

Economic conditions

International environment

According to the OECD figures, some of which are still estimates, aggregate output in the industrial countries went up by 3 % in 1997 at constant prices; growth was hence stronger than at any time since 1989. Among the G-7 countries, the United States performed best, at just under 4 %, followed by Canada and the United Kingdom, at 3 ½ % each. Japan was at the bottom of the table, at no more than ½ % growth in GDP. The smaller member states of the OECD, which achieved an average rate of expansion of 4 %, recorded significantly stronger growth than the major industrial countries. In most countries, the buoyant upswing in the real economy was accompanied by a continuing moderate rate of inflation at the consumer level; excluding the high-inflation countries, which include the central and east European member states as well as Turkey and Mexico within the extended OECD group, the inflation rate in 1997 was 2.0 %, compared with 2.2 % in each of the two preceding years.

*Industrial
countries*

According to the December 1997 official OECD forecast for 1998, it is likely that real GDP in the member states will grow, at a rate of just under 3 %, only slightly less slowly than last year. However, this expectation still took scarce account of events in East Asia. In a supplementary simulation, the OECD points out that the pace of expansion in the OECD could slow down by just under 1 percentage point in 1997-8 as a result of contractionary effects in the shape of a lower absorption propensity in the countries in crisis and greater export pressure from that region.

*OECD forecast
for 1998*

These retarding effects would, in all probability, be partly offset by a more elastic monetary policy, particularly in the United States, leading on balance to estimated growth losses being lower than this. Taking these factors into account, the OECD's assessment for 1998 scarcely differs from that of the IMF, which made a downward adjustment of ½ percentage point to 2 ½ % in its forecast for the (somewhat differently defined) group of "advanced economies" in December of last year.

East Asia

The most severely affected East Asian countries have now agreed on extensive support programmes with the IMF. In addition, other international organisations and a number of countries have also taken part in the assistance measures on a bilateral basis. The agreements negotiated in the second half of 1997 have since had to be revised or improved in some cases – not least because the measures contained in them have not been (fully) implemented by several countries affected by the crisis. Furthermore, it has become increasingly clear that adjustments should primarily start in the regulatory and structural policy area, and that a radical restructuring of both the financial system and the corporate sector is regarded as a particular priority. It will now be important to implement the agreed reforms in a resolute and consistent manner so that a clear and credible prospect of a change for the better becomes apparent as soon as possible. That is something which is of crucial importance for the behaviour of the financial markets.

Of the major industrial countries, Japan is the most affected by the turbulence in the East Asian financial and foreign exchange markets on account of its closer trading and financial links with the countries in crisis. This has further intensified the economic slowdown, which was already discernible in the summer half-year 1997, and the existing problems in the financial system. Seasonally adjusted industrial output in the final quarter of the year fell by slightly more than 2 % below the already depressed level of the summer months. Its level of one year ago was undershot again, too, for the first time since spring 1994. The main reason for this was, firstly, the continuing slowdown in private consumption. Secondly, industrial investment was probably showing a downward trend, too, of late; this is, at any rate, indicated by the trend decline in domestic orders for machinery and equipment after the middle of the year. Factors which have contributed to low investment activity are not only uncertainty on the part of investors faced with the events in major Asian importing countries but also restraint in lending on the part of the embattled banking industry. On account of the major losses of capital that have already occurred, or are to be expected, as a result of the necessity of writing-off problem loans, the banking industry is less and less in a position to engage in new credit exposures.

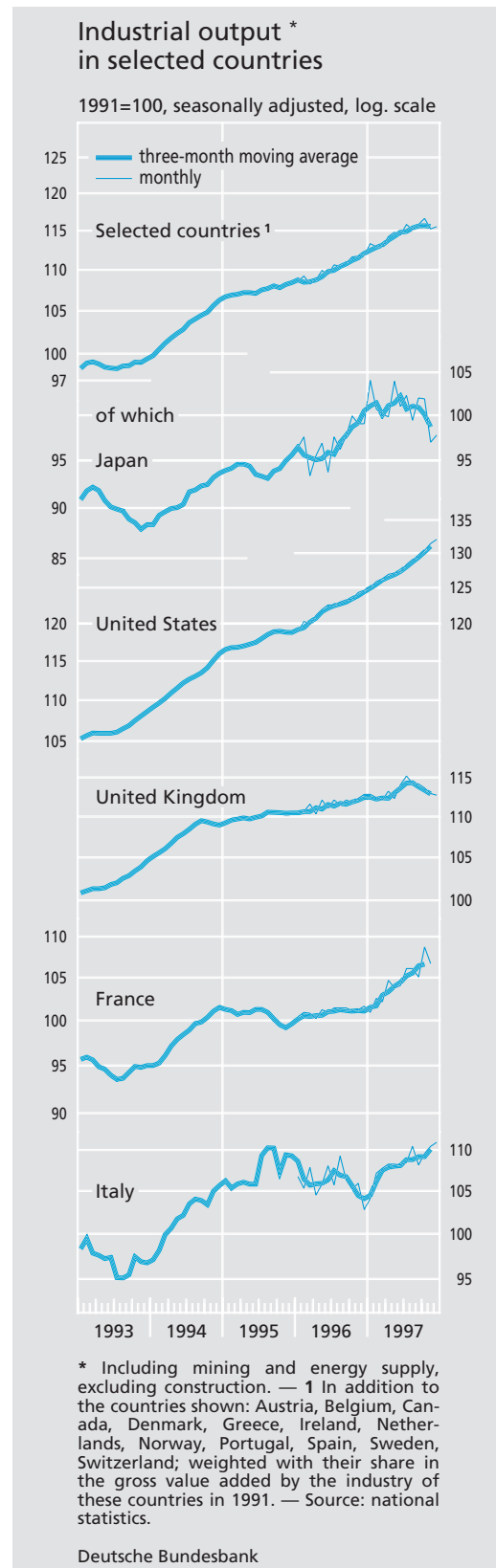
Japan

As early as mid-December, the Japanese government slightly relaxed the course of public sector budget consolidation it had embarked on as recently as 1996 and decided on a personal income tax reduction with a volume of just under ½ % of GDP for the fiscal year run-

ning up to the end of March 1998. A further economic policy programme is to be launched in the new financial year 1998-99. This includes a lowering of personal income tax by the same amount and an acceleration of public sector construction projects. These measures aim to ease the burden on consumers and investors, who are very unsettled, and thereby strengthen private domestic demand.

United States

Economic developments in the United States, on the other hand, were largely disturbance-free during the last few months of 1997; the effects of the crisis in East Asia are likely to be felt more strongly in 1998, and will probably take the form of a slowdown in growth and a lower rate of inflation. According to data which are still provisional, after adjustment for seasonal and working-day variations, real GDP in the period between October and December 1997 expanded by 1% against the summer quarter and by just under 4% compared with its level a year before. For the calendar year 1997 as a whole, this gives a growth of likewise almost 4% – a figure which was last achieved in 1988. Private consumption again generated strong expansionary stimuli in autumn 1997; after eliminating seasonal and working-day variations, it was almost 1% higher than in the preceding period. Additionally, in contrast to the industrial sector, investment in new residential buildings was on a sharp upward trend. For the first time in a long while, the trade deficit fell back appreciably in the period October/November 1997. A renewed expansion of the foreign trade deficit is likely, however, given the sharp appreciation of the US dollar (par-



ticularly against East Asian currencies) over the past few months, and the fact that domestic demand has been very buoyant right up to the present. The positive overall picture presented by the US economy is completed by the favourable government budgetary situation and the fact that the rate of inflation at the consumer level fell from 3.3 % in December 1996 to 1.7 % in December 1997 – the lowest inflation rate since early 1987. In addition to the high level of labour market flexibility, the fall in energy prices played a major role in this stabilisation success.

Western Europe

Much as in the United States, the driving forces behind the upswing in western Europe have not been significantly affected so far by the turbulence in East Asia. Some growth losses can likewise be expected only later in the year. Industrial output in the EU (excluding Germany) continued to rise in October/November and was 4½ % higher than the figure a year before. The pace of expansion continued to differ quite widely between the individual countries but the gap has narrowed of late. One factor in this was that the cyclical pace-setters – such as the United Kingdom and Ireland – fell back slightly, whereas the previous stragglers on the European continent – France and Italy, in particular, besides Germany – made up ground.

United Kingdom

As in the preceding four months, British industry again cut back its production in December in seasonally adjusted terms; after adjustment for working-day variations, it was also slightly lower than the level in the corresponding period of 1996. There was no comparable slowdown in the services sector

which is less exposed to international competition, and therefore also affected to a lesser extent by the appreciation of the pound sterling. Overall, the risk of the economy overheating has, if anything, become slighter. In January, consumer prices were 3.3 % (excluding mortgage rates, 2.5 %) higher than a year before. Private consumption, which is still buoyant, and increasing labour cost pressure both had an inflationary effect, whereas calming price effects were generated by the exchange rate.

In France, the favourable trend in exports continued in the second half of the year; 1997 is thus likely to show a new record foreign trade surplus. Moreover, there are increasing signs that domestic demand for consumer and capital goods, which was previously slack, has become more buoyant. Since August, the seasonally adjusted number of unemployed has also fallen; the unemployment rate in autumn was still 12.4 %, however. The inflation rate in December was 1.1 %.

France

According to official announcements, there is likely to have been no more than a slight rise in real GDP in Italy in the fourth quarter of 1997, which is attributable mainly to the increased number of days taken off to make a longer holiday in the second half of December. The basic cyclical momentum was hence maintained. Private consumption in 1997 was mainly boosted by government incentives (partly on environmental policy grounds) to purchase new passenger cars; the number of new vehicle registrations was 40 % higher than in 1996. Italian enterprises now seem to

Italy

have a distinctly higher propensity to invest. The principal reasons for this are likely to be the expansion of aggregate demand and the marked decline in long-term interest rates. This trend towards lower capital market rates was also observable in other south European countries and has likewise led to an improvement in the climate for investment there.

Germany

Output and labour market

Overall situation

The upswing in the German economy continued in the autumn of last year. Despite continuing favourable underlying conditions, its momentum is unlikely to have been as great as in summer, however. In particular, foreign trade, which had hitherto generated crucial stimuli for the cyclical expansion, became less buoyant. Export firms continue to assess future business prospects positively, however. The mood in the business community remained split between moderate optimism in industry and muted expectations in trade and construction. The domestic forces of growth have remained subdued and no sign of a turn for the better was apparent on the labour market.

Statistical gaps

A more accurate assessment of the current trend in the German economy as a whole is made more difficult at present by the fact that the Federal Statistical Office has not yet published any annual figures from the national accounts for 1997. The relevant data will not be available until the end of February. This delay is due to the special requirements



placed on official statistics by the Maastricht Treaty. For that reason, the following analysis must be confined to the current official sector statistics, which nevertheless reflect major parts of the overall economic picture.

Manufacturing output, which had gone up extremely sharply last summer, again expanded in the autumn months – even though the rise was considerably less than before. After eliminating seasonal fluctuations and taking account of the differing number of working days, manufacturing output on an average of the fourth quarter was not quite ½ % above the figure for the preceding three-month period. Compared with 1996, which also reflects the increase during 1997 as a whole, the rate of expansion was 4 ¼ %. As is shown by the trend in sales, there was a particularly

Manufacturing

sharp rise in foreign business, although this became somewhat weaker towards the end of the year. Domestic turnover, on the other hand, was comparatively subdued right up to the present.

The intermediate goods industry remained the pace-setter in growth. The steel industry again showed particularly sharp growth towards the end of the year; its output exceeded the previous year's figure by more than 10%, the figure for eastern Germany even being as much as around 17½%. Among capital goods producers, manufacturers of office machinery and computers, in particular, recorded a sharp expansion in production. By contrast, motor manufacturing was no longer as buoyant. This affected the durable consumer goods industry, under which the cars produced for households are classified. Since other branches of this sector, including manufacturers of television and radio receivers, also recorded slow business, the sector as a whole slipped back further in comparison with the preceding year.

Capacity utilisation

There was a further rise in capacity utilisation in industry up to the end of 1997. According to ifo institute data, capacity utilisation in western Germany in December was 4 percentage points higher than the previous year's level; the range of average medium-term utilisation was hence exceeded on roughly the same scale. More and more frequently enterprises rated their production capacity as no longer sufficient. Apart from the special situation during the reunification boom in the early nineties, an assessment of this kind has not been observed during the last two dec-

ades. Again, leaving aside the period of reunification, order books were fuller than at any time since the early eighties. There was, however, no further increase in the forward reach of orders on hand between September and December 1997.

The sharp increase in utilisation of production capacity and in the order books is also due to the fact that production facilities in the old Länder have been increased only slightly since the reunification period. Over the past few years, investment has not even been sufficient to offset disposals from the capital stock – something which applies, in particular, to manufacturing machinery and equipment. This does not take account of the fact that a number of machines included in the calculations of the Federal Statistical Office are already classified as no longer economic by the enterprises. The restraint in investment in western Germany is likely to have been partly due to the fact that it has been relatively easy to make use of additional modern capacity, say, in eastern Germany, or in other European or non-European countries.

Capital stock

An assessment of the economic position of the construction industry is made very difficult at present for statistical reasons. Firstly, the output figures from October onwards are not comparable with the preceding data since the number of reporting firms was newly derived from the regular annual overall survey. Secondly, firms identified as belonging to the construction sector under the survey of craft enterprises, are now increasingly being included in the ongoing reporting requirements. It cannot therefore be regarded as a

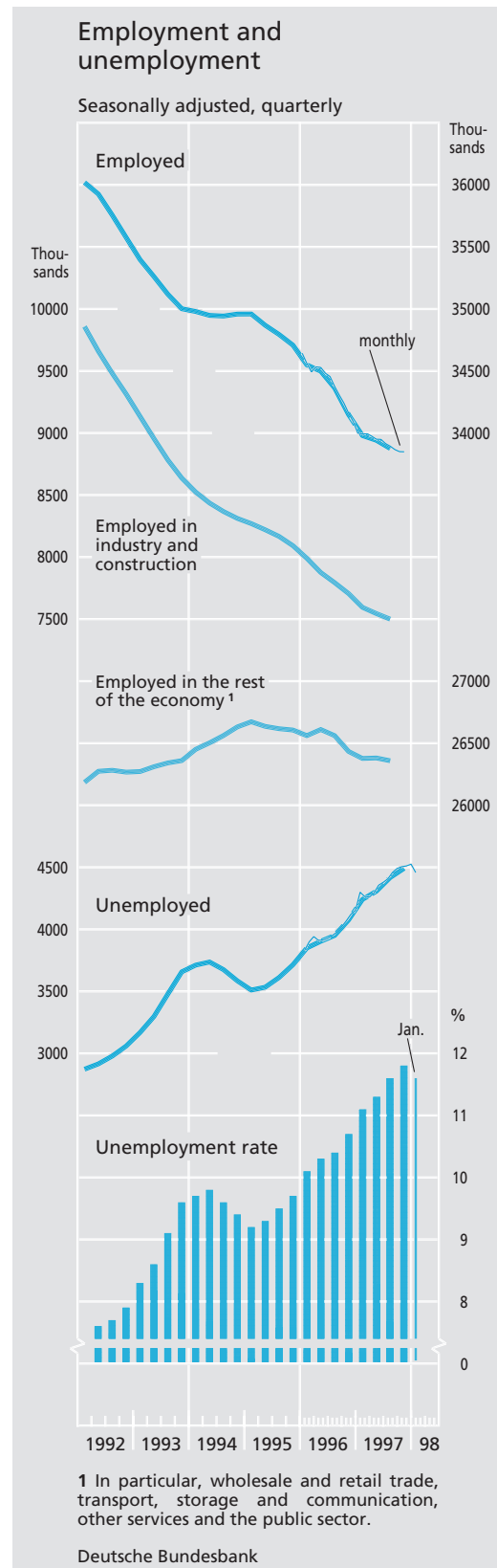
Construction

clear sign of cyclical improvement that construction sector output was only about 5 ½ % down on the previous year's level, compared with just over 9 % in the third quarter of 1997; there is much to suggest that overall output in the second half of 1997 was between 5 ½ % and 6 ½ % lower than in 1996. It is therefore likely that the construction industry did not make any growth contribution to the domestic product in the fourth quarter of last year.

Employment

The basic trend in employment was a downward one. According to the calculations of the Federal Statistical Office, the seasonally adjusted total in November – more recent figures are not available at present – was 33.86 million. Taking the two autumn months of October and November together, this was 42,000 persons fewer than in the third quarter; in a year-on-year comparison, job losses amounted to 355,000 or 1%.

The main reason for the continuing sharp fall in the number of jobs was the unfavourable trend in the new Länder. In eastern Germany, the decline accelerated again following a temporary slowdown in the spring. Allowing for seasonal fluctuations, only 5.99 million persons were gainfully employed on an average of the months of October and November, i.e. around 80,000 fewer than in mid-1997 and almost 210,000 fewer than twelve months previously. At around 3 ¼ %, the decrease was much sharper than in the old Länder, where the figure was ½ %. According to the available data, which are still very incomplete, employment fell in nearly all economic sectors. The sole exceptions to this



were agriculture and some branches of the services sector. This was a long way from counterbalancing the severe losses in construction and manufacturing, wholesale and retail trade, transport, storage and communication, and in the case of the central, regional and local authorities.

*Labour market
policy measures*

One factor which played a role in this was that labour market policy measures were perceptibly reduced. At the end of January 1998, only 300,000 persons were taking part in vocational training courses and job creation schemes (including productive labour cost subsidies) in eastern Germany, i.e. 165,000 fewer, or one-third less, than a year before. In the old Länder, the number fell by 90,000 to 250,000 latterly, which corresponds to a reduction of just over one-quarter.

Unemployment

The transition from previously concealed to officially recorded unemployment, particularly in the new Länder, has been a factor in the distinct rise of late in the number of persons registered as unemployed. At the end of January, 1.59 million east German members of the labour force were unemployed, i.e. just under 180,000 more than last year. The seasonally adjusted number was somewhat lower in January than in December, the unemployment rate falling to 19.4%, compared with 19.8% in December. However, this was due, not least, to the quite late onset of winter weather this year. As a result, a comparatively small number of workers with weather-dependent occupations had registered as unemployed at the end of January. In autumn of last year, one in seven of all unemployed persons in east Germany came from the con-

struction trades, one-tenth were from administrative and office-working occupations. Whereas the latter group, as well as sales staff, had a major impact on the trend in unemployment in western Germany, there was a notably small percentage of persons from the construction trades in the number of registered unemployed in western Germany. In the metal-working trades, which may be regarded as representative of industry, unemployment in the old Länder – in contrast to eastern Germany – was, in fact, lower at the end of last year than in 1996. Overall, the number of unemployed in western Germany at the end of January was 3.24 million. It was likewise primarily weather conditions which led to the seasonally adjusted unemployment rate falling to 9.8% from 9.9% in December. On an average of Germany as a whole, it was 11.6%, which corresponds to 4.47 million unemployed.

Trends in demand

Orders placed with industry provide a major indication of output in the following months and were no longer as high in the autumn of last year as they had been in the summer months. At constant prices, the seasonally adjusted level of orders received by manufacturing in the last three months of 1997 was around 1% lower than in the third quarter, which was characterised by a number of major export orders. Although ordering activity thus remained 6½% higher than in the same period of 1996, growth in the period from July to September had been somewhat more than 7½%.

*Orders
received by
manufacturing*

*Foreign
demand*

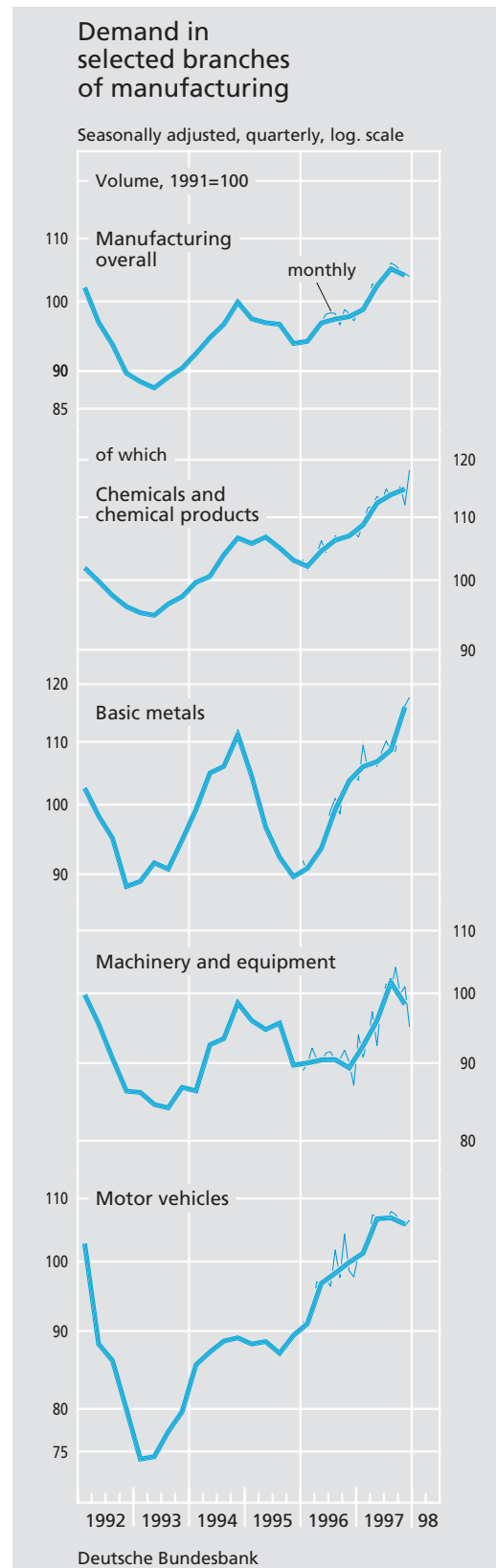
The main reason for the slowdown in demand was the behaviour of foreign customers. After eliminating seasonal fluctuations, the fourth quarter witnessed a fall in orders of 2½% against the summer. The previous year's figure was now exceeded by 12%, compared with just over 16% before. Manufacturers of capital goods were particularly affected by this. Fairly sizeable losses were recorded especially by machinery and equipment manufacturers and motor vehicle manufacturers. In the case of the latter, this also had an impact on the area of durable goods through private demand for passenger cars.

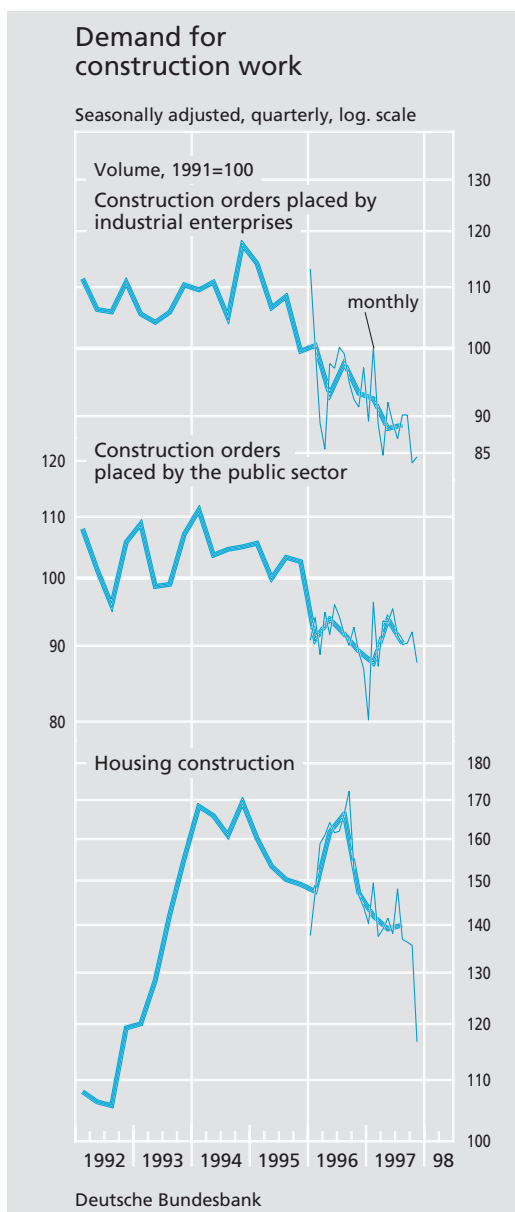
*Domestic
demand*

By contrast, seasonally adjusted domestic orders remained stable in autumn; in real terms, they have risen by 3% during the past twelve months. This indicates a certain improvement in comparison with the summer months, too, in which the year-on-year rate was 2½%. Nevertheless, this improvement was almost entirely confined to the basic goods sector, in which the year-on-year rise in orders was around 6%. By contrast, orders placed with both manufacturers of capital goods and of durable and non-durable consumer goods were either no higher, or only slightly higher, than the previous year's level.

*Orders position
in construction*

There was a further fall in demand for construction work in autumn 1997. After eliminating seasonal factors, orders received in the two-month period October/November were 5% below the summer level, which had already brought a decline in comparison with the first half of the year. In real terms, orders received were around 8% down on the pre-





vious year, a figure which was just as high as in the preceding months. Ordering had already been showing a negative trend for some time; it is now more than one-fifth below its most recent high of autumn 1994. There has been a major slump in residential construction right up to the present. Although construction permits for single-family houses have stabilised since summer 1997 in the old Länder, the decline in demand for

housing construction resulting in orders has fallen so sharply of late that there was a fall of around 15% in Germany as a whole in October and November. At almost 9%, industry continued to cut back its demand appreciably – something which was again especially marked in the new Länder. No positive stimuli were generated by public sector orders either, although contracted building projects remained at the previous year's level.

Prices

Price movements at the turn of the year 1997-8 remained calm at all major processing and marketing levels. One of the main reasons for this was the marked decline in international prices for raw materials. Oil prices, in particular, showed a sharp fall and were as much as one-third lower than the previous year's level, calculated on a US dollar basis. A significant factor in this was that the earlier and, if anything, generous production quotas were confirmed at the autumn conference of the OPEC countries; additionally, demand was limited due to the comparatively mild winter in Europe up to early January and the growth losses in the East Asian countries affected by the financial crisis. The latter situation is also likely to have played a part in the persistent fall in prices for industrial raw materials, which, according to the surveys of the Hamburg Institute for Economic Research (HWWA), were just over 10% cheaper at the beginning of 1998 than a year before. Only prices for internationally traded food, drink and tobacco goods held up more strongly; even though they had peaked before spring

*International
raw material
prices*

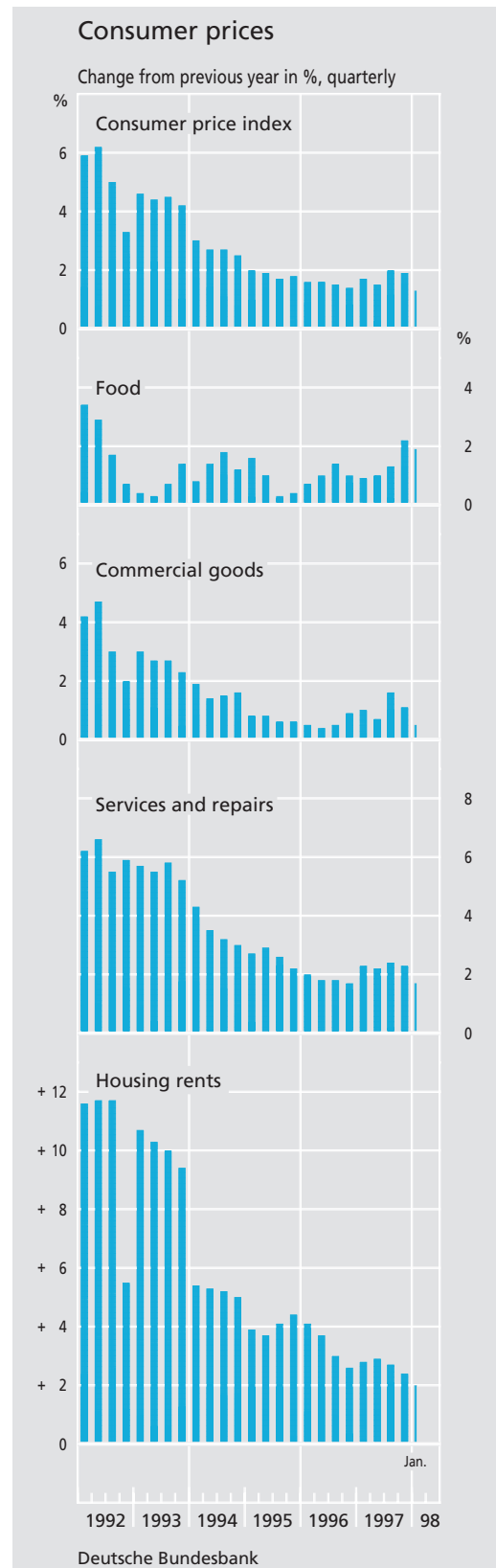
1997, at the beginning of 1998 they were still one-fifth higher than the previous year's level.

Import prices

Although the overall easing of prices generated by the commodity markets was not fully reflected in prices in local currency terms in Germany due to the trend depreciation of the Deutsche Mark against the US dollar, import prices did fall during the last few months of 1997. The year-on-year increase fell from 5.4% in August to 2.0% in December. Raw materials and semi-finished products, which had generated strong inflationary pressure at the beginning and in the summer of 1997, were much cheaper to buy recently than a year before, in fact.

Producer prices

External easing of pressure and continuing fierce competition in the domestic sales markets have played a part in domestic industrial selling prices having remained virtually constant in the last few months of 1997 in seasonally adjusted terms. The comparable level of 1996 was undershot by no more than 1.1% in December. The figures for products of the capital goods sector and for consumer goods were no more than + 1/2 % and + 1/4 %, respectively. By contrast, there was a comparatively sharp rise in prices for products of the food, drink and tobacco industry, at 1 1/2 %. This was due, firstly, to the effects of the fairly high prices for drink and tobacco on the world markets and, secondly, domestic agricultural sales prices at the end of 1997, which were around 5 % higher than the previous year's level.



*Construction
prices*

The slight fall in construction prices in the preceding two years did not continue in autumn 1997. After eliminating seasonal factors, the overall construction price level, calculated by the Bundesbank from the data of the Federal Statistical Office, was just as high in November as it had been in August. In Germany as a whole, the comparable level of the previous year was undershot by 0.5%. At 1.3%, the year-on-year fall was below average in the new Länder. Given the continuing unfavourable situation in eastern Germany, prices were reduced further in autumn, too, whereas prices stabilised slightly in western Germany.

*Consumer
prices*

Given the moderate price trend in imported and domestically produced consumer goods, the price movements of industrial products at the consumer level were likewise within narrow bounds. In seasonally adjusted terms, they were scarcely dearer at the beginning of 1998 than on an average of the summer months. Although they were 1% higher than the level in the corresponding period last year, it should be borne in mind that the dramatic increase in prescription charges in July 1997 was still having an effect on this; excluding prescription charges, the year-on-year increase in the rate of inflation for industrial products was less than half as much. Given the price slump in the international markets, mineral oil products have latterly be-

come appreciably cheaper for households, too. There was a year-on-year fall of 2½% in prices for energy overall; in autumn 1997, there had been a rise of ½% compared with the corresponding period of 1996. On the other hand, there was hardly any easing in pressure on prices for food, services and rents. Seasonally adjusted, the rise in the last three months was more or less as high, at around ½%, as in the period August to October; the year-on-year rise at the beginning of 1998 was roughly 2%. In January, the consumer price index was 1.3% higher than the figure for 1997. This is a sharp fall compared with the average of the last quarter of 1997 (1.9%), although it is partly a reflection of a statistical baseline effect due to a significant increase in radio and television licence fees in the previous year.

Measured by the harmonised indices, the rise in consumer prices in the European Union over the preceding 12 months was 1.7% in December 1997. (The comparative German rate at the same time was 1.4%). Here, too, the price increase for industrial products was well below average, and was, for example, no more than 1% in the case of clothing, footwear and household goods. Inflation in some services was far above average; the year-on-year rate in the health care and education sectors was 3.4% and 3.8%, respectively.

*Harmonised
consumer price
index*