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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 slowdown which began last year in Germany and in nearly all the other industrial countries has been overcome. Since spring aggregate production in Germany has been on the rise again, although the pace of the recovery has been magnified by the backlog effects arising above all in the building industry following the prolonged and harsh winter. As in similar previous business cycles the recovery gained its initial momentum from high growth in foreign demand. A turnaround in stockbuilding resulting in greater demand for inputs is the likely crucial factor, but investment activities by foreign businesses have evidently also picked up again since the end of 1995, as the increased orders placed with German investment goods manufacturers indicate. Domestic demand for inputs, in contrast, began to rise later; demand for equipment has remained moderate. Spurred by tax relief, private consumption rose tangibly since the beginning of the year and has thus also supported the recovery.

The decisive factor in the global turnaround has been the improvement in monetary parameters. Capital market interest rates, which had risen everywhere in 1994 and thus played a major role in the slowdown last year, declined substantially once more during 1995. In most countries at the end of last year they had almost reached the level of the low at the end of 1993, at least in nominal terms. Monetary policy also took a more relaxed course with central bank discount rates reduced in some cases to historic lows. In Germany, the readjustment of exchange rates also had a distinctly beneficial effect: there has been a complete reversal of the appreciation of the D-mark against the US dollar and a number of European currencies of spring 1995. The D-mark's effective real exchange rate is now more or less equivalent to its level at the end of 1994. Altogether, fiscal policy in Germany has acted as a minor stimulant to the

economy. Adjusted for special factors, the budget deficit has grown markedly despite spending cuts. Although major determinants here were the effects of the automatic stabilizers, i.e. the acceptance of cyclical drops in revenue and rises in expenditure, there were also large losses in income resulting from the relief granted to private households in the form of tax exemption for the subsistence minimum, higher family allowances and the abolition of the surcharge on electricity consumption used to subsidize the use of German coal. This year's wage agreements have been much lower than those that helped depress the economic climate in 1995, and have thus taken account of the less favourable economic situation.

Real gross domestic product rose in the summer half of 1996 at a current annual rate of 4% but a considerable portion of this was because the building sector was catching up on the backlog of production shortfalls caused by bad weather. "Adjusted for weather", gross domestic product ought to have risen by an extrapolated annual rate of some 2½%; the rise in aggregate production thus corresponds to the growth of productive capacity for the first time since the growth year 1994. Prices have remained stable; the latest year-on-year rate of increase of consumer prices was 1½% and was thus the lowest since 1988. The number of unemployed, however, rose further during the year. In September, the seasonally adjusted figure was nearly 4 million. This means a rate of 10.4% of the domestic economically active population. In western Germany the recovery has resulted in a distinct rise in industrial production with higher capacity utilization. Particularly high growth has been registered in the production of semi-finished goods, reflecting the turnaround in stockbuilding both at home and abroad. The production of investment goods in contrast has risen little due to the hesitant rise in domestic demand. The basic trend in building has remained weak, the marked rise in spring being largely a response to shortfalls due to bad weather. The surge in private consumption has mainly benefited the services sector rather than the manufacturers of consumer goods or trade and commerce.

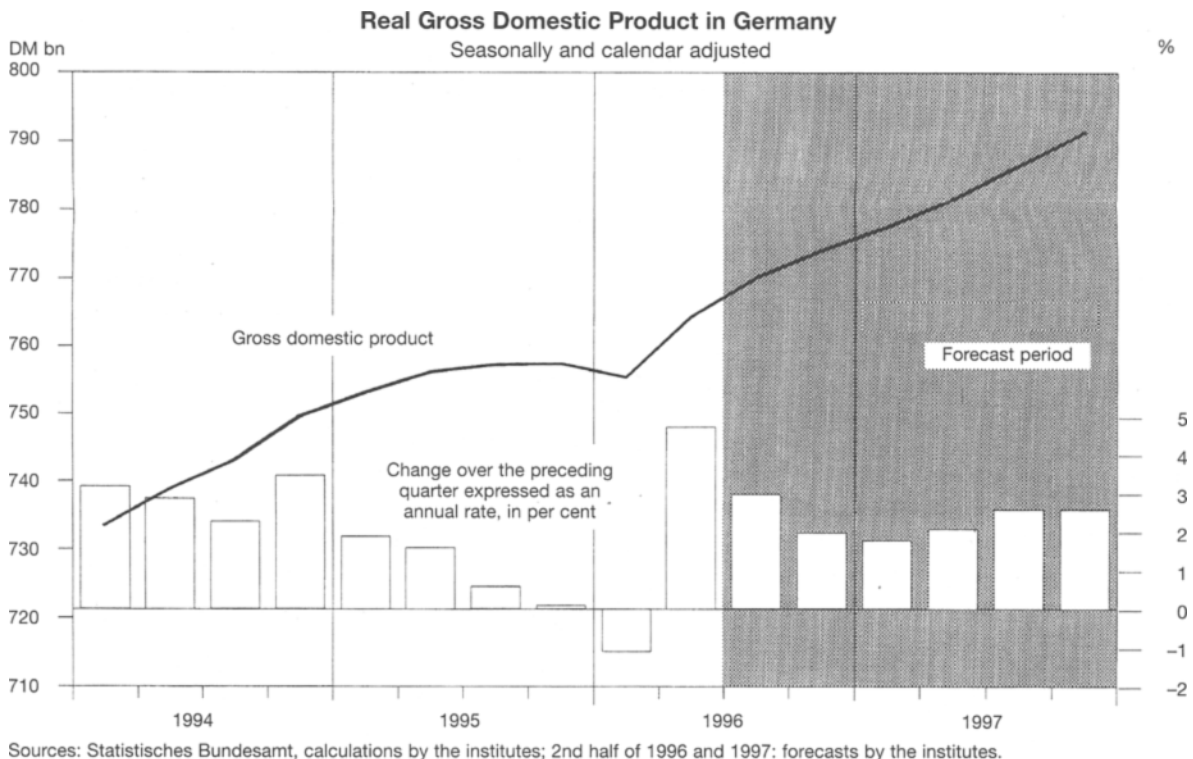
* Participating institutes: Deutsches Institut für Wirtschaftsforschung, Berlin; HWWA-Institut für Wirtschaftsforschung, Hamburg; Ifo-Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Institut für Wirtschaftsforschung Halle; Rheinisch-Westfälisches Institut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

In east Germany six years after reunification convergence is losing more and more momentum. Self-sustaining growth is not in sight. Since public development funds have not been increased, production growth has declined especially in the building sector, which had previously been particularly favoured. There are also indications that the forces for growth in manufacturing are slackening. Industrial production continues to show an upward trend but the inflow of new orders is only slightly above the figure for last year. The main reason for the lack of inherent momentum in east Germany is the continuing inadequate competitiveness of many businesses. A considerable number of enterprises have failed to enter the profit zone because the achieved improvements in productivity have been rapidly devoured by high wage rises. Unit labour costs in the east German economy – with considerable disparities even within branches – are still about a third above the level in western Germany. Productivity has only attained a good 50% of the west German level. Despite this fact, the growth rates of labour productivity in the new and the old Länder are becoming more and more similar.

A reduction in the productivity gap and hence a lowering of the excessive unit labour costs will be impossible as long as there is no basic change in the fundamentals. As there are no indications of this so

far, even with further improvements in the west German economy, the new Länder cannot be expected to achieve similar overall growth rates to those they averaged between 1992 and 1995. The fears voiced by the economic research institutes that the convergence process in east Germany has been slowing down were evidently warranted. In summer overall production in east Germany rose again somewhat but the making up of backlog due to bad weather played a not insignificant role in this. The basic trend in the building industry, particularly in commercial construction and in public works, has been slow. Industrial production in the second quarter exceeded the previous year by more than 8%, but given the great weight of building-allied industries there will have been large backlog effects here as well. On the labour market in east Germany, the number of employed rose in the summer half of 1996 by 50,000 largely in response to the steep drop in the winter; unemployment has declined by a similar figure, but the unemployment rate during this period still amounted to 15.4%.

The forecast is based on a number of assumptions, most of which in turn are based on predictions but in some cases are simply postulates. Demand and production in the industrial countries are expected to rise moderately this year and next. World trade will continue to expand rapidly. The oil price will decline



from the current high mark in the course of 1997. In the coming year it will average US \$ 21 per barrel, on a par with the 1996 average. World market prices for industrial raw materials will rise in response to the improved economic situation. The D-mark will drop slightly against the dollar and remain more or less constant against the other European currencies. The real external value of the D-mark will fall slightly. Wage agreements in the old Länder will in 1997 keep within this year's moderate range. Standard wage rates in east Germany will move more slowly towards the west German level than has been the case to date. In fiscal policy, the austerity measures, the reorganization of motor vehicle tax according to pollutant ratings, and the annual tax law for 1997 will be implemented in modified form. Family allowances for the first and second child will be raised and the solidarity surtax will not be lowered for the time being. Compulsory social security contributions will go up by near on one percentage point. The Bundesbank will not reduce key interest rates any further. Somewhat higher short-term and long-term interest rates are not to be expected until the second half of 1997 at the earliest.

Conditions are favourable for continued recovery in the Western industrial countries in 1997, particularly monetary conditions. There is no risk of inflation in the foreseeable future. In most industrial countries capacity utilization is still a long way from normal rates, unemployment will remain high, and the strain

on company profits exerted by wage rises will be further reduced. Price increases on international markets for raw materials will keep within narrow bounds and exchange rates ought to remain comparatively stable. Under these conditions, the central banks, particularly in Europe and Japan, will stick to their course of supporting economic growth. On the basis of the fundamental data for the major western countries, capital market interest rates are unlikely to rise.

Nevertheless, there are risks for future economic growth which may compel economic policymakers to take action. This applies on the one hand to fiscal policy in Europe. There is a real danger that nearly all the members of the European Union will attempt in a *tour de force* to meet the reference value for the current government deficit (3% of gross domestic product). Greatly intensified and overhasty steps aimed solely at cutting the deficit could jeopardize the transition from a moderate recovery to a phase of sustained growth. If the economies of Western Europe falter again this could exacerbate labour market problems because the disqualification and demotivation of job-seekers makes their integration into the normal labour market more difficult. A risk which is difficult to assess arises from the fact that the US economy finds itself in a later stage of the upswing than the economy in Europe or Japan. If, contrary to the assumptions made here, the expansion in the

Key Data of the Forecast for the Federal Republic of Germany

	Federal Republic of Germany			West Germany			East Germany		
	1995	1996	1997	1995	1996	1997	1995	1996	1997
Gross domestic product ¹ (% change on previous year)	1.9	1.5	2.5	1.6	1.5	2.5	5.3	2.0	2.0
Gainfully employed ² (% change on previous year)	-0.3	-1.0	0.0	-0.6	-1.0	0.0	1.1	-1.0	-0.5
Unemployed (1,000 persons)	3,612	3,945	4,000	2,565	2,785	2,800	1,047	1,160	1,200
Rate of unemployment ³ (in %)	9.4	10.3	10.4	8.3	9.0	9.0	14.1	15.5	16.0
Consumer prices ⁴ (% change on previous year)	1.8	1.5	1.5	1.7	1.5	1.5	2.1	2.5	1.5
Unit labour costs ⁵ (% change on previous year)	1.1	0.5	-0.5	0.9	0.0	-0.5	1.6	1.5	1.0
Net gov. financial investment ⁶ (DM bn)	-122.6 ^a	-144.0	-126.9	-	-	-	-	-	-
Balance on current account ⁷ (DM bn)	-30.1	-26.0	-15.5	-	-	-	-	-	-

¹ At 1991 prices. ² Domestic gainfully employed. ³ Unemployed as a percentage of the resident labour force (place of residence concept); west and east Germany: unemployed as a percentage of the labour force within the region (place of employment concept). ⁴ Price index for the cost of living of all private households. ⁵ Gross income from dependent employment originating within the region related to real gross domestic product at 1991 prices. ⁶ As defined in the national accounts. ⁷ As defined in the balance of payments statistics. ^a Excluding the revenue from the takeover of the capital of the Deutsche Kreditbank to the tune of DM 5.6 bn and excluding the asset transfers to the tune of DM 204.6 bn made to the corporate sector as a consequence of the assumption of the debts of the Treuhandanstalt and DM 30.0 bn as a consequence of the assumption of the debts of the east German housing companies.

Sources: Statistisches Bundesamt; Deutsche Bundesbank; Bundesanstalt für Arbeit; calculations by the institutes; 1996 and 1997: forecast by the institutes, rounded figures.

United States were to speed up and wage rates to increase by a large margin – there is almost full employment on the labour market – the Federal Reserve would certainly not hesitate to raise short-term interest rates higher than expected in order to forestall the threat of inflation. It cannot be excluded that in this case there might then be a considerable rise in long-term interest rates similar to that of 1994. As in 1994/95, this could impair the growth of investment activity just developing in Europe. Investment activity in the major European countries following the last recession suffered markedly from the aftermath of capital market interest rate rises in 1994. After investment in plant and equipment had bottomed out, if conditions on the money and capital markets had been more conducive, a normal cyclical recovery would have been to be expected in continental Europe, such as had previously been observed in the USA and the United Kingdom. This also holds for Germany where, furthermore, investment activity remained weaker than in the rest of Europe due to the steep rise in the value of the D-mark in spring 1995 and the preceding reunification boom. If these developments do not take place or if economic policy can mitigate their adverse effects, a sustained and later vigorous upswing is likely.

Despite the potentially dampening influence of fiscal policy and assuming ongoing conducive general monetary conditions, economic recovery in Germany will continue next year, though only at a moderate pace. Investment activity in particular will tend to remain sluggish compared with earlier growth phases. In west Germany the recovery will speed up a little in the course of the coming year provided foreign demand remains strong and investment activity picks up somewhat. This applies in particular to industry. The decline in the building sector should at least come to a halt. In east Germany, however, a slight slowdown in the growth of aggregate production is to

be expected. Decisive here are developments in the building sector. As state support declines in particular in the residential building sector, construction activity will be markedly subdued. Industrial production will be boosted somewhat by the improvement in the economy in west Germany but growth will remain modest. Competitiveness remains unsatisfactory and the adverse trends in the building sector have a considerable impact on manufacturing due to the considerable weight of the former. Altogether real annual gross domestic product in Germany in 1997 will go up by 2½% after 1½% this year. In east Germany production growth in the coming year will be somewhat below this year's figure. Convergence between the new and the old Länder is not progressing.

In spite of continued recovery the situation on the labour market next year will only improve marginally. As a rule, available personnel is utilised more intensively first. Also, recruitment by enterprises does not usually pick up noticeably until the upward trend is regarded as established. Employment is therefore unlikely to improve until late on in 1997, and only in west Germany. The number of employed, however, will not be higher on average than this year. In east Germany the slight improvement on the labour market will continue at first. In 1997, however, there will be more dismissals because of flagging activity in the building sector and allied industries. Small increases in employment in other areas, mainly in the services sector, will not suffice to offset higher redundancies. Altogether, the number of employed will thus decline somewhat on average in 1997. The number of unemployed in Germany will decrease slightly in late 1997 as recovery progresses; however, it will again average 4 million for the year. This is equivalent to an unemployment rate of 10.4% of the domestic workforce. In east Germany the unemployment rate will rise to 16% (1996: 15½%).

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

Raw Materials and Groups of Materials	1995		1996					
	AA ²	October	July	August	Septembre	October	8. 11.	22. 11.
Total index	162.7	156.0	167.6	171.4	181.0	187.7	180.0	185.5
Total, excl. energy raw materials	163.3	159.5	145.4	144.3	142.1	140.1	140.5	142.6
Food, tropical beverages	117.4	112.6	117.8	115.3	111.3	105.9	104.2	105.6
Industrial raw materials	198.2	195.2	166.5	166.4	165.5	166.1	168.2	170.9
Agricultural raw materials	213.9	212.0	176.0	175.2	177.2	180.1	179.9	178.6
Non-ferrous metals	209.4	201.4	162.3	163.0	159.2	157.2	165.2	176.1
Energy raw materials	162.3	154.0	180.5	187.3	203.7	215.5	203.1	210.6

¹ On dollar basis. ² Annual Average.