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## The economic situation in Germany

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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 situation in Germany has improved. After the downswing in west Germany bottomed out in the spring of 1993, aggregate production has, however, only risen slightly. The number of unemployed has not gone up quite as rapidly as in the two previous years. In east Germany the pace of growth in 1993 remained high; it ought to have accelerated somewhat in the course of the year. The number of employed has continued to fall, but only a little, while after temporary stagnation the unemployment figures rose again in the winter half-year.

There are many indications that aggregate production in west Germany has picked up considerably now that the overall economic conditions have much improved. Foreign orders in manufacturing have been on a distinct upswing for over a year. The Bundesbank has continued its policy of gradual monetary relaxation which it embarked on in autumn 1992; short-term interest rates are now somewhat below capital market rates, which dropped sharply until the beginning of the year to rise again afterwards. The interest rate decline has made financial investment much less attractive and substantially cut the cost of finance for businesses. The attractiveness of real investment has also risen because of a marked increase in business profitability. Capacity has been shut down on a large scale in manufacturing and a large number of workers made redundant. The low wage rises in 1993 as compared with previous years have also contributed to cutting unit labour

costs significantly, which means that the break-even point is now reached at a far lower rate of utilization of capacity than before the recession.

This year, the strong economic expansion in the United States and in many Southeast Asian countries will continue and recovery has begun in the West European partner countries. The Bundesbank will continue to lower its interest rates especially as the price upswell will recede a little more, and capital market interest rates ought to decline a little. Earnings expectations of businesses have brightened up considerably thanks in particular to the wage agreements this year. The low wage rises and greater flexibility in pay and employment of labour and broader scope in scheduling working hours means that more account can be taken of individual company needs and enterprises can adjust better to the ups and downs of economic activity as well as to changes in other factors affecting their business. Altogether, aggregate production can be expected to pick up noticeably this spring. The improved economic outlook does not mean, however, that the course has already been set for robust growth and high employment in west Germany.

Aggregate production in eastern Germany expanded less last year than in the previous year, but the pace remained high overall, which is all the more remarkable considering that the recession in west Germany and the rest of Western Europe may be expected to have had an adverse effect on sales opportunities for east German products and to have induced a stretching of investment in the new Länder. The increase in public transfers from west to east has also slowed down substantially. There are indications that the transformation process in the east German economy has made marked progress and self-

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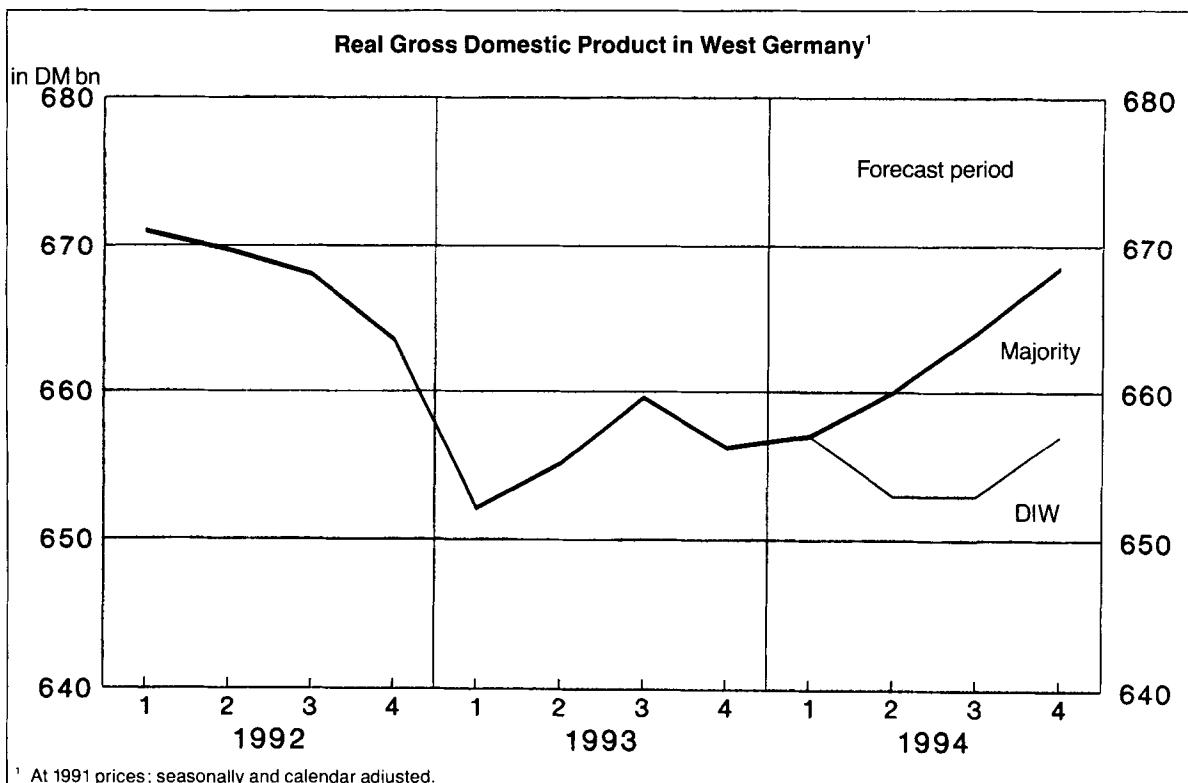
\* Participating institutes: Deutsches Institut für Wirtschaftsforschung, Berlin; HWWA-Institut für Wirtschaftsforschung, Hamburg; Ifo-Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Institut für Wirtschaftsforschung Halle; Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen. The DIW takes a different view from the other institutes regarding the further development of business activity (cf. graph).

sustained growth is discernible at least in some individual areas. Industrial production has now stepped up a lot and is expanding faster than the overall economy. After the powerful contraction process, however, industry takes up a very small proportion; services and above all building construction are still the motors of growth, with residential building making a growing contribution.

Adjustment success is reflected by the fact that the expansion of east German domestic demand is being increasingly met by local production. Investment has become the major impetus for growth whereas private consumption provided only little support in 1993. Private consumption cannot be expected to expand as rapidly in the coming years as in the first years after unification since the increase in both wages and transfer incomes will be much smaller. Key, then, is a sustained investment dynamic, in particular in industry. Investment activity here has been keen so far, but it cannot be ruled out that with the completion of major investment projects by western companies the upswing could gradually level off. Industrial production growth is still heavily attributable to individual large-scale projects by western investors now entering the production stage. As a whole, developments in industry remain too narrow and labour costs are still a crucial constraint on the establishment and expansion of small and medium-sized enterprises.

The forecast is based on a number of largely predictive assumptions, though some are simply postulates: production in the industrial countries will rise more rapidly in the course of the year. The oil price will alter little and the world market prices of other raw materials will increase moderately. The external value of the D-mark will tend to diminish against the US dollar and remain more or less constant against the other European currencies. The impending wage agreements will be similarly moderate as those already concluded this year. As regards fiscal policy the decisions taken so far will be implemented; we do not assume any other decisions of significance for the developments this year. Interest rates on the capital market will drop again to below the 6 percent mark. The Bundesbank will proceed with its policy of monetary relaxation and the money market rates will show a further significant decline.

There are growing signs of an impending economic upswing. The cyclical factors that were decisive for the past recession are now favourable enough. There are still structural shortcomings, in particular rigidity in many economic sectors, not least on the labour market, and the unsolved problems of government finance, but they will not prevent a new upswing. In the view of five of the six participating institutes, the economy will now resuscitate, at first in response to growing foreign demand. In the latter



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half of the year, the rate of utilization of the overall production potential, which is growing by some 2½% a year, will start increasing again. Not until this has happened is the term upswing warranted. The economic development will probably be overshadowed throughout 1994 by declining employment and rising unemployment. Whether a high level of employment is reached in the following years will depend largely on wage policy.

The world economic conditions for exports have improved further. In particular in the European countries which are specially important for German exports demand and production have started to expand. Evidently the appreciation of the D-mark against a number of European currencies in 1992 is no longer acting as a constraint on German exports; more vigorous efforts by German business to cut costs have also had a positive impact here. Another real appreciation of the D-mark against the other European currencies appears unlikely. With the appreciation of the dollar and the yen in the course of last year, the international competitiveness of the German economy has tangibly improved as against its competitors in the dollar bloc and Japan. This gives grounds to expect a marked rise in exports, which will accelerate further in 1995. Exports are thus the motor force of the economy.

Major factors point to a recovery in investment activity during 1994: according to the Ifo-institute's survey, current earnings of manufacturing enterprises have improved in recent months. Their earnings and sales prospects have improved even more. The sweeping cost cuts by German

businesses have started to have a positive effect on earnings prospects and thus the propensity to invest. The moderate wage agreements concluded this year further ease cost pressure on businesses. The recovery of overall demand will also make for a sustained improvement in profitability. Furthermore, financial investments are becoming increasingly less attractive relative to real investments because short-term interest rates are falling and the interest rate structure is returning to normal. The recovery of investment in machinery and equipment will make slow progress at first but gain momentum in the second half of the year. Building activity as a whole will expand slightly in 1994. Residential building will continue to underpin the economy thanks to the sustained high demand, the subsidies still in effect and low interest rates. Commercial building will not pick up again until later in the year, when investors are convinced that the upswing has taken hold. Public building investment will continue to decline.

Already weak demand on the part of private households has come under even more pressure from the heavier fiscal burden. The past recession also has a delayed dampening effect on the development of wages and salaries. In the face of rising unemployment, the trade unions have been prepared to make substantial concessions in this year's pay rounds: effective wage rises have kept to between 1% and 1½%. Allowing for a further reduction in the number of employed and in hours worked this year a declining wages and salaries total is thus to be expected. Income losses due to the dismissal of

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

	West Germany			East Germany			Federal Republic of Germany		
	1992	1993	1994 <sup>1</sup>	1992	1993	1994 <sup>1</sup>	1992	1993	1994 <sup>1</sup>
Gross national product <sup>2</sup> (% change on previous year)	1.6	-1.9	1.0	9.7	7.1	7.5	2.1	-1.2	1.5
Gainfully employed <sup>3</sup> (1,000 persons)	29,487	29,014	28,575	6,344	6,128	6,070	35,831	35,142	34,645
Unemployed (1,000 persons)	1,808	2,270	2,600	1,170	1,149	1,220	2,978	3,419	3,820
Rate of unemployment <sup>4</sup> (%)	5.8	7.3	8.4	14.8	15.1	16.0	7.7	8.9	9.9
Consumer prices <sup>5</sup> (% change on previous year)	4.0	3.4	3.0	10.1	7.9	4.0	4.7	4.0	3.0
Net. gov. financial investment <sup>6</sup> (DM bn.)	-	-	-	-	-	-	-78.5	-101.8	-100
Balance on current account <sup>7</sup> (DM bn.)	-	-	-	-	-	-	-39.4	-36.2	-28

<sup>1</sup>Forecast by the participating institutes in rounded figures. <sup>2</sup>At 1991 prices. <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.

labour will only be partially offset by unemployment benefits. On top of this, social security benefits will be cut further. As a whole, the disposable income of private households in west Germany will be 1½% up on 1993; in real terms, this means another substantial loss. Consumers will probably respond to the renewed drop in real income by spending less. The reduction will, however, be partly compensated by curtailments in saving, in particular as saving is less attractive due to low interest rates. Consumer prices will rise at a slower pace due to still weak overall demand and less pressure from the cost side. Price rises will be even less pronounced next year.

The uptrend in demand has not yet had an effect on the labour market. As the recovery proceeds, first of all working hours will be raised and not until the upswing has gained momentum will new workers be recruited. The decline in demand for labour ought to continue in the course of the year. It will only be towards the end of the year that the decline in the number of employed will come to a halt. The potential force will increase in 1994 by about 150,000, so labour supply will expand far less than in the previous year, in particular as immigration is diminishing. Given still low demand for labour and growing supply, the seasonally adjusted number of employed will not stop increasing until the turn of the year.

At 7%, aggregate production growth in east Germany in 1993 was still pointing upward. Manufacturing also contributed for the first time to production growth, which had till then been largely sustained by the building industry and the services sector. Compared with 1992 industry raised production in 1993 by close on 10%. In the building sector the uptrend in production kept up almost the same pace. Due mostly to sluggish growth in consumption by private households, gross value added recorded lower growth rates in services and trade. Despite rapid growth in production, the situation on the labour market has not eased. In the first half of 1993, the number of

unemployed went down on the previous year, only to rise again in the second half, partly due to the marked cut in public labour market spending. In all, an annual average of 1.5 million were spared open unemployment by labour market policy measures; at the end of the year, the figure was 1.3 million.

Last year production grew faster than demand for the first time. Investment became the most dynamic part of domestic demand. On a per capita basis gross fixed capital formation in east Germany has now overtaken that in west Germany. Investment activity has had to be supported to a large degree by public funds. In the coming years these transfers will probably not be increased further, i.e. investment funds will increasingly have to be earned by businesses themselves. To that end the cost level must fall tangibly; if employment is not to decline in the process, wage adjustments must slow down further. The backlog on the productivity front has narrowed, but unit labour costs are still some 50% higher than in the west.

Altogether, aggregate production in eastern Germany will grow by some 7½% in 1994. As the reconstruction of infrastructure and the economy will take time, the building trade will inevitably continue to play a major role and its growth rates will remain two-digit. The powerful growth in production will, however, still be attended by weak demand for labour in the face of high rationalization pressure. Another reason why the labour market cannot be expected to improve are the cutbacks in financing the "second" labour market. Nevertheless, the east German labour market should bottom out in 1994. The decline in employment in manufacturing ought to come to a stop by the end of the year. In agriculture and forestry, power supply and mining as well as the state sector and transport, however, the decline will continue. Increased employment can be expected in the building sector and services as well as in retailing.

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

Raw Materials and Groups of Materials	1993		1994					
	AA <sup>2</sup>	April	January	February	March	April	6. 5.	20. 5.
Total index . . . . .	144.3	153.0	130.3	130.0	129.3	137.7	145.6	148.9
Total, excl. energy raw materials . . . .	120.0	120.4	124.6	126.8	128.9	130.6	135.2	139.5
Food, tropical beverages . . . . .	91.4	89.3	99.7	99.4	100.3	100.7	105.0	110.9
Industrial raw materials . . . . .	141.7	144.1	143.4	147.7	150.7	153.5	158.2	161.3
Agricultural raw materials . . . . .	140.9	143.4	144.8	150.2	155.1	162.2	167.2	165.7
Non-ferrous metals . . . . .	145.0	149.6	142.7	147.8	148.9	146.9	153.7	166.7
Energy raw materials . . . . .	158.5	172.0	133.7	131.9	129.5	141.9	151.8	154.4

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