Global and European setting

World economic activity

Slower global growth due, above all, to higher oil prices

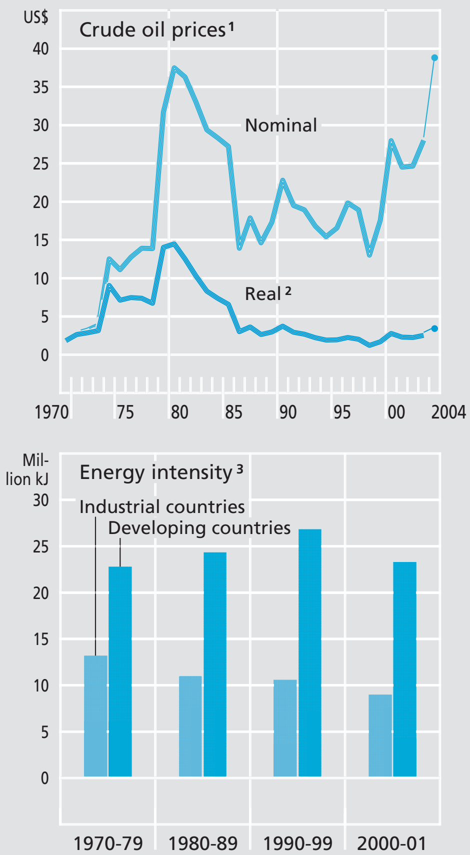
The global economy lost momentum in the second half of the year. The main reason for this was the sharp rise in crude oil prices which had occurred in several surges since the beginning of 2004. At the end of October, they reached a new all-time high at US$51½ (North Sea Brent).[1] Although crude oil prices have receded perceptibly in the past few weeks, in mid-November they still exceeded by far their average of the first three quarters and were 42% higher than their level one year earlier. The rise in energy prices has led to perceptible losses in purchasing power among households in the oil-consuming countries and has burdened firms' cost accounts. This has also had a negative impact on the consumer climate and on business sentiment. Although the growth-dampening effects have been counteracted to a degree by expansionary effects in the oil-producing countries owing to rising export receipts, from a global perspective the retarding effects still outweigh the benefits. Industrial raw material prices denominated in dollars likewise hit a new all-time high in the past few weeks. In mid-November, they were 22% up on the year.

Industrial countries ...

Although third-quarter overall economic growth in the USA was somewhat stronger than in the second quarter, it was unable to match its fast pace of the winter of 2003-04. In the United Kingdom, growth, having been

1 In real terms, however – ie taking consumer price increases in the industrial countries into account – crude oil prices were, as of late, still well below their level at the end of the 1970s and the beginning of the 1980s.

Crude oil prices
and energy intensity



1 Spot market price for a barrel of Brent North Sea oil. ● = Average for the year 2004; partly estimated. Source: Thomson Financial. — 2 Deflated using the OECD consumer price index (base year: 1970). Source: OECD. — 3 Energy consumption (million kilojoules) relative to real GDP (US$1,000 at 1997 prices). Source: Energy Information Administration, Washington DC.

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extremely buoyant in the first half of the year, slowed down after mid-year. In the third quarter, the euro-area economy was not able to maintain its relatively fast-paced growth of the first two quarters, either. Japan's economic growth, having already slowed down noticeably in the second quarter, virtually ground to a halt in the third quarter. According to initial country estimates, real GDP in the United States, Japan, the United Kingdom and the euro area altogether rose in the third quarter by a seasonally adjusted ½% on the period compared with well over 1% in the first quarter and just over ½% in the second quarter. It was up by 3¼% on the year.

... and crude oil-importing emerging economies affected, ...

A distinction should be made with regard to emerging economies between oil-importing countries and oil-exporting countries. The oil-importing emerging economies, as a rule, are affected by oil-price rises even more than industrial countries because they are generally much more energy-intensive, ie they use more energy to manufacture one unit of GDP, and their energy production is heavier on crude oil. Moreover, emerging economies' energy intensity – unlike that of industrial countries – was still on the increase until the end of the 1990s; however, since the beginning of this decade, it has likewise been exhibiting a downward trend. In China, year-on-year aggregate output growth in the third quarter, at just over 9%, was not quite as high as in the first half of the year (+9¾%). Growth in other south and east Asian emerging economies – for which no current information on GDP growth is yet available, however – is likely to have slowed down as well. In some of the region's countries, such as Thailand, the government has resorted to providing subsidies to push refined petroleum prices below the market level.

... whereas countries exporting crude oil and raw materials are booming

Overall output in the key crude oil and industrial raw material exporting countries is still running at full steam. According to the IMF autumn forecast, in 2004 the Commonwealth of Independent States (CIS) will achieve its fastest growth since the boom year of 2000 (+8%). In Latin America which, on the whole, is likewise benefiting from the booming markets for crude oil and raw materials, growth will increase from 1¾% in 2003 to 4½%. The oil-producing countries in the Middle East are expected to see a 5½% rise in GDP.

Global GDP rise weaker in 2005

According to the IMF forecast, global GDP growth in 2004 (+5%) will be at its highest mark since the mid-1970s. As a long-term average (+3½%), the increase in output should be described as exceptional, too. For 2005, however, the IMF expects growth to weaken to 4¼%. This is based on a slowdown in industrial countries from 3½% to 3% and in other parts of the world from 6½% to 6%. In a historical comparison, however, these growth rates are still noteworthy. Although the projections are based on the assumption that the average price for the most important types of crude oil will be US$37½ on an annual average for 2004 and 2005, even higher oil prices such as are currently looming on the horizon will not necessarily mean that next year the global upswing will be disturbed to such an extent that this might call the entire upswing into question. However, growth will probably slow down more considerably than had been expected in the third quarter.[2]

More subdued global economic growth with positive aspects

In this connection, it should also be noted that global output – given significant regional differences in the level of growth – has increased at a pace that, in some cases, has considerably exceeded the growth rate of potential output and would have led to tension sooner or later. A certain calming of growth was inevitable anyway following the long period of extremely strong monetary and fiscal policy impulses and should be viewed quite positively. In addition, a shift in overall demand to a potential growth path, as is now the case in the USA and, to a degree also in China, will contribute to a more balanced global development, which will most likely also have a calming effect on the markets for raw materials.

Conditions for growth remain good

Despite the current oil price-related burdens, the fundamentals for sustained strong world economic growth remain intact. Corporate balance sheets have improved considerably. Productivity and, with it, profitability have risen significantly. Banking system stability has increased and the credit quality of loans has improved. The means of obtaining external finance continue to be regarded as very favourable. The signs of overheating on the real estate markets, especially in Anglo-Saxon countries and in Spain, seem to be waning. In addition, the industrial countries so far hardly seem to have experienced any second-round effects as a response to higher energy prices, which means that the price climate has not fundamentally worsened.

Risks

Nevertheless, crude oil price movements remain the main short-term risk to the world economy. The crude oil supply may possibly be less elastic than is generally assumed at present. In the light of minimal spare capacity and the continuing tension in the Middle

2 IMF simulations provide certain indications regarding the extent of the growth slowdown. They show that a permanent rise of US$5 in the price of crude oil after one year will cause global growth to slow down by 0.3 percentage point.

East, the oil markets remain volatile and highly prone to disruptions. The major external imbalances, which have recently tended to resume growth – especially on account of oil prices – are a further risk factor. At all events, the US current account deficit rose in the second quarter of 2004 by just over 1 percentage point from its temporary low in autumn 2003 to 5.7% of GDP. This contrasts with large surpluses in east Asia and an improvement in the external balance in Latin America, the CIS and the Middle East. This development has encouraged foreign exchange market players to rethink their investment behaviour in the past few weeks. As a result, the US dollar sustained considerable losses.

Prices in industrial countries

Seasonally adjusted consumer price inflation in industrial countries calmed down distinctly in the third quarter; it was 0.3% up on the period following a rise of 0.8% in the second quarter. On the year, prices for consumer goods were up by an average of 2.1% in the third quarter and were thus slightly lower than the second-quarter figure (2.2%). Excluding Japan, where prices fell slightly once again, consumer prices rose by 2.5%. However, in the light of the latest price surges on the oil markets, October is likely to see a return to higher inflation. According to the IMF forecast, consumer prices in the advanced economies will rise next year (as in 2004 already) by 2.1% overall. However, if oil prices significantly exceed the assumed level of US$37½, inflation is likely to be somewhat stronger.

USA

Despite the strains caused by the considerable rise in crude oil prices during the course of 2004, according to initial calculations, real GDP in the United States grew in the third quarter by just under 1% on the quarter or by 3¾% on the year after adjustment for seasonal and working-day variations. Overall economic capacity utilisation increased, too, with potential output growth up by 3¼% (according to IMF estimates). GDP rose by nearly 4% on the year. The result would probably have been even better had it not been for the output losses caused by hurricanes in September. The strongest second-quarter stimuli came from private consumption, which rebounded from a phase of weaker growth in the previous quarter to rise by just over 1%. Purchases of new cars picked up especially sharply. What is remarkable is that the rise in consumption, given only a slight increase in income, was very much at the expense of saving, which – as a percentage of disposable income – hit new all-time lows, at just under ½% in the quarter and ¼% in September. Commercial investment grew by 2¾% on the period, thereby generating one-third of total GDP growth. Real expenditure on new residential buildings likewise increased distinctly. Total economic output in the third quarter was curbed by the failure of inventory replenishment to match previous months' levels. In addition, export growth, at 1¼% after seasonal adjustment, was no longer as strong as earlier. By contrast, however, import growth was even more sluggish, which meant that the real foreign balance did not deteriorate as much as in the three preceding quarters.

On the whole, leading indicators for the USA and reports from the Federal Reserve's districts indicate a continuation of steady economic growth. Doubts about the sustainability of the US upswing that had arisen in the past few months have been dispelled following the publication of exceptionally good employment figures for October and the sharp upward revision for the two preceding months. After seasonal adjustment, around 760,000 new non-farm jobs were created between July and October; on average over this period, just under ½% more people were employed than in the second quarter and nearly 1½% more than a year earlier. This positive picture changes little if one takes into consideration that, in October, additional temporary employees were hired, particularly in construction, to repair the damage caused by hurricanes.

Inflation risks continue to be regarded as moderate. This assessment is supported by the fact that the core rate of the personal consumption expenditure deflator (excluding energy and food), which plays a key role in the Fed's price analyses, averaged 1.4% in the third quarter, a figure that was no higher than in the first half of 2004. The overall index of consumer prices, however, was 2.7% up on the year. This was mainly due to the sharp rise in energy prices (+10.4%) since the third quarter of 2003. In October, year-on-year overall consumer price inflation surged to 3.2% because of the latest rise in crude oil prices.

Japan

Following a rather weak second-quarter rise of ¼%, seasonally adjusted overall output in Japan virtually stagnated in the third quarter. On the year, however, it went up – owing to the strong growth overhang from 2003 and dynamic growth in the winter months – by no less than 4%. The disappointing third-quarter developments are due entirely to the negative contribution to growth provided by foreign trade and payments, which amounted to ¼ percentage point of GDP. Real exports, having increased in the first and second quarters by a seasonally adjusted 4½% and 3½% respectively, were up by only ½% on the period, whereas imports, at 2¾%, rose somewhat more sharply than in the second quarter. In addition, government investment once again showed a clear downward trend. Domestic private demand, however, continued to rise, growing by ½% during the period under review. The main reason for this was that seasonally adjusted household consumer demand picked up distinctly (+1%) owing not least to the onset of recovery on the labour market. Although rising oil prices put a strain on Japanese consumers, too, consumer prices in the third quarter were still slightly lower on average than a year earlier. The Bank of Japan presumes that the deflationary tendencies will end in the 2005-06 fiscal year beginning on 1 April 2005.

United Kingdom

Initial figures show that real third-quarter GDP in the United Kingdom was up by just under ½% from its level in the second quarter (in which it had grown by nearly 1%) after seasonal and working-day adjustment. The year-on-year rise amounted to 3%. The weakening of economic activity after mid-year was concentrated on the production sector (excluding construction), which saw output decline by 1% on the period. By contrast, seasonally adjusted output growth in the services sector, at ¾%, was almost as strong as before. The UK labour market is still in a healthy state; in the third quarter, the standardised unemployment rate was 4½%; it had been just under 5% a year earlier. UK property prices, which have risen extremely sharply in the past few years and have increasingly been regarded as a risk to economic growth, have tended to decline somewhat in the past few months; however, in October, the Halifax House Price Index was still just under one-fifth higher than a year earlier. According to the UK Harmonised Index of Consumer Prices (HICP), consumer price inflation measured only 1.2% over the July-October period. According to the traditional Retail Price Index excluding Mortgage Interest Payments (RPIX) – which is methodologically different from the HICP – prices went up by 2.1%.

New EU member states

In the new EU member states, economic activity likewise lost momentum in the third quarter. Seasonally adjusted third-quarter industrial output was down by 1¾% on the exceptionally high level of the preceding period. The substantial cutbacks in output that affected Polish industry were a key factor. For the entire group of new EU countries together, the year-on-year growth rate was "only" 7¾%, down from as high as 12½% in the first half of the year. The seasonally adjusted unemployment rate among the new EU member states was 14% in the third quarter and thus ¼ percentage point lower than a year earlier. Youth unemployment is a particularly pressing problem in this group of countries. As this report went to press, youth unemployment rates ranged from 10% in Cyprus to nearly 40% in Poland.

After mid-year, consumer prices maintained their sharp rising trend. After the elimination of seasonal variations, on an average of the July-October period, they were 1.4% higher than in the second quarter, in which they had likewise risen on a similar scale. The annual rate of inflation was 4.9%, compared with 4.1% in the second quarter and the last all-time low of 1.5% in the second quarter of 2003. The divergence in the inflation rates of the individual countries remained very large throughout the reporting period, with rates ranging in October from 2.0% in Cyprus to 7.2% in Latvia.

Macroeconomic trends in the euro area

Weaker GDP growth in the third quarter

According to the initial Flash Estimate, euro-area growth slowed down to a seasonally adjusted ¼% in the third quarter from levels of ¾% in the first quarter and ½% in the second. GDP rose by just under 2% on the year. Although no information on the individual expenditure components is available yet, there is much to indicate that, in particular, the contribution of real exports to growth has fallen. According to the European Commission's indicator-based short-run forecast, the macroeconomic growth rate will range between 0.2% and 0.6% in the fourth quarter of 2004 and the first quarter of 2005.

Subdued industrial activity

After seasonal adjustment, third-quarter industrial production was only ¼% higher than in the second quarter, in which growth had been as high as 1%. The reduced output of durable consumer goods made a particular contribution to the moderate result. The production of energy and non-durable consumer goods stagnated at second-quarter levels. By contrast, the manufacture of intermediate goods and capital goods continued to rise. The fact that capacity utilisation in manufacturing rose only sluggishly between July and October is in keeping with the levelling-off of industrial activity in the third quarter.[3]

Mixed outlook

Leading indicators for the euro area present a rather mixed picture with regard to industrial activity in the coming months. Ordering activity in the euro-area order-based manufacturing industry was exceptionally weak in the July-August period. Seasonally adjusted new orders, in terms of value, were down by 2½% on the quarter. In addition, the purchasing manager indices for manufacturing continued to slump in October. However, this contrasts to a certain extent with the latest EU survey, which indicates a renewed improvement in industrial confidence.

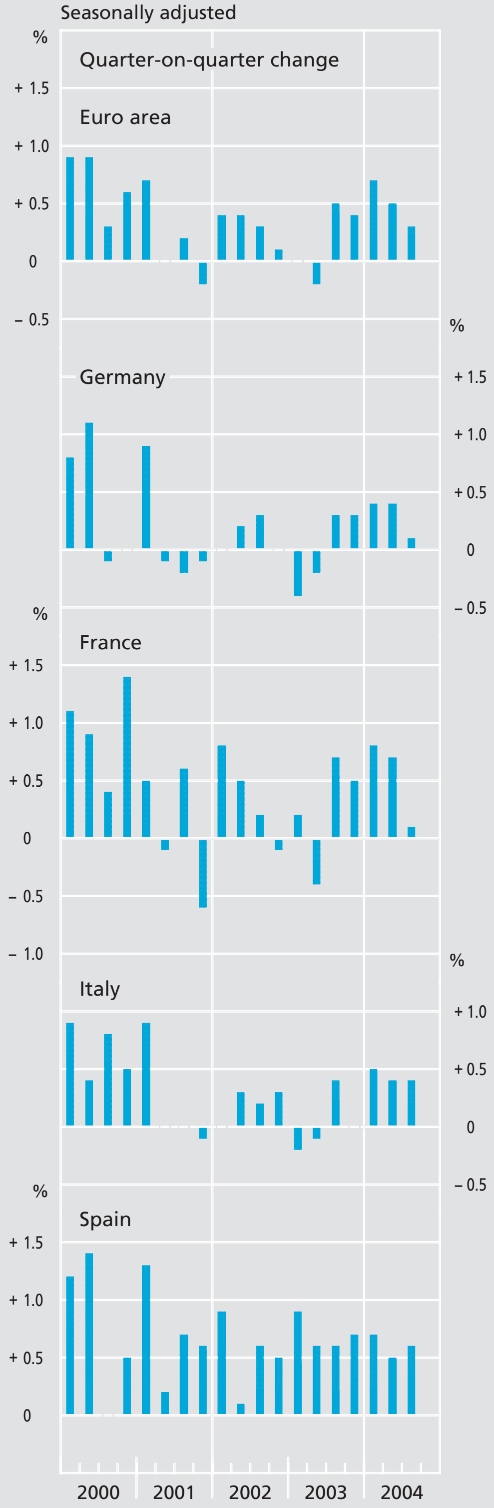
Consumer climate and the labour market

Consumer sentiment has seen no improvement since the beginning of the year. The low propensity to purchase is also illustrated by real retail sales, which declined once again in the third quarter after seasonal adjustment. One reason for the persistently weak consumption is the loss of purchasing power caused by the sharp rise in oil prices. Another is that continued difficulties on the labour market are putting a strain on private con-

3 Owing to a break in the statistical series at the turn of 2003-04, longer comparisons, such as with the long-term average, are uninformative.

Growth trends in the euro area

Seasonally adjusted



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sumption. Although euro-area unemployment did not rise further in the third quarter, 12.7 million people were still without employment in the euro area. The unemployment rate has stood at 8.9% since early 2003.

Consumer prices

In the third quarter, euro-area consumer prices rose by ½% from second-quarter levels after seasonal adjustment. This represents a slight levelling-off of the rate of price increase compared to the second quarter, at the beginning of which tax increases had come into effect. Price movements over the past few months have been influenced by the sharp rise in crude oil prices. Overall, consumers had to pay just under 6½% more for energy in the third quarter than a year earlier. By contrast, unprocessed foods were cheaper owing to the weather, which was relatively favourable for agriculture. The prices of processed foods, drinks and tobacco rose by 3½% on the year, especially due to the hike in taxes on tobacco products in various euro-area countries. The prices of services, which rose by an average of just over 2½%, were influenced in Germany and the Netherlands by the increases in patients' additional charges and cutbacks in benefits as part of the health system reforms. Although pharmaceuticals – which are regarded as industrial goods – were also affected in both countries, prices for this category of goods rose by only slightly less than 1%.

Euro-area consumer prices in the third quarter were up by 2.2% on the year. The renewed surge in crude oil prices at the beginning of the fourth quarter, however, caused the year-on-year rise in the HICP to increase to 2.4% in October. Core inflation (excluding energy and unprocessed food), however, remained unchanged at 2.0%.

Exchange rates

Renewed stronger exchange rate fluctuations on foreign exchange markets

In the past few weeks, the exchange rate parities on the international foreign exchange markets have begun to fluctuate more sharply again following the second and third quarters, in which exchange rate fluctuations had been contained within relatively narrow bands. The US dollar, in particular, fell against a background of partly weaker business data and the US presidential elections. By contrast, the euro gained ground against several currencies.

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

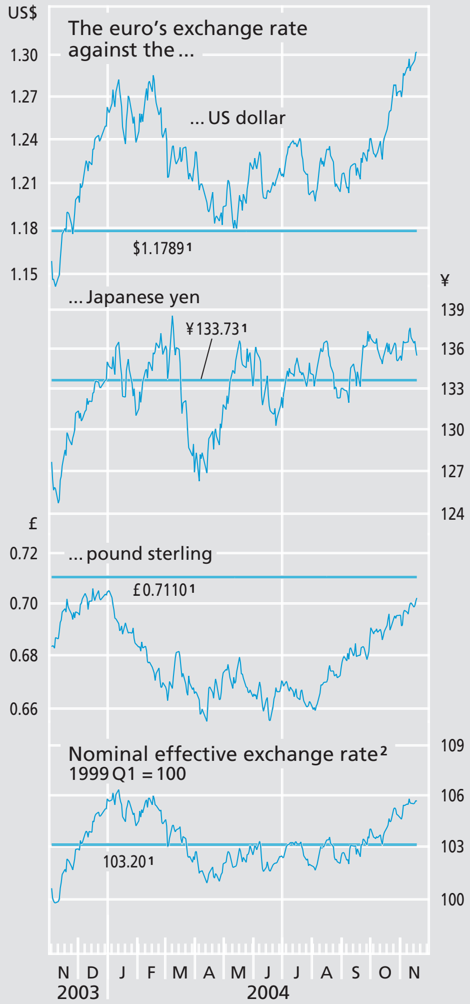
Following a period from mid-May to the end of September when the euro-US dollar exchange rate had largely fluctuated between around US\$1.20 and US\$1.24 to the euro, the euro subsequently grew stronger against the dollar. The persistently large US deficit in foreign trade in goods and services, as well as intermittently unfavourable labour market data in the USA, put pressure on the dollar. The deterioration in the US economic outlook perceived by market participants was accompanied by a reduction in the speed at which they expect the US Federal Reserve to tighten monetary policy. At times, this caused a decline in the yield advantage enjoyed by long-term US government bonds over similar euro-area instruments, despite increases of 25 basis points in the federal funds rate in August, September and November.

Foreign exchange market watchers regarded the euro's appreciation against the US dollar in the period under review as being linked in some part to the rise in oil prices. In actual fact, in a departure from normal circumstances, a rather close positive correlation between the euro-US dollar exchange rate and the oil price can be observed for the August-October period. The considerable US current account deficit helped to make this correlation possible, especially since this deficit tends to grow in line with rising oil prices owing to the high consumption of oil in the USA. As higher oil prices are causing the outlook for US economic growth to deteriorate, financing the deficit is also becoming more difficult. However, the fragility of the correlation described above is shown by the countervailing movements of the euro-US dollar exchange rate and oil prices in November.

At around the same time as the US presidential elections, the euro began to surge against the US dollar. In mid-November, the euro-US dollar exchange rate reached new all-time highs, with reference rates surpassing the US$1.30 mark. As this report went to press, the euro was thus trading 3½% higher than at the turn of 2003-04.

Exchange rate of the euro

Daily data, log scale



1 Debut level at the start of monetary union on 4 January 1999. — 2 As calculated by the ECB against the currencies of 23 countries.

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... against the yen ...

The uneven summer trend in the euro-yen exchange rate carried over into the autumn months. Following reports of positive Japanese economic data, the euro initially fell somewhat against the yen. In the second half of September, however, news that the Japanese trade surplus had declined distinctly put downward pressure on the yen. The weaker growth of Japanese exports, in particular, raised fears in some quarters about the continuation of economic recovery in Japan. This caused the euro to regain ground against the yen. In October, tension between positive economic data from Japan and speculation about renewed intervention on the part of the Bank of Japan caused the euro-yen exchange rate to remain within relatively narrow margins. As this report went to press, the euro was trading at ¥136, ½% higher than at the end of last year.

... and against the pound sterling

In the autumn months, the euro rose virtually continuously against the pound sterling. The relative weakness of the pound is linked, above all, to the cooling of the UK economic upturn, which had been very robust for a long time. In the UK, this development and a detectable slowdown in property price rises both led to deflated expectations of interest rate increases, which reduced the attractiveness of investing in the pound sterling. In addition, reports about the burgeoning budget deficit and the gradual deterioration in the UK balance of trade put downward pressure on the pound sterling. Towards the end of the reporting period, the euro was valued at £0.70; however, despite its latest gains, the euro was still ½% lower than at the end of 2003.

Effective exchange rate of the euro

In September, the number of important trading partners included in the calculations of the euro's nominal effective exchange rate was increased from 12 to 23 countries.[4] The new additions are the countries that joined the EU in May 2004 and China. On a weighted average against these 23 currencies, the euro has appreciated by a total of around 2½% since mid-August and has thus now returned to its level at the end of last year.

4 The new calculation method is explained in detail in European Central Bank, Update of the overall trade weights for the effective exchange rates of the euro and computation of a new set of euro indicators, *Monthly Bulletin,* September 2004, pp 69-72.