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# Upturn Overshadowed by Asian Crisis

*The German economy is beginning to show signs of a steady recovery which is increasingly being reflected on the labour market. How do trends in the western and eastern parts of Germany differ? What are the effects of the Asian crisis? What is the outlook for the coming year?*

Thanks to favourable monetary conditions in the first half of this year, Germany's economic recovery has become stronger and broader based despite the continuing crisis in Southeast Asia. New orders and production continue to show a marked upward trend (see Figure 1), and there has even been a perceptible acceleration in real gross domestic product growth in the first quarter of 1998, although this was partly the result of the mild winter. Furthermore, many purchases were brought forward to avoid the VAT increase on 1 April, and it may be assumed that some state expenditures were postponed until the first months of this year in order to meet the reference value for the Maastricht budget criterion in 1997. The fact that there has been no significant improvement in the business climate in the manufacturing sector this year is another indication that current figures exaggerate the fundamental economic trend.

## Stronger Increase in Domestic Demand

While exports continue to be a considerable mainstay of the economy despite a general slowdown in growth rates, the upturn is spreading increasingly to include domestic demand. Investments in new equipment have thus expanded strongly since the start of the year - a sign that the marked improvement which has taken place in important investment conditions now appears to be bearing fruit. There has also been distinct growth in private consumption in the first months of the year. While some purchases have been brought forward as a result of the VAT increase, the marked increase in new orders in the consumer goods industry also points to a strengthening of the propensity to consume. The situation in the construction industry, on the other

hand, has hardly improved at all, and the slight increase in construction investments in the first quarter of the year was solely due to the favourable weather conditions. All the same it can be said that in western Germany, at least, there has again been a slight increase in new orders in most areas of the economy since the start of the year.

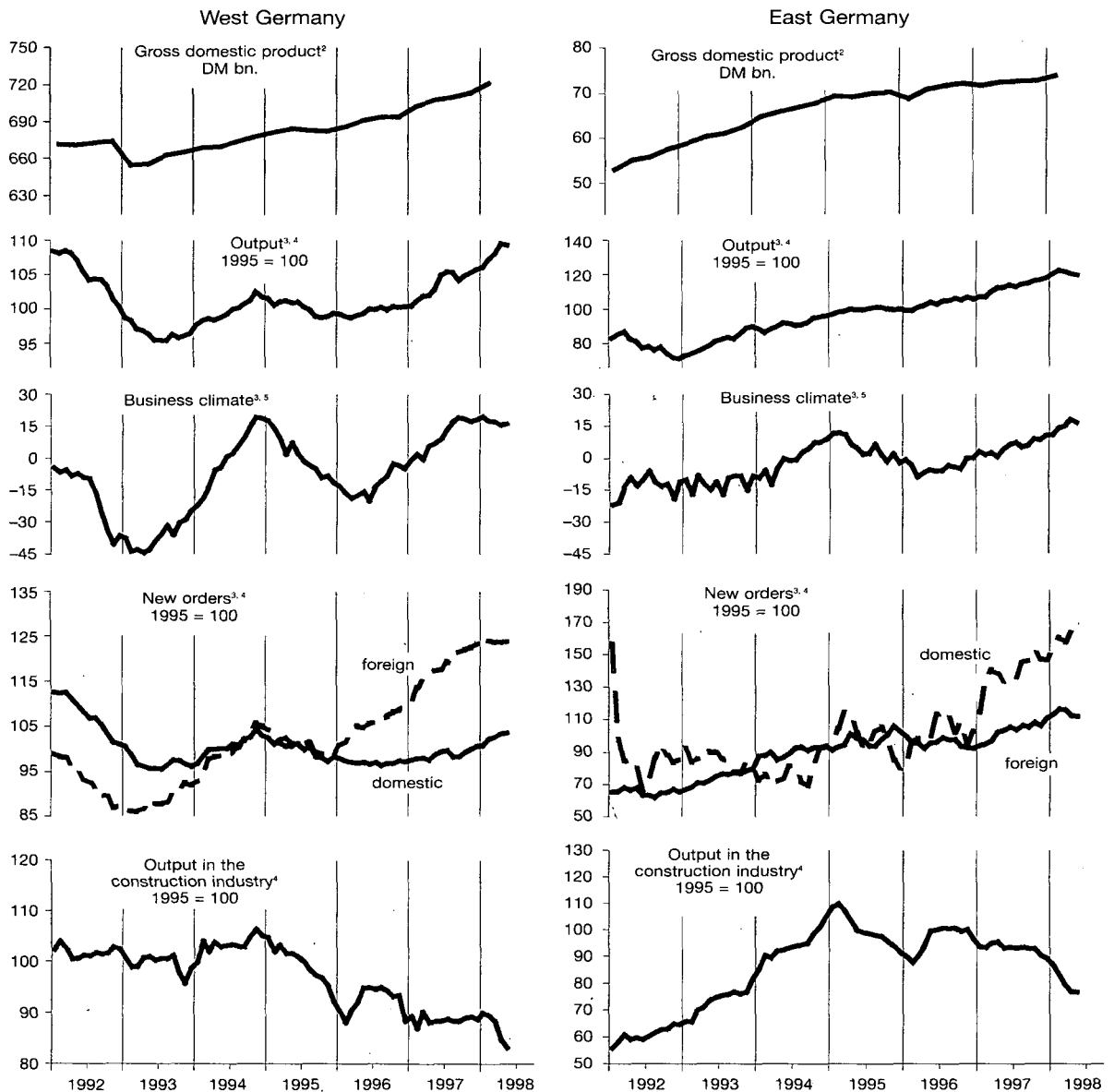
Considerable differences still remain between western and eastern Germany, however. A self-sustaining, relatively robust upward trend has so far developed only in western Germany. For some time now, there has been virtually no growth in aggregate output in eastern Germany; in the first quarter of 1998, seasonally adjusted real gross domestic product was not much greater than in the final quarter of 1996. This is primarily due to continuingly poor developments in the building and construction sector. In eastern German industry, where there was already production growth of around 8% in 1997, the upward trend continued. To a large extent, however, higher production is still being achieved by utilising productivity potential; productivity in the first quarter of this year was around ten per cent higher than in the previous year. There has thus been a further reduction in the difference between eastern and western Germany in this respect.

## Labour Market Turnaround

Economic recovery is having an increasingly strong effect on the labour market. In western Germany the turnaround appears to have been reached; employment has been increasing again since the start of the year, and the number of unemployed has fallen noticeably - in the months from January to June by around 140,000 seasonally adjusted. While there has also been a slight rise in employment and a perceptible fall in the number of unemployed in eastern Germany in the past months, this is primarily the result of government labour market policy

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**Figure 1**  
**Economic Indicators for Germany<sup>1</sup>**



<sup>1</sup> Seasonally adjusted using method ASA II (HWWA-version). <sup>2</sup> At 1991 prices, quarterly values. <sup>3</sup> Manufacturing industry. <sup>4</sup> Three-month moving averages. <sup>5</sup> Balance of firms' positive and negative reports.

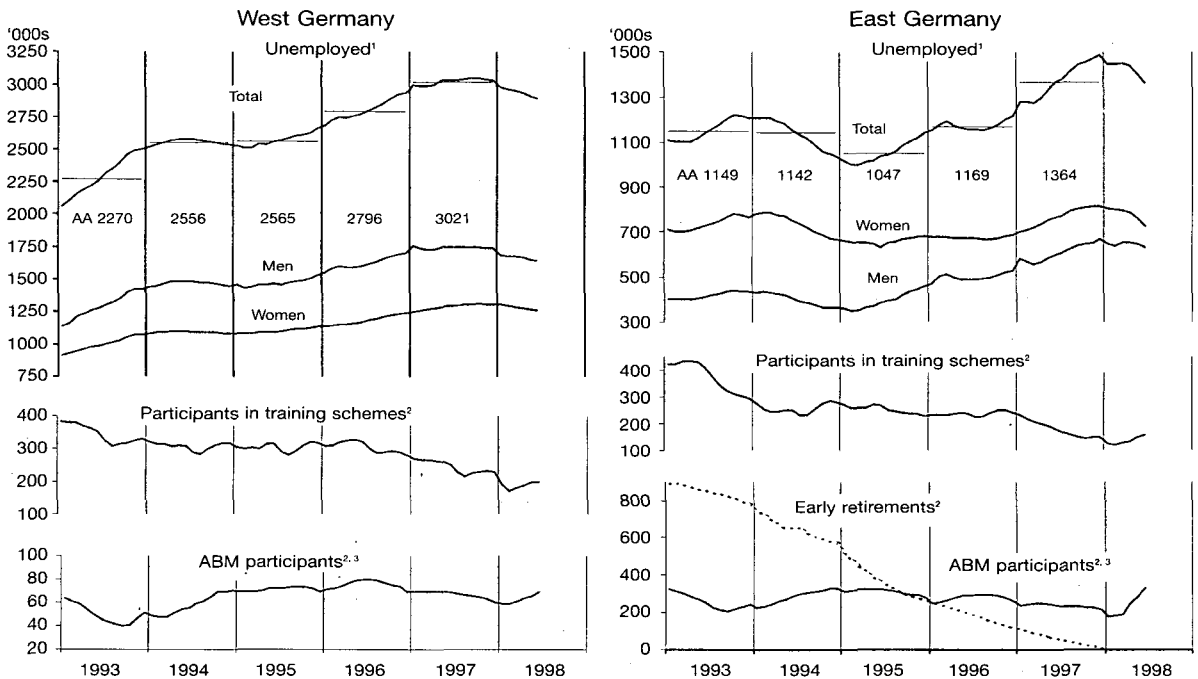
Sources: Statistisches Bundesamt, Deutsche Bundesbank, ifo Institut; HWWA calculations.

measures. Following marked reductions last year under the pressure of the Maastricht criteria, the funds for such measures have been increased considerably in election year 1998. In eastern Germany in particular, the additional funds have clearly been "spent" relatively quickly. At any rate, the number of participants in job creation measures (ABM)<sup>1</sup> and educational measures has risen sharply since the spring (see Figure 2).

All in all, Germany presents a picture of an economic upturn which got off to a sluggish start and is now progressing on an increasingly broad basis and can be said to be following a perfectly traditional "sequence of development". It is marred somewhat by the financial crisis in Southeast Asia which has now been going on for almost a year, but which has

<sup>1</sup> Including structural adjustment measures (SAM).

Figure 2  
Unemployment Trends



<sup>1</sup> Seasonally adjusted monthly figures. <sup>2</sup> Not seasonally adjusted. <sup>3</sup> Including participants in structural adjustment measures.  
Source: Bundesanstalt für Arbeit.

so far had no serious adverse effects in Europe at least. While there has been a considerable drop in German exports to the crisis region, this shortfall has been largely offset by an increase in deliveries to other regions, particularly to EU countries.

### Increased Global Economic Risks

In previous forecasts it was assumed that the financial crisis in Southeast Asia would have only slight adverse effects on Europe's economic development.<sup>2</sup> The rate of economic growth in Germany was expected to lose a quarter of a percentage point. However, the duration of the crisis has turned out to be longer than had been expected even until quite recently. Some of the countries affected are hesitant about proceeding with necessary reforms. There is still resistance to a swift and rigorous implementation of the – by no means undisputed – conditions stipulated by the International Monetary Fund (IMF), particularly as the social hardships associated with restructuring measures have led in part to considerable unrest. For this reason alone, it will still be some time before the economic situation in Southeast Asia stabilises again.

Developments in Japan have added a new

dimension to the Far Eastern crisis. With the devaluation of the yen – which not least reflects the financial markets' lack of confidence in the ability of the Japanese to solve their structural problems – there has been a sharp improvement in the competitiveness of Japanese manufacturers compared to European or dollar-zone competitors. Given its large share of world markets and its wide range of products, Japan should be able to capitalise on this advantage in terms of increased exports much sooner than the developing countries of Southeast Asia. The worsening situation in Japan also hampers stabilisation in the other countries and holds the danger that further countries and currencies will be affected. The recent heightening of the Southeast Asian financial crisis has thus increased foreign trade risks considerably.

<sup>2</sup> Cf. Günter Weinert, Eckhardt Wohlers et al.: Krise in Südostasien belastet Konjunktur, HWWA-Report No. 171, pp. 10 ff; Die Lage der Weltwirtschaft und der deutschen Wirtschaft, Assessment of the global economic situation and the German economic situation by the following members of the Arbeitsgemeinschaft deutscher wirtschaftswissenschaftlicher Forschungsinstitute e.V., Berlin: Deutsches Institut für Wirtschaftsforschung, Berlin (Institut für Konjunkturforschung); HWWA-Institut für Wirtschaftsforschung-Hamburg; ifo Institut für Wirtschaftsforschung, Munich; Institut für Weltwirtschaft an der Universität Kiel; Institut für Wirtschaftsforschung, Halle; Rheinisch-Westfälisches Institut für Wirtschaftsforschung, Essen; HWWA-Report No. 181, pp. 12 ff.

This spring, Japan came up with an extensive package of measures to boost the economy. Moreover, the government has now designed measures to put the finance sector back on its feet.<sup>3</sup> Much will depend on how resolutely the structural problems in the finance sector are really tackled and how quickly the measures taken to strengthen domestic demand take effect. It is assumed here that there will be a revitalisation of the Japanese economy in the second half of 1998 and that the exchange rate of the yen will be held at roughly its current level. Furthermore, it is assumed that the situation in those Southeast Asian developing countries directly affected by the crisis will not deteriorate any further and that a spillover to other countries in the region can be avoided. Under these conditions, the strain placed on Europe's economies by the Asian crisis will be somewhat greater than previously assumed; however, as a result of the continuingly favourable monetary conditions – to which the effects of the finance crisis indirectly contribute – a major economic setback is not to be expected.

On the whole, the foreign trade environment continues to be relatively good. While the on-going crisis in Asia will leave its mark on German foreign trade more strongly than had previously been anticipated – whereby the devaluation of the yen will not be felt fully until 1999 due to the usual time lags – this will be offset by strong impulses which are still coming not least from the consolidation of the European economy. Furthermore, the cost competitiveness of the German economy will again improve, with unit labour costs hardly rising at all thanks to moderate wage increases together with further marked rises in productivity compared with the world's other major trading countries. All this indicates that exports will continue along a clear upward path in spite of a noticeable slowdown in the rate of expansion.

### **Monetary Framework Remains Favourable**

In May this year, the way was cleared for the third stage of the European Monetary Union. It will start on schedule with 11 countries on 1 January 1999, when responsibility for monetary policy in the EMU is finally transferred to the European Central Bank (ECB). In the coming months, the remaining short-term interest rate differences will be levelled off by the participating countries' central banks. In view of the increased foreign trade risks resulting from the recent worsening of the Asian crisis, it is probable that alignment will take place via the lowering of interest rates in the

“high-interest” countries, especially as inflation in the EMU countries is still very moderate. This would mean short-term interest rates in Germany remaining at more or less their current low level this year; the level of interest rates for three month money is at present 3.6%.

The European Central Bank will – and should – make its monetary policy dependent on economic trends in the entire EMU region. Here, however, there is no perceptible acceleration of price pressure to be expected even in 1999, despite the continuing economic recovery. A possible exception could be presented by a few smaller countries with a certain head start in the economic cycle where the price climate could worsen as a result of stronger cost increases. In order to stress its determination to maintain economic stability and to gain reputation, however, the ECB can be expected to set an “interest rate signal” early on, should any inflationary trends become apparent. The forecast assumes that short-term interest rates will be raised slightly in the course of next year. However, this will by no means imply a general change of course in monetary policy, which will, all in all, continue to have a slightly expansive effect even then. A moderate increase in short-term interest rates in the euro-zone could lead to a general reduction in the interest rate gap between the EMU and the USA. This, too, would support the euro; it is assumed here that the euro will gain somewhat in value against the dollar in 1999.

In contrast to short-term interest rates, long-term rates within the EMU region have already come into alignment to a large extent; current yields for 10 year government bonds are presently running at between 4% and 5%. Given the moderate price climate and the persisting Asian financial crisis which encourages capital investments in the “safe havens” of Europe and the USA, a renewed increase is not expected for the time being. As the economic upturn in Europe continues and tension in Asia gradually eases, there could be a slight rise in “long end” interest rates in 1999. However, this is not expected to have any major adverse effects on economic development in the EMU.

### **Fiscal Policy Less Restrictive**

In contrast to monetary policy, fiscal policy in the EMU remains a matter of national responsibility. In Germany, fiscal policy in 1997 was primarily geared to

<sup>3</sup> Cf. Günter We in e r t: Critical Developments in Japan, in this issue, pp. 153-154.

**Table 1**  
**Key Data of the Forecast for the Federal Republic of Germany**

	Germany				West Germany				East Germany			
	1996	1997	1998	1999	1996	1997	1998	1999	1996	1997	1998	1999
Gross domestic product <sup>1</sup> (% change on previous year)	1.4	2.2	2.6	2.6	1.3	2.2	2.6	2.6	1.9	1.6	2.0	2.7
Private consumption	1.4	0.2	1.7	2.3	-	-	-	-	-	-	-	-
Government consumption	2.0	-0.4	0.9	1.1	-	-	-	-	-	-	-	-
Plant and equipment	1.6	3.9	7.5	7.8	-	-	-	-	-	-	-	-
Buildings	0.3	-2.2	-0.5	1.1	-	-	-	-	-	-	-	-
Domestic demand	1.8	1.2	2.1	2.2	-	-	-	-	-	-	-	-
Exports	6.6	10.7	10.3	7.1	-	-	-	-	-	-	-	-
Imports	7.3	7.0	9.0	6.1	-	-	-	-	-	-	-	-
Gainfully employed <sup>2</sup> (% change on previous year)	-1.3	-1.4	-0.1	0.5	-1.1	-1.0	0.2	0.6	-2.1	-3.3	-1.2	0.1
Unemployed (1000 persons)	3965	4385	4300	4150	2796	3021	2910	2765	1170	1364	1390	1385
Rate of unemployment <sup>3</sup> (in %)	10.3	11.5	11.3	10.9	9.0	9.8	9.4	9.0	15.7	18.4	18.8	18.8
Consumer prices <sup>4</sup> (% change on previous year)	1.5	1.8	1.1	1.5	1.4	1.8	1.1	1.5	2.2	2.1	1.4	1.5
Public sector borrowing requirement <sup>5</sup> (in % of GDP)	3.4	2.7	2.4	1.8	-	-	-	-	-	-	-	-
Balance on current account <sup>6</sup> (DM bn)	-20.7	-1.7	21.0	35.0	-	-	-	-	-	-	-	-

<sup>1</sup> At 1991 prices. <sup>2</sup> Domestic gainfully employed. <sup>3</sup> Unemployed as a percentage of the resident labour force (place of residence concept); west and east Germany: unemployed as a percentage of the labour force within the region (place of employment concept). <sup>4</sup> Price index for the cost of living of all private households. <sup>5</sup> As defined in the European System of National Accounts (ESA 95). <sup>6</sup> As defined in the balance of payments statistics.

Sources: Statistisches Bundesamt; Deutsche Bundesbank; Bundesanstalt für Arbeit; 1998 and 1999: HWWA forecast; rounded figures.

fulfilling the reference values of the fiscal criteria laid down in the Maastricht treaty and thus led to marked restrictive effects on aggregate demand in the economy. Now that the hurdles for membership in the Monetary Union have been cleared, the restrictive course has been relaxed in election year 1998. Although the rate of VAT was raised by one percentage point on 1 April, this is offset by a reduction in the Solidaritätszuschlag (income tax solidarity surcharge for eastern Germany) and an increase in the basic income tax allowance which came into force at the start of the year. Furthermore, there has been a considerable increase in funds for job creation measures (ABM). All in all, fiscal policy should therefore have a much less restrictive effect this year than it did last. It is very difficult to make a prognosis for next year if only because of the uncertainties surrounding the outcome of the general election in September. To judge by recent announcements made by the various political parties, fiscal policy is more likely to be relaxed still further than to be tightened.

Wage trends were very moderate in the past two

years and have thus made a major contribution to the turnaround in the labour market. Wage increases have so far remained moderate this year, too. If only because of the continuing high level of unemployment, 1999 is also unlikely to see a general change in wage policy, although wage settlements will probably be a little higher than this year.

### Continuation of the Economic Upswing

Under the conditions cited above, the economic upswing in Germany will continue at much the same speed. Although export growth will slow down noticeably,<sup>4</sup> this will be largely offset by a strong increase in domestic demand. Private consumption will make a major contribution here, increasing again markedly for the first time as the retarding effects from the labour market diminish. Investments in new equipment, too, will expand again strongly. Although the outlook for export sales and profits has dulled somewhat – not least as a result of the Asian crisis – this will be offset by more favourable prospects in more domestic-oriented areas.<sup>5</sup> While construction is

<sup>4</sup> This will not be seen in the annual rates until 1999. As a result of the sizeable overhang at the start of the year, the rate of growth in 1998 will be similar to that in 1997.

<sup>5</sup> Empirical studies show that export developments are of little importance for investment activities in the economy as a whole. Cf. Wilhelm Mailand: Ausfuhrentwicklung und Investitionstätigkeit, in: Wirtschaftsdienst, No. 6, 1998, pp. 367 ff.

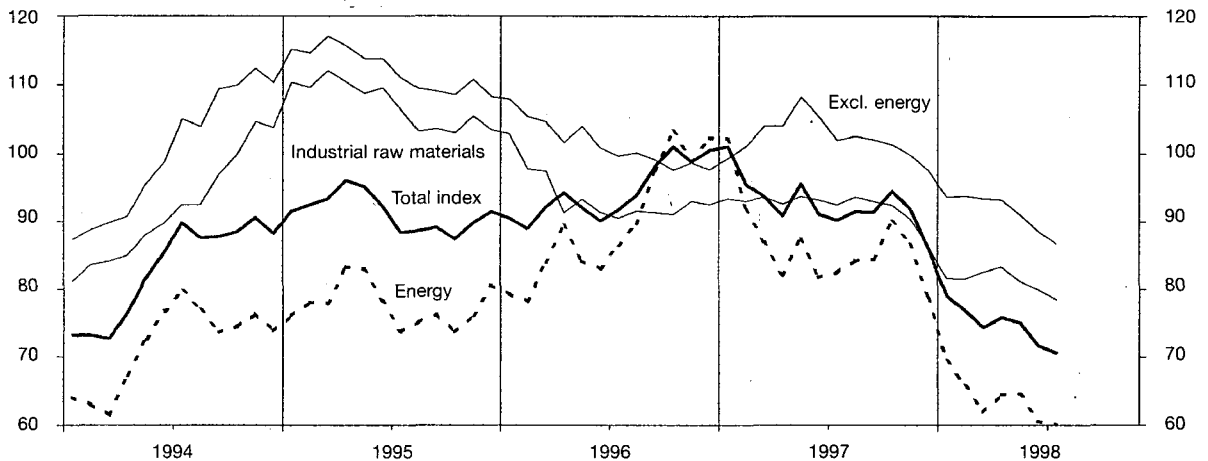
still on the down side of the economic cycle, the dampening influences should slacken off. In western Germany, the slide has probably almost bottomed out, and a slight increase in construction investments can be expected here again next year. In eastern Germany, on the other hand, stabilisation cannot be expected until some time next year at the earliest. All in all, real gross domestic product in Germany is forecast to increase by 2.6% this year; a similar increase is likely in 1999 (see Table 1). Western Germany in particular will benefit from the favourable economic conditions. The outlook for eastern Germany remains depressed. Although a similar growth rate to that in western Germany will probably be achieved again in 1999, this will not be sufficient to make any progress in the catching-up process.

As the economic recovery continues, there will be a further improvement in the labour market situation.

Employment will increase noticeably in the course of this year, although the annual average will not be significantly higher than last year's figure; not until 1999 will there be a marked increase in the annual figures. The number of unemployed will fall by more than 300,000 in the course of this year; however, the annual average of 4.3 million will be only around 90,000 lower than last year. A sustained improvement in the labour market situation will be seen above all in western Germany. While employment in eastern Germany will also increase slightly this year, and unemployment will even show a marked fall, this is primarily the result of the increased funds for job creation measures (ABM). If the volume of financial resources for ABM remains unchanged, there will hardly be any further fall in unemployment in the new Bundesländer and the annual average rate of unemployment will still be almost 19%. The labour market situation will thus remain unsatisfactory.

**HWWA Index of World Market Prices of Raw Materials<sup>1</sup>**

(1990 = 100)



Raw Materials and Groups of Materials <sup>1</sup>	1997	Jan. 98	Feb. 98	March 98	April 98	May 98	June 98	July-98 <sup>2</sup>
Total Index	92.7 (-1.7)	78.9 (-21.9)	76.8 (-19.5)	74.3 (-20.6)	75.8 (-16.5)	75.0 (-21.5)	71.6 (-21.4)	70.6 (-21.7)
Total, excl. energy	102.3 (0.8)	93.6 (-5.7)	93.8 (-7.2)	93.4 (-10.3)	93.2 (-10.5)	91.0 (-15.8)	88.6 (-15.9)	86.7 (-15.0)
Food, tropical beverages	132.0 (12.5)	129.1 (10.4)	130.1 (3.9)	125.4 (-7.3)	122.4 (-11.5)	120.2 (-20.4)	114.4 (-19.2)	110.9 (-14.9)
Industrial raw materials	92.3 (-1.5)	81.6 (-12.5)	81.5 (-12.3)	82.6 (-11.7)	83.3 (-10.0)	81.2 (-13.3)	79.9 (-14.2)	78.5 (-15.1)
Agricultural raw materials	92.6 (-3.5)	81.0 (-14.4)	81.5 (-12.6)	82.9 (-10.8)	83.9 (-9.8)	81.7 (-11.8)	81.3 (-11.8)	79.2 (-13.4)
Non-ferrous metals	89.8 (2.0)	76.4 (-15.3)	74.9 (-18.1)	75.3 (-19.6)	76.0 (-15.8)	73.1 (-22.5)	69.8 (-25.3)	69.1 (-25.4)
Energy	86.5 (-3.5)	69.4 (-32.1)	65.7 (-28.3)	61.9 (-28.7)	64.5 (-21.5)	64.6 (-26.0)	60.6 (-25.9)	60.1 (-27.1)

<sup>1</sup> On a US dollar basis, averages for the period; figures in brackets: percentage year-on-year change.

<sup>2</sup> Up to and incl. 24th July.