Average.