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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.**

The economic downswing in Germany came to a halt in the spring of this year, but this does not yet mean that the deep recession in the west has been overcome, while the east German economy is still struggling with its adjustment crisis. In west Germany overall production has stagnated in the course of the summer half-year after the renewed pronounced decline at the start of the year. The utilization of capacity has dropped further, the number of gainfully employed has gone down substantially and unemployment has risen. In east Germany overall production has basically tended to rise in 1993, though slower than last year. Employment has gone down only moderately and unemployment has hardly risen at all.

There is much to indicate that the west German economy will not suffer another setback. In manufacturing industry new orders from both Germany and abroad have been on the rise for some time. Thanks to the vigorous rationalization efforts and the general overhaul of operations, lower wage rises and cheaper borrowing, company profitability ought to have improved. Enterprises now take a more optimistic view of their business prospects than in the spring and earnings expectations are brighter. This, economic developments abroad and the direction of economic policy both here and there give reason to hope that west Germany's economy has reached the end of the downswing. The economic trends in major non-European markets are pointing upward and the situation in Europe has not deteriorated further. The previously restrictive monetary policy has now been relaxed everywhere; the central banks have cut their interest rates substantially. After the excesses during the

boom, wage agreements have recently been much more moderate. Economic policy must however provide further impetus to make sure that the upswing in west Germany gets off to a good start soon. The parties to collective wage bargaining must signal their intention to help achieve a sustained improvement in company profits. Progress made in price stability would not be jeopardized by the recovery; the Bundesbank should quickly bring short-term interest rates down below long-term rates. This would encourage investors to give up their wait-and-see attitude. Other European countries would certainly be quick to emulate such a course by German monetary policy, which in turn would give a boost to their economies and hence stimulate the German economy as well.

Although overall production is unlikely to decline again, there are still no clear signs of economic recovery. The lasting improvement in the general economic conditions would argue for an early recovery. We had already stressed in our spring assessment that structural problems do not preclude a new upswing. The steep drop in demand in industry is largely a cyclical phenomenon. In addition to the cyclical problems, largely caused by the collision between wage and monetary policy, there are also structural distortions that weigh upon economic development, as in the past, but the turnaround of the economy depends on other factors, in particular the normalization of the interest rate structure, an improvement in the interest/profit ratio, the stabilisation of prices and costs and the global economic recovery. Advances have been made in all these areas, recently including the interest/profit ratio, which heavily influences the propensity to invest.

The forecast is based on a number of largely predictive assumptions, though some are simply postulates: production in the industrial countries will increase more rapidly in the course of next year. The oil price will not alter significantly; the world market prices for other raw

* Participating institutes: Deutsches Institut für Wirtschaftsforschung, Berlin (DIW); 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. The DIW takes a different view from the other institutes regarding the further development of business activity (cf. graph).

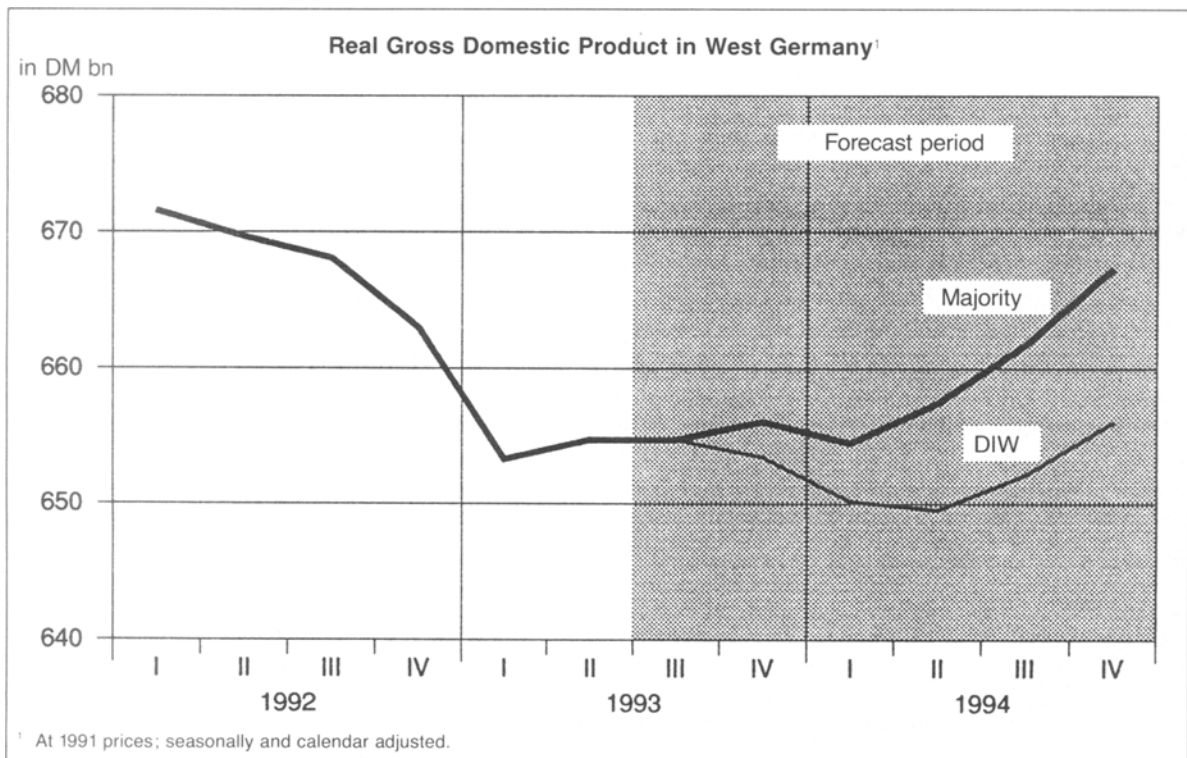
materials will go up slightly. The external value of the D-mark will tend to decline against the dollar, while remaining more or less steady against the European currencies. Demand from east Germany will rise only a little. Wage agreements will keep slightly under this year's. As regards fiscal policy the decisions taken so far will be put into effect; the possible introduction of insurance cover for nursing care has not been accounted for. Capital market interest rates will hardly decrease further. The Bundesbank will continue to pursue its policy of cutting interest rates with money market rates dropping markedly again. At the beginning of next year, short-term interest rates will be lower than the long-term rates for the first time since the end of 1990.

The cyclical conditions for German exports are expected to improve gradually. In the USA, the recovery will go on and gain some more momentum next year. In Western Europe, the downswing ought to have reached the trough; stimulating forces will prevail here too as next year progresses although the pace of expansion will be moderate at first. Admittedly, the competitiveness of German firms compared to that of contenders from most of the other West European countries has deteriorated, in some cases tangibly, due to the appreciation of the D-mark. Even though—as we assume here—the competitive positions of German firms will not worsen further, the

present adverse trend will continue to make itself felt for some time. On the other hand, the D-mark has depreciated markedly against the dollar and the yen. Competitiveness as against suppliers from the dollar bloc and in particular Japan, a major rival, has thus improved considerably on all markets. With rising demand and production in the Western European partner countries, exports to these countries will gradually start to pick up despite the real appreciation of the D-mark, but the pace will be moderate at first. Further stimuli can be expected to come from the USA and the developing countries. Exports to the Central and Eastern European reforming countries will also expand. Exports, then, will underpin the incipient upswing.

Since spring, the previous heavy decline in investment in machinery and equipment has slowed down tangibly, but a rise cannot be expected before next year. Several factors are key to a recovery in 1994. The increase in labour costs will continue to slow down given the lower wage agreements. On top of this there are the tax relief for businesses and a normalization of the interest rate structure.

Rationalization measures by businesses have much improved prospects for increases in productivity. Another important element is the better sales outlook. Demand from abroad has been on the rise since the end of last year and it will gain further momentum next year. New orders



from domestic customers have also been pointing upward in recent months. In 1994 there will be an additional upturn in domestic demand in the wake of the monetary relaxation. Thanks to this development in demand and the cost-cutting measures taken by businesses, profitability will improve soon. West Germany's building sector is presently powered solely by residential building. As regards commercial building and public construction, a cutback in production is expected. Overall construction activity in west Germany will recover somewhat next year. Residential building will continue to generate powerful impulses. Businesses, however, will remain reluctant to invest in building. Commercial building will not recover until the onset of the general revival of economic activity later on next year. Activities in public construction can be expected to continue to decline.

As in 1993, real private consumption will be below that of the previous year. Due to increases in taxes and other fiscal charges, consumption will be significantly inhibited at the beginning of 1994; it is likely to revive a little during the second half-year. The gross wages and salaries total will rise moderately as in 1993. The number of employed will decline less rapidly and the downward trend in the total number of man-hours worked will not be as steep, but at the same time effective hourly earnings will rise more slowly. For the first time since 1967, the net wages and salaries total will be below that of the previous year. Transfer income of private households will go up markedly slower than in 1993, largely due to the planned cut in social security benefits. Pensions will also be raised at a lower rate. Based on past experience, consumers will probably respond to the drop in real disposable income by reducing the savings-income ratios somewhat. The pace of price

risers has slowed down tangibly at the consumer level. In the coming months, service charges will also rise less than previously, in particular because pressure from wage increases will again slacken. The steadying of prices will continue next year. Nevertheless, partly due to the sizable rise in mineral oil tax at the beginning of the year and the renewed rise in administered prices, the price level in 1994 ought to be 3% up on 1993.

Given the low level at the beginning of the year, gross domestic product for 1993 ought to average some 2% under the previous year. Despite the marked expansion later in the year, it will only be about 1% higher in 1994. The decline in employment will continue into the coming year. The anticipated economic recovery will at first simply contribute to a reduction of short-time work and an increase in productivity. Businesses will only recruit additional workers when their labour reserves have been exhausted and the upswing has gained momentum. The labour force will continue to expand in 1994, particularly as a result of immigration. With persistent low labour demand, seasonally adjusted unemployment will go on rising until towards the end of 1994 reaching almost 2.7 million.

In east Germany the upswing this year has lost momentum on last year. Contributory factors here have been the recession in west Germany and the rest of Western Europe, impeding sales of east German products outside the new Länder and inducing western investors to curb or defer their investment projects. This will improve in the wake of a recovery in the west. Nevertheless, there is a danger that the upswing might flatten out. So far, it has been propelled by the voluminous government transfer payments from the west to the east for businesses, private

Key Data of the Forecast for the Federal Republic of Germany

	West Germany			East Germany			Federal Republic of Germany		
	1992	1993 ¹	1994 ¹	1992	1993 ¹	1994 ¹	1992	1993 ¹	1994 ¹
Gross national product ² (% change on previous year)	1.6	-2.0	1.0	9.7	6.0	7.0	2.1	-1.5	1.5
Gainfully employed ³ (1,000 persons)	29 487	28 980	28 575	6 344	6 120	6 040	35 831	35 100	34 615
Unemployed (1,000 persons)	1 808	2 260	2 600	1 170	1 150	1 170	2 978	3 410	3 770
Rate of unemployment ⁴ (%)	5.8	7.3	8.4	14.8	15.1	15.5	7.7	8.9	9.8
Consumer prices ⁵ (% change on previous year)	4.0	3.5	3.0	10.1	8.0	4.5	4.7	4.0	3.0
Net. gov. financial investment ⁶ (DM bn.)	-63.8	-91.0	-86.5	-14.7	-16.5	-23.0	-78.5	-107.0	-110.0
Balance on current account ⁷ (DM bn.)	-	-	-	-	-	-	-39.4	-41.5	-41.0

¹Forecast by the participating institutes in rounded figures. ²At 1991 prices. 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; Deutsche Bundesbank; own calculations.

households and public budgets, which have stimulated production in the building sector and in services in particular. In future, the transfer will increase at a much slower pace, which will inhibit the robust expansion in these areas. It is thus crucial that private investors be encouraged to invest more in the new Länder and that production in other branches, especially in industry, is rapidly expanded. Much progress has been made in individual cases in industry and overall production is increasing, but the unsteady pace is a gauge of how unstable the situation is. For the bulk of all industrial enterprises, the privatized ones as well as those still in the hands of the Treuhandanstalt, the high labour costs remain a very serious competitive disadvantage. That is why the number of employed in industry has continued to decline this year, although more slowly at the present very low level.

Despite the sustained high investment in the transport and communications sector and in services, machinery and equipment investment has expanded less rapidly in the current year. On the one hand, this reflects the repercussions of the recession in the west but, on the other hand, it also means a return to normal after the very rapid initial pace in 1991 and 1992. Particularly in industry, the after-effects of the recession will still make themselves felt in the earlier part of the coming year; investors intend to spin out planned investment projects. Investment activity ought not to pick up again until later in the year. Accounting for a three-quarter share in industrial investment, west German firms still play a major role. With increasing investment activity, the modernization of the east German economy will make further progress. It is to be expected that, for the first time, more will be invested per capita in the new Länder in 1994 than in west Germany.

Investment in residential building is increasingly gaining momentum. The rise in rents and the improved

general conditions, such as the arrangements for the old debts of housing companies in the Federal Consolidation Programme and the replenishment of the KfW development programme have triggered a surge in new orders. With a 25% growth rate, residential building will remain the major driving force for growth in building investment in 1994 as well. Whereas modernization of existing housing has so far been predominant, the construction of new housing is now also gaining in importance, although uncertainty about future income trends is a retarding factor. In view of the narrower financial scope available to public authorities, public building will expand less rapidly than in previous years. Commercial building will also register more moderate growth due to the reduced propensity of west German firms to invest.

Production will keep to its upward path in 1994. The pattern will hardly alter at all: the expansion will continue to be marked by building construction and related areas in industry and crafts. Given the slow pace of real income growth, the performance of trading and service firms will improve much less rapidly. Production growth in industry will continue but the picture is fragmented: alongside high growth branches, there will still be branches whose production can only be sustained with the help of public funding, and those that will contract tangibly. A modern capital stock is being built up and new factories are starting up but not to the extent needed to keep employment steady. The labour market will therefore remain under pressure, with unemployment probably sticking to 1.2 million. During 1994, the number of those that have escaped unemployment thanks to short-time work, job creation schemes, full-time further training or early retirement will also keep to more or less the same level. The decline in employment should come to a halt in the latter course of the coming year. Gradually, more jobs will be created than are lost.

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

Raw Materials and Groups of Materials	1992		1993					
	AA ²	October	July	August	September	October	5. 11.	19. 11.
Total index	160.1	165.5	141.1	141.7	139.2	142.1	137.6	137.3
Total, excl. energy raw materials	132.1	130.3	119.3	118.5	118.3	117.0	118.0	118.7
Food, tropical beverages	88.6	84.7	92.1	91.3	92.4	93.2	95.5	97.8
Industrial raw materials	165.2	165.0	140.1	139.2	138.0	135.2	135.1	134.7
Agricultural raw materials	169.8	170.4	137.5	136.0	136.4	135.4	135.0	134.8
Non-ferrous metals	172.3	167.7	145.7	144.9	138.3	129.8	130.1	129.6
Energy raw materials	176.5	186.1	153.8	155.2	151.4	156.8	149.0	148.1

¹ On dollar basis. ² Annual Average.