Global and European setting

World economic activity

Global upturn has stabilised ...

The global economic upturn has stabilised further over the past few months. In addition, there are many signs that global economic activity is clearly still on the rise. Although the Madrid terrorist attacks and the escalation of violence in the Middle East have at times led to palpable uncertainty on the financial markets, from today's vantage point a serious disruption to global economic activity appears unlikely despite the major geopolitical risks. In addition, other important underlying conditions for a world economic recovery, such as low financing costs, relatively subdued price developments and improved corporate profitability, have remained intact.

... amid major geopolitical risks

Sharp rise in commodity prices as a potential brake

The persistently high crude oil prices and the sharp rise in the cost of industrial raw materials, however, could put a strain on the global economy. In the first half of May the price of Brent North Sea oil was US$36½ per barrel, 1½ times the previous year's price; in euro terms the year-on-year increase was 43%. Industrial raw material prices rose by 27½% on the year in US dollar terms and by 20% in euro terms. The price increases on the international commodity markets mainly reflect the cyclical increase in demand stemming from the United States and East Asia. The Chinese economy's demand for commodities rose particularly sharply. Its share in global consumption of non-ferrous metals has doubled over the past six years to nearly one-fifth. However, supply-side and speculative factors also play a role in crude oil price movements. Another important fact is that OPEC is apparently seeking some compensation for the loss of purchasing power caused by the US dollar's depreciation. The latest announcement that Saudi Arabia would increase its oil production, however, also made it clear that the oil-producing countries have no interest in excesses and tensions on the oil market which would jeopardise the global upturn. Global economic growth has not been noticeably affected so far by the sharp price increases on commodities markets. However, certain retarding effects, especially in the dollar zone, cannot be ruled out if oil prices, in particular, hold firm at their current levels for a longer period of time or even rise further, thus causing overall energy price levels to move upwards.

Considerable regional growth differentials still exist

After the turn of 2003-04, the global upswing largely followed the underlying regional pattern which had formed in 2003. The USA and the East Asian emerging market economies, especially China, remain the driving forces. The Chinese economy, however, is facing the prospect of overheating if additional economic policy countermeasures are not taken. In Japan, the demand base of the cyclical recovery has broadened over the past few months insofar as households' propensity to purchase has gone up perceptibly. In the euro area, too, the economic recovery picked up somewhat after the turn of the year; however, it remains the straggler among the "big three" industrial economies. The growth rate of the economies of the central and east European countries in transition – starting from a very high level – has accelerated even further. The Commonwealth of Independent States (CIS) is currently benefiting from sharply rising oil revenues. Not only Russia and the central Asian oil exporting countries but also the rest of the CIS (via close foreign trade links) are benefiting from these revenues. In those countries, real GDP in 2003 grew by an average of 8%, or even more sharply than in the group of net oil-exporting countries. The majority of Latin American countries are back on a growth track. This is particularly true of Argentina, whose GDP rose by 8¾% in 2003. Its output has not yet returned to pre-crisis levels, though.

Production and consumer prices in industrial countries

Industrial production in industrial countries rose in the first quarter of 2004 by a seasonally adjusted 1% vis-à-vis the previous period, in which it had increased by nearly 2%. It was up by 3¼% from its level of early 2003. Following the turn of 2003-04, price movements in the industrial countries remained quiescent on the whole. As an average of the first three months, the year-on-year inflation rate was 1.3%, or 1.6% excluding Japan. However, this should not be allowed to obscure the fact that the seasonally adjusted inflation rate has accelerated, particularly owing to rising energy prices, from 0.3% in the last quarter of 2003 to 0.6% in the January-March period.

IMF forecast

According to the IMF forecast, global GDP growth, at just over 4½%, will be higher this year than in any year since 2000. It is expected to fall slightly to just under 4½% in 2005. In each of the two years, global output growth will be well over ½ percentage point stronger than had been predicted as late as September 2003. According to the IMF's spring forecast, GDP growth in the advanced economies is expected to be 3½% in 2004, with the euro area, at 1¾%, remaining well

IMF forecast for 2004 and 2005 *

Item	2002	2003	2004	2005
Real gross domestic product	Annual percentage change			
Advanced economies 1	+ 1.7	+ 2.1	+ 3.5	+ 3.1
of which				
United States	+ 2.2	+ 3.1	+ 4.6	+ 3.9
Japan	– 0.3	+ 2.7	+ 3.4	+ 1.9
Euro area	+ 0.9	+ 0.4	+ 1.7	+ 2.3
Consumer prices 2				
Advanced economies 1	+ 1.5	+ 1.8	+ 1.7	+ 1.7
of which				
United States	+ 1.6	+ 2.3	+ 2.3	+ 2.2
Japan	– 0.9	– 0.2	– 0.4	– 0.1
Euro area	+ 2.3	+ 2.1	+ 1.7	+ 1.6
Unemployment	Number of unemployed persons as a percentage of the labour force			
Advanced economies 1	6.4	6.6	6.4	6.3
of which				
United States	5.8	6.0	5.5	5.4
Japan	5.4	5.3	4.9	4.9
Euro area	8.4	8.8	9.1	8.9

* Source: IMF, World Economic Outlook, April 2004. — 1 Including Taiwan, Hong Kong, South Korea and Singapore. — 2 Consumer price index; for the euro area, HICP.

Deutsche Bundesbank

behind the USA (4½%) and Japan and the United Kingdom (each 3½%). The IMF also predicts that the developing countries and emerging economies will once again see a 6% increase in output. Within this group of countries, the growth differentials could even diminish, especially because Asian and CIS growth rates are not expected to be as high as in 2003, whereas Latin American output is expected to expand by 4% this year following 1¾% a year earlier.

USA

In the first quarter of 2004, overall output in the USA rose by 1% according to preliminary calculations and after adjustment for seasonal and working-day variations; this rate was similar to that in the fourth quarter of 2003. The year-on-year rise amounted to 5%. Private consumption, which rose by nearly 1% after seasonal adjustment, once again gave a strong boost to growth. The household saving ratio went up slightly to 1.9%. Commercial investment rose by 1¾%; the continued buoyancy of investment in machinery and equipment was offset by declining investment in commercial construction. The deficit in the real foreign balance, however, declined only slightly. Real exports as defined in the national accounts grew by ¾%; although this outpaced import growth (+½%), this growth differential was insignificant owing to the gulf between import and export levels. According to key early indicators, the US economy may be expected to see further strong growth in the current quarter.

Consumer prices were up by a seasonally adjusted 1% in the first quarter, a rate which clearly outpaced the previous quarter's figure (+¼%). Not only higher energy prices but also a relatively strong increase in services prices contributed to this outcome. However, this has not been reflected in year-on-year consumer price inflation, which, at 1.8% in the January-March period, was even somewhat lower than in the preceding period. In March, the personal consumption deflator (excluding energy and food), which is the US Federal Reserve's preferred measure, was 1.4% higher than a year earlier.

Japan

The economic recovery in Japan has been increasingly taking shape. One piece of important evidence for this is that private consumer demand, having already gone up distinctly in the second half of 2003, continued its recovery. In the January-February period, nominal retail sales, after adjustment for seasonal variations, were up by not less than 4% from their level in the fourth quarter of 2003, and were up on the year for the first time in quite a long time. In addition, it must be noted that average consumer prices in the January-April period were practically unchanged from the levels in both the fourth quarter and the same period a year earlier. Besides private consumption, commercial investment and foreign demand probably gave a fresh boost to the Japanese economy in the winter months. The palpable improvement in confidence among major industrial enterprises is a particular indication. The balance of favourable responses in the Bank of Japan's Tankan survey for the first quarter of 2004 saw a distinct improvement, hitting its highest level since the second quarter of 1997. The mounting positive reports about the economy from Japan must not, however, be allowed to obscure the fact that, in particular, the financial sector and the small and medium-sized enterprises (SMEs) sector are still in considerable need of consolidation.

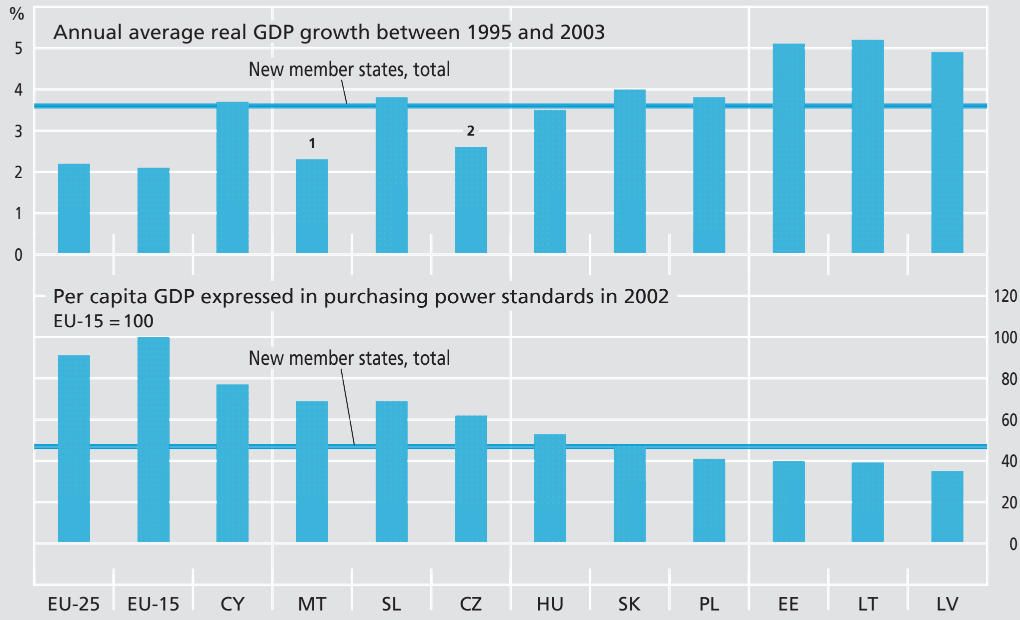
United Kingdom

In the first quarter of 2004, the UK economy, according to preliminary calculations, was up by just over ½% (after adjustment for seasonal and working-day variations) from the last quarter of 2003, in which it had grown by just under 1%. Total economic production increased by 3% on the year. Real GDP growth was supported once again by the services sector, in which value added grew by a seasonally adjusted ¾%. Among the individual services, commerce, hotels and restaurants were the best performers. This is a reflection of, among other things, the continued liveliness of consumer spending; its impact on retail trade in the first quarter was that sales grew by a seasonally adjusted 1½%. They were up by not less than 5½% from early-2003 levels. By contrast, industrial production shrank by ½% (after seasonal adjustment). The appreciation of the pound sterling and the deterioration of price competitiveness may also have contributed to the UK's weak industrial performance. The Harmonised Index of Consumer Prices (HICP) inflation rate, on which the UK inflation target of 2% is based, stood at 1.1% in March. According to the national Retail Price Index (RPIX), which is methodologically different from the HICP, inflation was +2.1%.

New EU member states

The economies of the new EU member states are running full steam ahead. In 2003, the real GDP of this group of countries rose by 3.6%, compared to 0.7% in the EU-15 and 0.4% in the euro area. Following the turn of 2003-04, the growth rate seems to have picked up a notch. The upturn is being fuelled by brisk domestic demand and strong export growth. It is worth noting that real exports as defined in the national accounts rose by an estimated 11½% in 2003 despite the weak economic activity in the main western European purchasing countries, compared with real import growth of 9½%. For the current year, a considerable expansion in exports is to be expected, if only because of the euro area's economic recovery. According to the Commission's spring economic forecast, GDP growth in the new EU member states will accelerate in the years 2004 and 2005 to 4% and 4¼% respectively. The recent renewed price surge has dampened the economic outlook. The aggregated inflation rate, having

Economic growth and per capita income in the new EU member states and in the EU as a whole



1 Between 1999 and 2003. — **2** Between 2000 and 2003.

Deutsche Bundesbank

gone down from 8.5% in 2000 to 2.1% in 2003, is expected to go up relatively strongly this year. Rises in administrative prices in some countries are a major factor. The Commission expects consumer price inflation to average 3.8% in 2004.

The new member states' average growth rate of 3½% in the 1995-2003 period was considerably more dynamic than that of the EU-15 (+2%). This has reduced the prosperity gap to some extent, yet this gulf remains very large. In 2002, per capita GDP in the new member states – calculated in terms of purchasing power parities – was 47% of the EU-15 average. The spread ranged from 35% in Latvia to 77% in Cyprus. Measured against the per capita income of the richer EU-15 countries, the prosperity gap is even wider. Another clear indicator of the new member states' need for catching up is that they make up 16% of the population of the enlarged European Union yet generate only 5% of total GDP. These countries are so far behind in terms of income that the catching-up process is likely to take several decades to complete (see also article on pp 5-22).

Macroeconomic trends in the euro area

Driving forces behind upswing somewhat stronger

The tentative recovery in the euro area which began in the second half of 2003 picked up steam after the turn of 2003-04. One contributing factor was the revival in consumer demand. Retail sales rose in the first quarter by a seasonally adjusted ¾% (following +¼% in the fourth quarter of 2003). Given

Important figures for the old and new EU member states

2003

Item	Population		Area		Gross domestic product 1	
	Million	EU-25 = 100	1,000 km²	EU-25 = 100	€ bn	EU-25 = 100
EU-25	453.8	100	3,893	100	9,713.5	100
EU-15	379.5	84	3,154	81	9,276.0	95
of which Euro area	305.8	67	2,456	63	7,247.3	75
Memo item Germany	82.5	18	357	9	2,129.8	22
New member states	74.3	16	739	19	437.5	5

1 Calculated at market exchange rates.

Deutsche Bundesbank

that consumer sentiment is still in the doldrums, it is questionable, however, whether this trend will last. Exports, which grew quite strongly despite the dampening impact of the euro's appreciation, were another important factor supporting economic activity. Deliveries of goods to non-euro-area countries in the January-February period rose by 3½% from their fourth-quarter levels after adjustment for seasonal variations. They were up by just over ½% on the year.

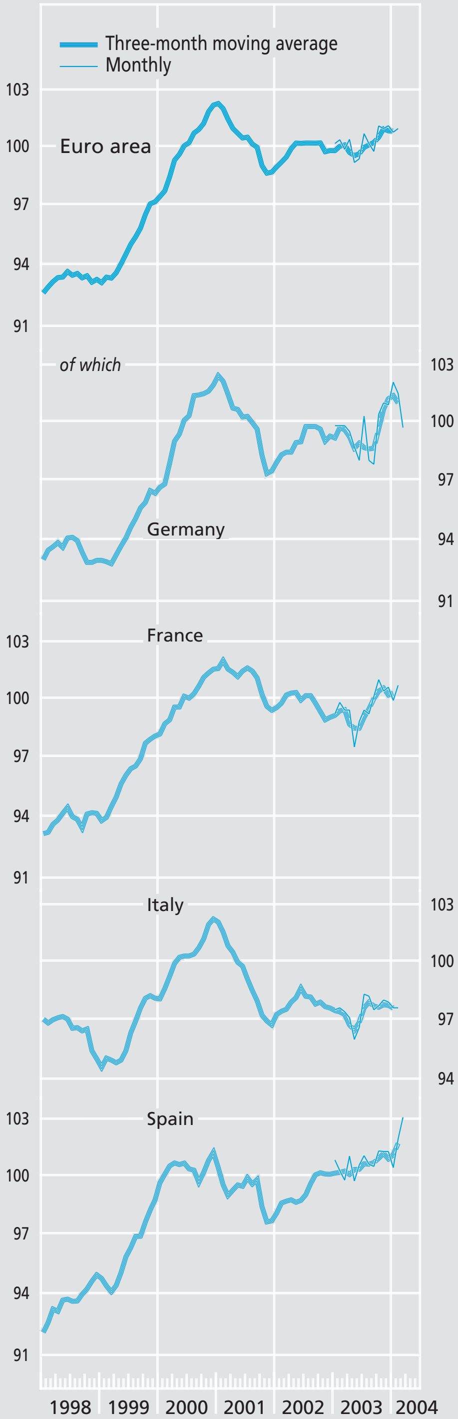
According to the Flash Estimate, seasonally adjusted real euro-area GDP increased by just over ½% in the January-March period, as against just under ½% in the preceding quarter (further information on the individual expenditure components is not yet available). It rose by 1¼% on the year. The European Commission predicts that total output will rise in the second quarter, too, at an aggregate rate of between 0.3% and 0.7%.

Industry off to a sluggish start in 2004

Aggregate output received no stimuli from industry in the January-February period. Seasonally adjusted industrial production fell slightly short of the rather positive result for the fourth quarter of 2003. Its year-on-year growth was merely ¾%. Fittingly, capacity utilisation in April was somewhat lower than in January. New orders in manufacturing were similarly weak. The value of orders placed in the January-February period was likewise down from its level of the fourth quarter of 2003. However, the situation in industry might improve somewhat in the second quarter. According to the EU survey, the confidence indicator certainly rose dis-

Industrial production *
in the euro area

2000 = 100, seasonally adjusted, log scale



Sources: Eurostat and national statistics. — * Excluding construction.

Deutsche Bundesbank

tinctly in April after stagnating in the first three months of 2004 on average at the previous quarter's levels after seasonal adjustment.

Labour market

The number of persons affected by unemployment in the euro area rose only slightly in the first quarter of 2004. In March 2004 a seasonally adjusted total of 12.42 million persons in the euro area were without paid employment. This corresponds to 8.8% of the labour force. The major economies of France, Germany, Italy and Spain continue to have unemployment rates in excess of 8%, along with Belgium and Finland. As the expected revival of overall economic output in the euro area progresses, the labour market situation is also likely to rebound slightly as the year progresses. However, national governments will need to make additional efforts to enact reforms, and the social partners will need to agree on employment-promoting wage policies in order to reduce the high structural unemployment which plagues some countries.

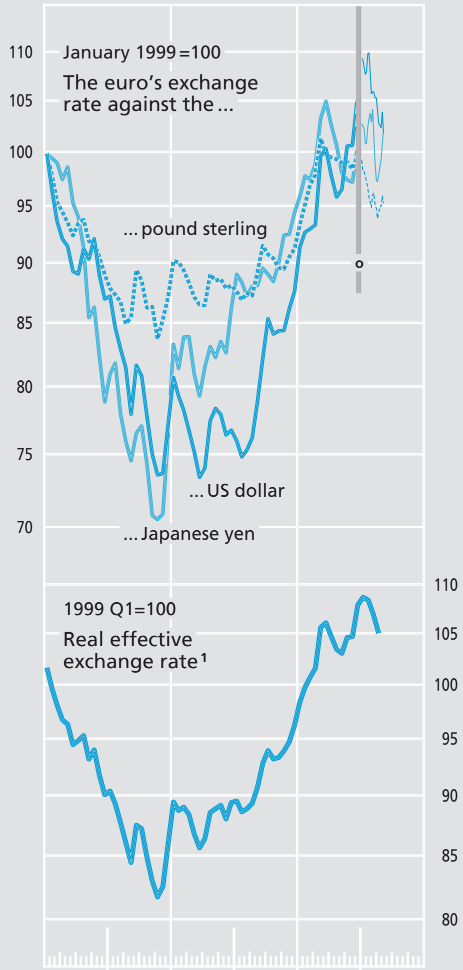
Consumer prices

In the first few months of 2004, consumer price movements in the euro area were influenced by measures to increase tax receipts and to restore public health systems. The portion of healthcare costs borne directly by consumers rose in Germany and the Netherlands with effect from 1 January. Since the HICP uses the net price concept to measure inflation for mixed-financed goods – ie the index includes the prices paid directly by the consumer and not the total cost of healthcare services – the index level for the item of healthcare in the first quarter of 2004 was up by not less than 6% on the period. Given a weight of around 4%, this corresponded to a contribution of around ¼ percentage point to the measured inflation rate. In addition, taxes on tobacco products were hiked sharply in several countries during the first quarter of the year. The prices of cigarettes and other tobacco products consequently rose by 4.7%. Since the HICP weight of tobacco products is 2.4%, the tax hikes contributed around one-tenth of a percentage point to inflation. All in all, in the first three months of the year prices were up by 0.4% on the period. Eliminating the tax increase and the effects of the health reform reduces this figure to less than 0.1%. Thus, excluding special effects, consumer price inflation remained within a narrow range. Unprocessed food prices, in particular, rose less sharply in early 2004 than is usual at that time of year.

Year-on-year HICP inflation, despite the burdens imposed by government measures, went down from 2.1% in the last quarter of 2003 to 1.7% in the first quarter of 2004. This returned the annual inflation rate to the price stability range for the euro. This happened not only because price trends are generally favourable at present but also due to a base effect – in the first quarter of 2003, crude oil had been very expensive in euro terms owing to the Iraq war. According to the Eurostat Flash Estimate, annual inflation rose to 2.0% in April 2004, with the diminishing of the aforementioned base effect and the rising prices for crude oil products likely to have contributed to this development.

Exchange rate of the euro

Monthly, log scale



1 Against the currencies of a small group of countries based on consumer prices. — o From 2004, weekly averages.

Deutsche Bundesbank

Exchange rates

Developments on the foreign exchange markets

In the first few months of this year the situation on the international foreign exchange markets was relatively volatile. The exchange rate movements of the key currencies were influenced by a turnaround in sentiment in favour of the US dollar. After a relatively long period of dollar weakness lasting until mid-February 2004 and causing the euro to hit an

US dollar

The exchange rate regimes of the new EU member states and exchange rate movements against the euro

The currencies of the countries which joined the European Union on 1 May 2004 exhibit a rather heterogeneous pattern in their exchange rate movements against the euro. This is due not only to the fact that the macroeconomic developments and degree of success in maintaining stability are very different from one country to the next but also, in particular, to the broad range of exchange rate regimes currently being applied in the new member states.

Poland, the most populous of these countries, leaves it up to the foreign exchange market players to fix the rate for its currency, the zloty. Against the background of rising budget deficits, the zloty has depreciated significantly against the euro in recent years. The exchange losses amounted to 13% in 2002 alone and a further 14½% in 2003. As of late, the zloty has been trading against the euro at a level around 15% lower than at the beginning of monetary union.

Like Poland, the Czech Republic pursues a floating exchange rate regime. Capital inflows – originating in part from privatisation activities – caused the Czech koruna to appreciate against the euro up to 2002. There was a reversal in this trend in the ensuing period, however, a development which, like in Poland, is likely to be connected with the incurrence of new government debt. At 2.6%, however, the depreciation of the Czech koruna remained comparatively low in 2003, which means that the Czech currency has risen against the euro by around 10% on balance since the launch of the single currency.

Hungary has allowed its currency, the forint, to fluctuate against the euro within an exchange rate band of ±15% since 2001. Following the introduction of the target zone system in Hungary, the forint always remained below the initial central rate of 276.1 forints to the euro. In June 2003, however, the central rate was raised to 282.36 forints to the euro, whereupon the forint depreciated perceptibly on the foreign exchange market even though the Hungarian central bank increased the key interest rates by a total of 3 percentage points in two stages in that month. During 2003, the forint depreciated by 10% on balance. However, owing to improvements in the economic outlook in Hungary, the forint has rebounded noticeably against the euro since then.

Slovakia, like Poland and the Czech Republic, applies a regime of floating exchange rates. The Slovak koruna has posted slight gains against the euro since the fourth quarter of 2003. This development is attributable to large capital inflows attracted by the economic policy reforms in recent years.

The Slovenian tolar is pegged to the euro within a crawling band. In this exchange rate regime, the tolar's central rate is continuously devalued against the euro. Since the start of monetary union, the depreciation rate has totalled 21%.

Lithuania and Estonia have rigidly fixed the exchange rates of their currencies to the euro in a currency board arrangement. The exchange rates of the Lithuanian litas and the Estonian kroon have, therefore, remained constant against the euro in recent years.

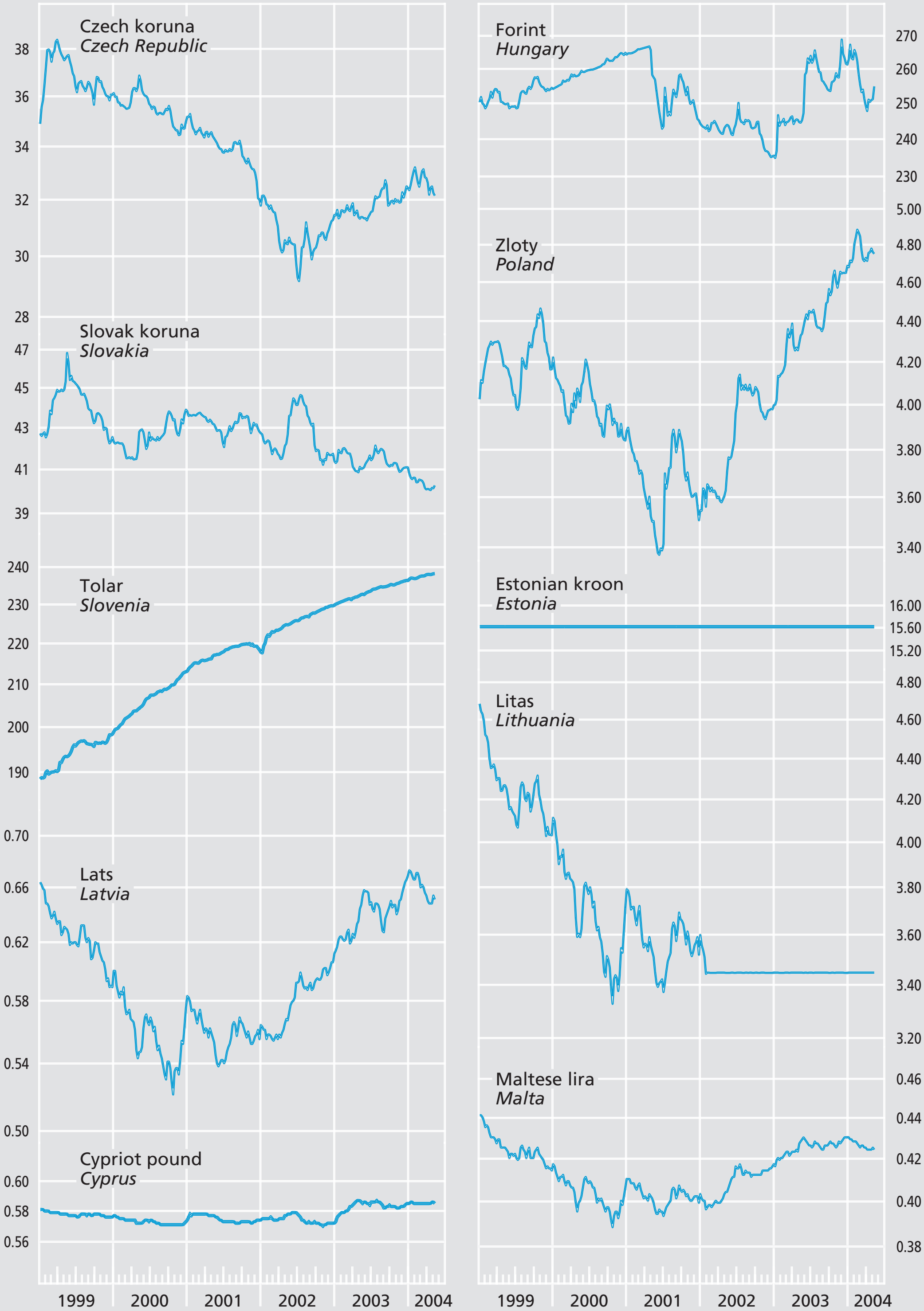
Latvia and Malta have pegged their currencies to a basket of currencies. In Latvia, this basket of currencies corresponds to the International Monetary Fund's special drawing right. The US dollar has the greatest weighting in this basket. Thus, the movements of the Latvian lats against the euro mirror the movements in the euro-US dollar exchange rate relatively clearly. The currency basket to which the Maltese lira is pegged also includes the US dollar, but has been dominated by the euro, especially since August 2002. Therefore, this currency fluctuates only slightly against the euro.

Cyprus has pegged its pound to the euro within an exchange rate target zone. In a similar fashion to Hungary, the maximum fluctuation margin is ±15% of the central rate. In actual fact, however, the exchange rate fluctuations of the Cypriot pound against the euro have been very limited in recent years.

Deutsche Bundesbank

The euro's exchange rate against the currencies of the new EU member states

€1 = ... currency units, weekly averages, log scale



Deutsche Bundesbank

all-time high of nearly US$1.29, market sentiment changed. The euro consequently went back down somewhat. As this report went to press it traded at US$1.18. Economic developments in the United States were the key factor. The publication of new data on strong net portfolio inflows initially pushed doubts about the ability to finance the high US current account deficit somewhat into the background. As the period continued, the turnaround in sentiment in favour of the US dollar was supported by, in particular, the announcement of unexpectedly positive US economic data which indicated that the economic recovery in the United States was increasingly spilling over to the labour market. In this context, the US Federal Reserve "intensified" its phraseology regarding future interest rate moves, and capital market yields rose sharply. This helped the US dollar gain even more ground. The terrorist attacks in Madrid on 11 March 2004 put depreciation pressure on the US dollar only temporarily.

Yen

Ups and downs characterised the pattern of the euro's movements against the yen over the past few months. The euro lost some ground for a time against the yen on the heels of surprisingly positive Japanese cyclical and economic data which indicated that a robust economic recovery was in store for Japan. As the end of the period under review approached, however, the euro rebounded following the Japanese government's declaration of its determination to smooth the rate of the yen by intervening on foreign exchange markets. As this report went to press, the euro was trading at ¥135, its level at the beginning of the year.

Pound sterling

Unlike against the US dollar and the yen, the euro has been losing ground against the pound sterling since the beginning of the year. Favourable UK economic data were the major factor causing the pound sterling to rise against the euro as well as against other currencies. In addition, speculation surrounding the interest rate hike made by the Bank of England in early May and the rise in capital market yields probably gave an additional boost to the pound sterling. Most recently, 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 the euro area's 12 most important trading partners, the euro has lost appreciable value since mid-February of this year. As this report went to press, it was 3½% below its value at the beginning of the year. This is certainly providing some relief to euro-area exporters, who lost some of their former competitive advantage owing to the extent and the speed of the preceding euro appreciation.