

Hamburg Institute of International Economics (HWWA) (Ed.)

Article — Digitized Version

## The economic situation in Germany

Intereconomics

*Suggested Citation:* Hamburg Institute of International Economics (HWWA) (Ed.) (1993) : The economic situation in Germany, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 28, Iss. 3, pp. 153-156,  
<https://doi.org/10.1007/BF02928120>

This Version is available at:

<https://hdl.handle.net/10419/140403>

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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.\**

**T**he economic climate deteriorated further this spring. West Germany finds itself in a recession stemming initially from the industrial sector but now spreading to other areas of the economy. The building sector and some services have had a stabilizing effect. The decline in industrial production was so pronounced after the unification boom that even highly competitive branches and regions hitherto thought crisis-resistant have been affected. Certain successes have been achieved in realigning the east German economy to market-friendly adjustment and decision-making processes. Serious adverse trends, however, are still impeding a self-sustained upswing. The slight rise in aggregate production after the sharp decline has only been possible thanks to massive government assistance. The health of the economy as a whole is still poor because industry is under enormous pressure from costs and the market for industrial goods in west Germany is contracting.

In west Germany, the downswing that started in the summer of 1991 has now developed into a recession. Up to last autumn, utilization of overall capacity had been on the decline, but production itself had remained resilient; since then real seasonally adjusted gross domestic product has been going down substantially. The economic climate is thus worse than the institutes forecast in their joint report last autumn. The downturn was anticipated but it was not thought probable that real gross domestic product would decline as much as it has done. The institutes did, however, perceive the danger of recession: in their autumn report they pointed out that owing to widespread uncertainty amongst consumers and investors a self-reinforcement of

the downswing could not be ruled out; it was, they said, difficult to predict the dynamic of a downturn once it had begun. There was at all events a need for "powerful positive signals to bolster confidence in economic development". The assumption that such signals would be forthcoming proved in major respects to be mistaken; on the contrary, adverse influences have prevailed. Recurrent turmoil on the foreign exchange markets, for example, has had a detrimental effect on the overall climate. Although interest rates on the capital markets declined to a surprising extent, monetary policy did not fulfil expectations of lower interest rates at all at first and then only to a limited degree. Up until the conclusion of the solidarity pact in March, the uncertainty of consumers and investors was considerably fuelled by fiscal policy. It is doubtful whether the solidarity pact has actually banished uncertainties as to future tax burdens. Wages policy, though, has sent positive signals: this year's wage agreements in west Germany mark the necessary policy shift. The upswing in the USA ought to have improved the outlook as well.

The basic scenario of economic developments and their pattern for the winter six months described in the autumn report has been largely confirmed. The drop in exports and investments in machinery and equipment occurred as forecast, as did the stock shedding and the drop in consumption at the beginning of the year, which was to be expected in reaction to advance purchases made because of the planned increase in value added tax. All these developments were, however, more marked than expected. Another forecast which was confirmed by events was the comparatively favourable development in construction and in deliveries to east Germany. The decline in gross domestic product during the first quarter of the year was reinforced by exceptional influences such as the effects of the health services reform and poor weather,

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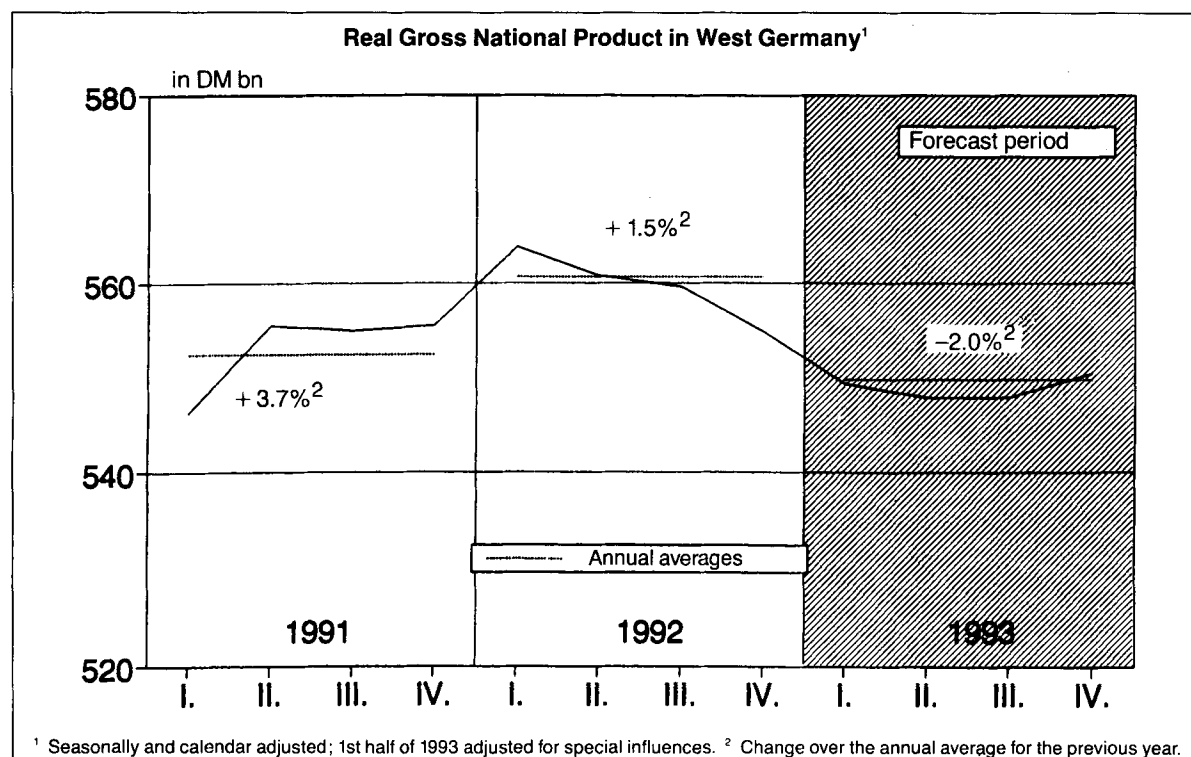
\* Participating institutes: Deutsches Institut für Wirtschaftsforschung, Berlin; HWWA-Institut für Wirtschaftsforschung, Hamburg; Ifo-Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Institut für Wirtschaftsforschung, Halle; Rheinisch-Westfälisches Institut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

which tended to exaggerate the actual downward trend. The recession in the winter six months centred on industry. Incoming orders and production dropped rapidly and utilization of capacity reached its lowest point this spring since 1983. In construction and in some services, on the other hand, there has still been a modest upward trend. The fall in employment has thus been concentrated on industry. With a growing labour supply, the number of unemployed has gone up considerably. The marked downswing has not yet been fully reflected in prices. Although producer prices for finished industrial goods have hardly risen, consumer prices increased again substantially under the influence of the rise in value added tax and of housing shortages and due to the raising of many administered prices.

The recession continues, as evidenced by the trend in incoming orders in industry, which tends to anticipate production trends. Domestic orders have not yet revived and the tendency towards stability in foreign orders cannot rate as a sign of improvement in view of the poor business conditions still prevailing in western Europe. A further downswing in the national product in the second quarter is also likely because services are being increasingly pulled into the wake of the downtrend in industry. The decline will, however, be much less severe than in the first quarter due

to the absence of the exceptional effects mentioned above. From the trend in overall economic conditions we can infer that the trough will soon be reached. Some parameters have already improved in recent months and further improvement is likely, particularly on the monetary front. The timing of the economic turnaround is, as always, very difficult to predict. We estimate that the decline in the national product will come to a halt around the middle of the year, largely thanks to the end of stock shedding, which has had a contractionary influence.

Production can be expected to recover slightly towards the end of the year as foreign demand ought to have revived somewhat by then. Business investment, in contrast, will certainly not begin to expand until next year, followed by private consumption. Doubts have been voiced as to a turnaround in the foreseeable future, citing the major role of "structural impediments". We view this as unwarranted. There has always been an inclination to overestimate the importance of such problems for economic development whenever there is a recession. Along with cyclical problems – particularly due to the collision of wages policy and monetary policy – there are unquestionably at present serious structural problems as reflected in the debate on Germany as a business location. The strength of the next upswing will certainly be affected



by this, but the turnaround depends on other factors, on the normalization of interest rate patterns, on improved interest/profit ratios, on progress in stabilizing prices and costs and on the recovery of the world economy. Some foundation stones have already been laid for this but others are still missing.

Now in the third year since German unification, the east German economy is still in a precarious state. Aggregate production revived in 1992 and gross domestic product rose by nearly 7%. Considering the dramatic drop in production in 1990 and 1991, however, this growth should not be overrated. No self-sustained upswing has yet got underway. Demand in the growth areas is largely driven by public contracts and transfers. Industrial production is stagnant and most firms are making losses. High wages remain a crucial obstacle to robust growth. The recession in west Germany and western Europe is exerting heavier competitive pressure on east German businesses and has induced many western investors to postpone or abandon involvement in the new Länder. There is reason to fear that the incipient recovery will be slowed down by the recession.

Despite rising aggregate production, the reduction in employment has still not come to a halt. The economic adjustment has created many new jobs but so far even more uncompetitive jobs have been lost, although the pace has slowed down noticeably. In 1992 average annual unemployment was registered at 1.2 million. After a slight drop in the course of the year, the number of registered unemployed rose again in early 1993. At this time some 1.8 million were kept from direct unemployment through

various job creation and retraining schemes. Besides, many job seekers no longer register with employment offices after their unemployment benefit has expired.

The weakest link in the transformation of the east German economy has proved to be manufacturing industry. The inevitable contraction has now turned into a deindustrialization which has taken on dramatic proportions. Production in east German manufacturing has sunk to a third of its original level. Some 2 million workers in this sector have been made redundant. At the beginning of 1993, production in manufacturing dropped to a new low. Incoming domestic and foreign orders declined tangibly. This is also a reflection of the recession in west Germany and in western Europe generally. The situation varies considerably from branch to branch, however. A number of branches have been expanding for some time, largely those benefitting from the upswing in private and public construction or from private consumption in their local region. In other major branches, not least in the capital goods industry, production has continued to decline. Average unit labour costs in east German industry are still about double those in west Germany. Many industrial enterprises will again have to lay off workers during the current year.

The building trade is one of the driving forces for overall recovery in east Germany. Investment in construction rose substantially in 1992, a good third up on the previous year in real terms. Incoming orders and net production rose distinctly during 1992 and this trend – leaving aside seasonal influences – has persisted into early 1993. Building activity continues to be determined largely by

## Key Data of the Forecast for the Federal Republic of Germany

	West Germany			East Germany			Federal Republic of Germany		
	1991	1992	1993 <sup>1</sup>	1991	1992	1993 <sup>1</sup>	1991	1992	1993 <sup>1</sup>
Gross national product <sup>2</sup> (% change on previous year)	3.7	1.5	-2.0	-31.4	6.8	5.5	0.6	2.0	-1.5
Gainfully employed <sup>3</sup> (1,000 persons)	29,219	29,450	28,975	7,179	6,341	6,100	36,398	35,791	35,075
Unemployed (1,000 persons)	1,689	1,808	2,300	913	1,170	1,250	2,602	2,978	3,550
Rate of unemployment <sup>4</sup> (%)	5.5	5.8	7.5	10.9	14.9	16.5	6.7	7.7	9.2
Consumer prices <sup>5</sup> (% change on previous year)	3.8	4.1	4.0	12.8	9.9	8.5	4.8	4.7	4.5
Net. gov. financial investment <sup>6</sup> (DM bn)	-93.6	-66.4	-105.5	4.5	-17.1	-17.5	-89.1	-83.5	-123
Balance on current account <sup>7</sup> (DM bn)	-	-	-	-	-	-	-32.9	-39.1	-40

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

Sources: Statistisches Bundesamt; Deutsche Bundesbank; own calculations.

public contracts and transfers from west Germany. These mainly go to support infrastructure development, but via promotion schemes they also benefit private investment in industry. There has also been a marked upward trend in residential building; spending has been increased particularly in modernization and repairs. Thanks to the discharge from liability for old debts provided to house-building associations by the solidarity pact and the increase in the support programme for housing construction, the conditions for increased building activities in this area have distinctly improved.

Investment still plays a key role in the reorganization of the economies in the new Länder along free enterprise lines. Last year, DM 109 bn were invested in east Germany, nearly three-fifths of which on buildings and just over two-fifths on machinery and equipment. Investment in plant and equipment was thus a quarter above the previous year's level in real terms. A major contributory factor to this has been the massive government sponsoring of investment. In the current year, real investment in plant and machinery will, at an estimated 15%, again rise strongly compared to the previous year, though more slowly than in 1992. The propensity to invest is more pronounced amongst privatized companies than those still under the auspices of the Treuhandanstalt. Business investment is largely determined by the commitment of west German investors. According to surveys, investments by western enterprises in east Germany will reach just about DM 50 bn in 1993, a rise of 17% on the previous year, which is well below the figure for 1992, but nevertheless quite respectable in view of the recession. The downswing has caused industrial enterprises in particular to revise their investment plans.

Aggregate production ought to grow at a similar rate in 1993 as last year. Growth will again be propelled by

construction and services. The dominance of expansionary forces, however, should not be allowed to obscure the contraction in certain branches, which will persist, and the existential problems facing many businesses. Step by step, redevelopment and the establishment of a modern capital stock will enhance competitiveness in production, but because of the recession in the west it will be difficult even for those east German enterprises that have made sizable investments and brought new products onto the market to find sales openings. The situation on the labour market will not improve in 1993. Production growth will be attended by a shift in employment from goods-producing sectors to services, but this will not entail an increase in employment as a whole. With the envisaged retraction of individual labour market policy instruments and those already withdrawn, in particular the early retirement scheme, registered unemployment can be expected to go up again, though to a lesser extent than last year. Employment will probably not rise until during the course of next year.

Altogether, then, the east German economy is still very much in a critical condition. To expedite the transformation, the expansion of investments must be continued rapidly. Judging by the assurances of the buyers of Treuhand firms, investments can be expected to increase more substantially than in 1992. Recent surveys conducted amongst west German enterprises, however, indicate that investments in east Germany will increase less in the coming year than in the current one. Presumably a major factor here is the recession in western Europe. As the downswing comes to an end in the coming year, the propensity to invest should also pick up again. This should not, however, obscure the point that the speed of the reconstruction process and the creation of new jobs depend to a crucial degree on how fast the return on business investment in east Germany improves.

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

Raw Materials and Groups of Materials	1992		1993					
	AA <sup>2</sup>	April	January	February	March	April	30. 4.	14. 5.
Total index . . . . .	160.1	157.8	148.1	151.9	153.1	153.0	154.4	150.3
Total, excl. energy raw materials . . . . .	132.1	132.3	124.2	122.9	121.5	120.4	120.5	119.9
Food, tropical beverages . . . . .	88.6	89.3	88.2	87.5	89.3	89.3	90.5	89.7
Industrial raw materials . . . . .	165.2	165.1	151.6	149.9	146.0	144.1	143.3	142.9
Agricultural raw materials . . . . .	169.8	171.7	151.1	150.2	143.3	143.4	144.0	145.0
Non-ferrous metals . . . . .	172.3	171.8	163.9	159.2	156.5	149.6	145.7	143.3
Energy raw materials . . . . .	176.5	172.7	162.1	168.8	171.6	172.0	174.2	168.1

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