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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 German economy slowed down distinctly in the course of last year. A weakening of economic activity so early in a recovery is nothing unusual. In the mid-80s, economic activity initially fell back after a roughly two-year upswing in production. At the beginning of a recovery there is usually considerable building. As inventories adjust to the expected increase in sales, the associated stimuli for the economy recede. In the past, this has been followed by a surge of investment in machinery and equipment. This time, however, investment growth has been unusually weak in Germany with investment activity even stagnating last year. Aggregate production accordingly averaged a mere 1.9% above the previous year's level. In the winter six months it even declined and the labour market situation deteriorated even further. Alongside cyclical determinants, the long and harsh winter played a considerable role, not only in the building sector. Overall utilization of capacity diminished, although it fell only slightly below the long-term average – unlike the pattern usual in recessions.

The cyclical slow-down is partly the result of the steep worldwide increase in interest rates in 1994, which also placed a distinct damper on trends in the other industrial countries. The decline in growth in Germany, though, was far more pronounced than elsewhere. The slackening of the forces for growth last year was largely determined by the coincidence of the sharp rise in the value of the D-mark and the unexpectedly high wage rises in the spring, which made for even gloomier sales and earnings prospects and acted on businesses as a disincentive to invest or

hire manpower. A cumulative downswing in business investment, as is typical for an impending recession, did not, however, occur. Economic growth was also inhibited last year by government measures. Demand for housing was considerably lower than in 1994 after tax allowance for interest payments expired. Here we see the typical effects of fixed-term assistance: the increased expansion due to the bringing forward of projects is promptly followed by a contraction. The heavier burden of taxes and other deductions curtailed private consumption, which nevertheless continued to bolster the economy because private households again reduced their propensity to save. With economic momentum slowing in Western Europe and due to less competitive prices as a result of the appreciation of the D-mark and higher costs, exports expanded markedly less than in 1994.

With recovery weak, the situation on the labour market had improved little up to the summer of last year. The number of employed, which at that time looked like stabilizing, dropped noticeably in the winter six months and unemployment increased faster. Poor weather was certainly a major contributory factor; on top of this, the new provisions on bad weather allowances will have resulted in increased temporary redundancies in the building trade. Due to the economic downswing and to cheaper imports due to the appreciation of the D-mark, prices have again risen more slowly despite higher unit labour costs. Germany is again a country with almost stable prices.

Even five years after reunification, east Germany has still failed to achieve enough self-sustained momentum. With government-sponsored stimuli abating, progress towards convergence with west Germany has been noticeably slower. The central problem remains the often inadequate competitiveness of enterprises, in particular in manufacturing. Although productivity has been raised considerably by modernizing production plant and

\* 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 Deutsches Institut für Wirtschaftsforschung, Berlin, and the Institut für Wirtschaftsforschung, Halle, estimate next year's development of economic activity to be less favourable than do the majority of the institutes.

## ECONOMIC TRENDS

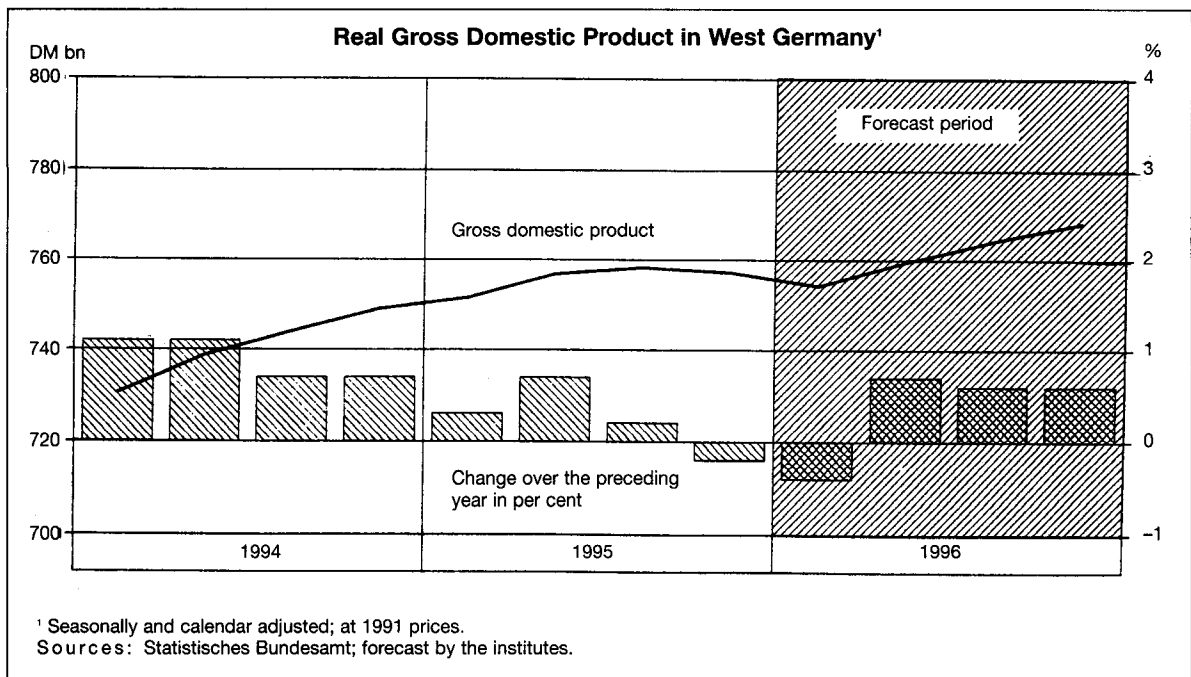
reorganizing production processes in recent years, the ground gained has repeatedly been lost by strong increases in wages. Unit labour costs on an overall average - with large disparities even within individual industries - are still much higher than in west Germany and this has prevented the profits which are essential for self-sustaining growth.

In east Germany industrial production was considerably higher than the previous year but hardly increased at all in the course of the year. There was a very marked decline in forces for growth in building, which then spilt over into other sectors. Public investment was expanded a good deal less than previously. A slowing down was to be expected here after the strong initial boom, but it has been compounded by tight public finances. Investments in commercial buildings have even been declining since the middle of last year. Only residential building continued to expand strongly thanks to massive government assistance and substantial increases in incomes. With convergence less rapid, the situation on the east German labour market has deteriorated further. The number of employed declined in the winter six months and the number of unemployed went up considerably. Contributory factors here were bad weather and a scaling back of labour market policy measures.

The forecast is based on a number of assumptions, most of which are based on predictions, but in some cases are simply postulates: economic growth in the industrial countries will strengthen in the course of

this year and continue at a good pace next year. World trade will grow faster. The oil price will soon return to a level just a little higher than the average last year. World market prices for industrial raw materials will pick up slightly in response to the recovery of the world economy. The D-mark will decline slightly against the US dollar with no notable changes altogether in relation to the other European currencies. The real external value of the D-mark will diminish a little. This year's wage agreements will be well under last year's. Wage rises in 1997 will remain moderate on the whole. The fiscal policy measures adopted for 1996 will be implemented. Cyclical increases in spending and revenue shortfalls will not be accepted in full. The solidarity surtax will be reduced from 7.5% to 6.5% at the beginning of the coming year and the reform of corporate tax will be carried out as planned. The tax revenue shortfalls for 1997 resulting from the tax reductions will be offset by slightly larger savings in expenditure. Short-term interest rates will diminish somewhat at first with long-term rates persisting at present levels. Slightly higher interest rates, at both the short end and the long end of the spectrum, are to be expected in the course of next year, not before.

Under these conditions it is unlikely that the current downturn will worsen. In the past, cumulative downswing processes have always been preceded by a marked strengthening of upward trends in prices and costs combined with a high utilization of capacity, prompting the Bundesbank to adopt a restrictive



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monetary policy; the shorter money supply and increases in interest rates then culminated in a downswing and recession. Neither here nor abroad has there been a tangible acceleration of the increase in costs and prices this time. So far, the monetary policy reins have continually been loosened and short-term interest rates have been reduced by a large margin. Long-term interest rates have again fallen considerably, following the global downtrend of interest rates on the capital markets; the rise at the beginning of the year is primarily a correction of a certain overshooting beforehand and does not indicate a turnaround in interest rates. The monetary indicators thus point to a recovery. Furthermore, the appreciation of the D-mark in the spring of 1995 has now reverted downward. Fiscal policy in 1996 and 1997 will act as a constraint on the economy but private consumption will receive a boost on balance from the tax relief effective from the start of the year, despite higher social insurance contributions. Finally, wage agreements will be a lot lower this year and next than in 1995 under the influence of high unemployment and low inflation.

In view of the generally favourable conditions, the institutes consider it likely that the economy in Germany as well as in the other Western European countries will pick up again as the year proceeds and stabilise next year. Utilization of capacity will already go up towards the end of 1996 but even in 1997 the

economy will not acquire particular momentum. Under these circumstances there is no immediate prospect of any notable easing of the labour market. In the course of next year, though, a gradual rise in the number of employed and a drop in unemployment can be expected. A lasting improvement in the employment situation presupposes low wage agreements and robust economic growth for years to come. The outlook for stable prices remains bright. Sizable free production capacity is still available to meet the recovery in demand. Costs at home will only go up a little; ancillary labour costs will go up due to higher social insurance contributions but wage rises will keep well below those of the previous year.

Major determinants for exports have meanwhile improved again. The appreciation of the D-mark in spring 1995 has for example reversed. Also, an economic recovery in the industrial countries, not least Western Europe, is to be expected in the course of this year that will continue on into next year. German exporters will also profit here from the cyclical revival of investment in most of the industrial countries. Finally, demand for imports by the Southeast Asian countries and the transition economies in Central and Eastern Europe will continue to show an upward trend. Under these conditions exports will rise more rapidly. Altogether, German exports in 1996 will, however, not keep up with growth in world trade. The export surplus in

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

	Federal Republic of Germany			West Germany			East Germany		
	1994	1995	1996	1994	1995	1996	1994	1995	1996
Gross national product <sup>1</sup> (% change on previous year)	2.9	1.9	¾	2.4	1.6	0.5	8.5	5.6	3.0
Gainfully employed <sup>2</sup> (1,000 persons)	34,957	34,864	34,670	28,654	28,458	28,275	6,303	6,406	6,395
Unemployed (1,000 persons)	3,698	3,612	3,905	2,556	2,565	2,730	1,142	1,047	1,175
Rate of unemployment <sup>3</sup> (in %)	9.6	9.4	10.1	8.2	8.3	8.8	15.3	14.0	15.5
Consumer prices <sup>4</sup> (% change on previous year)	2.8	2.0	1.5	2.7	1.7	1.5	3.7	2.1	2.0
Unit labour costs <sup>5</sup> (% change on previous year)	-0.6	1.3	2.0	-1.0	1.0	1.5	-0.4	2.1	3.0
Net gov. financial investment <sup>6</sup> (DM bn)	-82.6	-122.7 <sup>a</sup>	-136.5	-	-	-	-	-	-
Balance on current account <sup>7</sup>	-34.7	-24.9	-20.0	-	-	-	-	-	-

<sup>1</sup> At 1991 prices. <sup>2</sup> Domestic gainfully employed. <sup>3</sup> Fed. Rep.: related to the resident labour force (employed and unemployed); west and east Germany: related to the domestic labour force (employed and unemployed). <sup>4</sup> West and east Germany: price index for the cost of living of all private households; Fed. Rep.: price index for private consumption. <sup>5</sup> Gross income from dependent employment originating within the region related to real gross domestic product. <sup>6</sup> As defined in the national accounts. <sup>7</sup> As defined in the balance of payments statistics. <sup>a</sup> 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 234.6 bn made to the corporate sector as a consequence of the assumption of the debts of the Treuhandanstalt and the east German housing companies.

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

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goods trade will go up again this year and the deficit on current account can be expected to decline further.

The recovery in machinery and equipment investment which began in 1994 remained very weak as a whole compared with previous cycles. This disappointing trend is also the outcome of the investment boom in the wake of German reunification, when machinery and equipment investment attained its highest level in relation to gross domestic product since the war. When no additional demand stimuli were forthcoming, the extra capacity created could no longer be fully utilized. In addition, wages went up fast. Return on fixed capital diminished as a result. The investment rate has now fallen back to a level similar to that in west Germany in the latter half of the 80s. In our view the exceptional situation caused by reunification has now returned to normal so that cyclical factors will make themselves more strongly felt again on machinery and equipment investment trends. The general climate for a recovery of business investment activity has now markedly improved. Short-term and long-term interest rates have declined and the D-mark appreciation has again receded. Demand from abroad has revived distinctly recently. Also, the foreseeable wage rises can be expected to boost profits. Under these conditions the profitability of machinery and equipment investment will improve. We can therefore expect a reignition of investment in west Germany during 1996, whereas the indicators for east Germany point increasingly to a much slower pace.

Developments in building in west and east Germany will remain diverse in 1996 in most segments. Thanks to low interest rates, demand in west Germany for single-family and two-family houses should pick up in the course of this year but due to the much less favourable yield outlook in

apartment houses the overall trend is downward. In east Germany, in contrast, the construction of apartment houses is likely to go on expanding fast at first, driven by the downscaling of high tax write-offs next year. In commercial building the investment outlook in east and west alike remains gloomy. Public construction activity will be cut back due to continuing budget constraints on regional and local authorities. Taken as a whole, building investment will fall in Germany in 1996. Nor can any major improvement be expected next year. After the curtailment of the special tax allowances for apartment houses at the end of 1996, accounting for about a quarter of construction volume, a noticeable decline is likely in east Germany's residential building activity.

Overall production in Germany will pick up again in the course of the year. A cyclical upswing in gross domestic product can be expected as early as spring and the backlog caused by production stoppages due to bad weather will be made good. In west Germany industrial production will expand in the second half of the year, especially that of inputs and investment goods. Despite a rise in the course of the year, though, it will fall well short of the previous year's level. Partly thanks to recovery in west Germany, industrial production in east Germany too will again gain momentum. Gross domestic product in 1996 will increase by  $\frac{3}{4}\%$ ; in west Germany the figure will be  $\frac{1}{2}\%$  and in east Germany about 3%. Growth next year will amount to around  $2\frac{1}{2}\%$ ; in west Germany it will be considerably higher than in 1996 and in east Germany markedly lower. The convergence process in east Germany is threatening to falter. A prime factor is the low competitiveness of east Germany as an industrial base but the cutbacks in promotional measures, in particular in residential building, will also place constraints on development.

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

Raw Materials and Groups of Materials	1995		1996					
	AA <sup>2</sup>	April	January	February	March	April	10. 5.	24. 5.
Total index	162.7	171.7	162.6	161.1	168.6	176.8	170.1	170.9
Total, excl. energy raw materials	163.3	166.3	157.2	157.0	156.7	159.4	159.1	155.2
Food, tropical beverages	117.4	121.0	113.1	117.4	116.1	122.4	126.7	124.9
Industrial raw materials	198.2	200.7	190.8	187.2	187.7	187.6	183.8	178.3
Agricultural raw materials	213.9	220.1	209.9	203.3	202.1	201.8	188.8	184.7
Non-ferrous metals	209.4	206.1	192.7	190.0	192.1	193.5	201.6	190.2
Energy raw materials	162.3	174.9	165.7	163.4	175.5	187.0	176.5	180.0

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