# Global and European setting

## World economic activity

*World economy undergoing upswing*

The global economic recovery continued at a brisk pace in the past few months and has now entered into a rather robust and broadly-based upswing. The USA and the East Asian emerging economies remain at the heart of the upswing. The cyclical upturn of the world economy also benefited from the fact that the Japanese economy continued to grow in the fourth quarter, as indicated by the available cyclical data. The euro area maintained the moderate recovery path embarked upon in the second quarter. However, it still lags considerably behind the USA in terms of growth and this gap is not likely to diminish this year according to forecasts by international institutions. Starting from an already fairly high level, the economies of central and east European countries in transition grew at an even faster pace. The Latin American economies, which benefited in particular from rising demand for commodities and the attendant distinct rise in prices, likewise seem to have bottomed out. Most of these economies, however, remain exposed to considerable financial vulnerability and thus also to the threat of a cyclical setback.

Continued favourable financial conditions promoted fast-paced global economic growth in the past few months. Rising corporate earnings and an increased risk appetite caused international share prices to rise further, thereby noticeably improving many companies' scope for raising new capital. In addition, debt financing remained inexpensive. The quite sharp depreciation of the US dollar against major currencies hardly made a dent in the upswing, either on a global scale or from the point of view of the countries concerned. However, in the past few weeks US-dollar-denominated prices on crude oil markets have almost returned to their high levels of the previous year, which had been affected by the imminent Iraq war. It is dollarised countries and countries whose currencies are pegged to the dollar, though, which are being primarily affected by the high oil prices. In early February these prices, converted to euro, were around one-fifth down on the year.

*Fourth-quarter industrial production and prices*

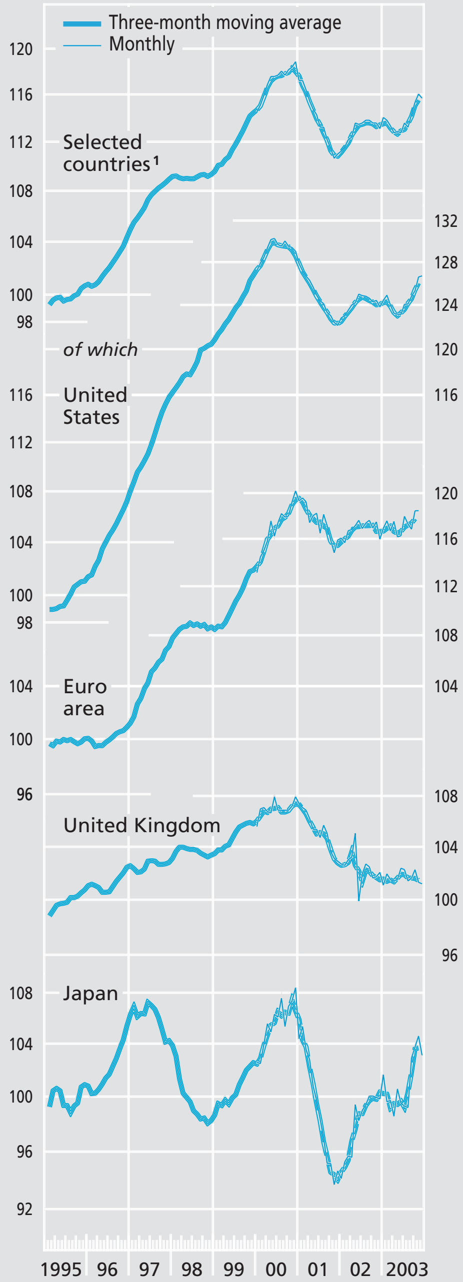
Fourth-quarter industrial production in industrial countries was up by an estimated 1¾% in seasonally adjusted terms on both the quarter and the year. Its average growth rate for 2003 was ¾% following a decline of 3½% in total in the two preceding years. In the past few months, inflation developments in industrial countries remained relatively subdued. Average consumer price inflation in the November-December 2003 period, at 1.4%, was lower than in any period since the third quarter of 2002. Excluding Japan, which is still experiencing slight deflation, inflation was at 1.9%.

*Chinese economy booming*

Among the emerging markets, the Chinese economy has experienced particularly dynamic growth. There is already mounting concern that the economy could overheat. In the last quarter of 2003, real GDP, according to official statistics, was 10% up on the year. Average growth for 2003 was 9%. Fixed capital formation went up by no less than one-fifth. It is also noteworthy that foreign trade has continued its strong growth, which is over-

Industrial production* in selected countries

1995=100, seasonally adjusted, log scale




Sources: National statistics, Eurostat and the Bundesbank's own calculations. — * Including mining and energy, excluding construction. — 1 In addition to euro-area countries and countries shown, the selected countries are Denmark, Norway, Sweden, Switzerland and Canada; weighted with the respective share in gross value added of industry in those countries in 1995.

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whelming evidence that China's economy is becoming a new centre of gravitation in East Asia. As an average of the past ten years, real GDP in China has gone up by 8¾% as against 3¼% in the USA and 2% in the euro area. If this growth gap were to remain, Chinese overall economic output – valued in terms of purchasing power parities, which take account of differences in price levels between countries – could even overtake the USA by 2013.[1] However, Chinese per capita income would still be a mere one-fifth of that of the USA owing to the vastly larger population across which the volume of overall output would be spread.

*USA*

According to initial estimates, aggregate output in the USA rose by 1% in the last quarter of 2003 after adjustment for seasonal and working-day variations. This represents a year-on-year rise of 4¼%. In 2003 as a whole, real GDP grew by just over 3%, the highest growth rate since the last boom year, which was 2000. In the fourth quarter, the strongest contribution to growth came once again from private consumption, which was up by a seasonally adjusted ½% on the third quarter's level, which had been very high owing to special factors. However, this was at the expense of the private saving ratio, which went down by ¾ percentage point to 1.5%. Industrial fixed capital formation was a seasonally adjusted 1¾% higher than in the third quarter and 6½% up vis-à-vis the same period in the previous year. Private residential construction likewise provided expansionary stimuli. Real expenditure on new housing grew by 10% on the year; since the end of 2001, it has risen by nearly one-fifth. Inventories grew once again in the fourth quarter after having been depleted in the third quarter.

Real exports joined private consumption in the last quarter of the year as the most important growth-sustaining factor. They grew by a seasonally adjusted 4½% (as defined in the national accounts). Exports of goods to East Asian emerging markets and the central and east European countries in transition grew particularly strongly. A renewed slowdown in import growth (of 2¾%) caused a further improvement in real net exports, continuing a trend which began in the third quarter. The nominal foreign balance reacted in similar fashion. This indicates that the current account deficit declined slightly again in the fourth quarter, although exact figures for this period are not yet available. It therefore appears that the reduction in the external disequilibrium (caused by the depreciation of the US dollar) seems to have already begun to take hold. However, the downside for those countries whose economies are swept along by the USA is that the US economy's real net demand for goods and services from the rest of the world was in decline in seasonally adjusted terms in the second half of 2003 for the first time in a long time.

The strong fourth-quarter economic growth in the United States – as in the preceding quarters – was associated with high productivity growth. Seasonally adjusted non-farm employment accordingly rose only sluggishly.

**1** See also A Maddison, Chinese Economic Performance in the Long Run, *OECD Development Centre Studies*, 1998, pp 96-97.

In January, however, more jobs were created than in the fourth quarter. At the end of the period under review, the seasonally adjusted unemployment rate was 5.6%, ½ percentage point lower than September's level. Prices grew moderately in the United States over the past few months. Consumer inflation was 1.9% in December; its average for the year was 2.3% owing to the sharp price rises in the first quarter. The personal consumption deflator (excluding food and energy), which is the US Federal Reserve's preferred measure, paints an even more favourable picture: in December it was only 0.7% higher than a year earlier.

*Japan*

Japanese fourth-quarter industrial production was up by a seasonally adjusted 3½% on the quarter and by 3¾% on the year. The average growth rate for 2003 was 3%, yet this did not compensate for even one-half of the sharp decline in the two preceding years. Aggregate output, for which data are not yet available, is also expected to have risen perceptibly in the last quarter of 2003. Rapid growth in foreign demand gave a renewed boost to the Japanese economy. The remarkable thing is that, in the first eleven months of 2003, four-fifths of total growth was accounted for by nominal goods exports in trade with China (including Hong Kong). The domestic economy was again unable to keep up with the rapid pace of export growth. Buoyant domestic demand for machinery and equipment certainly points to an uninterrupted rise in commercial investment. However, this was offset by continued sluggishness in housing construction and a decline in government investment. In addition, consumer demand – expressed in terms of retail sales – stagnated in the fourth quarter at the depressed level of the previous period. In the past few months, however, the conditions for a moderate consumption revival have improved. In December, the seasonally adjusted unemployment rate went down by 0.3 percentage point to 4.9% and the decline in labour income is gradually petering out. At the turn of 2003-04, consumer prices were 0.5% lower than at the same time a year earlier. It must be taken into account that part of the price decline is associated with the appreciation-related improvement in the terms of trade.

*United Kingdom*

In the fourth quarter, the UK economy, according to initial calculations, grew by just under 1% on the quarter after adjustment for seasonal and working-day variations. At 2½%, year-on-year growth was at its strongest rate since early 2001. Average real GDP growth for the year 2003 was just over 2%. This means that the United Kingdom, along with the catching-up countries of Greece and Spain, is likely to have been the EU's top performer. UK economic growth was driven once again by the services sector, whereas manufacturing output was down by ¼% on the quarter after seasonal adjustment. On the demand side, private consumption retained its role as the driving force of the economy. In the fourth quarter, retail sales grew by a seasonally adjusted 1½% on the quarter and by 3½% on the year. Consumption benefited from both a positive labour market situation and a calm price climate. The Harmonised Index of Consumer Prices (HICP) inflation rate, on which the UK inflation target of 2% is now based, was 1.3% at the end of the period under review. It averaged 1.4% for 2003. The national Retail Price Index excluding mortgage interest payments (RPIX), which is methodologically different from HICP and includes the costs of owner-occupied housing, was 2.6% in December.

## Macroeconomic trends in the euro area

*GDP growth in the fourth quarter of 2003*

Real euro-area GDP rose by ¼% in the fourth quarter of 2003 after seasonal adjustment, according to the Flash Estimate; this represents a year-on-year rise of ½%. Because of the weak start in early 2003 and the stagnation which lasted until mid-year, annual average growth, at just under ½%, was at its weakest level since 1993. Despite the unavailability of more detailed data on the individual expenditure components at present, domestic demand is likely to have been the main pillar of GDP growth at the end of 2003. The balance of payments data available up to November indicate that imports as defined in the national accounts rose more sharply than exports after adjustment for price and seasonal variations and that real net exports were therefore on the decline.

*Industrial activity on the rise*

In a sectoral analysis, industry gave an important boost to the cyclical recovery in the euro area, with seasonally adjusted industrial production in October-November just under 1% higher than in the third quarter. This is confirmed by the new orders index, which was published for the first time in November 2003 (see notes on pp 16-17). According to the index, in October-November, the value of orders in the euro-area manufacturing sector rose by a seasonally adjusted 2½% from third-quarter levels. Seasonally adjusted capacity utilisation in the manufacturing sector is expected to have risen in the fourth quarter, too. The decline in January vis-à-vis October figures shown by the current EU survey is based on a statistical break in the corresponding series for France and should therefore be interpreted with caution. [2]

*EU survey*

The EU survey showed a renewed seasonally adjusted increase in industry confidence in January following a moderate decline in December, which is an indication of a continuation of the cyclical recovery in the euro-area industrial sector. The main reason was that production expectations improved distinctly while assessments of order books and warehouse stocks remained unchanged. In this context it is also worth noting that, according to the recently published results of the October-November 2003 investment test for the EU, euro-area industrial enterprises are planning to increase their investment budgets by a price-adjusted 2%. This contrasts with an aggregate decrease of 12% in real expenditure on new plant and equipment in 2002-03 according to the test. In January, the consumer confidence indicator held firm at its low level of the two preceding months. Households' persistent scepticism in assessing their financial outlook played a role in this respect.

2 According to European Commission data, the quarterly survey of capacity utilisation in France was brought into line with the harmonised EU programme with effect from the first quarter of 2004. This led to a statistical break in the series for France, which was also reflected in the aggregated series for the EU and the euro area.

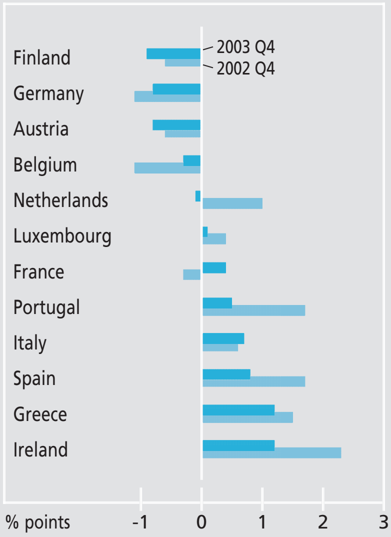
*Labour market*

Euro-area unemployment hardly rose any further in the last three months of 2003. At 8.8%, the standardised unemployment rate was just as high as in the two preceding quarters in seasonally adjusted terms. This figure was only 0.2 percentage point up on the year. However, it clearly surpassed the cyclical trough of 8.0% reached in the second quarter of 2001. The recent stability in the euro-area labour market situation owes something to labour market policy reform in Germany and Italy, to name just one factor.

*Consumer prices*

In the last quarter of 2003, consumer prices rose at a seasonally adjusted 0.5%, a pace similar to that of the third quarter. This corresponds to an annualised rate of around 2%. The year-on-year increase was likewise 2%; the result is the same even if the volatile components (energy and unprocessed foods) are excluded. This means that euro-area consumer inflation at the end of 2003 had stabilised at the upper limit of price stability defined by the European System of Central Banks. Of the key components of the Harmonised Index of Consumer Prices (HICP), processed foods showed the strongest increase in seasonally adjusted terms at the end of the period under review – especially owing to a renewed strong tobacco tax hike in France. Unprocessed food prices continued to rise sharply owing to the after-effects of the hot and dry summer weather. The prices of industrial goods, however, changed only very little; energy even became cheaper. The rate of price increase for services held firm at the level of the two preceding quarters.

Euro-area inflation differentials*




* Change in the Harmonised Index of Consumer Prices (HICP) in 2003 Q4 from 2002 Q4 and in 2002 Q4 from 2001 Q4; deviation of national inflation rates from the euro-area average.

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In January 2004, euro-area consumer prices (according to Eurostat's Flash Estimate) rose by 2.0% on the year. Excluding the price effects of the health system, reform in Germany might have lowered the euro-area inflation by an estimated 0.2 percentage point.

*Inflation differentials*

The spread of euro-area inflation rates has continued to diminish. The gap between the country with the lowest inflation rate and those countries with the highest rates fell from nearly 3 percentage points in the third quarter to around 2 percentage points in the fourth quarter of last year. This spread had been as high as just under 3½ percentage points in early 2003. Other measures of the spread, such as the standard deviation, confirm this decline in inflation differentials. A key factor in the convergence of euro-area price

## New orders index for the euro area and the EU

In late November 2003 Eurostat published an industrial new orders index for the euro area and the EU as a whole for the first time.[1] The monthly data go back to January 1996 for the euro area and January 1998 for the EU15. This has added an important demand indicator to European business cycle statistics. In Germany, incoming orders have already been statistically recorded in the statistical publication *Monatsbericht für Betriebe im verarbeitenden Gewerbe* (Monthly Report for manufacturing enterprises) since 1977.

The new orders index designed by Eurostat measures the value of new orders for industrial products in the reporting month relative to the monthly average of the base year (currently 2000). New orders also include production-related services such as assembly and maintenance. However, the index calculation comprises only those economic sectors in which order-based production is significant. This "manufacturing working on orders", as Eurostat calls it, accounts for 62.6% of total manufacturing turnover in the euro area and 62.9% in the EU15.[2] The manufacture of transport equipment has the greatest weight in the index (22% in the euro area), followed by the "manufacture of electrical and optical equipment" at 19% and by the manufacture of basic metals and the manufacture of chemicals and chemical products at 17% each. The index does not include, for example, mining and the manufacture of food products and beverages, in which manufacturing is almost never order-based.

The index is currently calculated on the basis of data from nine EU member states (eight of which are euro-area countries). Greece and Ireland do not provide data on new orders at present; Austria will begin to provide such information in March 2004. Although new orders data from the United Kingdom, Sweden and the Netherlands are available, they still contain cancelled orders, which violates the provisions of a Commission Regulation implementing the Council Regulation. These data are not included in the calculation of aggregates for the EU and the euro area for reasons of statistical consistency. In the euro area, 35.8% of new orders in the base year (2000) were accounted for by Germany, with 20.8% by France and 17.9% by Italy.

The member states provide unadjusted figures which are aggregated by Eurostat to form total figures for the EU15 and the euro area and then subjected to a special seasonal adjustment procedure (using TRAMO/SEATS). Germany also provides seasonally adjusted data. For that reason, the seasonally adjusted growth rates for the euro area and the EU15 might deviate from the weighted growth rates of the member states. The weights and the base year are adjusted at five-year intervals. The aggregated new orders statistics are published around seven weeks after the end of the reporting month.

Unlike the German new orders statistics, the new EU15 and euro-area statistics do not make a distinction

**1** See Eurostat, €uro-indicators, News Release 135/2003, 26 November 2003. — **2** The main aggregate "manufacturing working on orders" encompasses, pursuant to Council Regulation (EC) No 1165/98 of 19 May 1998, NACE Rev. 1 divisions 17,18, 21, 24 and 27-35. — **3** In

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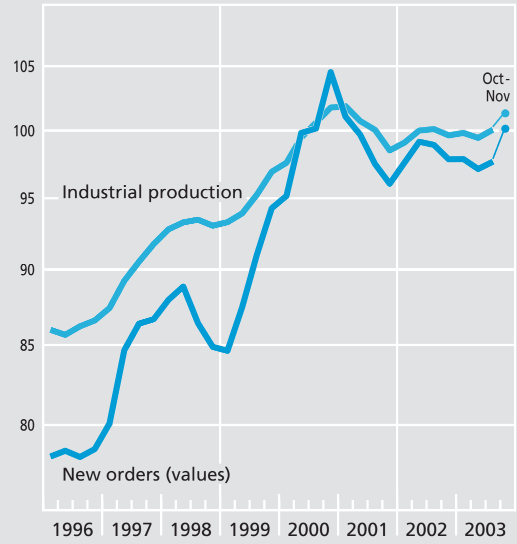
between domestic and foreign orders. Moreover, new orders are shown only as values; no volume series exists. This is because in most of Germany's neighbouring countries only producer prices for domestic sales are calculated statistically, but not producer prices for foreign sales, also known as export prices.[3]

New orders data are often used as an early indicator of production or turnover trends. However, studies have shown that the new indicator does not provide exact information about when and to what extent new orders are reflected in manufacturing production and sales. This may be associated with varying intervals between orders, production and invoicing, even within a given sector of industry. In addition, replies to surveys often feature a blurring of the distinction between sales from warehouse stocks, which are classifiable as turnover, and new orders, as well as a parallelism of manufacturing to order and ongoing manufacturing (which is accordingly not based on new orders) in some companies.

The available monthly data show that new orders have only a weak leading indicator property with regard to production. It must be noted, however, that the new orders index records manufacturing industries working on orders only, whereas the production index refers to the entire manufacturing industry. The correlation coefficient – in terms of the change in the seasonally adjusted monthly values (in logarithms) for the euro area – at 0.7

New orders and industrial production in the euro area

2000 = 100, seasonally adjusted, quarterly, log scale




is highest for the contemporaneous relationship of the two variables. It is only slightly higher if quarterly values are used in place of monthly values in order to make the initial data smoother. However, the two data series seem to share a longer-term trend which is determined by the trend in new orders.

In summary, the new orders index, despite its limited power as a leading indicator, can still provide useful additional information for ongoing cycle analysis in the EU and the euro area.

these countries, price adjustment of exports, such as for the national accounts, is done using average foreign trade values.

movements was the slowdown in inflation rates in some countries which had previously been characterised by above-average rates of price increase. Inflation in Portugal and the Netherlands fell by no less than 1.5 percentage points on the year. It fell by 1.4 percentage points in Ireland and by 1.2 in Spain. By contrast, the inflation rate in Germany remained unchanged; in France, however, it rose by 0.4 percentage point owing to the sharp tobacco tax hike in 2003.

## Exchange rates

*Highly volatile foreign exchange markets*

Events on the foreign exchange markets were marked by high exchange rate volatility at the turn of 2003-04. Renewed doubts about the ability to finance the high US current account deficit put the US dollar under downward pressure over long periods. At the same time, the euro – along with other currencies – posted significant gains. The euro-US dollar rate was reversed to a degree in mid-January 2004 when several ECB Governing Council members expressed concern about the sharp exchange rate fluctuations.

*The euro's exchange rate against the US dollar, ...*

The euro began to surge against the US dollar in the second week of November and continued to do so without any major interruptions for over two months. Data published at the time indicating that those net capital imports resulting from long-term securities transactions had fallen in September to less than one-tenth of their previous month's level apparently raised fears in the markets that international investors could be turning their backs on the United States. Such concerns were also engendered by the fact that the US growth advantage and the large budget deficit indicated that permanent relief was nowhere in sight for the US current account deficit. They received new impetus in December when figures showed that securities-based net capital imports in October once again fell far short of their average of the preceding months.

The fact that yields on long-term government bonds in the euro area regained a clear lead over those on US government bonds as of mid-November also contributed to the US dollar's weakness against the euro. The interest rate differential at the short end has already favoured the euro for nearly three years. Finally, there were mounting reports during this period that an economic upswing in the euro-area countries was gaining strength, which lent the euro an additional boost. The single currency's rise encouraged markets to expect further gains, which led to a self-perpetuating cycle causing the euro to reach one all-time high after another in December and early January.

After the euro-US dollar exchange rate had hit its hitherto highest mark of over US$1.28 (corresponding to a US dollar-DM rate of around DM1.52 to the US dollar, last reached in November 1996) in mid-January 2004, an exchange rate correction took place. Apparently a lower valuation prevailed temporarily on the markets following repeated official statements indicating that excessive exchange rate volatility was undesirable. In addition, a steady stream of positive business data from the USA caused the US Federal Reserve to modify its assessment of monetary policy. As this report went to press, however, the euro was back up to US\$1.28. This was 9% higher than its initial exchange rate and 13% higher than the average rate for 2003.

*... against the yen ...*

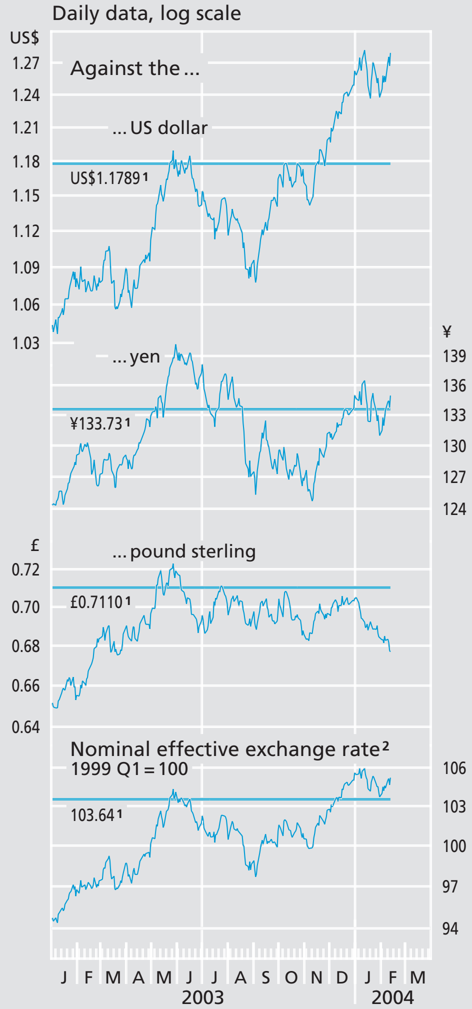
Much like against the US dollar, the euro gained against the yen since November as well. Although there were signs of an improvement in the Japanese economic outlook during that period, which boosted the yen, Japan's monetary authorities repeatedly employed massive intervention on foreign exchange markets to resist (although ultimately with limited success) the upward pressure on the yen against the US dollar, thus passing part of the adjustment burden on to the euro. All in all, Japan's foreign reserves swelled by an estimated figure of over US\$100 billion between late October and late January. In addition, the funding for such forex intervention was significantly expanded in December 2003, a move interpreted by the markets as a signal of dogged resistance to the yen's appreciation. Despite the euro's appreciation, the euro-yen rate remained below its high of last May and, at the end of the period under review, the euro was trading at ¥135, 1% higher than at the beginning of monetary union.

*... and against the pound sterling*

Compared with its fluctuations against the US dollar and the yen, the euro's movement against the pound sterling remained within relatively narrow bounds. After a period of euro strength in November and early December, the euro-pound sterling rate went back down, especially following the turn of the year. The relative strength of the pound sterling – also against other major currencies – is associated with the bright outlook for the UK economy, which ultimately also led the Bank of England to raise interest rates in February. At the end of the reporting period, the euro was worth £0.68. This was around 5% less than at the beginning of monetary union in 1999.

Exchange rate of the euro

Daily data, log scale




**1** Initial level at the beginning of monetary union on 4 January 1999. — **2** According to ECB calculations, against the currencies of 12 countries.

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*Effective exchange rate of the euro*

Influenced by the movement of its exchange rate against the US dollar and the yen, the euro also rose perceptibly as of mid-November 2003 on a weighted average against the currencies of the euro area's 12 most important trading partners. Beginning in mid-January, it had to relinquish some of its gains, however. As this report went to press, it was around 2% higher than at the beginning of monetary union, yet 5% higher than its average level for 2003.

*Impact of the euro's rise*

On the one hand, the euro's appreciation has improved the euro area's terms of trade, reducing cost and price pressure in the euro area and, along with many other factors, enabling low central bank interest rates. On the other hand, the euro's rise over the past two years has put a strain on exporters throughout the euro area, especially since the euro's real effective exchange rate, the calculation of which takes into account the varying rates of inflation in the euro area and its partner countries, has now surpassed its post-1990 long-term average. For Germany, the competitive situation is somewhat more advantageous because its relatively favourable cost and price movements compared with the rest of the euro area have given domestic sellers something against which their competitive losses vis-à-vis companies from non-euro-area countries can be offset (see pp 50-57).