Global and European setting

World economic activity

Sharp upswing in the global economy

Global economic growth continued at a fast pace in spring. Strong stimuli still emanated from the United States and China even though real gross domestic product (GDP) in both countries grew somewhat more slowly during the second quarter than at the beginning of the year. The Japanese economy continued its upward trend but the increase in total value added was not as sharp as before. The global upswing became even more broadly based insofar as output in most other regions also showed a steep upwards trend. This was boosted not only by rapidly expanding exports but often also by more buoyant domestic demand. This is the case in the new EU member states where investment and private consumption rose considerably. In addition, the euro-area economic recovery made good progress in spring but still remained quite export-dependent up to the end of the period under review. The majority of CIS countries, a number of Latin American economies and the OPEC countries in the Middle East continued to benefit from the improved terms of trade following the price rally on the international commodity markets.

Prices in industrial countries

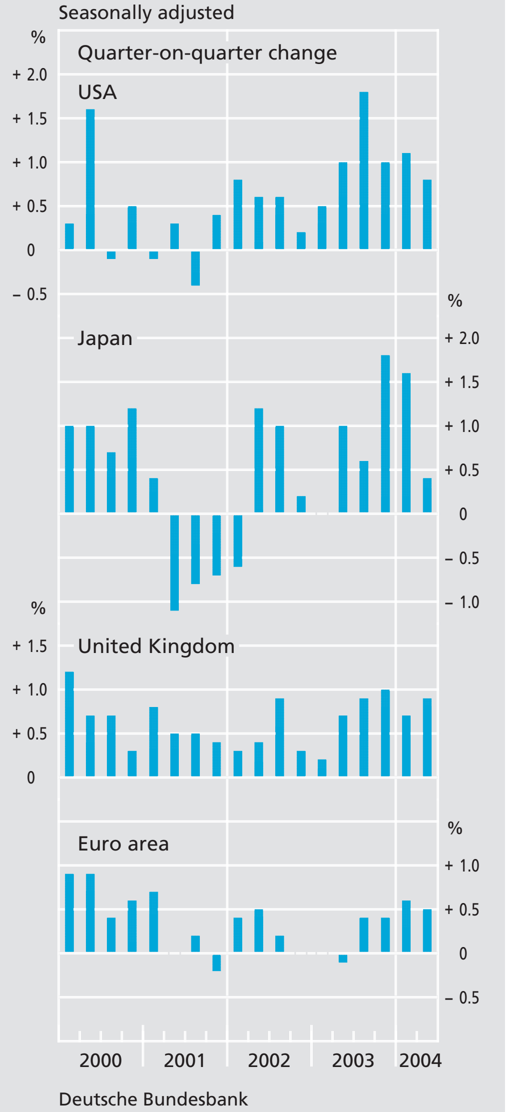
The generally favourable global economic outlook has been clouded by increased inflationary pressures in the past few months, however. Overall, average consumer prices in industrial countries – for which up-to-date data are available – showed a 2.2% year-on-year increase in the April-June period compared with 1.4% in the first quarter. Excluding Japan, where consumer prices continued to fall, the rate climbed from 1.7% to 2.5%.

This was primarily attributable to the marked increase in international crude oil prices which, in the case of Brent North Sea oil, amounted to 37% on a quarterly average year-on-year in dollar terms and 29% in euro terms. (Oil prices continued to rise after mid-year, reaching a record high in US dollar terms in the middle of August). At 1.5% in the second quarter, the core inflation rate (ie the year-on-year rate excluding the volatile components of energy and food) for the industrial countries was perceptibly lower than the headline rate. It was only 0.3 percentage point up on the first quarter. It is a positive sign that the majority of industrial countries are not suffering any significant second-round effects in the form of greater wage increases. Measured on the basis of inflation-indexed bonds (French OATei 2012 and US TIP 2012), long-term inflation expectations (including the risk premium) were at 2.2% and 2.4% in the USA and the euro area respectively in mid-August.

Boom in China somewhat dampened

At 5%, the inflation rate in China reached its highest level for seven years in June. Not least for this reason, the government implemented above all administrative measures – which were sometimes not particularly in keeping with market principles – in order to curb domestic demand, for example, the limitation of credit to certain economic sectors. An important factor in this was that the Chinese central bank's scope for monetary policy action is rather limited and will remain so as long as the exchange rate is de facto pegged to the US dollar. The first success of China's efforts to maintain stability is the fact that, in comparison with the same period last year, second-quarter real GDP growth (at 9½%) was somewhat lower than in the first quarter. A further slowdown has been forecast for the second half of 2004.

Growth trends in selected industrial countries



Burdens and risks

Although permanently high oil prices could dampen global economic growth, it is unlikely – from today's viewpoint – that they will stop it completely, however. It must also be taken into consideration that the situation on the industrial raw material markets did not deteriorate further at the end of the period under review; the corresponding dollar index has fallen somewhat since mid-July. The high geopolitical risks continued to squeeze growth but have at least not increased over the past few months. On the whole, there has also been no change in the potential disruptive impact of external imbalances.

USA: slowdown in GDP growth in the second quarter

Initial calculations show that second-quarter aggregate output in the USA was up by ¾% on the quarter after adjustment for seasonal and working-day variations; it had increased by just over 1% in the first quarter. Year on year, it rose by 4¾%. The perceptible slowdown in GDP growth in the second quarter was primarily attributable to an only moderate increase in private consumption (+¼%) after rises of approximately 1% in each of the previous four quarters. Demand for durable goods, in particular motor vehicles, actually fell in the second quarter. Households' propensity to buy was subdued as a result of the sharp increases in energy prices, which placed a noticeable strain on the purchasing power of nominal disposable income. Moreover, the fiscal stimuli which fuelled private consumption in the second half of 2003 and at the beginning of 2004 have waned. Furthermore, the hike in long-term interest rates in anticipation of the change in course in US monetary policy in the second half of June, appears to have reduced the volume of mortgage refinancing which, until then, had had a strong expansionary impact on private consumption.

By contrast, commercial investment, buoyed by positive earnings growth, rocketed by a seasonally adjusted 2% in the second quarter and constituted ¼ percentage point of GDP growth. It exceeded the previous year's level by 10%. In the aggregate, housing investment even rose by 3½% in real terms. It may, however, stabilise slightly during the second half of the year as a result of the increase in mortgage interest rates. After adjustment for price and seasonal variations, exports climbed by 3%, thereby exceeding the previous year's level by 12¼%. Although import growth fell considerably quarter on quarter (+2¼%), the deficit in real net exports remained virtually unchanged owing to the higher starting level.

Improved conditions on the labour market

The aforementioned slowdown in private consumption, over the next few months, could be offset, at least in part, by the expansionary effects of strong employment growth. The wave of concern over the past year that the upturn in the USA would pass the labour market by as a "jobless recovery" ebbed considerably during the spring months. The number of employed people outside the agricultural sector – as determined by the corporate survey – which rose by a total of "only" 0.4% in seasonally adjusted terms between its cyclical trough in August 2003 and February 2004, climbed by 0.7% in the four months from March to July. In July, however, there was only a negligible increase in the number of new jobs created.[1] Unemployment was at 5.5% at the end of the period under review, which was 0.8 per-

1 One of the discrepancies in the US labour market statistics, however, is the fact that the number of persons in work as determined by the household survey rose particularly sharply in July (+0.5% after seasonal adjustment) compared with the previous month.

centage point below the peak measured in June 2003.

Employment and the hidden reserve in the USA

The strong interaction between employment and the hidden reserve in the USA is notable in this respect. For example, the labour force as a percentage of the total working-age population decreased in seasonally adjusted terms from 67% at the end of 2000 to 66% in spring 2004. Withdrawal into the hidden reserve, which has been especially apparent among young people, has helped to improve the situation on the US labour market over the past few years. Labour force participation has started to increase again since the beginning of 2004, which is tending to slow down the decline in the overall unemployment rate.

Stronger inflation, but favourable Fed forecast

The increase in the consumer price index (CPI) has accelerated sharply in the USA since the beginning of the year. The year-on-year rate was 3.3% in June as against 1.9% at the beginning of the year. This was mainly attributable to soaring energy prices over recent months. However, the core CPI rate (excluding energy and food) also climbed from 1.1% in January to 1.9% in June. The corresponding rate of the deflator for private consumption (core PCE inflation), which is now the focus of the Fed's price analysis, rose from 1.2% to 1.5%. These core rates were driven up not only by the indirect cost-related effects of higher energy prices but also by the rise in other raw material prices and the higher prices of imported goods resulting from currency depreciation. Furthermore, enterprises' pricing power has increased once again in some sectors. The Fed assumes, however, that the most recent inflation rise will not continue in the second half of the year. According to the current forecasts being made by the members of the Federal Open Market Committee (FOMC), the core PCE inflation rate will remain within a range (central ten-

Labour market participation and unemployment in the USA

Source: Bureau of Labor Statistics, household survey. — 1 Labour force as a percentage of the total working-age population. — 2 Persons unemployed as a percentage of the labour force.

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dency) of 1¾% to 2% at the end of 2004 and 1½% to 2% at the end of 2005.[2]

Japan

The Japanese economy grew by almost ½% on the quarter in seasonally adjusted terms in the second quarter of 2004. It expanded by 4½% on the year. The slowdown is also to be considered against the backdrop of the extremely rapid rate of expansion in the winter of 2003-04, when real GDP rose by a seasonally adjusted and annualised rate of almost 6%. Exports once again made a considerable contribution to growth, expanding by 3½% on the quarter after adjustment for price and seasonal variations and thereby exceeding the year-on-year level by 18%. By contrast, domestic demand remained virtually unchanged after rapid expansion in the two preceding quarters. In seasonally adjusted terms, private consumption increased by well over ½% while expenditure on new machinery, equipment and premises in the industrial sector remained at the high level which it had previously reached. Government investment was down once again. In the light of generally favourable economic developments, the Japanese government's cabinet office raised its forecast for the fiscal year 2004-05, which began on 1 April, from 1¾% to 3½%. Positive growth has been forecast again for the first time since 1997 and in nominal terms is expected to reach 1¾%. Impacted by the rise in energy prices, consumer prices tended to point upwards in seasonally adjusted terms in June and July although there was a 0.1% fall on the year. Excluding energy and food, prices fell by 0.4% in June.

United Kingdom

According to initial calculations, real GDP in the United Kingdom was up by almost 1% in the second quarter of 2004 after seasonal and working-day adjustments which represents a slight rise on the first quarter (+¾%) and on the year (+3¾%). Overall economic growth was fairly balanced in that the manufacturing sector, which, as an economic straggler, had previously put the brakes on expansion, brought its output into line with that of the construction industry and the services sector. Private consumption once again played a major role in shoring up the UK economy, with real retail turnover up by almost 2% on the quarter in the three-month period from April to June. Given the generally fast pace of growth in the UK, which has persisted for some time now, as well as the low level of unemployment and buoyant consumer demand, the relative sluggishness of consumer price developments is surprising. The inflation rate – as measured by the Harmonised Index of Consumer Prices (HICP), on which the UK inflation target of 2% is based – was 1.4% during the April to July period and therefore only slightly higher than in the first quarter. At 2.2% in July, the national index (PRIX), which has a different methodology to the HICP, even showed a somewhat smaller rise in prices than in the previous two months. By contrast, house prices were up by a huge 20% on the year, which means that they have actually doubled since the middle of 1999.

2 The most recent forecasts of the members of the Federal Open Market Committee, which were published on 20 July 2004 in the "Monetary Policy Report to the Congress", refer to the core PCE inflation rate. The February report focused on the overall PCE rate. It is therefore difficult to compare the two forecasts.

New EU member states

The countries that joined the EU on 1 May 2004 continue to enjoy a strong economic upturn. In the April-May period, industrial output in this group of countries was up by a seasonally adjusted 2¾% on the first quarter and no less than 13¾% on the year, with Hungary, Latvia, the Czech Republic, Lithuania and Poland attaining two-digit growth rates between 10% and 17%. Owing to higher productivity gains, however, the vigorous industrial activity in the new member states is having only a low impact on reducing unemployment. In May, the standardised rate was 14.1% in seasonally adjusted terms and thus grossly exceeded the average for the old EU countries (8.1%). The spread ranged from 4.2% in Cyprus to 18.9% in Poland.

Price developments on the other hand have been rather unfavourable over the past few months. In eight of the ten countries, ie excluding Slovenia and Slovakia, year-on-year HICP inflation has risen considerably since the beginning of 2004. The unweighted average of the inflation rates in the ten new countries – Eurostat does not compile an overall index for this group of countries – rose by no less than 1½ percentage points to 4.4% from January to June. This increased upward pressure on prices was primarily attributable to higher energy prices and the fact that in some cases major tax increases came into force upon accession to the EU on 1 May 2004. The divergence in the inflation rates of the individual countries remained stark. The spread ranged from 1.0% in Lithuania to 8.1% in Slovakia at the end of the period under review.

Macroeconomic trends in the euro area

Sustained growth in the second quarter

The economic recovery in the euro area continued at approximately the same pace as during the first quarter throughout the spring. According to the Flash Estimate, seasonally adjusted real GDP increased by ½%. Compared with the same period last year, it went up by 2% (further information on the individual expenditure components is not yet available). According to the short-term forecast of the European Commission, aggregate output will continue to grow within a range of 0.3% and 0.7% in the third quarter.

More buoyant industrial activity

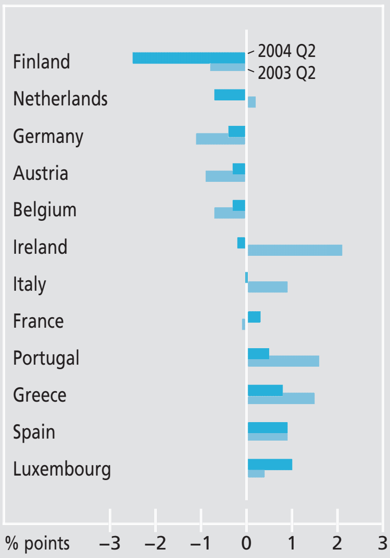
In contrast to the first quarter, industrial output in the April-May period also tended to point clearly upwards, exceeding the first-quarter level by almost 1% after seasonal adjustment and the year-on-year level by 2¾%. In July, capacity utilisation was considerably higher than in April and January.[3] Industrial activity was bolstered primarily by foreign demand. The value of goods exported to non-euro-area countries rose by a seasonally adjusted 5¼% on the first quarter in the April-May period. Furthermore, there was also a perceptible increase in domestic demand in some member states.

Favourable outlook for the second half of the year

Most of the leading economic indicators point to a continuation of the upturn during the second half of the year. For example, the volume of manufacturing orders received in the April-May period exceeded the level of

3 Owing to a break in the statistical series at the turn of 2003-04, longer comparisons, for example, with the long-term average for capacity utilisation, are currently uninformative.

Inflation differentials in the euro area *



* Change in the Harmonised Index of Consumer Prices 2004 Q2 vs 2003 Q2 and 2003 Q2 vs 2002 Q2; deviation of the national inflation rate from the euro-area average.

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the first quarter by 3¾% after adjustment for working-day effects. According to the most recent EU survey, industrial confidence has remained at the level reached in June. In terms of the components of the confidence indicator, better assessments of order books were offset by poorer production expectations. The fact that, according to the investment survey carried out in the March-April period, industrial enterprises in the euro area intend to step up their real expenditure on new machinery, equipment and premises by 3% this year – which is somewhat more than the figure specified in autumn 2003 – is consistent with this picture. In July, however, consumer confidence in the euro area remained at the same depressed level as in the first half of the year, indicating that a sustained improvement in consumption is unlikely over the next few months.

Labour market

The persistently sluggish consumer climate is likely to be the result of, among other things, the beleaguered labour markets in several of the larger member states, where the cyclical recovery has not yet had much of an impact. Overall, unemployment in the euro area rose into the spring months. The standardised unemployment rate was 9.0% in June.

Consumer prices

The second quarter of 2004 saw a deterioration in the price situation in the euro area. In seasonally adjusted terms, the HICP was up by 0.8% on the first quarter. In each of the three preceding quarters it had risen by only 0.5%. As inflation in the second quarter of 2003 had been relatively low at 0.2%, the year-on-year rate increased from 1.7% to 2.3%. According to the Eurostat Flash Estimate, the year-on-year rate was 2.4% in July.

In the period from April to June, inflationary effects were generated, in particular, by the international crude oil markets. For households, energy prices were up by no less than 3.3% on the quarter. By contrast, after seasonal adjustment, there was virtually no change in the prices of unprocessed food. Disregarding these two components, consumer prices were up by 0.6% on the first quarter of 2004. This figure takes account of the impact of tobacco tax hikes in several member countries and the effects of the health system reform in Germany. In a year-on-year comparison, the inflation rate for the core components was 2.1% as against 2.0% in the first quarter. Therefore, excluding the particularly volatile components, the rate has remained at 2% for the past one-and-a-half years despite considerable spare capacity. It would have been significantly lower, however, if numerous administrative measures had not pushed up prices.[4]

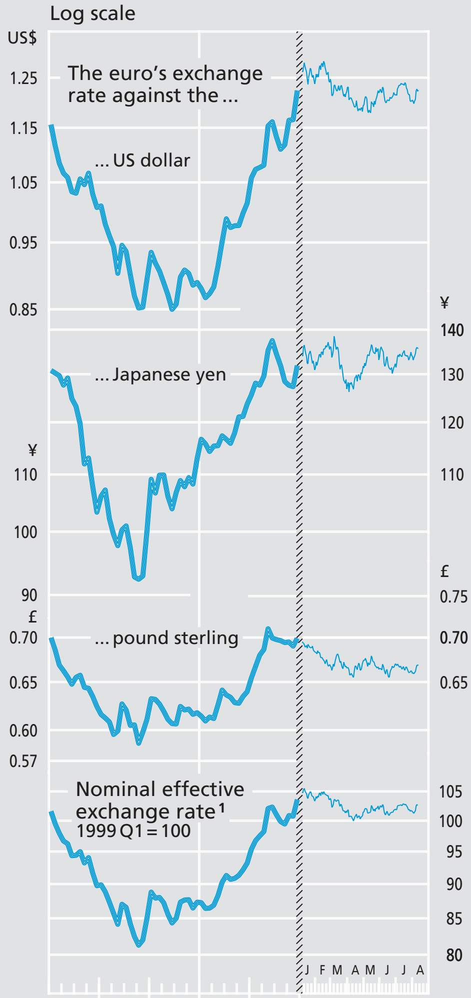
At the end of the period under review, there was a somewhat greater divergence in euro-area price developments. Measured by the spread of inflation rates, it grew from 2½ percentage points in the first quarter of 2004 to 3½ percentage points in the second quarter. Other unweighted measurements of divergence also point towards a further increase in divergence, albeit maybe only a temporary one.[5] Since the diverging forces were at work particularly in the smaller countries and the inflation rates in the large countries tended rather to converge somewhat, the measures weighted according to the size of the country did not indicate a greater degree of dispersion. Compared with the previous year, discounting Finland,[6] price developments in the euro area became more uniform as the price increases in several countries with above-average inflation rates were considerably smaller than before.

Exchange rates

Development of the euro's exchange rate against the US dollar, ...

Following the sizeable appreciation of the euro up to the beginning of 2004 and the subsequent depreciation, there was comparatively little fluctuation in the euro exchange rate during the spring and summer months. At US$1.29, the euro had already peaked against the dollar in February and then fell through to the middle of May when it hit US$1.18. Since then, the euro's exchange rate against the dollar has hovered around the US$1.20 mark. A series of predominantly favourable economic data for the USA and the subsequent expectations of a gradual tightening of monetary policy by the Fed strengthened the dollar. At the same time, however, the US currency was burdened by renewed concerns about the ability to finance the US current account deficit. In both May and June, new record deficits were reported in the US trade balance for March and April respectively. Against this backdrop, the euro gradually appreciated again, sometimes trading at US$1.24. The euro's slight upward trend during the period under review was interrupted temporarily in mid-June and the second half of July. First, in June, growing inflation in the USA generated the impression that the Fed could raise interest rates more sharply and more quickly than previously expected. Secondly, the euro momentarily depreciated against the US dollar in July after the report by the Federal Reserve Chairman to Congress sparked fresh hope among market participants as regards the economic situation in the USA. However, subsequent publications of US economic data, in particular the surprisingly small increase in the number of

4 For information on the key index effects of the health reform in Germany, see Deutsche Bundesbank, The economic scene in Germany around the turn of 2003-04, *Monthly Report,* February 2004, p 48.
5 For example, the European football championship resulted in a more than 30% year-on-year increase in hotel prices in Portugal in June, which may have temporarily pushed up the overall index by up to 1 percentage point. Similar, albeit not so noticeable effects are to be expected as a result of the Olympic Games in Greece.
6 In March 2004, Finland considerably lowered its alcohol tax, thus bringing the HICP down below the level of the previous year.



* Monthly averages; daily data as of 2004. — 1 As calculated by the ECB against the currencies of 12 countries.

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jobs in both June and July, then again resulted in a more cautious economic forecast for the USA and gave the euro new impetus. The foreign exchange markets had, to a large extent, anticipated the 25 basis point hike in the Fed's key interest rate on both 30 June and 10 August 2004 which meant that these increases did not have much of an impact on the euro-dollar exchange rate. At almost US\$1.23 at the end of the period under review, it was approximately 2½% below its level at the beginning of the year.

... against the yen ...

There has been no noticeable trend in the euro-yen exchange rate over the past few months. Since the middle of May, accompanied at times by relatively high volatility, the euro initially depreciated against the yen. During this period, the Japanese economy repeatedly reported unexpectedly favourable economic data, for example, on the growth in industrial output or GDP, which boosted the attractiveness of investing in Japan. Towards the end of June, however, the trend was reversed in favour of the euro. This was boosted by reports that industrial output growth in Japan was significantly lower than expected as well as by relatively poor labour market and retail trade figures. Given Japan's heavy oil dependency, investors may also have been unsettled by the high oil price. Therefore, at 136 yen in mid-August, the euro had gained somewhat on its value at the beginning of the year.

... and against the pound sterling

Against the backdrop of countervailing determinants, there was little change on the whole in the euro's exchange rate against the pound sterling during the summer. The pound sterling was bolstered by the robust developments in the UK economy and further key interest rate hikes by the Bank of England in June and August. This further heightened the interest rate advantage of investments in the UK compared with those in the euro area. Furthermore, market participants appear to have speculated on further increases in interest rates. However, the appreciation of the pound sterling is tending to be curbed by re-

Entry of new currencies into the Exchange Rate Mechanism II (ERM II)

It is expected that the ten new EU member states will, sooner or later, also participate in monetary union. Exemption clauses such as those negotiated by the UK and Denmark in the Maastricht Treaty are not an option for these countries. Before accession to monetary union, however, they must fulfil the convergence criteria, one of which is tension-free ERM II membership for two years, whereby the exchange rate must remain close to the central rate.

Upon the application of Estonia, Lithuania and Slovenia, on 27 June 2004 the currencies of these three countries joined ERM II. The standard fluctuation band of ±15% around the central rate was agreed. Estonia and Lithuania had already fixed the exchange rates of their currencies to the euro in a currency board arrangement without any scope for fluctuation. After assessment, these fixed rates were taken as the central rates for the Estonian kroon and Lithuanian litas in ERM II. Furthermore, Estonia and Lithuania have waived the scope for fluctuation of their currencies within ERM II on their own initiative by retaining their existing currency board arrangements. These voluntary and unilateral commitments, however, do not place any additional obligations on the ECB.

By contrast, Slovenia had previously allowed the exchange rate of the tolar to fluctuate within a specific band around a depreciation path as part of a crawling peg system (see chart on page 20). From the launch of the euro at the beginning of 1999 up to Slovenia's entry into ERM II, the tolar lost a total of 21% in value against the euro via controlled depreciation. The chart, however, also highlights the fact that the depreciation rate of the euro-tolar exchange rate was scaled back over time by the Slovenian central bank.

The success of Slovenia's ERM II membership will depend on whether the depreciation trend of the tolar against the euro can be credibly broken. Initial indications are encouraging even though the observation period is still very short. The tolar's central rate in ERM II was set at its euro reference rate on the last trading day before its entry (€1 = 239.64 tolars). Since then, the tolar has fluctuated only slightly around this rate. When this report went to press on 12 August, the exchange rate of the Slovenian currency was 240 tolars to one euro, which is only 0.15% above its central rate. Up to now, therefore, the euro-tolar rate has remained within a very narrow margin without making full use of the allowed fluctuation band of ±15% around the central rate.

Continued tension-free developments in the Slovenian tolar, as well as the Estonian kroon and Lithuanian litas, will depend primarily on domestic economic policy being stability-oriented. The agreements to include the currencies of Estonia, Lithuania and Slovenia in ERM II are also based on firm commitments by these countries to continue in their efforts to preserve macroeconomic stability, not least in public finances, and to implement structural reforms.

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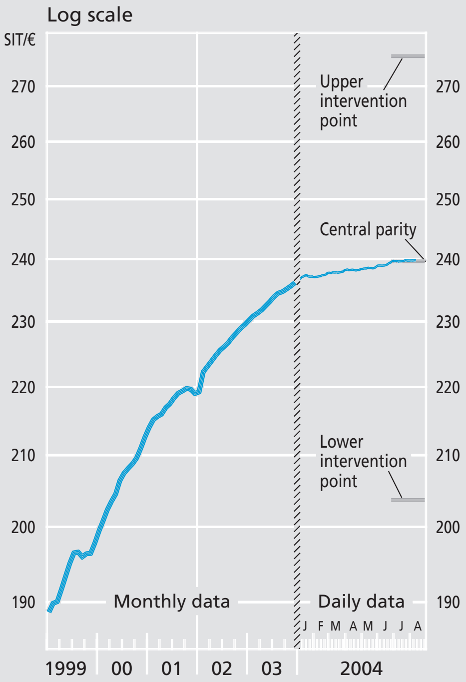
Exchange rate of the euro against the Slowenian tolar



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peatedly expressed concerns – particularly on the part of the Bank of England – about a price adjustment on the real estate market as well as by the trade deficit, which was again somewhat larger at the end of the period under review. As this report went to press, the euro was trading at £0.67, ie 5% below its rate at the beginning of the year.

Effective exchange rate of the euro

As a weighted average against the currencies of 12 major trading partners, the (effective) exchange rate of the euro hardly changed overall during the summer. It was trading at around 2½% below its value at the beginning of the year as this report went to press. In real terms, ie taking into account the prevailing inflation differentials between the euro area and its most important trading partners, the effective exchange rate of the euro was still somewhat higher than its average value since the beginning of the 1990s.

ERM II

On 27 June 2004, the first currencies from the group of new EU member states joined the Exchange Rate Mechanism (ERM II); these were the Estonian kroon, the Lithuanian litas and the Slovenian tolar (see the overview on page 19). Apart from the euro against which central rates are set only the Danish krone participated in ERM II at that time. The central rates of the new currencies against the euro were set at €1 = 15.6466 Estonian kroons, €1 = 3.45280 litas and €1 = 239.640 tolars. In contrast to Denmark, the standard fluctuation band of ±15% to the euro applies to these three currencies. Estonia and Lithuania, however, may maintain their present currency board arrangements for the euro without this placing any additional obligation on the European Central Bank. Two years of tension-free membership of ERM II, whereby the exchange rate should remain close to the central rate, is one of the prerequisites for the introduction of the euro in these countries.