

## Economic conditions

### International environment

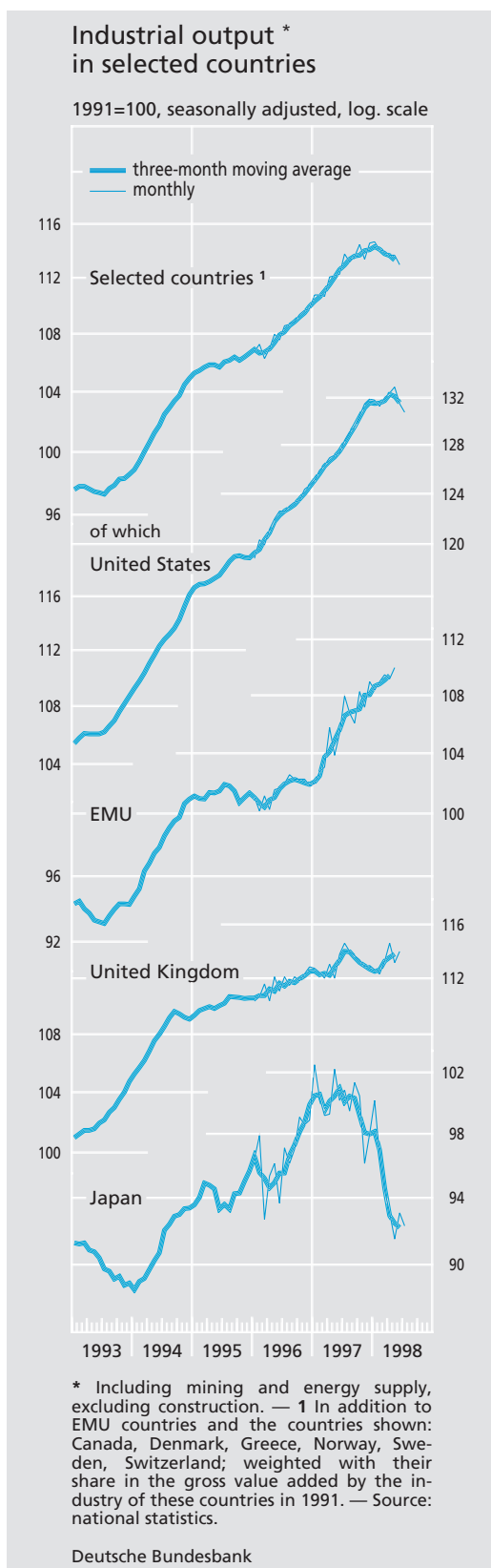
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There was a perceptible slackening of momentum in the world economy during the first half of 1998. The slump in overall output – especially in those East Asian countries from where the turbulence in the financial and foreign exchange markets emanated in the second half of 1997 and thereafter – was considerably greater than had been widely expected initially. As a result of the dramatic cutback in domestic demand in those countries and the sharp depreciation of their currencies (including the Japanese yen), other economies in that region, which had been comparatively little affected at first and had maintained their parities with the US dollar largely unchanged, came under pressure to adjust. In the case of Japan, the recession that was heavily marked by domestic problems was further exacerbated by negative stimuli from its neighbouring countries. In the summer months of this year Russia, too, again suffered a severe setback. The initial successes achieved on the road to stabilising overall economic growth have thus been called into question once more.

*Loss of momentum in the world economy...*

These strains and risk factors stand in contrast to the fact that cyclical activity in North America is still in full swing, despite the existence of some weakening factors, and sharp growth in the countries of the future European monetary union (EMU) in the first half of 1998. Given very robust domestic demand in the United States, the quite considerable losses in the foreign markets in the Far East and the rise in imports from that region also had a stabilising effect on prices and steadied

*... while the trend continues to be favourable in North America and western Europe*



the economy. In the future EMU area, losses in exports to East Asia (which have a lesser impact on the economy as a whole in any case on account of there being fewer trade links) were, in fact, more than offset by the strengthening of domestic economic activity. A part in this was played by the expansionary side effects of the crises in East Asia, such as the decline in capital market rates fostered by shifts in portfolios and the sharp fall in the prices of major imported raw materials and intermediates. The latter factor has also had a favourable impact on the price climate in the industrial countries.

It is likely that aggregate output in the East Asian countries most severely affected by the crisis has not yet reached its lowest point. Furthermore, the foreign exchange and financial markets remain highly susceptible to disturbances. However, it is encouraging that these countries' previously large current account deficits have, in all cases, been sharply reduced or even entirely eliminated since the outbreak of the crises. Pressing consolidation requirements are also a feature of the problematic situation of the Russian economy, where the weakness of the producing sector and a shaken financial sector coexist with chronic shortcomings in public sector budgeting and political uncertainty. Putting in place a "weatherproof architecture" for the economic structures, in general, and the financial sector, in particular, is a major requirement for overcoming the crises on a lasting basis. Experience has shown, however, that this needs time. It will therefore be all the more important that the forces bearing political responsibility are capable of action and that

*Fragile situation  
in East Asia,  
severe setback  
in Russia*

convincing steps are taken in the right direction.

*Japan*

One of the factors making it significantly more difficult to overcome the crises in East Asia is that Japan is currently unable to perform its role as a strong and dominant economic power in the region because it has cyclical and structural problems of its own. Intermittently heavy pressure on the yen to depreciate even generated a considerable destabilising impact on its neighbouring countries. According to the most important cyclical indicators, the downward trend continued unabated in the months of April to July. Seasonally adjusted industrial output was 4½% lower than in the first quarter, and thus 8% below its level in the corresponding period last year. This was mainly due to a further decline in households' consumption expenditure and drastic cutbacks in enterprises' plans for investment. Added to this were recessionary tendencies in residential construction; given extremely low interest rates, one factor in this is likely to have been deep-seated uncertainty on the part of households. So far, exports have not been able to form a counterweight to this, especially as sales of Japanese goods to neighbouring countries continued to contract sharply despite major increases in turnover in the case of exports to western Europe and North America. At constant prices, total exports of goods were still below their mid-1997 level at the end of the period under review. The current weakness of the Japanese economy is also reflected by the fact that consumer goods were somewhat cheaper on average in July and August than a year be-

fore, despite import prices rising again due to depreciation.

*United States*

In spring 1998, exporters in the United States, who were selling more than one-quarter of their goods to the East Asian market (including China and Japan) before the outbreak of the crises, supplied one-fifth less to that region than in the corresponding period of 1997. This was a major factor in total real exports of goods and services being no more than 1% higher than they had been twelve months earlier. In seasonally adjusted terms, they were 2% down on the level of the previous quarter. Given a simultaneous sharp rise in imports, there was a further increase in the foreign trade deficit. Other retarding effects were generated in the second quarter by a major reduction in stocks, which had been built up quite significantly in the preceding period. By contrast, private consumption remained very buoyant. There was also a sharp increase again in industrial investment and residential construction. According to figures which are still provisional, real gross domestic product in the second quarter, seasonally adjusted, was ½% higher than in the preceding period and 3½% up on the corresponding period of last year. In manufacturing, which is the sector most severely affected by the fall in exports, there were (for the first time in quite some while) seasonally adjusted job losses on balance in the period from April to August. The unemployment rate, at latterly 4.5%, remained very low, however. Despite the continuing tight situation on the labour market, price rises at the consumer level, at a year-on-year rate of 1.6%, remained quite subdued in the four-month period of April to

July – mainly on account of external stimuli fostering stability.

*United  
Kingdom*

Much as in the United States, sentiment among British exporters was severely depressed in spring. There were considerable falls in sales compared with a year earlier, not only because of the decline in demand from East Asia but also on account of the high valuation of the pound sterling against major partner currencies. The fact that real value added in manufacturing stagnated at the (already depressed) level of the first quarter in seasonally adjusted terms and the continuing decline in capacity utilisation are consistent with this picture. All of this is likely to have played a major part in the downward trend in expenditure on new machinery, equipment and buildings. Private consumption, on the other hand, was a mainstay of the economy, being a seasonally adjusted  $\frac{3}{4}$  % higher in the period from April to June than it had been in the winter months. After eliminating seasonal variations, aggregate output grew by  $\frac{1}{2}$  % against the first quarter (when it had expanded by  $\frac{3}{4}$  %) and by  $2\frac{1}{2}$  % compared with the corresponding period of 1997. The rise in consumer prices, which had been affected at the beginning of spring mainly by the raising of indirect taxes and charges, slowed down to 2.6 % (excluding mortgage rates) in July.

*EMU*

In the future EMU, the upswing, increasingly being driven by domestic demand, continued in the spring. Measured by the real GDP of four larger member countries (Germany, France, Spain and the Netherlands), for which more recent data are available, economic growth did decline in seasonally adjusted

terms from just under 1% in the first quarter of 1998 to  $\frac{1}{2}$  % (exceeding the figure for the corresponding period of 1997 by  $2\frac{1}{2}$  %). However, this was essentially a reflection of the sharp expansion in the winter months, which had been favourably affected by special factors. There was a further rise in capacity utilisation in industry in the period from April to July; together with low interest rates, this chiefly buoyed up industrial investment. As a result of the general upward cyclical trend in the EMU, there was a slight easing of the situation on the labour market; the (standardised) unemployment rate in the EMU fell within one year by  $\frac{1}{2}$  percentage point to 11.1% in July.

In spring, the price trend at the consumer level in the EMU was no longer quite so favourable as it had been at the start of the year. The year-on-year rate of inflation had fallen to 1.1% in the first quarter, but rose to 1.4% by July. Especially in Ireland and Portugal, the quite sharp rise in the inflation rate to latterly 2.5% and 2.8%, respectively, reveals a strengthening of expansionary forces. In addition to cyclical influences, the raising of indirect taxes contributed to the somewhat faster pace of price rises in the EMU as a whole.

## Germany

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### Output and labour market

In spring, the German economy moved in comparatively calm waters, but the basic trend remained upwards. In the first few months of the year, a number of temporary

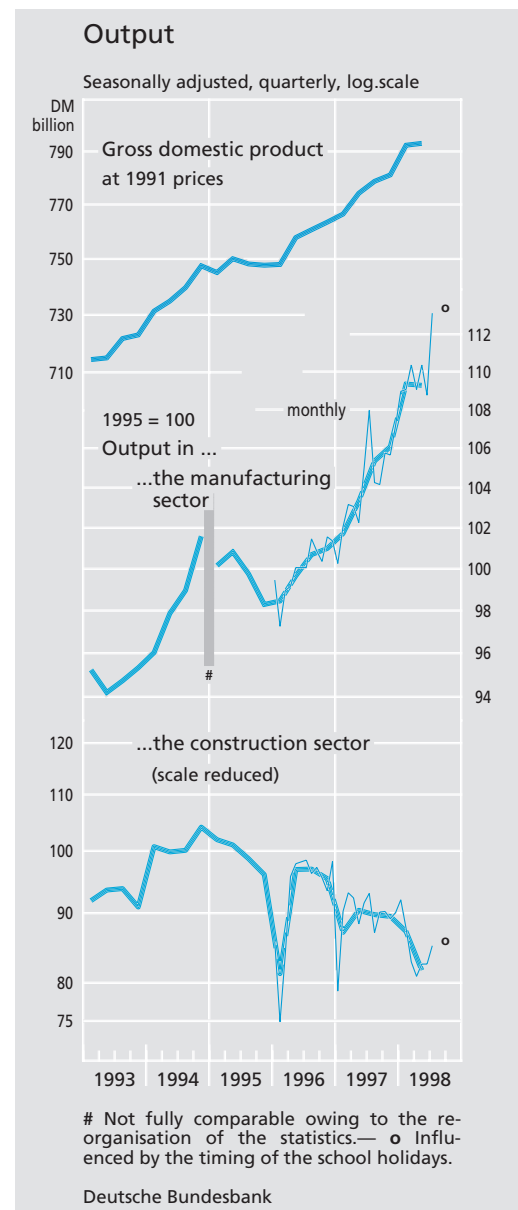
*Gross domestic  
product in the  
second quarter*

factors – not least, the mild winter weather and anticipatory effects associated with the raising of value added tax – had contributed to aggregate output expanding, if anything, more sharply than was consistent with the pace of economic growth. The sideways movement in the real economy in the second quarter thus mainly reflects a “technical reaction” to the preceding special factors. The effects of the gloomier global economic setting were being felt but so far remained limited overall.

Initial calculations by the Federal Statistical Office for the period from April to June, adjusted for seasonal and working-day variations, show that real GDP was just as high as in the first three months of the year. In comparison with the corresponding period of 1997, this means a rise in output of 2 ½ %. In the first half of the year as a whole – which is far less distorted by the special influences – aggregate output increased in seasonally adjusted terms by slightly more than 1 ½ % compared with the second half of 1997; the level of the first six months of 1997 was exceeded by 3 %.

*Sentiment in industry*

The most recent results of the ifo Institute’s surveys reveal that sentiment in German industry – which generates the crucial cyclical stimuli – is still largely characterised by positive expectations despite the external disrupting factors. In the spring months, a clear (and, in fact, what has become a slightly larger majority) of enterprises rated the current business situation as good. Orders on hand were increasing up to the end of the period under review and, at the end of the



first half-year of 1998, were larger than at any time since the early nineties. The continuing high degree of utilisation of industrial plant and equipment and the sounder earnings position reinforced this tendency. Even so, the assessment of the future trend has become more cautious, which has meant that prospects for output in the near future have not remained unaffected. The fact that major underlying conditions continue to be favour-

able was the main reason why the positive elements nevertheless predominated. Furthermore, rationalisation efforts during the past few years have strengthened enterprises' resilience.

*Manufacturing  
output*

On an average of the months April to July, seasonally adjusted manufacturing output was somewhat higher than its level in the first quarter of 1998.<sup>1</sup> Since it had almost shot up at the start of the year, production continued to be at a high level. This is reflected, firstly, by the sharp year-on-year rise in output of nearly 5%. Secondly, capacities continued to be used to a noticeably higher extent than on a long-term average. East German industry – which can boast modern and efficient production plant in many cases – again performed well above average. In the observation period of April to July, there was a year-on-year rise in east German output of no less than 9%.

*Capital goods  
sector*

Both in western and eastern Germany, the trend in the case of capital goods producers was less dynamic than in the first few months of the year. On an average of the period from April to July, seasonally adjusted overall output was not significantly higher than the level reached in the winter quarter of 1998. Even though a growth of as much as around 6½% was achieved compared with the corresponding period last year, this was still much less than at the beginning of the year when the rise, at just over 10%, had been decidedly high. In particular, manufacturers of machinery and equipment, the most important area in the capital goods sector, were unable to maintain the starting pace of early

1998. The same applies to manufacturers of structural metal products. Taking turnover as a yardstick, supplies to domestic customers, in particular, were no longer as large. Thus, according to the calculations for the national accounts, real investment in machinery and equipment, too, fell by a seasonally adjusted 2½% in the second quarter. Even though the previous year's level continued to be distinctly exceeded, namely by 7½%. Taking the first half-year as a whole, enterprises invested over 6½% more than in the second half of 1997 – a clear sign of a greater propensity to invest on the part of many firms, following a period of several years in which they had tended to exercise restraint in terms of new commitments.

Business activity in the construction sector, on the other hand, remained subdued. In construction, output during the period of April to July – after eliminating seasonal fluctuations – was 5½% lower than in the first quarter of the year, which had, however, benefited from the mild winter weather. Compared with 1997, this signifies a decline in output of 9%. The decline in construction output was especially sharp in eastern Germany, where the slowdown over the past few months amounted to no less than 16%; in the over-ground building industry alone – in which residential construction has the greatest share – the figure was almost one-fifth. Despite this sharp downturn, the construction sector's share in total output in eastern Ger-

*Construction  
output*

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<sup>1</sup> Although there was a very sharp rise in output in July – taken in isolation – this may be regarded only in part as a reflection of the cyclical trend since the impact of the holidays, which is usual at this time, was extremely slight.

## Expenditure of gross domestic product (GDP)

Adjusted for seasonal and working-day variations \*

Germany

Period	GDP	Domestic expenditure	of which				Buildings	Net exports	Exports	Imports
			Private consumption	Government consumption	Machinery and equipment					
at 1991 prices in DM billion										
1997 3rd qtr	779.8	768.3	441.2	153.6	67.8	97.3	11.5	239.7	228.2	
4th qtr	782.2	774.3	443.7	149.0	68.7	96.6	7.9	239.1	231.2	
1998 1st qtr	793.5	787.3	447.5	154.6	73.8	96.8	6.2	239.6	233.4	
2nd qtr	794.3	788.0	444.5	156.5	71.9	91.2	6.2	245.5	239.3	
Change from previous quarter in %										
1997 3rd qtr	0.6	-0.2	-0.5	-1.3	1.3	0.3	.	5.4	2.9	
4th qtr	0.3	0.8	0.6	-3.0	1.3	-0.7	.	-0.3	1.3	
1998 1st qtr	1.4	1.7	0.9	3.8	7.4	0.2	.	0.2	1.0	
2nd qtr	0.1	0.1	-0.7	1.2	-2.6	-5.8	.	2.5	2.5	
at current prices in DM billion										
1997 3rd qtr	910.9	892.5	525.1	175.4	70.3	111.5	18.4	252.0	233.6	
4th qtr	915.5	900.8	529.1	171.2	71.3	110.6	14.7	252.6	238.0	
1998 1st qtr	933.4	917.0	533.6	177.7	76.3	110.7	16.4	253.9	237.5	
2nd qtr	936.5	917.6	533.1	179.7	74.5	104.0	18.9	260.3	241.3	
Change from previous quarter in %										
1997 3rd qtr	0.7	0.2	0.1	-1.7	1.6	0.4	.	5.5	3.9	
4th qtr	0.5	0.9	0.8	-2.4	1.4	-0.8	.	0.2	1.9	
1998 1st qtr	2.0	1.8	0.9	3.8	7.0	0.1	.	0.5	-0.2	
2nd qtr	0.3	0.1	-0.1	1.1	-2.4	-6.1	.	2.5	1.6	

\* Revised figures.

Deutsche Bundesbank

many is still around three times higher than in western Germany.

### Employment

In spring, there was a further improvement in the situation on the labour market in Germany as a whole. Employment is now showing a distinct upward trend. According to the calculations of the Federal Statistical Office, there was a seasonally adjusted rise in the number of persons in work to 33.95 million up to June. This was around 100,000 more than at the turn of 1997-98. The comparable 1997 level, too, was only slightly under-shot by 15,000; in the first quarter the figure had still been - 190,000 compared with 1997.

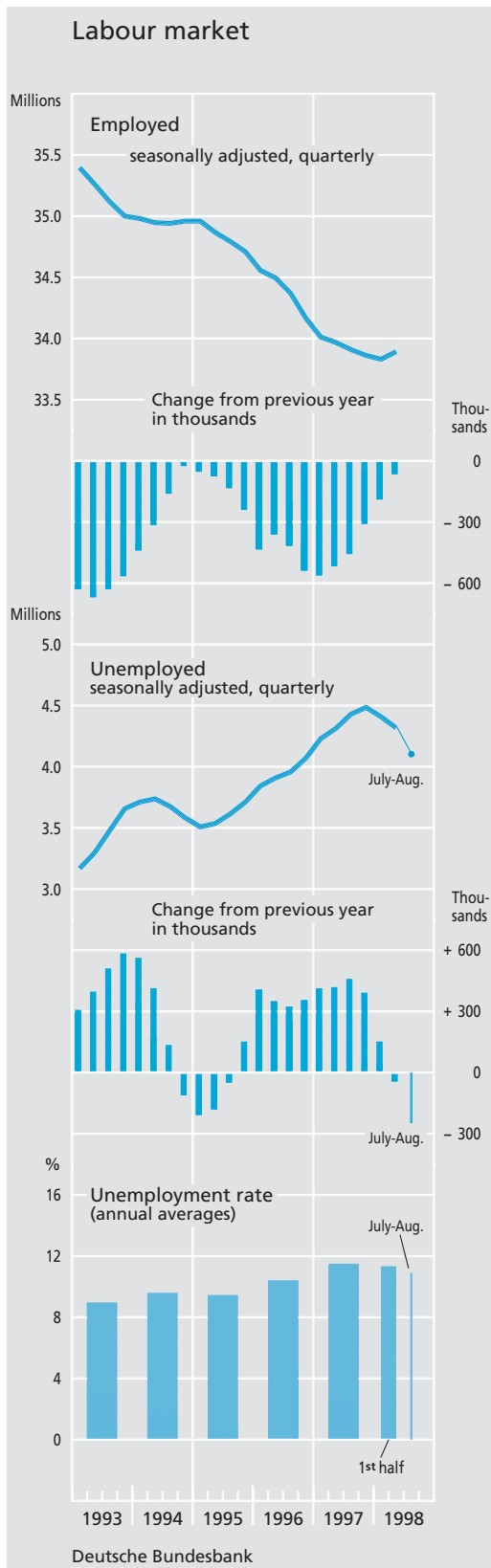
### Sectoral trends in employment

As far as is shown by the statistical information, the shedding of labour in industry over a

number of years has come to a standstill and, in some sectors, has already given way to a slight increase; additionally, firms have raised the working hours per employee. In the construction sector, on the other hand, the shedding of jobs - especially in eastern Germany - has continued.

Apart from the favourable cyclical trend, the increase in employment is also due to a perceptible expansion of job creation measures by the Federal Labour Office. In June, just under 400,000 employees were being supported by structural adjustment measures (which include labour cost subsidies) and job creation schemes, i.e. 130,000 more than at the end of 1997 and around 95,000 more than twelve months previously. In July and August the number rose again sharply to

*Job creation measures*



nearly 470,000; 80% of these measures were to the benefit of the new Länder.

There has been a perceptible fall in unemployment over the last few months. Calculated from the base of the most recent peak at the turn of 1997-98, the number of unemployed registered with the Federal Labour Office – after eliminating seasonal variations – fell by around 320,000 up to August. At the end of that month, their seasonally adjusted number came to 4.20 million. The unemployment rate fell from 11.8% at the end of 1997 to 10.9% at the end of the period under review; in eastern Germany the corresponding figure declined from 19.7% to 17.7%. In addition to the improvement in the cyclical situation, labour market policy measures, too, played a part in the decline in unemployment.

*Unemployment*

#### Trends in demand

During the last few months, domestic and foreign customers continued to show great interest in German industrial products. Measured in terms of manufacturing orders received, seasonally adjusted demand in the period from April to July was just as high as in the preceding first quarter, which was itself significantly up on the figure for the end of 1997. At the end of the period under review, there was thus a perceptible increase (at constant prices) of 4½% compared with the level in the same period last year.

*Manufacturing orders received*

There was a further slight increase in orders from abroad in spring, too. On an average of the period from April to July, they were nearly

*Foreign demand*



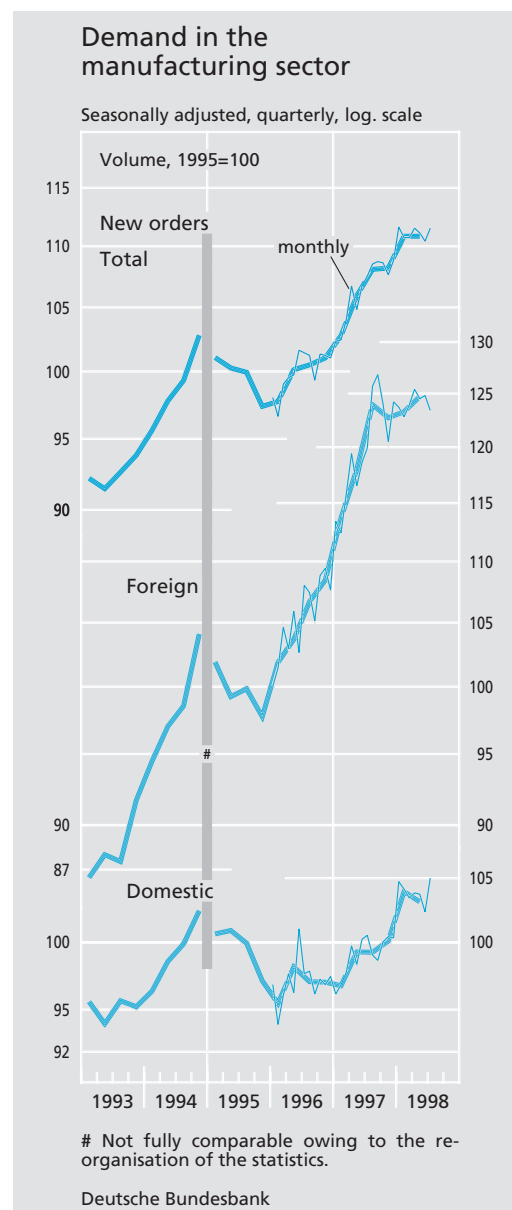
1% higher, seasonally adjusted, than the average figure for the first quarter. At the end of the period under review, their growth was up 5% on the year at constant prices. The fact that the surveys of the ifo Institute show that enterprises assess export business no more than cautiously at present is undoubtedly a reflection of a slackening of momentum in comparison with 1997, when year-on-year growth rates had still been in double figures.

*Domestic demand*

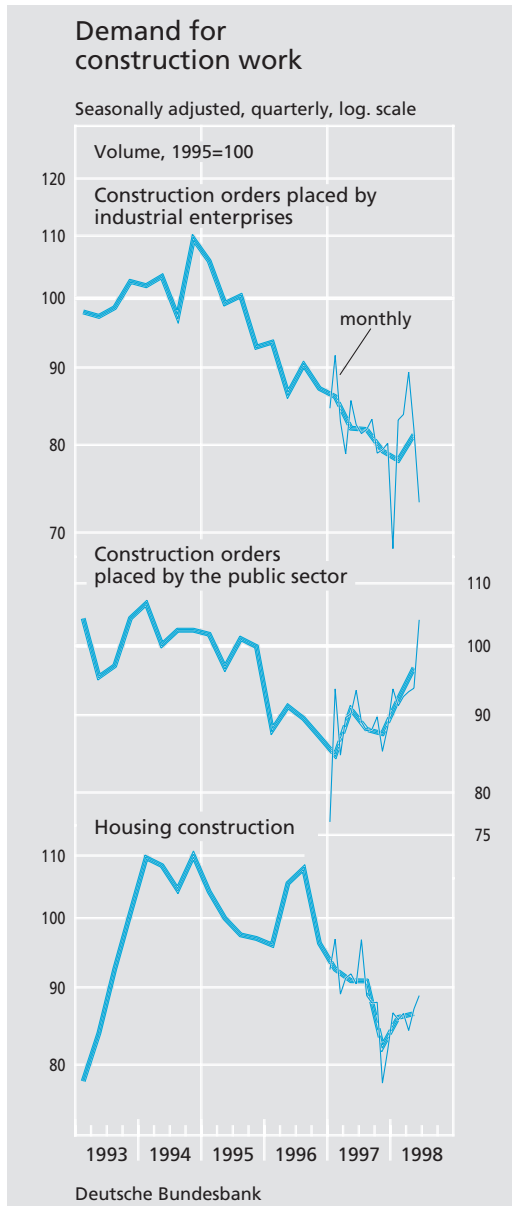
In the period from April to July, domestic orders received were just over ½% down on the first three months of the year in seasonally adjusted terms; however, taking into consideration the fact that several particularly large orders had been placed in the first quarter, resulting in almost a jump-rise in the flow of orders, this decline should not be over-emphasised. This is also indicated by the sharp year-on-year rise which – despite the obvious easing-off by comparison with the first quarter – was no less than twice as high, at around 4%, as in 1997 as a whole. The slight fall in incoming orders in the case of capital goods producers is therefore not an indication of a renewed sustained slowdown of investment activity, which had risen perceptibly in the first few months of 1998. At all events, in the spring survey of the ifo Institute, west German manufacturing enterprises stated that they intended to increase their expenditure on investment in machinery and equipment by around one-tenth in 1998.

*Construction orders received*

In spring, there appears to have been a further turn for the better in demand for construction work. At least, on an average of the



second quarter, orders received by the construction industry were around 3½% higher, seasonally adjusted, than they had been in the first three months of the year; compared with the low level of autumn 1997, this represents a growth of 6%. For the first time in four years, the year-on-year rate was not undershot (+0.6%).



*Individual construction subsectors*

The upward trend was sustained mainly by increased orders placed by the public sector, which had become more active in the first few months of 1998 following greater restraint last year. Another positive factor was a favourable trend in orders for industrial construction. In this subsector, the level of orders received in the first few months of the year was exceeded by almost 4% in spring, the shortfall compared with the corresponding

period of 1997 fell to 1.5%, against 8% previously. Taking construction permits as a yardstick, factory and workshop buildings, in particular, were in increasing demand recently, whereas shopping facilities and warehouses were somewhat relegated to the background. Demand for residential construction, on the other hand, remained comparatively subdued up to the end of the period under review; in the second quarter it was no less than a total of 4¾% below the previous year's level. The decline in eastern Germany was perceptibly greater still. The fact that the trend in western Germany is much less unfavourable is due, in particular, to the construction of single-family housing which is meeting with a growing demand against a backdrop of stable construction prices and decidedly favourable mortgage rates.

### Households' consumption, income and saving

With the waning of the short-term peak in sales, mainly of consumer durables, which had been generated by the raising of value added tax as of April 1, consumption latterly went back to a more subdued level. In the second quarter, households' purchases from specialist retailers (excluding motor vehicles) did not quite equal the high level of the preceding months; demand, especially for household furniture and appliances, was lower. There was also noticeably less interest in acquiring private cars. Measured in terms of new registrations for private vehicles, the very high level of the first quarter was under-shot by roughly one-sixth in the spring months. By contrast, expenditure on services

*Consumption expenditure*

showed a further increase. Overall, households' real consumption in the second quarter was a seasonally adjusted ½ % lower than in the preceding quarter, although it was ½ % up on the level in the corresponding period last year.

*Disposable  
income*

From the income side, there was distinct scope for an expansion of private consumption. For the first time in a long while, there was a slight increase in employment. In industry, besides an increase in average working hours per employee, the wage rises in the metal-working industry, in particular, were a significant factor, too. Consequently, gross wages and salaries rose by a total of 1%, seasonally adjusted, in the second quarter of 1998 compared with the preceding quarter.<sup>2</sup> Net, i.e. after the deduction of employees' social security contributions and wage tax, labour incomes likewise increased by 1% against the first three months. Households received significantly more transfer payments from public cash offices than at the beginning of the year. This was primarily due to a change in the arrangements for the payment of unemployment benefits. Including other incomes, which comprise the (recently probably weaker) self-employed persons' private withdrawals for consumption and saving in addition to property income, households' disposable income in the second quarter grew by a seasonally adjusted ½ %. In nominal terms, this was 2 % and, in real terms, just over ½ % higher than the level in the corresponding period last year.

*Private saving*

Despite the increase in value added tax on April 1, there was thus scope for higher pri-

vate saving in the spring months. Its share in total disposable income went up, both in seasonally adjusted terms and in a year-on-year comparison, by around 12 ¼ %. The main reason for this was that the buying pattern returned to normal; during the first quarter, households had preferred to acquire durables to a large extent in order to avoid paying the higher rate of value added tax. In addition to higher incomes associated with the raising of the basic personal income tax allowance and the lowering of the solidarity surcharge, greater use had also been made of instalment credits to finance those purchases.

The slight adjustment in the level of the saving ratio, which had been declining for some time, cannot yet be regarded as having been consolidated. In the first half of 1998 overall, at around 12 %, saving – as a proportion of income – was no more than roughly just as high as in the preceding six months, or even slightly lower than in the first half of 1997. Moreover, the additional burden on private purchasing power as a result of higher value added tax is likely to weigh more heavily than the easing of pressure on income in terms of direct taxes in the second half of 1998. Apart from that, the very low interest rate level at present does not suggest a higher propensity to save.

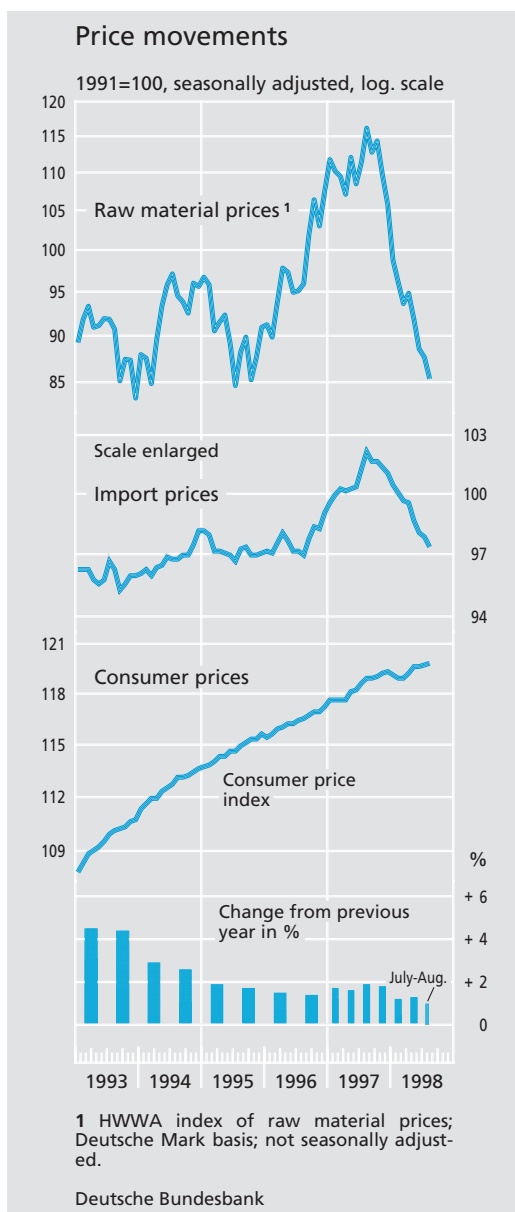
### Prices

The price climate in Germany remained decidedly friendly over the past few months,

*Consumer  
prices*

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<sup>2</sup> The retroactive 1.5% increase in the remuneration of civil servants as from January 1998 did not affect incomes until the third quarter.



too. Bearing in mind the probable “exaggerations” in statistical measurement, it is possible to speak generally of virtual price stability at present. By contrast, it is still not possible to identify deflationary trends, i. e. signs of a sustained downward trend in the general level of prices that is damaging to the real economy. This applies, not least, to consumer prices, even though the year-on-year rate of the consumer price index, which is in many

cases regarded as a yardstick of inflation by the general public, fell to + 0.8 % in August, compared with + 0.9 % in July and + 1.2 % in June. The fall in the year-on-year rate of inflation in both July and August was mainly due to special factors which somewhat understated the basic price trend. Firstly, the increase in surcharges when buying prescription drugs and, secondly, the raising of motor vehicle tax had a statistical base effect<sup>3</sup> in July. In August, the marked decline in the prices of heating oil and petrol, which has to be seen in close connection with movements in the international oil market, had a special effect when comparing this year with last year because their sales prices had shown a sharp rise in 1997. The year-on-year fall in the prices of these products doubled to nearly one-tenth at the end of the period under review.

Right up to the present, import prices have been a major factor in the calm price trend. Up to and including July – more recent information is not available at present – import prices were falling, resulting in imports, at the end of the period under review, being 3.3 % cheaper than they had been twelve months before. Significantly declining world market prices for raw materials and energy played a major part in this. Last year’s prices for finished products, too, were undershot latterly. Export prices had likewise been showing a seasonally adjusted decline well into the spring (even though this was noticeably less

*Import and export prices*

<sup>3</sup> The base effect means that a one-off increase in unit prices no longer has an effect after one year in a year-on-year comparison since the current price and the price a year ago are the same.

than the simultaneous decline in import prices), but have stabilised since May. This was accompanied by a further improvement in the Terms of Trade, the year-on-year rise growing to around 3 ½ %.

*Producer prices*

There was also a further decline in the domestic sales prices of German industry in seasonally adjusted terms. They were 0.4% below their level in the comparable period of 1997, one factor in which was the continuing decline in energy prices. Construction work became more expensive in the second quar-

ter as a result of the increase in value added tax. This also led to the overall year-on-year price level for construction work not being undershot for the first time in two years. Excluding value added tax, construction work remained around 1% cheaper than twelve months previously. The producer prices of agricultural products showed a further sharp decline in spring in seasonally adjusted terms. Since the last peak in autumn 1997, they have fallen by roughly 6%; compared with the corresponding level last year, the decline was not much smaller, at 4 ½ %.