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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.**

Since the spring, the German economy has been on the upswing again. After the west German economy emerged from recession in the second half of last year, the expansive forces have gained the upper hand: foreign and domestic demand are expanding substantially and the growth of gross domestic product has exceeded that of production capacity for the first time in two years. At the same time, reconstruction in the new federal states has made further progress, with production continuing to register robust growth, recently in manufacturing as well. The decline in employment and the rise in unemployment have come to a halt in both west and east Germany and there are signs of a slight improvement. Altogether, the expansive forces in the German economy have distinctly firmed and prospects are bright for a sustained upswing next year as well.

The economy in west Germany in the first half of the 1990s has been undergoing a sequence of boom, recession and upswing; this basic economic pattern does not differ essentially from earlier cycles despite the economic shock of reunification and the much discussed issue of Germany as an industrial location. The recent pick-up in economic dynamic comes as no surprise. The stimulus to the economy initially came from abroad: foreign orders in manufacturing already rose throughout last year, as of autumn at a rapidly accelerating pace; in

spring they exceeded the level attained prior to the recession. The major improvements in general conditions at home have been the progressive relaxation of the monetary reins, the pronounced drop in capital market interest rates up to the beginning of the year and the moderate wage agreements last year and this, which took into account the deterioration in profits due to the recession and the sharp drop in employment. Improved profitability prospects thanks to moderate wage claims and forced rationalization on the one hand and the clear drop in interest rates on the other had, by the beginning of the year, initiated a positive trend in the interest/profit ratio, which boosted the propensity to invest. Since as early as mid-1993 the business climate had been improving continuously; this trend has persisted up to the present.

The recovery of the west German economy in the second half of 1993 was only sluggish. Despite the sharp rise in taxes at the beginning of 1994 the upswing has since gained momentum rapidly. In addition to continued brisk growth in exports, domestic demand also made a marked contribution to this. Aggregate production rose unexpectedly strongly in the summer half-year at a seasonally adjusted annual rate of between 3% and 4%. After declining for two years in a row, utilization of production capacity has now picked up considerably, which has eased the labour market situation. The decline in the number of persons employed bottomed out; in the course of the summer half-year it almost came to a standstill. Unemployment also stopped rising. At 8.3%, the rate of unemployment has reached its 1985 peak.

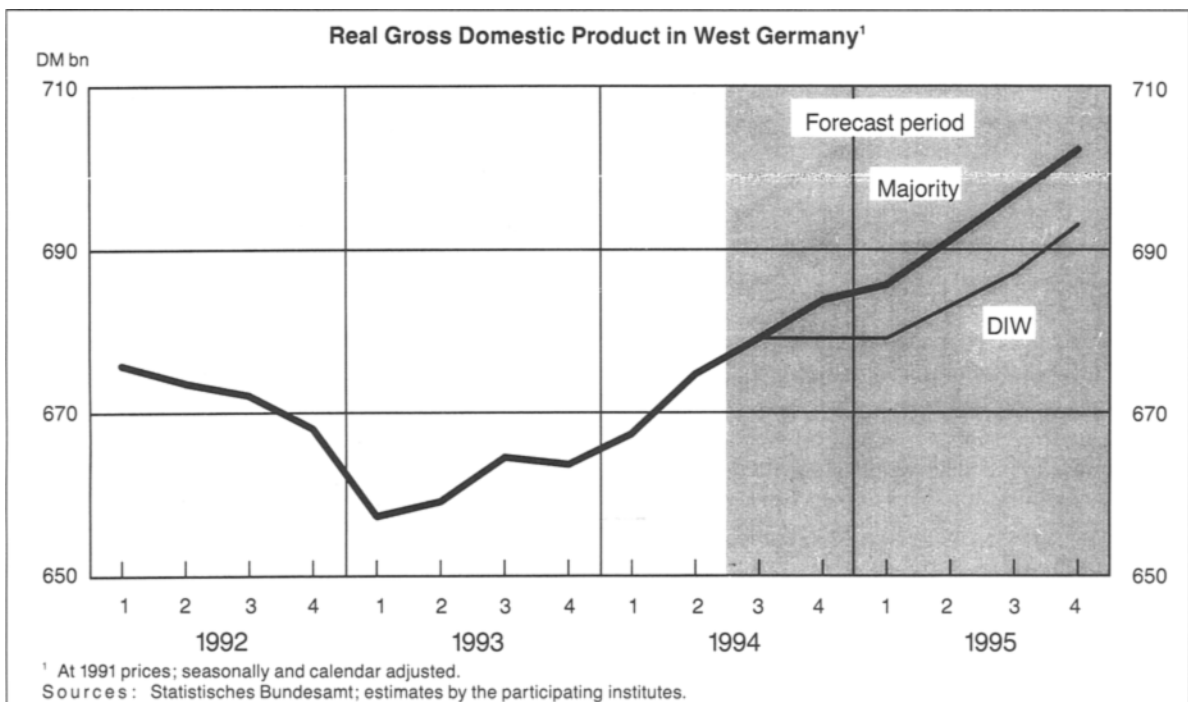
The reversal in stockbuilding was a major contributory factor to the increased growth in domestic demand in the

* Participating institutes: Deutsches Institut für Wirtschaftsforschung (DIW), 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).

summer half-year. This is a typical sign of the beginning of economic recovery: businesses in this phase adjust their stocks to their improved sales expectations and more inputs are tied to the production process as industrial production in particular picks up. As experience with earlier cycles shows, the recovery of domestic demand usually starts with investment. After the trough at the end of 1993, investment in plant and machinery rose only slightly up to the middle of the year, although there are reasons to assume that the figures available tend to underplay the trend. A definite upswing should now be underway since the propensity to invest has risen tangibly, as the growth in domestic orders in engineering in particular shows. Building investment is rising considerably faster than expected this year, largely borne by residential construction, which has been stimulated very strongly by the fall in interest rates up to the beginning of the year and by government promotion schemes. Growth in the disposable income of private households is still being substantially impeded by the aftermath of the recession as well as by the increases in taxes and cuts in various social benefits. The propensity to save ought not to have diminished further after the clear decline up to the beginning of the year and private consumption has recently tended to stagnate.

The economic revival in west Germany has improved the general conditions for economic development in east

Germany. Firstly, sales opportunities in the old federal states improve, and secondly, the higher propensity to invest on the part of western business also benefits locations in the new federal states. Altogether, however, cyclical impulses still play a secondary role as compared with that of the transformation process. Despite persistent constraints and friction, rapid progress is being made with the help of massive government financial transfers: this year's aggregate production is rising at a current rate of 8% to 9%. The uptrend has also broadened its base. Above all, there has been strong growth in manufacturing, although from an originally very low level and with large differences from branch to branch. Production here in the summer half-year topped the previous year's level for the same period by about a fifth. Building and construction, too, which have benefited to a special degree from the voluminous public investment in modernizing infrastructure and from the vigorous revival of demand in residential building, are still undergoing very rapid expansion. The progress achieved in adjusting to market conditions and the attendant surge in production are slowly providing support to the labour market. Apart from seasonal fluctuations, the number of persons employed has at least stopped declining since the spring of 1993. The number of unemployed in recent months has been somewhat below that of a year ago. At nearly 15% of the labour force, however, the rate of unemployment remains very high.



The high growth in production derives its main stimulus from investment. A major contributory factor to the advances made in the transformation process are still the public financial transfers. Including the credit-financed expenditure by the Treuhandanstalt for the transformation of the economy, they amount this year to some 50% of east Germany's gross domestic product. These transfers are intended to close the gap between economic performance and income. This gap has diminished only a little both last year and this, but it looks as if next year gross domestic product will rise distinctly faster than domestic demand. How far east Germany is from self-sustaining growth, i.e. growth independent of large-scale government assistance, can be seen from the level of aggregate unit labour costs. Despite a marked decline, these still exceed the west German figure to the order of a third. Nevertheless, the fact that along with east German per capita building investment, per capita investment in plant and machinery this year is also substantially higher than in west Germany provides evidence of the vigorous efforts of business to make speedier progress in this direction.

With the upswing in west Germany and the sustained high economic growth in east Germany, the German economy has left its weak phase of the last two years behind, but future economic development is still subject to risks. In particular, the rise in the capital-market interest rate by nearly two percentage points, which offset nearly half of the reduction since the beginning of 1991, has given rise to concern that this could very soon have a marked impact on the propensity to invest, which would

jeopardize future growth. An interest rate rise of this order is without doubt an impediment, but a large part of the current rise is due precisely to increased investment activity at home and abroad, which has raised demand for capital worldwide. A contributory factor in Germany, as in many other countries, is the improvement of the interest/profit ratio thanks to cost cuts following the fact that sales and earnings losses in the recession compelled businesses to seek and take advantage of rationalization opportunities. The sharp decline in employment in Western Europe in recent years and an accelerated rise in productivity reflect this development. At the same time, moderate wage rises have brought about a substantial improvement in the cost/earnings ratio of businesses.

Taking this into account, there is much to indicate that the burden placed on the profitability of investment by a rise in the capital-market interest rate, as has occurred since the beginning of the year, will not halt the investment upswing which is underway in Germany and many other West European countries. Rather, the fundamental trend in the economy remains a pronounced rise in overall production. This is stronger than the growth in capacity. The sizable rises in taxes and social charges planned for the start of 1995 will only temporarily impede the cyclical expansion of demand and production, but in the medium term they will have a lasting impact. The upswing facilitates progress in the solving of structural problems, which were often, during the downswing and recession, overestimated compared with cyclical determinants in the search for the causes of the sharp drop in capacity

Key Data of the Forecast for the Federal Republic of Germany

	West Germany			East Germany			Federal Republic of Germany		
	1993	1994 ¹	1995 ¹	1993	1994 ¹	1995 ¹	1993	1994 ¹	1995 ¹
Gross national product ² (% change on previous year)	-1.7	2.0	2.5	5.8	8.5	8.5	-1.1	2.5	3.0
Gainfully employed ³ (1,000 persons)	28,994	28,650	28,725	6,273	6,300	6,375	35,267	34,950	35,100
Unemployed (1,000 persons)	2,270	2,560	2,525	1,149	1,160	1,075	3,419	3,720	3,600
Rate of unemployment ⁴ (%)	7.3	8.3	8.2	14.8	14.9	13.9	8.8	9.6	9.3
Consumer prices ⁵ (% change on previous year)	3.2	3.0	2.5	8.4	3.5	2.5	3.9	3.0	2.5
Net. gov. financial investment ⁶ (DM bn.)	-	-	-	-	-	-	-105.1	-97	-93
Net. gov. financial investment ⁶ incl. the Treuhandanstalt (DM bn.)	-	-	-	-	-	-	-143.2	-137	-93
Balance on current account ⁷ (DM bn.)	-	-	-	-	-	-	-33.2	-45	-35

¹Forecast by the majority of the participating institutes in rounded figures. ²At 1991 prices. ³Domestic gainfully employed. ⁴Related to domestic 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.

utilization and employment. Now, however, there is a tendency to underestimate them in the light of the improved economic climate. The foreseeable general economic conditions and the incipient growth in demand have prepared the ground for an upswing well into next year, but this should not distract attention from the key task which is now to lay the foundations for sustained growth in Germany beyond the short term.

The forecast is based on a number of assumptions, themselves largely based on predictions. World economic recovery will continue this year and next at a steady pace. World trade will continue to expand strongly. The price of oil will rise slightly and the price increases of other major raw materials on the world market will slow down substantially. The D-mark will tend to drop somewhat in value as against the US dollar and remain more or less constant against the other European currencies. The wage agreements in the old federal states will be slightly higher in 1995 than this year. Wage rates in the new federal states will approach the western level less rapidly than to date. Fiscal policy will keep to its pledged consolidation course; we do not assume any new decisions of significance for short-term developments. Interest rates on the capital market will decline slightly during the period under consideration. The Bundesbank will continue to gear policy to money supply; no further significant reductions will be made in discount rates.

In west Germany the upswing in production will continue next year. Exports and investments in plant and machinery will continue to drive expansion. Building and construction will lose impetus a little. Private consumption will boost aggregate production later in the year. Industrial production as a whole will expand strongly. The east German economy will also benefit from the recovery in west Germany and in the other industrial countries.

Nonetheless, the recovery in those areas of east German industry which are regarded as its industrial core, such as chemicals, electrical and mechanical engineering, has only just got underway. With the continued expansion of infrastructure, rapid growth in residential building and the rise of new industries, the pace of building activity will remain high. The services sector, wholesale trade and transport will expand substantially, particularly in the production-allied areas. Real gross domestic product per capita in 1995 will slightly exceed half that in west Germany.

The rise in production in the summer half-year has had an effect on employment in both west and east Germany. The situation on the labour market in west Germany has eased slightly. Demand for labour will, however, increase only slowly at first. Businesses will use up personnel reserves and pay overtime to step up production. Employment will not rise tangibly until the second half of 1995. In the course of next year 130,000 additional persons will find a job. The labour force will grow little in 1995. There are demographic reason for this but it is also attributable to lower immigration. As employment ought to grow faster than the supply of labour, the number of unemployed ought to drop, in particular in the second half of the coming year. The situation on the labour market in east Germany has improved slightly in recent months. The trough in employment trends has probably been passed. Employment gains next year will be largely concentrated in the services sector, while government will cut back on staff. In industry, employment will not increase noticeably at first; expanding production will continue to be attended by high productivity growth. This improvement will continue throughout 1995; average annual unemployment can be expected to drop by just short of 100,000. Labour policy measures will contribute less to easing the labour market situation next year than in 1994.

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

Raw Materials and Groups of Materials	1993		1994					
	AA ²	October	July	August	September	October	4. 11.	18. 11.
Total index	144.3	142.1	160.8	157.0	155.1	156.6	162.9	158.1
Total, excl. energy raw materials	120.0	117.0	148.9	149.0	155.7	156.4	158.2	159.7
Food, tropical beverages	91.4	93.2	124.4	122.3	128.5	123.8	121.2	121.5
Industrial raw materials	141.7	135.2	167.5	169.3	176.4	181.2	186.4	188.7
Agricultural raw materials	140.9	135.4	171.4	176.7	185.7	191.5	194.6	194.7
Non-ferrous metals	145.0	129.8	177.3	173.5	181.3	187.3	200.7	209.8
Energy raw materials	158.5	156.8	167.8	161.7	154.8	156.7	165.6	157.3

¹ On dollar basis. ² Annual Average.