

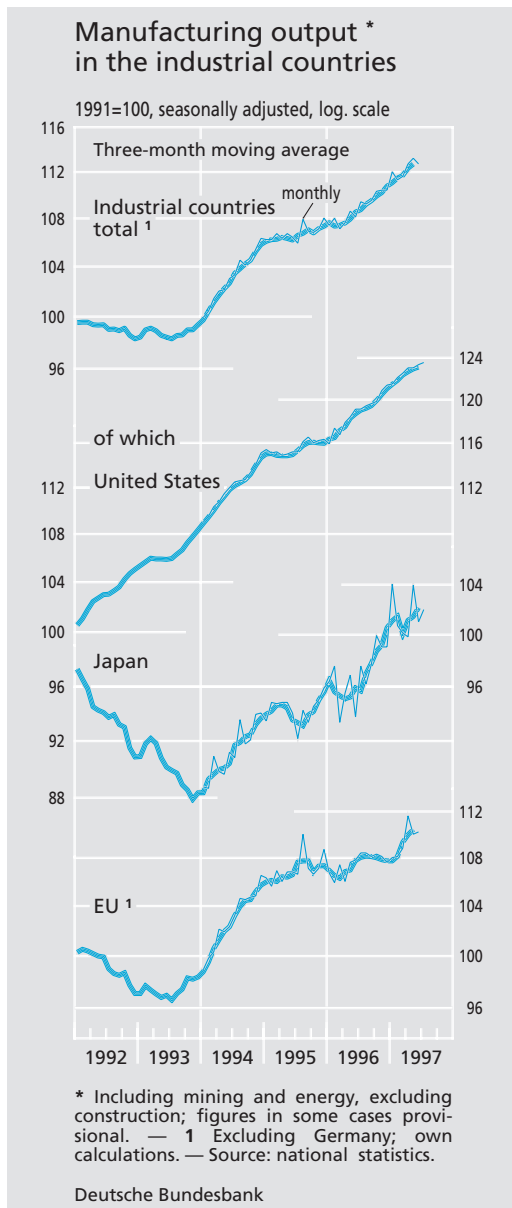
Economic conditions

International environment

The economic upturn in the industrial countries (excluding Germany) continued with unchanged momentum in spring 1997. In manufacturing (including energy production and mining), a sector which is particularly susceptible to cyclical changes, output exceeded the level of the first quarter by 1% in seasonally adjusted terms; it was thus 4½% higher than its level a year earlier. The regional breakdown, however, shows that there have been considerable shifts of emphasis. Japanese industry, which had still been expanding its production vigorously in the winter half year, stagnated in spring, whereas most of the continental European countries achieved stronger growth than at the beginning of the year. Industrial output in North America by and large continued on its previous course of expansion; capacity utilisation remained virtually unchanged of late.

*Industrial
countries*

The growth in output in the industrial countries continued to be free of particular pressure on prices. At 0.6%, the rate of inflation at the producer level of industrial products was, in fact, somewhat lower in spring than before. However, the slight fall in industrial selling prices in the United States compared with the corresponding period last year contrasted with a noticeable acceleration in western Europe and Japan. The differences in price movements are primarily due to the US dollar's appreciation against the continental European currencies and the Japanese Yen. As a result, raw material prices rose sharply for European and Japanese customers. So far, these imported inflationary stimuli have not



had much impact on the price climate in Germany. Overall, at 2.0%, the year-on-year rate of inflation at the consumer level remained relatively moderate in the industrial countries in the period from April to July.

South-East Asia, countries in transition

In some South-East Asian countries, especially in Thailand, the Philippines, Indonesia and Malaysia, currency turbulences have affected the economic outlook. Not least because the

US dollar, to which they had pegged their currencies, had continued to appreciate for some time, these countries found themselves facing increasing current account deficits, decelerating economic growth, rising capital outflows and shrinking foreign exchange reserves. Under those conditions, giving up pegging their exchange rate to the US dollar appeared inevitable. Growing external imbalances also affected the economic trend in some central and east European countries in transition. In the Czech Republic and in Poland floods caused severe damage in July, which is likely to hamper growth in the short term. There are initial signs of stabilising trends in the Russian economy following a lengthy period of decline. According to official figures, industrial production rose slightly in the first half of 1997 compared with the corresponding period last year and there was a dramatic fall in the inflation rate.

The growth of the US economy slowed down again somewhat in spring following a sharp rise in the preceding period. According to calculations which are still provisional, real GDP, adjusted for seasonal and working-day variations, rose by almost 1% compared with the first quarter and by 3½% against the corresponding period last year. The main reason for the more moderate growth rate was that households significantly cut back their demand for consumer goods in comparison with the winter months; overall real consumption, which accounts for some two-thirds of GDP, hence scarcely showed any increase over the period as a whole. However, the sharp rise in household income raises doubts as to whether this subdued propensity

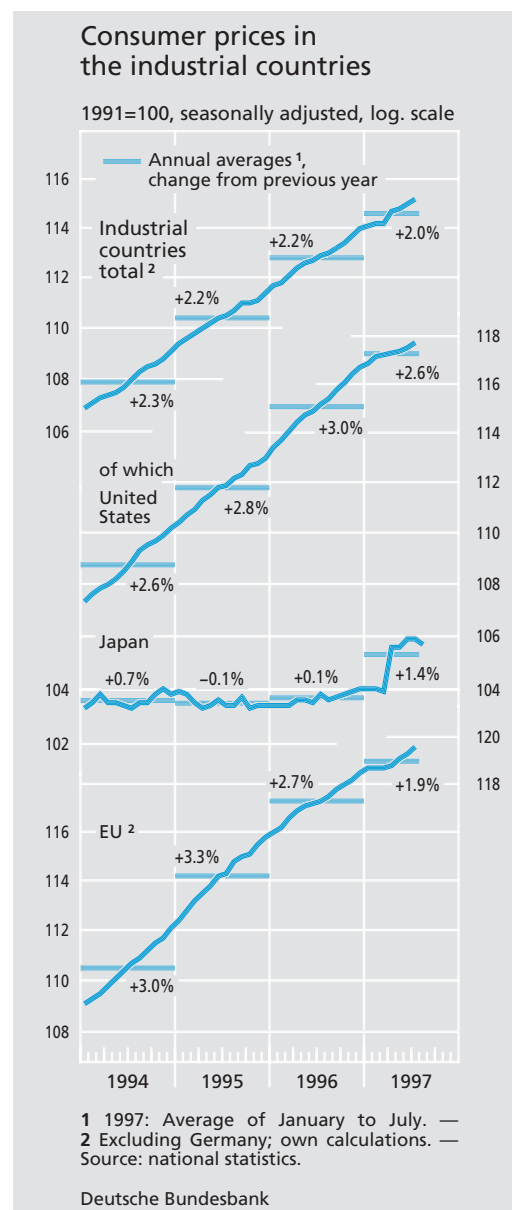
United States

to consume will persist. By contrast, investments, especially those of the manufacturing sector, grew much more strongly than in the preceding period. Despite the appreciation of the US dollar in real terms, this also applies to exports at constant prices and to imports, which grew at the same rate as exports; owing to the higher initial level of imports, the real foreign balance fell into deeper deficit, however.

As a result of continuing employment-intensive growth, a large number of new jobs were again created in the spring months, predominantly in the services sector. The unemployment rate was slightly below 5 %, seasonally adjusted, in July to August, which is the lowest level in 24 years. Even so, the US economy is obviously managing to mobilise ever new labour market reserves – something which is also reflected in an increasing share of woman and older persons in the labour force. Average hourly wages have risen comparatively little in the past few months. Together with the, at times, falling dollar prices in the commodity markets and more favourably priced imports this had a positive impact on the cost of living; there was a further slowdown in the inflation rate; in July, the year-on-year rate was 2.2 %.

Japan

As mentioned in the opening paragraph of this article, industrial output in Japan, after seasonal adjustment, was no higher in the period from April to July 1997 than it had been in the first quarter; it was, however, 6 % above the level of the corresponding period last year. This hiatus in growth did not come as a surprise, given the anticipatory effects as-



sociated with the increase in turnover tax as of April 1, with purchases – especially those of consumer durables – being brought forward. Weak domestic demand in spring also led to stockbuilding, which might tend to dampen enterprises' output further in the next few months. Exports were the mainstay of the Japanese economy in spring, and not least the buoyancy of export orders for capital goods suggests that this will remain the case

in the second half of the year, too. The 1.9% rise in consumer prices in July to August was a reflection of the preceding increase in turnover tax at the beginning of spring; in seasonally adjusted terms, however, consumer goods have scarcely become any more expensive since April.

Western Europe

The EU economies (excluding Germany) raised their industrial output by a seasonally adjusted 2% in the second quarter, which was a distinctly sharper increase than in the first three months of the year and nearly 4% higher than a year earlier. Capacity utilisation also rose in line with the expansion in output. In the EU as a whole, capacity utilisation in mid-year was, seasonally adjusted, 1 percentage point above the level of January 1997 and again noticeably higher than its long-term average. The improvement in output expectations in the first seven months was especially marked.

United Kingdom

The pace of expansion in British industry was not quite so buoyant, output in spring being ½% higher than in the preceding quarter in seasonally adjusted terms. By contrast, value added in the private services sector grew much more strongly, with enterprise-related services being the main beneficiaries. According to provisional figures, real GDP grew by 1% and was thus 3½% above the level of the corresponding period last year. A major stimulus to demand was again imparted by households, whose consumption budgets increased appreciably, for one thing, as a result of rising employment. Another factor is that these budgets were topped up by the sale of shares which were allocated in return

for previous shareholding rights when building societies and insurance enterprises gave up their mutual status and changed their legal form to that of a public limited company. In seasonally adjusted terms, British retail sales in the period from April to July exceeded the level of the first quarter by almost 2½% and that of a year earlier by just over 6%. Industrial investment activity is likely to have been very buoyant in view of the rapidly rising capacity utilisation. Information on the trend in foreign trade, however, is not entirely clear. Surveys suggest that foreign demand contracted dramatically, mainly as a result of the appreciation of the pound sterling; on the other hand, exports have held up quite well so far, and imports declined slightly in terms of value in the first half of 1997, which is due, in particular, to the J-curve effect which is active in the short term. The rate of inflation at the consumer level rose perceptibly by 3.4% in July to August – largely because of the increase in fuel taxes which came into force on July 1. Excluding mortgage interest payments, consumer prices were recently 2.9% higher than a year before.

France

In France, real GDP in the second quarter of the year exceeded the level of the previous quarter by 1%, seasonally adjusted, and was nearly 2½% higher than the level of the corresponding period last year. However, the cyclical upturn was not yet by any means broadly based, but was almost exclusively export-driven. Households' demand remained subdued in spring. The main reason for this was that unemployment, starting from a high level, was again showing a rising

trend. In addition, the disruptions which can still be observed in the car market caused by the abolition at the end of 1996 of government incentives to replace older cars were also a factor; registration figures in the second quarter were one-fifth below the level of the corresponding period last year. Consumer prices, by contrast, had a sustaining effect on purchasing power; their rate of increase, at 1.0%, was on a decidedly calm course.

Italy

At first glance, the Italian economy appears to have overcome its period of weakness in the winter half year: overall output, seasonally adjusted, rose by 1½% in spring compared with the first three months and exceeded the previous year's level by the same margin. Industrial output was buoyed up mainly by the higher demand for cars which was stimulated by government incentives (in terms of registrations in the second quarter, an increase of 48½% compared with last year). The question arises, however, as to whether there will be a slackening of demand next year – as in France at present – when this arrangement (which now has been extended) is to come to an end. Consumer prices in August were 1.7% higher than 12 months before.

Germany

Output and labour market

Overall output

After the lull of autumn 1996 had been overcome, the German economy began to grow again in the first few months of 1997 and ac-

celerated noticeably in spring. There was a distinct increase in capacity utilisation as well as a further improvement of mood in industry. One element which played a part in this more buoyant output activity was that difficulties which had arisen, in particular, as a result of the cold winter were no longer a relevant factor. According to the provisional calculations of the Federal Statistical Office, overall output, after adjustment for seasonal fluctuations and working-day variations, increased by 1% in the second quarter compared with the preceding three-month period; in comparison with the corresponding period last year it rose by 2%, after adjustment for working-day variations. The rate of expansion in the last few months was particularly high in the new Länder. Here, real GDP, adjusted for seasonal and working-day variations, rose by 2½% compared with the previous quarter, during which it had admittedly fallen just as markedly; the year-on-year rate shows a rise of no more than 1%. In western Germany, the year-on-year growth was 2%; compared with the first three months of the year, value added grew by slightly less than 1% at constant prices.

According to the latest revised figures of the national accounts, goods produced and services performed in Germany as a whole, adjusted for working-day variations, were 2¼% higher than in the corresponding period of 1996. This is likely to be also roughly in line with the current momentum of the revival in business activity.

The basis of the expansion, which was hitherto driven almost entirely by foreign

*Investment
activity*

demand, has now become more broader as a result of a perceptible rise in domestic industrial orders as well. However, investment activity is so far only picking up gradually in spite of the sharp increase in output and a greater capacity utilisation. A major factor in this might be that a large number of new production facilities have been created in the new Länder during the past few years, which it is now increasingly possible to use. The ifo institute's surveys show that the level of utilisation in eastern Germany was, until recently, distinctly below that of western Germany. An additional factor is that, in many cases, it is regarded as necessary to invest abroad in order to have a presence in the international markets. To that extent, domestic investments do not completely reflect the corporate sector's general propensity to invest. This also suggests that, when costing investments, the spread over the return on mostly risk-free financial assets is not the only important factor, but also the differential between the profitability of the fixed capital at home and abroad. Finally, uncertainties about the future development of labour costs, especially non-wage labour costs, and the taxation of corporate earnings might be having an unfavourable impact on the investment climate.

Manufacturing

In recent months, too, major stimuli to growth came – as before – from industry. After seasonal adjustment, its output in the period from April to July exceeded the average of the first quarter by 2 %. Within one year, manufacturing output hence rose by 5 ½ %, after adjustment for working-day variations. At 10 ½ %, the expansion was much sharper in the new Länder, whereas the

growth rate for western German was roughly 4 ½ %. While the producers of intermediate goods performed especially well in both parts of the country, trends were quite mixed in the case of suppliers of durable and non-durable consumer goods. Output in this segment fell appreciably in the old Länder, whereas there was a further perceptible increase in the new Länder. This also indicates that supplying regional markets continues to be of very great importance for east German industry. The increases in output by manufacturers of capital goods remained comparatively low in Germany as a whole.

There was a further increase in the utilisation of industrial capacity in the second quarter. At around 85 % of full production capacity, last year's level in western Germany was exceeded by about 3 percentage points in June and the upper end of the range of average medium-term utilisation by almost two percentage points. In eastern Germany, the degree of utilisation likewise rose distinctly – by 2 ½ percentage points compared with June 1996; according to ifo surveys, the level of 80 ½ % also continued to be much lower than that in the west recently.

The construction sector has recovered again somewhat from its dramatic slump in the first few months of the year. This had been caused partly by unfavourable weather conditions and partly by subsidy-induced anticipatory effects in eastern Germany. Measured by the figures for the construction industry, seasonally adjusted output in Germany as a whole was around 3 % higher on an average of the months April to July than it had been in the

Construction

Expenditure of gross domestic product (GDP)

Adjusted for seasonal and working-day variations *

Germany

Period	GDP	Domestic expenditure	of which				Buildings	Foreign balance	Exports	Imports
			Private consumption	Government consumption	Machinery and equipment					
at 1991 prices in DM billion										
1996 3rd qtr	768.3	764.9	440.4	155.3	64.9	103.1	3.4	208.0	204.6	
4th qtr	769.6	767.6	438.3	152.0	66.4	101.9	2.0	214.0	212.0	
1997 1st qtr	771.9	769.3	438.7	153.7	67.1	97.6	2.6	218.0	215.4	
2nd qtr	779.7	770.1	444.3	154.1	67.3	98.5	9.6	226.0	216.4	
Change from previous quarter in %										
1996 3rd qtr	0.5	-0.0	0.5	1.0	-0.0	0.5	.	3.0	0.5	
4th qtr	0.0	0.5	-0.5	-2.0	2.5	-1.0	.	3.0	3.5	
1997 1st qtr	0.5	0.0	0.0	1.0	1.0	-4.0	.	2.0	1.5	
2nd qtr	1.0	0.0	1.5	0.5	0.5	1.0	.	3.5	0.5	
at current prices in DM billion										
1996 3rd qtr	890.9	876.5	515.2	177.0	66.9	118.6	14.4	216.3	201.9	
4th qtr	893.3	882.7	515.0	173.8	68.4	117.3	10.5	222.0	211.4	
1997 1st qtr	902.2	891.8	518.6	177.6	69.0	113.3	10.4	227.2	216.8	
2nd qtr	909.2	891.3	526.6	178.1	69.4	113.3	17.9	237.0	219.2	
Change from previous quarter in %										
1996 3rd qtr	0.5	0.0	1.0	0.5	-0.0	1.0	.	2.5	0.5	
4th qtr	0.5	0.5	-0.0	-2.0	2.0	-1.0	.	2.5	4.5	
1997 1st qtr	1.0	1.0	0.5	2.0	1.0	-3.5	.	2.5	2.5	
2nd qtr	1.0	-0.0	1.5	0.5	0.5	0.0	.	4.5	1.0	

* Revised figures.

Deutsche Bundesbank

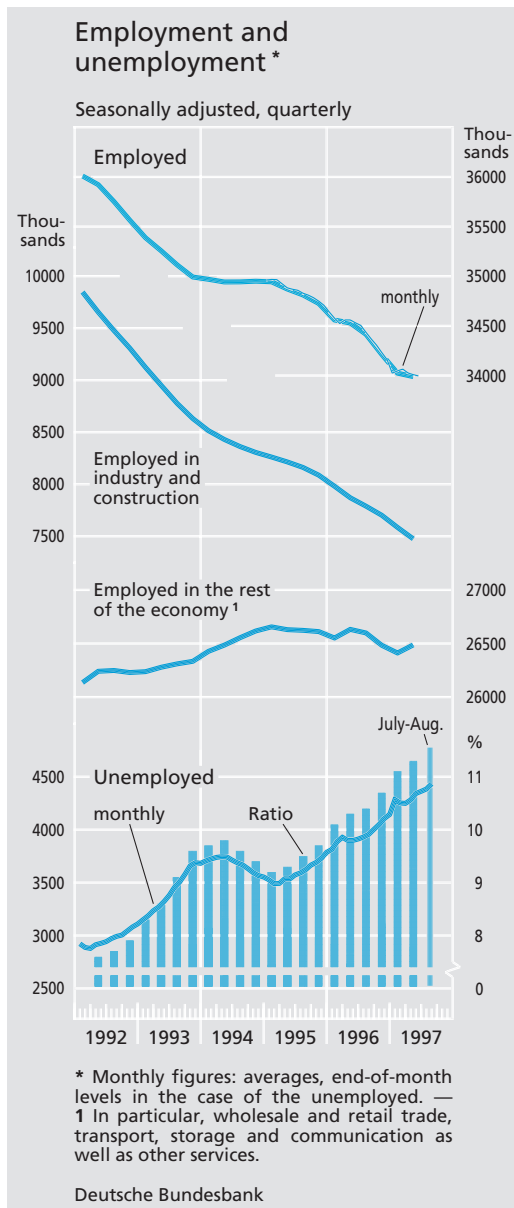
first quarter. Even so, it was still 8% lower than the level in the corresponding period last year. This clearly shows that the construction industry – which also includes many craft industries – is undergoing a phase of major structural adjustment after years of extremely buoyant construction activity.

Services

The little information available on the large area of the services sector indicates a sharp expansion in spring. The credit institutions, the insurance sector and the communications sector, in particular, played a part in the general increase in economic activity. The situation also improved in the wholesale and retail trade which had suffered a slump in the winter months.

The generally favourable trend in services had a decidedly positive impact on employment. The shedding of jobs, which had begun in spring 1996, is likely to have largely run its course. In the construction industry as well, the number of employees seems to be stabilising gradually, albeit at a very low level following the slump at the beginning of the year. Industry, by contrast, continued to make major cutbacks in its workforce. In spring, employment in those enterprises covered in the industrial statistics was again no less than 3¾% below its level in the corresponding period last year. The considerable restructuring efforts undertaken during the past few years, which result in significant gains in productivity, played a major part in this.

Employment



Overall, the number of employed persons continued to decline in Germany in the second quarter of 1997. According to initial calculations by the Federal Statistical Office, the seasonally adjusted number of employed persons was around 34 million in June. On an average of the spring months, this was roughly 535,000 persons fewer than the level of the corresponding period last year and a fall of 35,000, after adjustment for the usual

seasonal fluctuations, compared with the level of the first quarter. At all events, this is much less than in the first few months of the year, during which the fall against the previous quarter had been much higher at almost 190,000.

Unemployment, on the other hand, has increased at a virtually unchanged pace right up to the present. After seasonal adjustment, 4.46 million persons were registered as unemployed at the end of August, which is a rise of 470,000 against the previous year, compared with 400,000 in the second quarter. After elimination of seasonal fluctuations, the unemployment rate rose to 11.6 %; while almost one in ten persons of the labour force was jobless in the old Länder, the figure was almost one in five in eastern Germany.

The trend in the labour market should not be seen solely in connection with output activity. In purely mathematical terms, the sharp reduction in labour market policy measures likewise contributed to the rise in unemployment, although they still ease the regular labour market to a considerable extent. A quantitative indication of the changes in the "second labour market" is provided by a year-on-year comparison of the numbers of participants both in job creation projects and in the area of vocational training, which are the two most important instruments of the Work Promotion Act. For example, some 295,000 employees were still taking part in measures to promote employment at the end of August, i.e. almost 80,000 fewer than 12 months before. At the same time, 375,000 persons were attending vocational

Unemployment

Active labour market policy

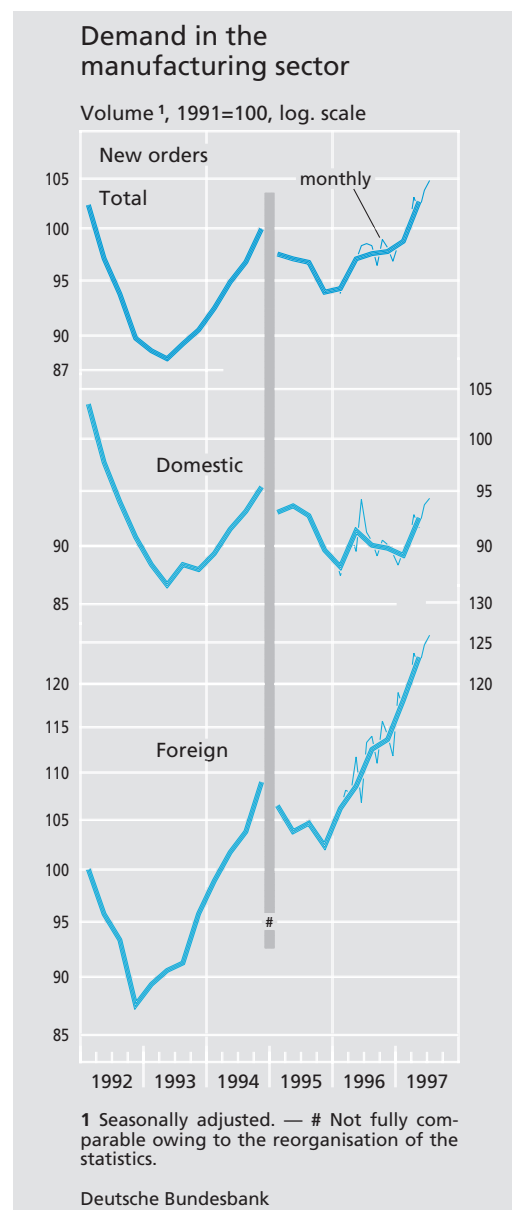
training courses, which was 145,000 fewer than last year's level. The easing effects of an active labour market policy have decreased, especially in the new Länder.

Trends in demand

*Orders received
by manufactur-
ing*

The demand for manufactured products rose even more sharply than output. At constant prices and seasonally adjusted, manufacturing orders on an average of the months April to July were 4 ½ % higher than in the preceding quarter; this was 6 % more than in the corresponding period of 1996 and almost 5 % compared with the first three months of that year. A major stimulus again came from foreign demand. The level of foreign orders showed a further increase of 4 ½ % in the spring months. The fact that they had been expanding sharply for some time is reflected by a growth rate of 13 % against the corresponding figure last year. The producers of intermediate goods and capital goods benefited from this in almost equal measure, whereas the producers of durable and non-durable consumer goods lagged behind somewhat.

For the first time in a long while, domestic demand showed a marked rise, too. At around 4 ½ %, seasonally adjusted, its growth in the spring months (including July) was not much lower than that of export business. Although the year-on-year rise was no more than 2 % latterly, this reflects the fact that domestic demand was very subdued until recently. In the recent past, there has been a particularly large increase in orders received by manufacturers of intermediate goods. Be-



sides the chemical industry, manufacturers of basic metals and fabricated metal products, and the suppliers to the electricity industry, in particular, recorded a marked improvement. Statistically, these industries are not classified as producers of capital goods; however, a whole series of their products may be considered as capital goods. Domestic business investment is therefore stronger than is indicated by an analysis restricted to capital

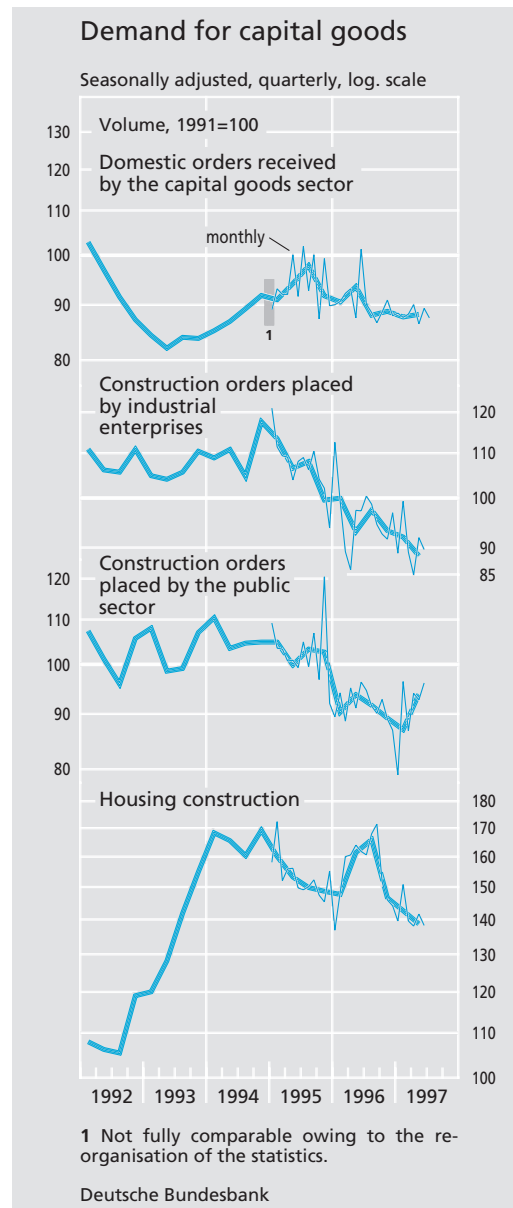
goods producers as defined in the official statistics. Demand here was rather subdued, the figure for the period from April to June was no less than 5 % below the figure for the comparable period last year. By contrast, orders received by the producers of durable and non-durable consumer goods were much more favourable, benefiting not least from the lively interest in new passenger cars.

Demand for construction work

Demand for construction work stabilised at a low level in the past few months. This was due to the considerable number of orders being placed by the public sector, which had been quite restrained in the first quarter of the year. Industry, however, again cut back its ordering. In the second quarter as whole, it was 5 ½ % lower in real terms than last year's level. At 14 %, the slump was, in fact, even larger in housing construction. Fewer orders were placed especially in the new Länder, where tax incentives had a pronounced stimulating effect last year. In western Germany, however, measured by the number of construction permits, the cutbacks in apartment house construction were largely offset by an increase in owner-occupied housing.

Capital formation of the producing enterprises

Although some current indicators of demand for capital goods brighten up the picture somewhat, the fact should not be overlooked that the expenditure structure of the gross domestic product does not yet suggest an improvement in longer-term growth prospects. This finding is also confirmed by the producing enterprises' investment activity, which is an important factor in the economic cycle. After adjustment for seasonal and working-day variations, actually realised



demand for investments in tangible fixed assets rose by ½ % in the second quarter; this applied equally to machinery and equipment and buildings. Investment in machinery and equipment was increased to the same extent as in the previous quarter; in the case of buildings, however, only part of the decline which had been witnessed since autumn 1996 was offset. After adjustment for working-day variations and in terms of volume,

construction investment in the second quarter of 1997 was 5 % lower than the corresponding figure for last year.

Households' consumption, income and saving

Private consumption

The level of consumption seems to have picked up recently. Overall, households' real consumption in the second quarter grew by 1½ % against the previous quarter as well as the previous year, after adjustment for seasonal and working-day variations. However, there is little to suggest that the cyclical bout of weakness since autumn 1996 has been finally overcome. The sharp increase in households' retail purchases, for instance, was solely due to a higher demand for food, drink and tobacco. On the other hand, a large number of consumers showed restraint in buying additional durable consumer goods, not least in view of the continued risks to jobs. For example, following a vigorous start at the beginning of the year, registrations of new cars for private use declined by almost 4 %, seasonally adjusted, falling by almost one-tenth below the corresponding level of last year. However, the current buoyant demand for cars has probably not yet been reflected in the registration figures, since many new models have lengthy delivery times. There has latterly been an increased demand for services; in the period from April to June, consumers spent around 4½ % more than in the preceding three-month period, seasonally adjusted, on foreign travel alone, although currency-induced price increases also played a part in that.

The expansion of consumption expenditure in the second quarter exceeded the scope of households' income growth. In particular, the most important item, total gross wages and salaries, fell by ½ %, seasonally adjusted, in the second quarter of 1997, and thus again remained slightly below the corresponding level of last year. This decline was due not only to the unfavourable employment trend, but also to the moderate wage agreements of this year's wage round being felt in full for the first time in the spring months and the fact that linear pay rises became effective in the metal-working industry which were lower than the lump-sum payments granted for the first three months of 1997. In addition, there was no further increase in average working hours per employee in major areas of the economy such as industry – in contrast to the first quarter of the year when overtime had apparently been worked to offset the extremely low number of working days. In net terms, i.e. after deducting employees' contributions to social security funds and wage taxes, the fall in income increased, seasonally adjusted, to 1 % against the previous quarter and to almost 2 % compared with the same quarter last year. Households received income transfers from public cash offices which were just as high as at the beginning of the year. However, income from other sources grew particularly vigorously. Besides investment income this item comprises higher private withdrawals from entrepreneurial income, which can be ascertained only by means of statistically less well substantiated residuals. In seasonally adjusted terms, households' nominal disposable income in the second quarter as a whole was 1 % higher than its

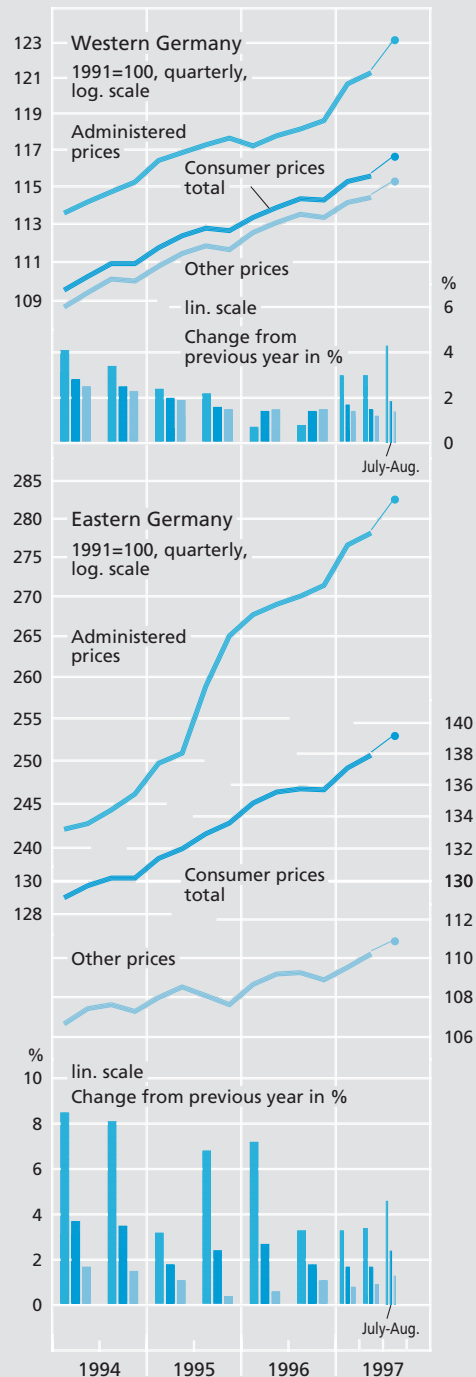
Disposable income

Households' saving ratio

level of the first quarter and 2 ½ % above the level of same period last year, which corresponds to a slight increase in real terms.

The higher expenditure on consumption was again partly financed by private savings. Their share in disposable income, at slightly below 12 % after seasonal adjustment, reached a level which had last been usual thirty years ago. Since then, the underlying conditions for private savings have changed radically. Besides unemployment, there has been an appreciable increase in the burden of taxes and social security contributions on households' gross wage and salary income, insofar as they are included directly under households in the national accounts. At around one-third, the average ratio of burden on wages and salaries was latterly approximately twice as high as three decades ago. The resulting impairment of the capacity to save from wages and salaries was offset to some extent, however, by the growing importance of entrepreneurial and investment income, of which a comparatively large part is usually saved. Their share in private income budgets rose from just under one-fifth to slightly more than one-quarter over the long term. However, the renewed decline in savings at the beginning of the year shows that there are limits to these compensatory effects under the present conditions. Furthermore, this tends to reduce households' financial contribution to overall capital formation, with which the Federal Republic of Germany not only has to accomplish the further restructuring of eastern Germany but also its adjustment to the challenges of the world economy.

**Administered prices *
at the consumer level**



* Calculation by the Federal Statistical Office based on the concept of the Council of Experts, 1994-5 Report. — ● = Latest position: July-Aug. 1997.

Prices

The price climate was no longer free of disruptive factors recently. The main reasons for this were the appreciable increases in administered prices as well as inflationary pressures from abroad, especially those due to exchange rate movements.

Import prices

Following a stabilisation in mid-year, US dollar prices in the international commodity markets rose again somewhat in August. From a German point of view, recent inflationary pressures have intensified owing to the continuing appreciation of the US dollar against the Deutsche Mark up to then. This also contributed to the sharp rise in import prices (invoiced in Deutsche Mark) in July. However, the fact that the year-on-year rate of increase rose from 3.3 % in June to no less than 4.2 % recently was also due to the imports having become cheaper a year before.

Producer prices

Despite that, the trend in German industry's domestic selling prices remained rather moderate of late. Seasonally adjusted, they rose only slightly in mid-year; at the same time, the year-on-year increase did not exceed 1.4 %. The annual inflation rate for capital goods and non-durable consumer goods was, in fact, much lower. Prices for construction services went down again slightly in spring. Between February and May they fell by almost ½ % in seasonally adjusted terms; latterly they were 0.6 % below the comparable 1996 level.

The rise in consumer prices has accelerated recently. In August, they rose by 0.3 %, seasonally adjusted, against the previous month; in the past four months they grew by slightly more than 1 %, after adjustment for the usual seasonal fluctuations, whereas they had been stable between January and April. The year-on-year rate of increase recently rose to 2.1 %, compared with 1.4 % in April and 1.4 % in December 1996.

Consumer prices

A major part of this acceleration is due – as mentioned – to administrative price increases. In particular, radio and television licence fees were raised significantly at the beginning of the year, which was followed by a sharp increase in medical prescription charges in July. In addition, motor vehicle tax was adjusted to take account of pollution emissions; given the age structure of cars owned, this signified an average increase in the tax burden. According to the calculations of the Federal Statistical Office (which are based on a classification of prices by the German Council of Experts for the Assessment of the Overall Economic Trend according to the degree of government influence), directly and partly administered prices in July were some 4½ % higher than a year before. By contrast, the other goods, services and rents included in the consumer price index rose by no more than just under 1½ % during the past 12 months.

Administered prices