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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.**

The forces supporting an increase in economic activity have firmed in Germany. There has been a pronounced increase in exports up to the present and business investment, the major economic motor, is expanding rapidly. On the other hand, the sharp rise in duties and taxes at the beginning of the year has temporarily dampened consumption. Utilization of capacity rose substantially last year, particularly in industry. On the labour market in both west and east Germany a slight drop in unemployment signals a gradual turn for the better. The market rise in the value of the D-mark against the dollar and some other Western European currencies is, however, depressing the economic climate because of fears of sales and earnings losses particularly in export-directed branches acting as a brake on the economy.

In west Germany, the recovery which got off to a faltering start two years ago continued with a more powerful upswing last year. Crucial was a sustained improvement in general conditions. Capital market interest rates declined markedly up to the beginning of 1994. Underpinned by the stabilization of prices and wages that got under way under the pressure of declining utilization of capacity and growing unemployment in the recession, the monetary reins were progressively loosened from the autumn of 1992 onward. At the same time businesses laid the ground for marked increases in earnings through sweeping rationalization. Unit labour costs in industry, which had already started to go down with stagnating production, thus fell steeply in the upswing. Under these circumstances, the propensity to invest improved substantially last year. A conducive factor was the improved utilization of capacity as a result of demand stimulus from abroad, in particular from non-European regions at first. On top of this, west German suppliers benefitted to a particularly high degree from

reviving demand in the rest of Western Europe. After the considerable appreciation of the D-mark from autumn 1992 to spring 1993, their competitiveness had improved again as a result of adjustments of cost and product structures.

Adjusted for seasonal variation, aggregate production in west Germany has grown at an annual rate of about 3% since spring 1994. Only in the first months of the current year was the pace distinctly slower. With the customary delays, the labour market is showing first signs of improvement. The number of employed had evidently reached its cyclical low during the winter half-year. As early as the middle of last year the number of jobless started to decline after the unemployment rate had been on a level with its previous peak in 1985. Growth in domestic demand, which last year – unexpectedly for some – had made an early contribution to the upswing, slowed down temporarily in the winter half-year, in particular because private consumers exercised restraint: running counter to the first cyclical impulses for private household incomes resulting in particular from higher total hours worked were the reintroduction of the solidarity surtax and the introduction of the nursing insurance contribution at the start of this year. Unlike the response to higher deductions from wages a year previously, there was no increased falling back on savings. Demand from the business sector, in contrast, remained keen. Business capital spending, particularly on machinery and equipment, rose at an increased pace. Up to the turn of the year residential building also acted as a major engine for growth impelled in turn by higher profitability due to higher rents as a result of housing shortages in recent years, to moderate interest rates and sizable government support.

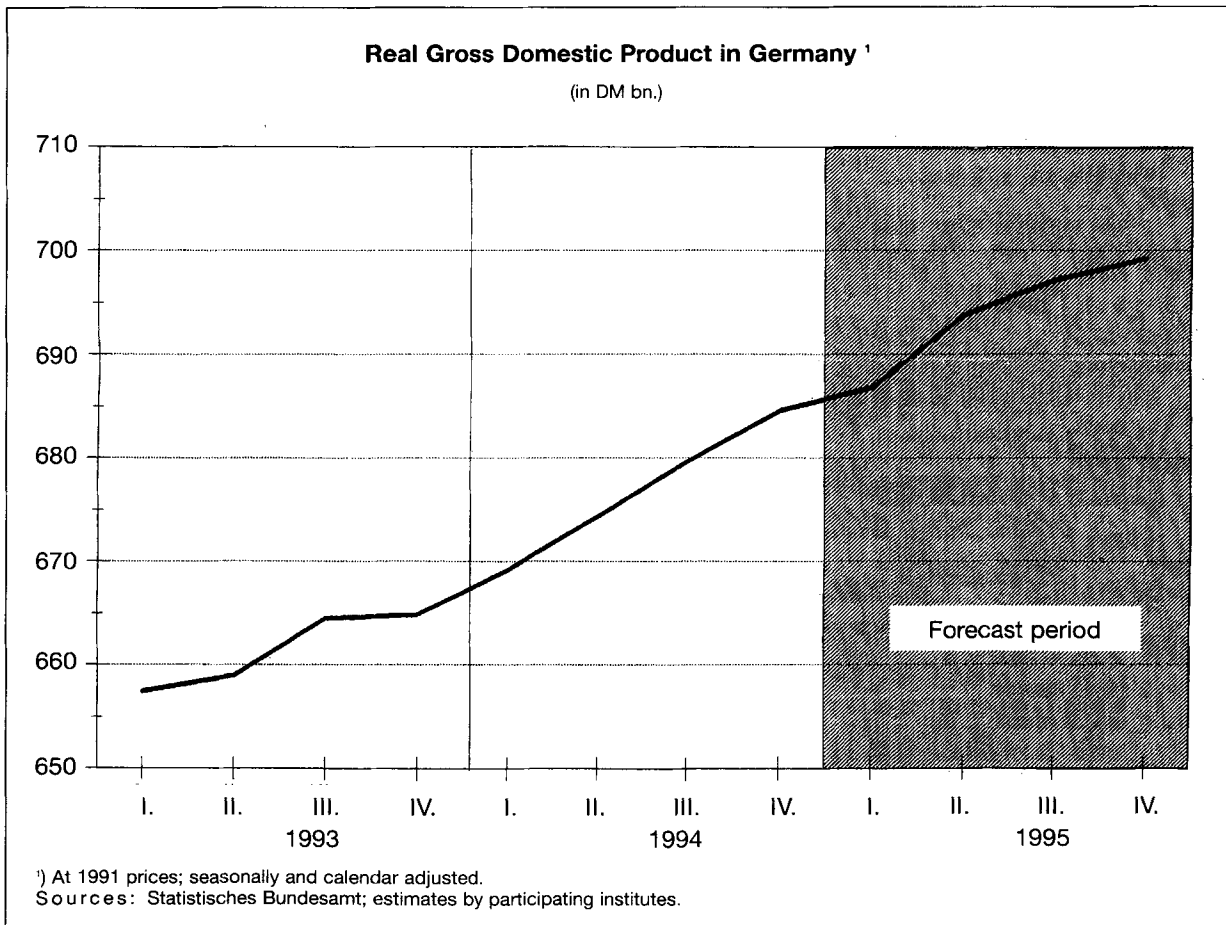
East Germany has continued to make progress in transforming its economy and catching up with its western counterpart. Production has gone on expanding at the same pace, with cyclical growth forces playing a part for the first time. Sales opportunities in west Germany in particular improved and, according to surveys on investment projects,

* 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.

west German businesses made additional investments. Key impulses are still being generated by economic policy which, by means of high financial transfers, seeks to overcome the serious shortcomings and constraints that still exist in companies and infrastructure, and promotes private consumption. Real growth in gross domestic product of over 9% in 1994 and a sustained rapid rise this year are certainly indicators of considerable success. These high rates must however be seen against the backdrop of the deep recession at the beginning of the 90s. Nevertheless the basis for the economic recovery is now widening as a growing number of industries are participating in the expansion. A central role is still being played by the surge in building investment, to which residential building is now a larger contributory factor than commercial and public building. The impulses emanate beyond the building trade to many related sectors, one reason why industrial production ought to be about 15% up on the level recorded one year ago. In some traditionally heavily export-oriented industries the present low competitiveness still stands in the way of a tangible

recovery, but as a whole reindustrialization is under way in east Germany. The overall dynamic has also had a turnaround effect on the labour market: the seasonally adjusted number of employed rose throughout 1994 with unemployment on the decline.

Nearly five years after economic union the question is whether the catching-up process in east Germany has now gained its own momentum. There are signs that this is the case. Public financial transfers have ceased to rise this year. With a persistently fast production growth the size of transfers will diminish in proportion to aggregate production. Analogous to this, east German gross domestic product is expanding slightly faster than aggregate demand although it is currently only just about half the size of the latter. The slight expansion of exports to other Western countries is also a sign that small advances have been made on the way to greater competitiveness; the level of exports is extraordinarily low, however. A major obstacle to a rapid improvement in competitiveness on an expanding base is the progressive approximation of wages



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towards the west German level. There are large disparities between individual cases but generally earnings prospects for enterprises competing with west German and foreign suppliers are still poor. The high increase in business investment is largely the result of government support measures.

The forecast is based on a number of largely predictive assumptions, though some are simply postulates: a continued robust expansion in demand and production in the Western industrial nations this year; strong growth in world trade, though at a somewhat slower pace; stable oil prices and only a small rise in world market prices for industrial raw materials; a slight drop in the D-mark against the dollar while the former remains more or less steady against the European currencies; pending wage agreements' keeping within the limits set by agreements so far; no new measures adopted in financial policy taking effect this year; little change in capital market interest rates after the marked drop in recent months; no short-term changes in the Bundesbank's key interest rates.

The firmer upswing in the west and the continuously strong growth in east Germany are attributable to factors that in themselves make for a continued rapid upward trend in the current year. This holds both for the general economic policy conditions and the economic climate abroad, particularly in Western Europe. In recent weeks, however, the economic climate has been clouded by unforeseeable factors and the attendant risks. These include the high wage agreements threatening to depart from the pay rate

policy course embarked upon during the recession and which is geared to creating/protecting jobs, and above all the D-mark's steep appreciation against the dollar and several Western European currencies. Assuming little realignment in the altered exchange rate relations even after the speculative forces have abated, this can be expected to have retarding effects on the development of economic activity. The strength of these effects depends on the responses of business at home and abroad and in particular on economic policy. The higher D-mark exchange rate makes production in Germany more expensive in comparison with that in countries whose currencies have depreciated. This tends to dampen exports and stimulate imports. Experience shows however that, for the time being, many national producers will try to uphold their market position through price concessions. This is one reason why foreign trade flows will probably show a delayed reaction to the appreciation of the D-mark. Earnings of businesses engaged in international competition will be impaired as a result of smaller profit margins or lower sales; as a rule, this can only partially be offset by lower import prices.

The relative competitiveness of the other businesses, in contrast, will improve, but it will take time for them to raise supply. The adjustment process as a whole is supported by the decline in interest rates resulting from the slower expansion of demand and the improved stability outlook. To the extent that lower import prices are passed on to consumers, this in itself will raise their real income. Owing to the

Key Data of the Forecast for the Federal Republic of Germany

	West Germany			East Germany			Federal Republic of Germany		
	1993	1994	1995	1993	1994	1995	1993	1994	1995
Gross national product ¹ (% change on previous year)	-1.7	2.3	2.5	5.8	9.2	8.5	-1.1	2.9	3.0
Gainfully employed ² (1,000 persons)	28,994	28,619	28,620	6,196	6,267	6,395	35,190	34,886	35,015
Unemployed (1,000 persons)	2,271	2,556	2,480	1,149	1,142	1,015	3,420	3,698	3,495
Rate of unemployment ³ (%)	7.3	8.3	8.1	15.0	14.8	13.1	8.9	9.6	9.1
Consumer prices ⁴ (% change on previous year)	3.2	2.6	2.0	8.4	3.0	3.0	3.9	2.7	2.0
Unit labour costs ⁵ (% change on previous year)	3.3	-1.0	1.0	3.0	-0.5	-1.0	3.6	-1.7	1.0
Net. gov. financial investment ⁶ incl. the Treuhandanstalt (DM bn.)	-	-	-	-	-	-	-143.2	-119.5	-71.5
excl. the Treuhandanstalt (DM bn.)	-	-	-	-	-	-	-105.1	-82.4	-71.5

¹At 1991 prices. ²Domestic gainfully employed. ³Related to domestic labour force (employed and unemployed). ⁴Price index for private consumption. ⁵Gross income from dependant employment related to real gross domestic product. ⁶As defined in the national accounts.

Sources: Statistisches Bundesamt; Deutsche Bundesbank; own calculations.

complexity of these relations forecasting the quantitative effects on overall demand and production and the phasing is beset with a high degree of uncertainty. How far business activity is affected depends ultimately on the adaptability of the economy. In all, the cyclical upturn this year will be less dynamic than it would have been without the large real appreciation of the D-mark. Nevertheless the prospects are for an upward movement at a moderate pace which will not lead to a sustained drop below current potential.

Despite the higher D-mark industrial production in west Germany will increase rapidly this year, too, in particular in the capital goods sector. Largely due to slower expansion in residential building, building output will grow more slowly. The still weak private consumption will continue to affect consumer services and retailing which will pick up little. Value added, however, will rise sharply in the production-related branches of the tertiary sector. Altogether, west Germany's gross domestic product will go up by 2½ % this year with a slight slowdown in the course of the year. Next year, the buoyant forces will shift increasingly from foreign to domestic demand; the growth rate of overall production will be slightly lower than this year, not least due to the D-mark's appreciation. In east Germany the rapid pace of growth in aggregate production will keep up. The change in the propellant forces will continue and the momentum in manufacturing industry will play a larger role. Thanks to new product lines and more modern production plant a growing number of industrial firms are manufacturing competitive products and holding their own beyond regional markets. They are benefiting increasingly from the upswing in west Germany and Western Europe. East German gross domestic product will rise by some 8½ % this year and by a similar rate next year.

The increase in production in both west and east Germany will make for higher employment. Despite decreasing support from active labour market policy, the number of unemployed will decline by nearly 200,000 in the course of this year and by a similar figure next year. In west Germany demand for labour will revive only slightly, as a corollary of the above-average rise in productivity due to rationalization in firms. The unexpectedly high wage agreements are likely to restrain recruitment in manufacturing industry and induce an increase in rationalization. Uncertainty as to future exchange rate developments will work in the same direction. In east Germany the rapid rise in production in 1995 will be attended by a marked increase in employment. At 130,000 the total rise in the number of employed will be nearly double the previous year's figure. Additional labour will at first be recruited mainly in those branches which produce for the domestic market and are therefore less exposed to international competition.

In west Germany the rise in prices will remain moderate this year. Although wage increases have been higher than expected, the rise in unit labour costs will slow down thanks to continuous increases in productivity. In addition, the demand of private households will rise only moderately at first. Due to the recent appreciation of the D-mark, the cost of imported consumer goods will hardly rise at all. Price rises in east Germany will remain similarly low to those in west Germany up to mid-year, but the cost of living will go up later due to renewed rent increases as a consequence of the introduction of the system of comparative rent lists. There is likely to be a slight acceleration of inflation in Germany next year as a result of the upswing in the consumer goods sector and increasing pressure from wage costs.

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

Raw Materials and Groups of Materials	1994		1995					
	AA ²	April	January	February	March	April	5.5.	19.5
Total index	147.8	137.7	160.6	163.0	164.2	171.7	173.8	170.1
Total, excl. energy raw materials	143.2	130.6	163.6	163.0	165.3	166.3	165.4	163.8
Food, tropical beverages	113.5	100.7	119.1	118.6	121.0	121.0	120.8	120.0
Industrial raw materials	165.9	153.5	197.5	196.7	199.1	200.7	199.3	197.1
Agricultural raw materials	171.8	162.2	204.7	210.2	216.5	220.1	224.3	220.7
Non-ferrous metals	171.2	146.9	220.2	209.3	205.7	206.1	196.2	197.2
Energy raw materials	150.4	141.9	158.8	163.1	163.6	174.9	178.7	173.8

¹ On dollar basis. ² Annual Average.