

## Global and European setting

### World economic activity

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The global economy maintained its strong growth in the second quarter of 2005. However, the pace of growth moderated somewhat. According to preliminary data, second-quarter aggregate output in key economic regions (the United States, Japan, the United Kingdom and the euro area) was a seasonally adjusted ½% up on the first three months of the year, in which the increase was just under 1%. According to the early indicators that are available, the industrial nations, as a whole, remained on a growth track even after mid-year, however. Consumer prices in the industrial countries rose more slowly in the second quarter than in the two preceding quarters. Inflation was 1.8% in June, as against 2.5% in the fourth quarter of 2004. At 1.5% in June, inflation in the industrial countries, excluding energy and food, remained virtually unchanged from its level at the beginning of the year. With the exception of Japan, where prices went down again in the second quarter, core inflation stood at 1.7% as this report went to press.

*Global growth continuing at slower pace*

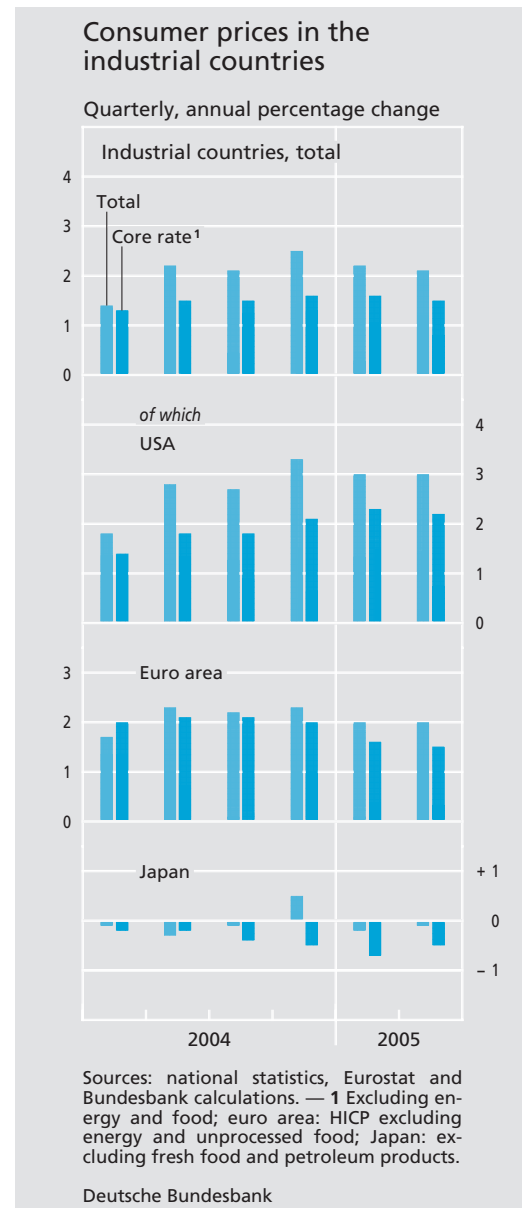
The continuing robustness of the global economy is remarkable in view of the considerable rise in the prices of oil and industrial raw materials, although some signs of a slowdown are beginning to appear owing to a surge in commodities prices. Oil price quotations did fall by nearly US\$10 from their high early-April level of US\$57 (Brent). However, they started to go back up sharply in mid-May and, in the first half of July, overstepped the US\$60 mark on a number of days. Oil prices then tended to fall somewhat for a brief

*Oil prices up once again ...*

period. In mid-August, however, a new record of US\$65 per barrel was hit. On the futures markets, it is expected that oil prices will remain very high for the foreseeable future. In terms of the euro, which fell perceptibly against the US dollar in the second quarter, the year-on-year increase amounted to around 55% at the end of the period under review. On the industrial commodities markets, by contrast, the situation has eased slightly in the past few months. In early August, the US dollar-denominated index of commodities prices was 5% down on its mid-March 2005 peak. Euro-denominated prices of industrial commodities, however, continued their climb owing to the euro's depreciation.

*... yet differing levels of burden among the "Big Three"*

The fact that the strains imposed on the consumer countries by higher oil prices have varied in intensity is not due solely to exchange rate shifts against the US dollar, the reference currency on the oil markets. For US consumers, the reduction in purchasing power owing to the sharp rise in crude oil prices since their most recent low at the end of 2001 has had a stronger impact than for households in western Europe and Japan – especially on account of the high energy intensity of private consumption in the US and the trend depreciation of the dollar against the euro and the yen (see box on pages 12 and 13). Against this background, it is remarkable that US consumption has been more resilient than has been the case in Europe. The main reason is probably that the real burden on US households caused by higher energy prices was disguised by relatively favourable nominal income trends and the posi-



tive wealth effects emanating from the real estate market.

Owing to the continuing global political uncertainty, the downside risks to the global economy stemming from the oil markets still require careful attention. The risks generated by external imbalances, however, are at least likely not to have increased in the spring months. The main reason for this was the

*Downside risks still high*

## The implications of the increase in oil prices on consumer prices in the world's main economic regions

The spot quotations on international crude oil markets, which are traditionally denominated in US dollars, have risen sharply worldwide since their last low in late 2001. Even so, the trend in consumer prices for petroleum products in the major economic regions – the USA, the euro area and Japan – has varied quite considerably. This trend will be analysed in greater detail below.

The varying impact on prices at the consumer level can partly be attributed to the fact that different grades of crude oil are imported and refined. The US dollar prices for these vary and, at times, may diverge. The various grades of crude oil are classified and traded by density ("light" or "heavy") and their sulphur content ("sweet" or "sour"). The price for a particular grade of crude oil is calculated using the price of a benchmark grade and a premium or discount determined mainly on the basis of variations in quality. In North America, the extremely "light" and "sweet" West Texas Intermediate (WTI) is the primary benchmark; in Europe, the equally high-quality Brent dominates, while Asia uses the comparatively "heavy" and "sour" Dubai Fateh.

Because of better local availability as well as relatively stringent environmental protection obligations, refineries in North America and western Europe mainly process crude oil that is light and low in sulphur. By contrast, Japan and other Asian countries source a large proportion of their oil from the Middle East. Importing crude oil grades that are predominantly heavy and high in sulphur does not per se preclude high environmental standards. However, the refineries require suitable technology to produce petroleum products to the required standard while avoiding an excessive impact on the environment. This is the primary reason why European and US refineries are only able to compensate for supply bottlenecks in light and low-sulphur crude oil grades to a limited extent by using heavier and sourer crude oil.

At the time of going to press, the spot price for a barrel of both US benchmark WTI and Brent crude was quoted at almost US\$66 and Dubai Fateh was trading at US\$57. Compared to the fourth quarter of 2001, prices for WTI have thus risen by 223% and by 212% for Dubai Fateh. The

price for the European benchmark grade Brent has actually increased by 239%. Despite the broadly parallel trends in the US dollar prices of the three benchmark grades, it is striking that in the fourth quarter of 2004 the heavy and sour Dubai Fateh did not quite keep pace with the price rises for the lighter and sweeter WTI and Brent grades. As a result, the price differential between WTI and Dubai Fateh has, at times, increased significantly. The diverging price gap between WTI and Brent on the one hand and Dubai Fateh on the other can probably be attributed to capacity bottlenecks at refineries. The situation was aggravated in the fourth quarter of 2004 when the oil producing plants and refineries along the American Gulf Coast suffered hurricane damage. The subsequent narrowing of the price differential might be a reflection of the fact that the situation was returning to normal and also of refineries' attempts to use more heavy oil because of the cost advantage.

For west European and Japanese consumers, it is the prices in their domestic currency that are relevant. Compared with early 2002, the US dollar has tended to lose ground against other major currencies. At least part of the rise in oil prices denominated in US dollars is, therefore, a reflection of the currency's weakness. The price of Brent crude in euro has only risen by 145% since the last quarter of 2001. Priced in yen, the cost of Dubai Fateh has increased by 179% over the same period. Conversely, the recent tendency of the euro and the yen to depreciate against the US dollar, and which began at the start of the year has accelerated the rise in oil prices denominated in euro and yen of late. In addition, the price differential between Dubai Fateh and WTI/Brent returned to normal in the last few months.

To track the pass-through between increased oil prices and consumer prices in the USA, the euro area and Japan, we have used the prices of the benchmark grades in their domestic currency as a base. In the case of the USA, the price increase in high-quality crude oil grades was reflected entirely by higher import costs, which rose by 160%. In the euro area, too, the increase in import costs – 79% over the same period – corresponded largely to the price increase for Brent denominated in euro (91%).<sup>1,2</sup> In Japan, although the price of Dubai Fateh jumped by 128%, import costs cal-

grades are also imported. Even in the case of a complete pass-through, it is conceivable that there would be a certain gap between price movements in the benchmark grades and those in oil imports. — <sup>3</sup> See OECD, Economic Surveys: Japan, vol. 2005/3, p 57 et seq. — <sup>4</sup> The change in overall consumer prices is influenced by the rate of mineral oil tax only in that demand for energy is less in countries with high volume-based taxes. It should also be noted that the lower percentage rise in mineral oil prices in countries with higher consumer taxes con-

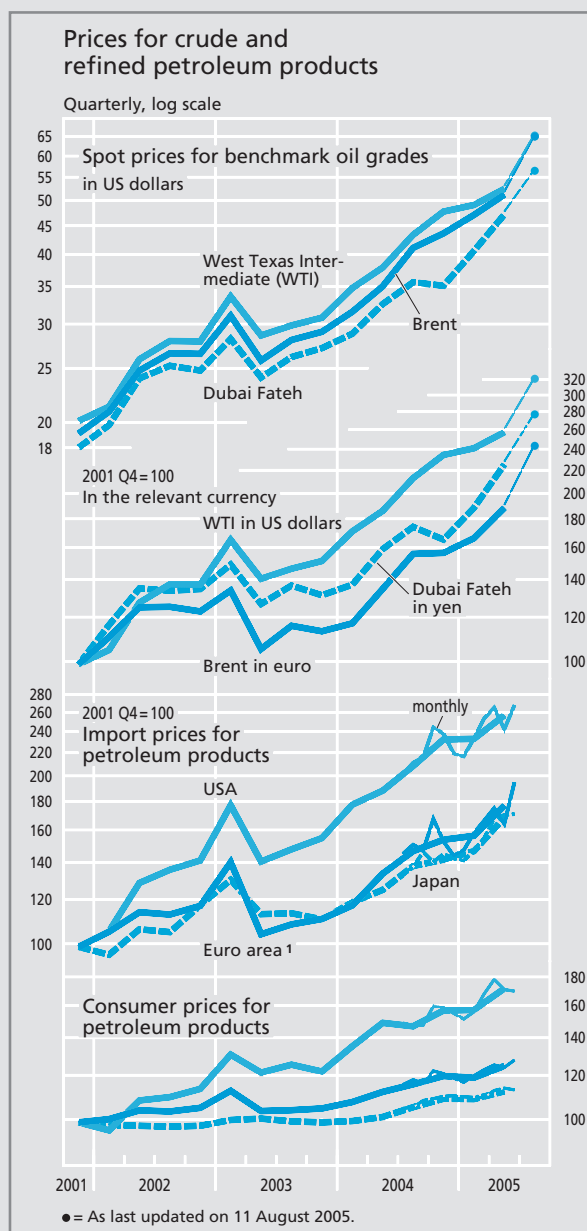
<sup>1</sup> Based on German import prices for petroleum products. Only average import prices are available for the euro area as a whole (and, at the current end, only up to April 2005). Generally speaking, both indicators depict a similar trend. For consumer prices, a subindex from the euro-area Harmonised Index of Consumer Prices for liquid fuels and fuels for personal transport is used. — <sup>2</sup> The price of the benchmark oil is not an ideal measure against which to estimate the pass-through of oil price changes via import prices to consumer prices because other oil

culated in yen only increased by 71%. One reason for the discrepancy might be the long-term supply contracts, which mean that changes in the spot quotations are only passed through to Japanese import prices to a lesser degree or after a delay.<sup>3</sup>

Consumer prices for petroleum products have risen far more slowly than import prices or the prices of the benchmark crude oil grades in their domestic currency (see adjacent chart). In the United States, seasonally-adjusted figures up to the second quarter of the year rose by 74% compared to the fourth quarter of 2001, by just 26% in the euro area and a mere 14% in Japan. Leaving aside national consumption habits, these varying price movements at the consumer level can partly be attributed to differing consumer tax rates. Conceived as a volume-based tax, the mineral oil tax causes a linear increase in the cost price level. As a result, even with a complete pass-through of a rise in import prices by a specific amount, the percentage rise in consumer prices for petroleum products is therefore lower. Above all, this effect applies in Japan and the euro area, where high rates of mineral oil tax are the norm.<sup>4</sup> Moreover, in Japan, part of the rise in import prices might have been absorbed at the expense of oil companies' profit margins.<sup>5</sup>

So far, the rising oil prices have had a relatively minor effect on core inflation in the three economic regions. Excluding food and energy, consumer prices in the USA rose 2% in June compared to the same month last year.<sup>6</sup> Again excluding food and energy, the private consumption deflator in the United States, which is closely monitored by the US Federal Reserve, increased by only 1.9% over June 2004. In the euro area, too, the Harmonised Index of Consumer Prices (HICP) excluding energy and unprocessed foods showed very modest price pressures, rising 1.4% year-on-year in June. The corresponding core rate for Japan even signalled a considerable 0.5% drop in prices for June 2005 compared to the same month a year ago.<sup>7</sup> In contrast to past periods of sharply rising oil prices, there have, as yet, been no marked second-round effects; this has meant that, recently, core rates have remained further below the headline rates of consumer price inflation than was the case during similar phases in the past.

trasts with a higher weighting for petroleum products in the basket of goods. — 5 See footnote 3. — 6 This moderate pressure on prices is a stark contrast to the experience in the 1970s. After the first oil price shock, the core inflation rate in the USA leapt from an average of 3.4% in 1973 to 8.1% then 9.3% respectively in the two years that followed. In 1980, annual core inflation actually reached 12.4% on the back of the second oil crisis. — 7 The official Japanese core rate is calculated from the overall consumer price index excluding fresh food.



The subindex including energy, amongst other things, is also included in this, but it has tended to decline recently – not least because of deregulation on the electricity market. For this reason, the overall consumer price index excluding fresh food used here is also stripped of the price index for petroleum products, which is shown as a subindex in Japanese price statistics.

quite favourable development in US foreign trade, which, for the second quarter as a whole, gives cause for expecting a slight decline in the US current account deficit. Given the US dollar's appreciation against key currencies since early 2005, however, it is doubtful whether this development will continue. In some countries, property markets still pose an additional risk to the world economy. A sudden slump in property prices in the United States or several of the other countries could put the brakes on global economic activity.

*South and  
South-East  
Asian emerging  
market  
economies*

Rising oil prices have imposed an especially heavy strain on the Asian emerging market economies owing to the fact that, in many cases, they have to import all of the crude oil they need and that their economies are generally highly energy-intensive. Nevertheless, output was for the most part still strong in the second quarter. Real GDP growth in China in the second quarter, which was 9½% up on the year, was just as dynamic as at the beginning of the year. Despite the rapid pace of growth and the sharp rise in energy prices, price pressure at the consumer level has diminished. The rate of inflation in China on an average of the period from April to July – owing not least to favourable agricultural output figures – stood at 1.8%, compared with 2.8% in the first quarter. The slight revaluation of the Chinese renminbi in July along with the decision to abandon the peg of the yuan to the US dollar (see page 20) will probably have no more than a slight impact on trade flows, growth and price movements.

*Latin America*

By contrast, the pace of growth in Latin America slowed down in the first half of the

year, in some cases noticeably. In Brazil, economic activity was retarded by the sharp multi-stage increase in key interest rates. This was accompanied by a 30% appreciation of the Brazilian real against the US dollar on the year. This is likely to make export business more and more difficult over the coming months, especially in the case of industrial goods. Overall economic growth in Mexico has likewise been dampened by higher interest rates. In addition, pressure on the textile industry from Asian competitors has been growing since the quota agreement expired at the beginning of 2005. Both countries, however, along with several other Latin American nations, continue to benefit from high commodity prices. Although the Argentinian economy grew sharply throughout the reporting period, upward pressure on prices has increased so sharply that the upturn in business activity could be jeopardised.

In the Commonwealth of Independent States (CIS), too, economic growth appears to be moderating – despite rising revenues from exports of crude oil and industrial commodities. In the first half of 2005, the Russian economy grew by “only” 5½%, compared with 7% in 2004. The Russian finance ministry has now down-revised its preliminary estimates for 2005 from 6½% to just under 6%. At the same time, the price forecast was revised upwards from 10% to between 10% and 11%. The downside of the CIS's high revenues from commodities is that the development of a modern services and industry sector is proceeding only at a very slow pace.

*Common-  
wealth of  
Independent  
States*

USA

Initial calculations show that second-quarter real GDP in the United States was  $\frac{3}{4}\%$  up on the quarter after adjustment for seasonal and working-day variations, having increased by just under 1% in the first quarter. Year-on-year growth was  $3\frac{1}{2}\%$ . Domestic demand and external activity each accounted for about half of this figure. Seasonally adjusted real private consumption rose in step with GDP. Industrial investment and residential construction expanded even more sharply, at  $2\frac{1}{4}\%$  and  $2\frac{1}{2}\%$  respectively. The exceptionally sharp increase in domestic final demand, however, contrasted with a negative growth contribution of inventories, which amounted to just over  $\frac{1}{2}$  percentage point. There was a concurrent  $\frac{1}{2}\%$  decline in real imports. At the same time, exports rose by a seasonally adjusted 3%, causing a discernible increase in US real net exports for the first time in two years. National accounts figures for the past few years have been revised, as is usual in the middle of the year. According to the re-worked figures, US GDP grew by an average of  $2\frac{3}{4}\%$  in the 2002-2004 period, as opposed to just over 3% prior to the revision.

One reason for the continued buoyancy of consumption in the United States lies in wealth effects owing to the continued sharp rise in property prices. Another is that disposable income grew quite strongly in the second quarter ( $1\frac{1}{4}\%$  seasonally adjusted) and the saving ratio declined by  $\frac{1}{2}$  percentage point on the quarter to 0.2%.<sup>1</sup> The continued expansion in employment –  $\frac{1}{2}\%$  on the quarter – also contributed to income growth. In mid-year, the seasonally adjusted unemployment rate, at 5.0%, was lower

than at any time since the third quarter of 2001. On an average of the second quarter, consumer prices were 3.0% up on the year. Excluding food and energy, US inflation – measured in terms of the private consumption deflator, the US Federal Reserve's key price analysis instrument – was significantly lower in the second quarter of 2005, at 2.0%. (The latest revision of the national accounts added just under  $\frac{1}{2}$  percentage point to the rate.)

For the second half of 2005 and for 2006, the US Federal Reserve is expecting robust economic growth and relatively moderate price movements to continue. According to its June forecast, the year-on-year increase in real GDP will be  $3\frac{1}{2}\%$  in the final quarter of 2005 and between  $3\frac{1}{4}\%$  to  $3\frac{1}{2}\%$  in the fourth quarter of 2006. The slight downward revision from the Fed's February forecast of  $+3\frac{3}{4}\%$  to +4% and  $+3\frac{1}{2}\%$  respectively can be explained by renewed rises in oil prices and reduced fiscal stimuli. Consumer price inflation – measured by the private consumption deflator excluding energy and food – is predicted to remain in the  $1\frac{3}{4}\%$  to 2% range over the course of this year and the next. This represents an upward revision of the February price forecasts by  $\frac{1}{4}$  percentage point for each year.

The Japanese economy, which overcame its temporary low with a sharp rise in real GDP in the first quarter, remained on a growth track

*Japan*

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<sup>1</sup> In the revision of the national accounts, the saving ratio for the period 2002 to 2004 was revised upwards. However, at figures between 2.4% for 2002 and 1.8% in 2004, it is still very low.

in the second quarter. At a seasonally adjusted  $\frac{1}{4}\%$ , however, aggregate output rose distinctly more weakly than in the first quarter. The year-on-year increase was  $1\frac{1}{2}\%$ . Private consumption, which was  $\frac{3}{4}\%$  up on the quarter and  $1\frac{3}{4}\%$  up on the year, proved once again to be the key pillar. A crucial factor in the buoyancy of household demand was the decline in the seasonally adjusted unemployment rate from 4.6% in January-February to 4.2% in June and an increase in bonus payments to employees owing to improved profitability. Industrial investment likewise continued to rise in the second quarter, whereas public spending on investment was still on a decline. Inventory investment, too, had a dampening impact that amounted to  $\frac{1}{2}\%$  of GDP. Unlike in the preceding three quarters, real net exports once again provided a positive contribution to growth, which amounted to  $\frac{1}{4}$  percentage point in the second quarter. Export growth, at a seasonally adjusted  $2\frac{3}{4}\%$ , was visibly stronger than import growth, at  $1\frac{1}{2}\%$ . It is notable that second-quarter consumer prices remained virtually stable on the year despite the sharp rise in oil prices and the depreciation of the yen. One explanation for this is the distinct fall in prices for electricity and telecommunications services owing to deregulation measures.

*United  
Kingdom*

According to initial estimates, real GDP in the United Kingdom in the spring after seasonal and working-day adjustment was up not quite  $\frac{1}{2}\%$  from its first-quarter level (which had shown the same pace of growth). The year-on-year increase was only  $1\frac{3}{4}\%$ , the smallest increase since early 1993. The growth profile, too, has hardly changed in

comparison with the winter months. Services grew by just over  $\frac{1}{2}\%$  after seasonal adjustment, and construction activity likewise showed an increase. By contrast, industry made a negative contribution to growth, with production down by  $\frac{1}{4}\%$  in the second quarter. Private consumption was once again one of the main drivers of aggregate demand; measured in terms of real retail turnover, it was  $\frac{3}{4}\%$  higher in the April-June period than in the first quarter. Consumption activity was supported, in particular, by rising labour income, whereas the positive wealth effects previously emanating from property markets are likely to have become less important. At all events, house prices have not shown any further increase in seasonal adjusted terms in the past few months, and the year-on-year increase according to the Halifax index was no more than just under  $2\frac{1}{2}\%$  in July, after having stood at 22% as recently as mid-2004. Inflation according to the Harmonised Index of Consumer Prices (HICP) rose from 1.6% in January to 2.0% in June, mainly on account of higher energy prices, and was therefore in line with the British government's medium-term inflation target. Core inflation (ie excluding energy and unprocessed food) was much lower, however, at 1.4%.

The pace of growth in the new EU member states declined perceptibly after the start of 2005. In the first quarter of 2005, overall output was "only"  $4\frac{1}{4}\%$  up on the year, compared with 5% on an average of 2004. This was due mainly to a weaker expansion of industrial output, which decelerated in year-on-year terms from  $5\frac{3}{4}\%$  in the final quarter of 2004 to  $2\frac{1}{4}\%$  in the first three months of

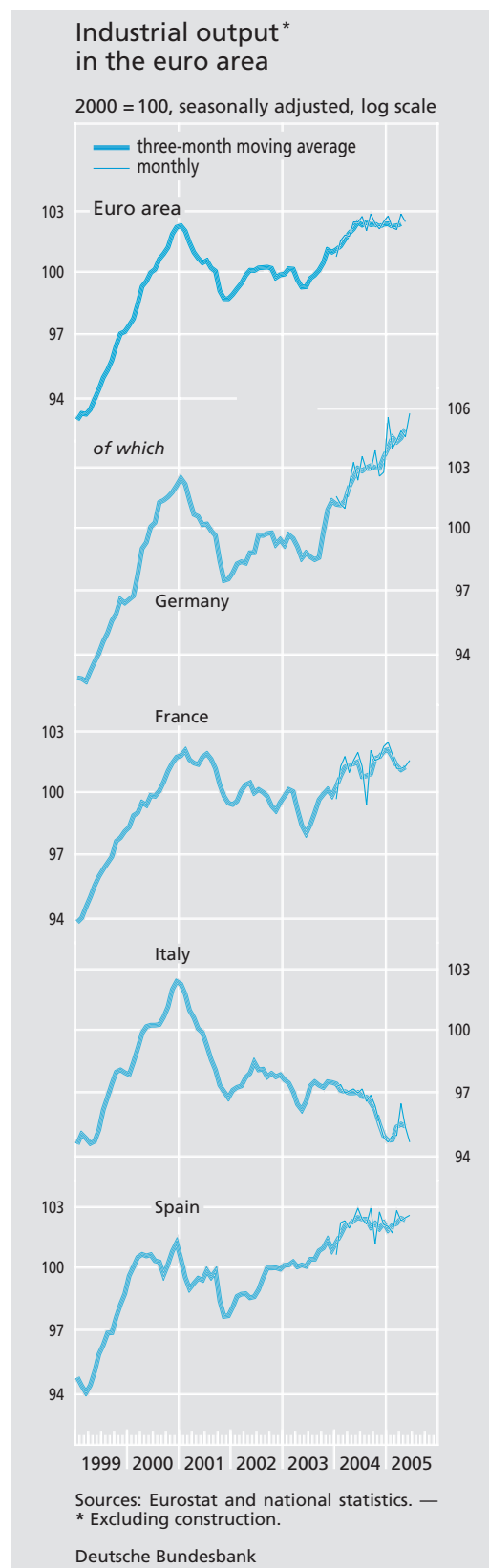
*New EU  
member states*

2005. For 2004 as a whole, industrial output rose by as much as nearly one-tenth. In April and May, however, industrial output increased somewhat more strongly again; in seasonally adjusted terms, it surpassed its first-quarter level by 2½%. The fact that investment activity and the economy in west European countries, which are among the main trading partners, were generally no longer as buoyant, contributed to the dampening of aggregate demand growth. The standardised unemployment figure continued to fall in the second quarter in seasonally adjusted terms, and, as this report went to press, amounted to 13.1% of the labour force, the lowest level since the beginning of 2000. Owing to weaker economic activity, consumer price inflation showed a further slowdown. The aggregate inflation rate of the new member states, which stood at 4.9% in the third quarter of 2004, had fallen to 2.0% by June 2005. At the end of the period under review, inflation rates ranged between 1.3% in the Czech Republic and 6.6% in Latvia.

### Macroeconomic trends in the euro area

*Weaker growth  
in second  
quarter*

Euro-area economic growth weakened in the second quarter. According to initial estimates, real GDP rose by only ¼% after seasonal and working-day adjustment, compared with ½% in the first quarter. The relevant year-on-year increase was no more than 1¼%. The continued weakness of domestic demand was the key factor in this. In addition, foreign trade is unlikely to have generated any stimuli in the second quarter. In seasonally adjusted





terms, nominal exports of goods rose much more slowly than imports in April and May, which led to a decline in the trade surplus. The rise in import prices also played a part, causing the picture to look somewhat brighter in real terms.

*Meagre increase in industrial output*

The fact that aggregate growth in the euro area was, on the whole, weak in the second quarter is due partly to the marginal increase in industrial output. For the two-month period of April and May, this averaged a seasonally adjusted  $\frac{1}{4}\%$  on the first quarter. The key factor behind this was a sharp decline in energy production from the rather high level of the first quarter, which had been characterised by exceptionally cold winter weather. In addition, the production of intermediate inputs fell somewhat. By contrast, the production of capital and consumer goods picked up distinctly in the April-May period. The fact that capacity utilisation in the manufacturing sector in July was no higher than in April, and only slightly exceeded the low level of the first half of 2004, fits in with the meagre increase in industrial output.

*More favourable business signals in mid-year*

Industry confidence improved in June and July after having been in continuous decline from the end of 2004 until May 2005. However, it still remained well below its long-run average. A more favourable assessment of order books and inventories was the main reason for the improvement in sentiment in July. By contrast, output expectations remained unchanged. The notable part about it is that industry confidence stabilised around mid-year, especially in the three large economies. Euro-area consumer sentiment, how-

ever, held firm in July at the low levels of the previous months.

Seasonally adjusted unemployment in the euro area went back down in the second quarter. This more than offset the slight rise during the winter months caused by the extremely cold weather. However, this still left, on average, 12.8 million persons without work in the second quarter of 2005. The unemployment figure in the second quarter was 140,000 down on the year. The seasonally adjusted, standardised unemployment rate remained at 8.8%. France, Germany, Greece and Spain were above the euro-area average, whereas the majority of member states showed lower figures. It is notable in this connection that the number of unemployed persons in Italy in the first quarter (more recent information is unavailable) was down nearly 90,000 on the year, and that the standardised unemployment rate, at 8.2%, was 0.5 percentage point lower than in the same period of 2004, despite the fact that the country was still in a general economic trough.

*Labour market*

After easing in the first few months of the year, euro-area consumer prices have been rising somewhat more sharply again of late. In seasonally adjusted terms, the HICP inflation for the April-June period was, on average, 0.7% higher than in the first quarter. In other words, inflation in the second quarter was more than twice as high as first-quarter inflation. The main reason for the accelerated pace of inflationary pressure was the sharp increase in energy prices. Excluding the relatively volatile components of energy and unprocessed foods, consumer prices in the second

*Consumer prices*

quarter were up by a seasonally adjusted 0.3% – as in the first quarter. This was due to slight increases in the prices of industrially manufactured goods (excluding energy), which had even become cheaper in the first quarter owing to the very marked impact of end-of-season sales this year. The rate of price increase for services remained unchanged and eased in the case of processed foods. Year-on-year inflation excluding energy and unprocessed foods slowed down from 1.6% in the first quarter to 1.5% in the second. By contrast, quarterly HICP inflation persisted at 2.0%. According to the preliminary estimate, the rate of price increase was 2.2% in July, compared with 2.1% in June and 2.0% in May.

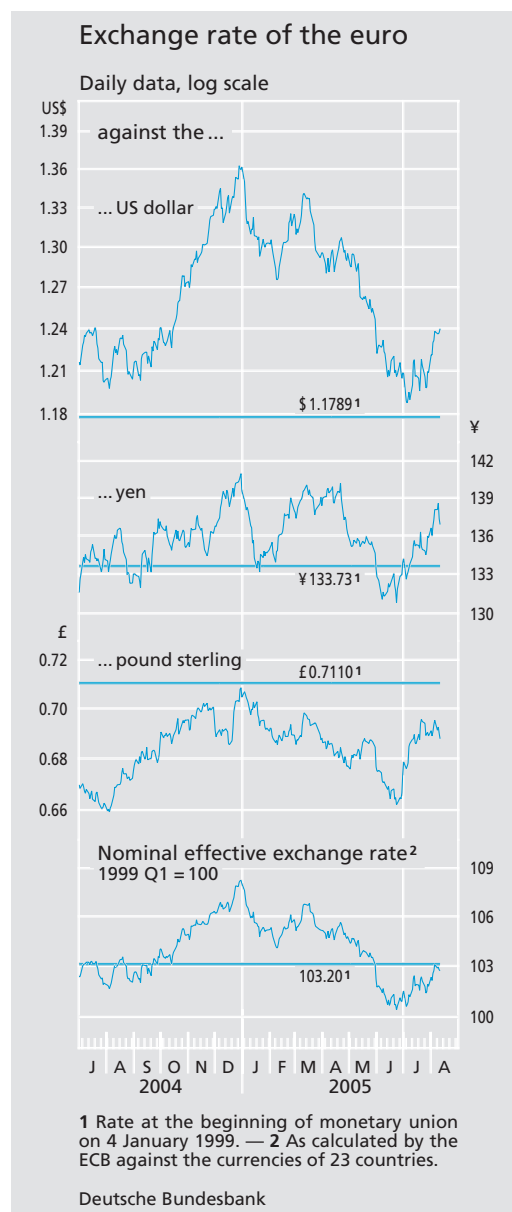
## Exchange rates

*Current trends in the foreign exchange market*

Developments in the foreign exchange market in the early summer of 2005 were marked by continued strong economic growth and rising interest rates in the United States. The US dollar was therefore able to pick up once again against the euro, the yen and the pound sterling. At the same time, the debate about the political future of the European Union put a strain on the euro's exchange rate.

*Movement of the euro's exchange rate against the US dollar...*

The US trade deficit, which was the key factor in price formation on the foreign exchange markets in the first few months of the year, was being given somewhat less attention by foreign exchange market agents in the period under review. This shift in perspective is not least also due to the fact that, in



May 2005, the trade deficit was lower than expected.

However, the firming-up of the US dollar has also taken place against the backdrop of sound US economic growth and an increase in the yield spread of US dollar-denominated investments over their euro-denominated counterparts across all maturities. This development has even been intensified by, at

## The reform of the Chinese exchange rate regime

On 21 July 2005, the People's Bank of China announced that the exchange rate regime for the renminbi, the Chinese currency, was to be reformed with immediate effect. At the same time as the reform of the currency regime, the Chinese currency was revalued by around 2% to 8.11 renminbi yuan (RMB.¥) against the US dollar. Hitherto, the renminbi had been fixed at a de facto rate of RMB.¥8.28 against the US dollar.<sup>1</sup> The reform of the Chinese currency regime dissolves the peg to the US dollar as the sole anchor currency. Instead, the renminbi exchange rate regime has moved to a managed float with reference to a basket of currencies. The most important currencies in the basket are the US dollar, the euro, the yen and the South Korean won. In addition, it would also appear to include the Singapore dollar, the pound sterling, the Malaysian ringgit, the Russian rouble, the Australian dollar, the Thai baht and the Canadian dollar. The precise weighting of the individual currencies, which also reflects China's trade pattern, was not disclosed by the authorities. It was announced, however, that fluctuations of the renminbi against the US dollar would be restricted to a maximum of  $\pm 0.3\%$  of the interbank market closing rate on the previous day. Fluctuations against other currencies in the basket are also to remain within a fixed band, although this is wider ( $\pm 1.5\%$ ). The People's Bank of China has reserved the right to adjust the permitted fluctuation margin if deemed necessary in the light of market developments or the economic and financial situation.

<sup>1</sup> The currency regime applicable hitherto and the exchange rate movement of the renminbi are described in detail in: Deutsche Bundesbank, The exchange rate and currency regime of the People's Republic of China, *Monthly Report*, June 2005, p 42.

Deutsche Bundesbank

times, unfavourable economic data for the euro area and associated market expectations of an interest rate cut by the ECB.

Moreover, political events such as the rejection of the EU constitutional treaty in the French and Dutch referendums and the breakdown of the EU budget negotiations have proved to be major special influences. These political developments in Europe, besides isolated cases of speculation on the outlook for monetary union, have contributed to the euro's depreciation against the US dollar. During the first few days of July, the euro was quoted briefly at US\$1.19. Following the positive outcome of the Luxembourg referendum and the waning of speculation about interest rate cuts in the euro area, the euro finally stabilised again at a somewhat higher level against the US dollar. As this report went to press, the euro was trading at US\$1.24, which was 9% below its US dollar value at the end of last year.

In May, the euro-yen rate initially remained almost unchanged at just under ¥136 to the euro. However, the general shift in sentiment placed a strain on the euro's exchange rate against the yen, too. On the other hand, the revival of domestic economic activity in Japan led to an increase in Japanese imports, thus reducing the trade deficit. This has enabled the euro to regain some of its value against the Japanese yen since the end of June. This development was temporarily interrupted at the end of July when the yen, in the wake of the renminbi's appreciation, likewise picked up somewhat against the US dollar (see box on this page). As this report went to press,

*... against  
the yen ...*

the euro was trading at ¥137, which was 2% lower than at the turn of the year.

*... and against  
the pound  
sterling*

The debate on the European Union's future following the outcome of the referendum in France was likewise reflected in the euro's exchange rate against the pound sterling. In June, the euro initially fell distinctly against the pound sterling, much as it did against the US dollar and the yen. The greater restraint on the part of market players in their assessment of the future growth outlook for the United Kingdom, however, represented a certain counterweight. Following the publication of the minutes of the Bank of England's Monetary Policy Committee meetings at the end of June and end of July, which showed that a growing group of members favoured an easing of monetary policy (in contrast to previous months, when, if anything, interest rate hikes were being discussed), speculation that interest rates would soon be cut became entrenched, and the pound sterling went back down again somewhat. In early August, such expectations were then confirmed, as the Bank of England reduced its interest rate by ¼ percentage point to 4.5%. Moreover, the pound sterling was placed under an additional strain by the terrorist attacks that rocked London in July. On balance, the euro posted gains in the past few weeks. At £0.69, however, the euro was still 2½% lower than at the end of 2004.

*Effective  
exchange rate  
of the euro*

On a weighted average against the currencies of 23 trading partners, the euro, on balance, depreciated in the past few months. The effective exchange rate is now 5% below its value at the turn of 2004-05 and thus – even

taking into account international inflation differentials – relatively close to its level at the launch of monetary union.

### Excursus: growth differentials in the euro area

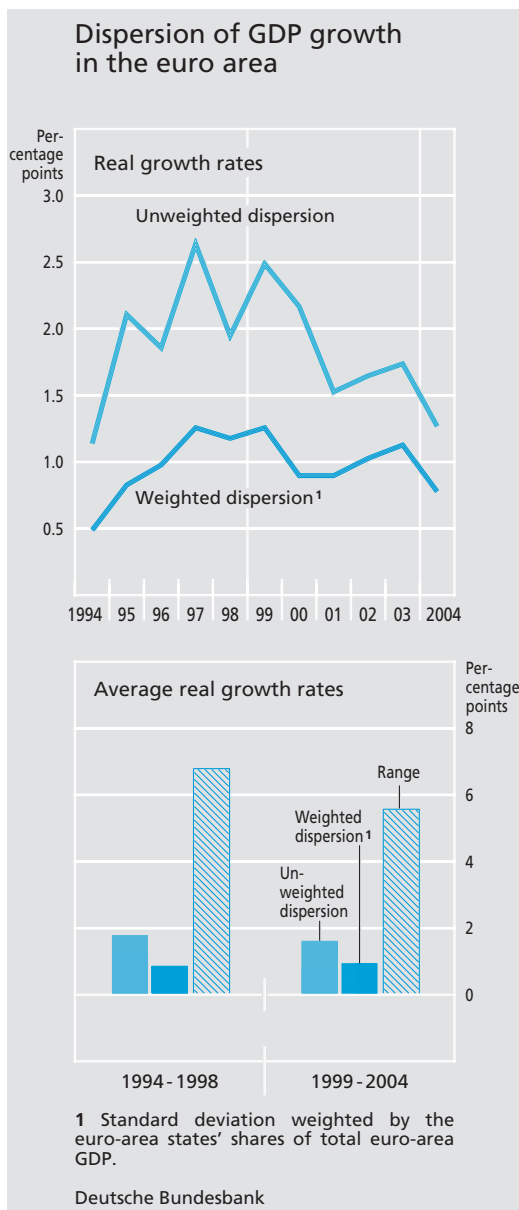
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Since the fourth quarter of 2004 a broader dispersion has been evident in the quarter-on-quarter rates of real GDP growth in the euro area. This is mainly due to wider divergences amongst the four largest member states of Germany, France, Italy and Spain. In the third quarter of 2004 growth rates in these four countries – which generate around four-fifths of euro-area GDP – had still kept within a narrow range from -0.1% (Germany) to 0.7% (Spain) (after adjustment for seasonal and working-day effects). In the fourth quarter of 2004 the gap between Spain and Italy, which recorded a 0.4% decline in real GDP, widened to nearly 1½ percentage points. There was a further widening of the gap in the first quarter of 2005 between Spain, which recorded a growth rate of 0.9% on the quarter, and Italy, which again recorded a decline in real GDP (-0.5%). In addition, the growth rates in France and Germany were fairly volatile during this period.

*Wider growth  
gap in 2004 Q4  
and 2005 Q1 ...*

The stronger dispersion in the quarterly data during the fourth quarter of 2004 and the first quarter of 2005 is, however, largely due to exceptional factors and should therefore not be overinterpreted. Particularly in the case of Germany, for instance, both the weak growth in the fourth quarter of 2004, in which a decline in seasonally and working-

*... and its  
causes*



day adjusted GDP of -0.1% was recorded, and the recovery in the first quarter of 2005 were probably overstated. By contrast, the sharp fall in real GDP in Italy in the final three months of 2004 and the first three months of 2005 appears to reflect another cyclical setback. Of the smaller countries, Portugal and the Netherlands also faced a rather difficult macroeconomic situation, while Ireland, for example, remained on a steep growth path.

The major impact of the special factors in the fourth quarter of 2004 and the first quarter of 2005 is also suggested by the fact that the growth disparity among the large member states narrowed again considerably in the second quarter of 2005.

The degree of dispersion of the quarterly rates remained virtually unchanged in 2004 as a whole. The differences in the member states' annual growth rates were actually somewhat smaller in 2004 than in 2003. Unadjusted for calendar effects, the disparity in the rates of expansion between Ireland, which headed the GDP growth table with 5%, and last-place Portugal amounted to around 4 percentage points, whereas in 2003 growth rates had shown a top-bottom spread of 5.8 percentage points between Greece and Portugal. The unweighted standard deviation fell by ½ percentage point in 2004 to 1.3 percentage points. The standard deviation weighted by each country's respective share in euro-area GDP declined from 1.2 percentage points to 0.8 percentage point.<sup>2</sup>

The structure of macroeconomic growth in the euro area in 2004 showed a very uneven picture, however. Both the unweighted and weighted dispersion of growth in domestic demand (1.5% and 1.6% respectively) were clearly above the comparable figures for overall GDP growth. There were particularly large differences in the demand profile between

*Smaller dispersion of GDP growth in 2004 ...*

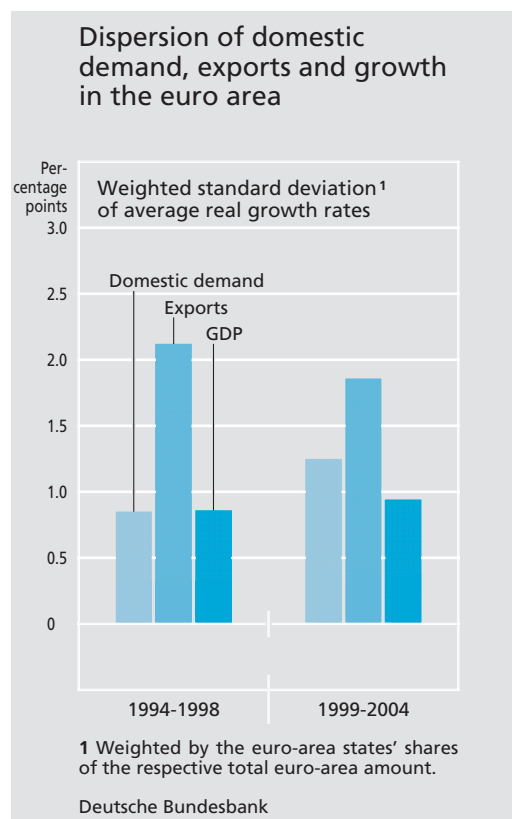
*... but very uneven demand structure*

<sup>2</sup> From an analytical standpoint, the weighted standard deviation is preferable to the unweighted standard deviation and an analysis of the top-bottom spread of growth rates as a measure of dispersion because it is the only method which takes account of the very different sizes of the economies that make up the euro area.

Germany and France. Whereas in Germany, two-thirds of the GDP growth of just over 1½% (unadjusted for calendar effects) was generated statistically by higher net exports and only one-third by greater domestic demand, in France the external balance dented output by 1 percentage point. By contrast, domestic demand contributed ¾ percentage points to output expansion. France's overall GDP growth thus totalled 2¼%.

*Since 1994  
largely constant  
growth  
dispersion  
patterns of  
real GDP...*

On a longer-term view, in which the importance of cyclical divergences and country-specific developments is naturally much smaller, the growth differences across the member states have remained approximately constant and, at all events, have not increased. This can be seen by comparing varying measures of dispersion for the period between 1994 and 1998, ie stage two of EMU, with the corresponding figures for the period after the start of stage three (between 1999 and 2004). At 0.9 percentage point, the weighted standard deviation of the average growth rates for the years 1999 to 2004 was on a par with that recorded during the 1994 to 1998 period. The top-bottom growth spread fell from 6.8 to 5.6 percentage points and the unweighted standard deviation also declined, albeit only slightly. It should be noted, however, that the "convergence" between the dispersion rates measured in this way masks the fact that the differences in growth have lessened only among the smaller member states, while these differences have tended to widen slightly in the case of the four largest countries.

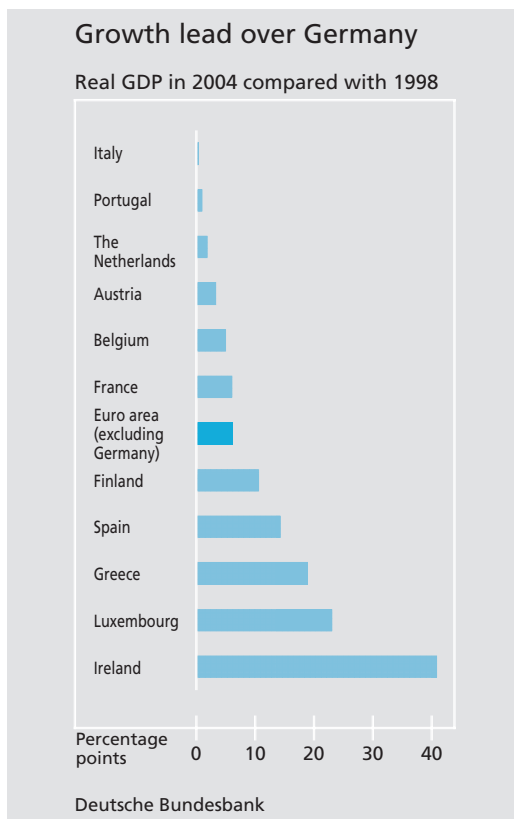


If, alternatively, the growth rates of potential output are taken as the measure of dispersion so as to eliminate measurement bias resulting from asynchronous cyclical developments across the member states, the picture remains broadly the same with merely some small differences vis-à-vis the results based on the actual rates of change of GDP.

*... and of  
potential  
output*

The picture of more or less unchanged growth differentials which emerges from an analysis of the weighted standard deviation for the period since 1994 remains much the same if dispersion is measured by the variation coefficient, which additionally takes account of the possible influence of the levels of euro area-wide growth rates on the volatility during the observation periods. This is hardly surprising as the average annual

*Variation  
coefficient  
as a measure  
of dispersion*



growth rate of real GDP in the period between 1999 and 2004 was 2%, or “only” 0.4 percentage point lower than in the period between 1994 and 1998. The level effect of the annual growth rates on volatility is therefore likely to have been fairly similar during both periods.

*Demand components*

The GDP growth differentials can only be partially reconciled with the divergences in the change in real domestic demand and exports in the two periods under review. Thus the growth differentials in domestic demand and exports were smaller between 1999 and 2004 than in the 1994 to 1998 period, both in terms of the top-bottom spread and the unweighted dispersion. This contrasts, however, with an increase in the weighted dispersion of domestic demand on an average of

the years 1999 to 2004 vis-à-vis the previous period. This suggests that the domestic economic dynamics have diverged at times, particularly in the larger countries. In the case of exports, by contrast, the weighted measure of dispersion also indicates that growth rates have tended to converge.

The low convergence of the relative changes in GDP in the euro area since the start of the third stage of EMU has been accompanied by a fairly stable regional growth profile. Since 1999, Germany has nearly always been the straggler in this respect, followed closely by Italy. By contrast, with the exception of 2003 when Greece took “first place”, the Irish economy was the top performer between 1999 and 2004. Growth in real GDP in Ireland during this period was more than 40 percentage points higher than in Germany (see chart). The cumulative growth lead of France and the euro area as a whole (excluding Germany) over Germany amounted to 6 percentage points in each case. It is also striking that, with the exception of Luxembourg, the countries with an above-average growth disparity vis-à-vis Germany are still in the catching-up process, or, as in the case of Ireland, have only recently completed this process. Conversely, with the exception of Portugal, the group of countries with a below-average lead is made up exclusively of the highly developed core countries.

*Cumulative growth gap vis-à-vis Germany*

In this context, comparisons with growth differentials in other currency areas, such as within Germany before the start of EMU or within the USA, prove informative. With respect to monetary policy, however, it should

*Comparisons with other currency areas*

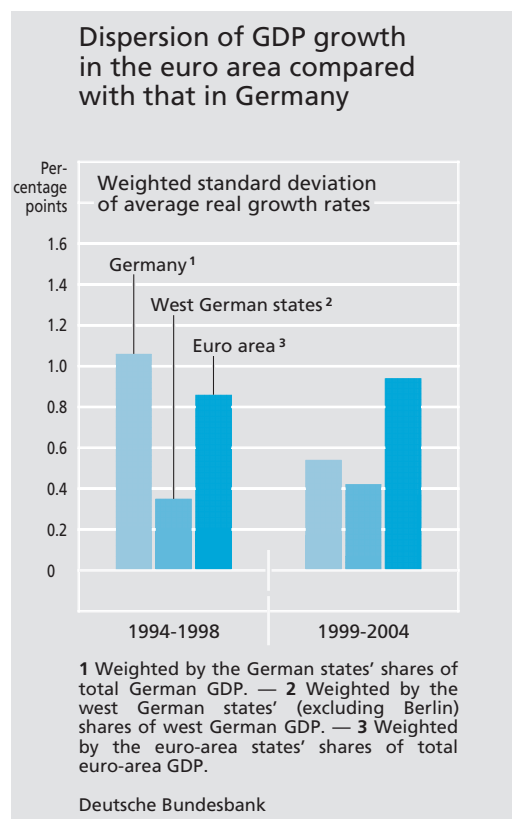
be noted that the ECB operates in a different institutional and political environment than the US Federal Reserve or that in which the Bundesbank formerly operated.

*Dispersion  
across German  
federal states ...*

Between 1994 and 1998 the growth differentials across the individual German federal states were of a similar magnitude to those in the euro area. This was primarily due to the strong economic catching-up process in the former east German states following reunification. This catching-up process has stalled in the past few years with the result that the growth divergences have likewise eroded. The weighted standard deviation of the average annual growth rates in Germany stood at around 0.5 percentage point between 1999 and 2004, or only half that of the euro area. The unweighted standard deviation was actually only one-third of the euro-area level. If the analysis is confined to the dispersion across the west German states in order to largely filter out the special effects of reunification, a markedly lower level of dispersion is evident than in the euro area. One major factor behind this development is that the differences in prosperity, measured in terms of per capita income, are much larger in the euro area than across the federal states in western Germany.

*USA and euro  
area show  
similar growth  
differences ...*

Compared with the United States, the growth differences in the euro area are by no means extraordinary (see chart on page 26). For instance, the weighted standard deviation of the growth rates across the US states in both periods, at 1.3 and 1.1 percentage points respectively, was actually higher than in the euro area.<sup>3</sup> In the case of the USA, too, the

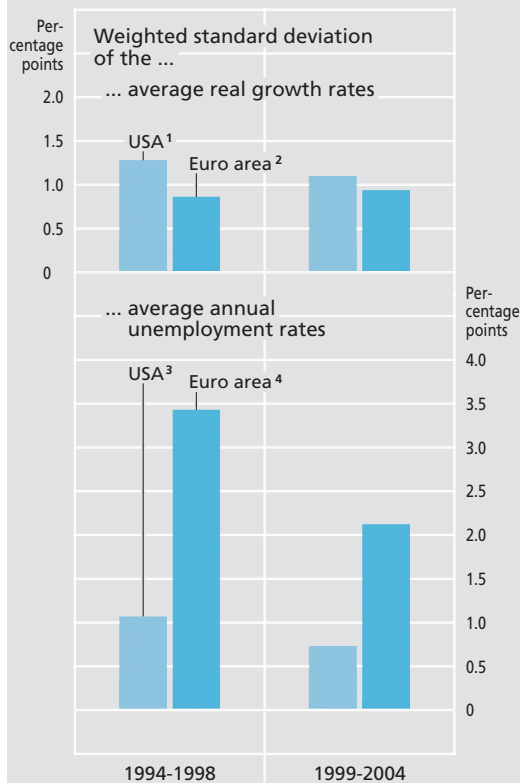


weighted measure of dispersion appears to be more informative (owing to the widely varying economic weights of the individual US states) than the unweighted standard deviation, although the differences between the two measures of dispersion are smaller than in the euro area. For the period between 1994 and 1998 the unweighted measure shows a dispersion of 1.8 percentage points for both the USA and the euro area. Furthermore, in terms of the unweighted standard deviation, the growth differences in the USA fell considerably between 1999 and 2004,

<sup>3</sup> If the analysis is based on the geographically defined eight regions in the USA as included in the official US statistics, the weighted dispersion in the USA was virtually the same as in the euro area for the 1994 to 1998 period. By contrast, between 1999 and 2004 the weighted standard deviation was somewhat lower. The unweighted standard deviation produces similar results for both periods as the weighted measure of dispersion.



### Dispersion of GDP growth and the unemployment rate in the euro area compared with that in the United States



1 Weighted by the US states' shares of total gross state product. — 2 Weighted by the euro-area states' shares of total euro-area GDP. — 3 Weighted by the US states' shares of the labour force in the USA. — 4 Standardised unemployment rates weighted by the euro-area states' shares of the labour force in the euro area.

Deutsche Bundesbank

by 0.7 percentage point to 1.1 percentage points, whereas this figure decreased only marginally in the euro area.

... but different labour market responses

However, it is questionable whether the US experience can simply be transposed to the euro area. The main difference lies in the regional integration of the labour markets. Experience shows that, in the USA, pronounced growth differences across states trigger rapid

and large migratory movements which, from a macroeconomic standpoint, have a positive impact. First, the wage pressure in the prospering regions is mitigated and second, the tension in the labour markets in the lagging states is eased. The growth differences across the US states are therefore not mirrored to the same extent in the labour market. In the euro area, by contrast, migratory movements from weak growth countries to high growth countries are relatively insignificant. Two major reasons for this are the language barrier and a generally low level of willingness to move, which is also evident within the member states. This latter is due in part to the social welfare framework, which is more generous than that in the USA. The consequence of this is that growth differences in the euro area are reflected to a greater extent in the national labour markets.

One measurable indication of the differing impact of the (similarly sized) growth spread in the USA and in the euro area on the respective labour markets is the dispersion of unemployment rates. The weighted and unweighted standard deviation of the average annual unemployment rates of the US states between 1999 and 2004 stood at 0.7 and 0.9 percentage point respectively, which was clearly lower than that of the member states in the euro area, where the comparable dispersion levels were 2.1 and 2.9 percentage points respectively. Calculations of the average dispersion of the annual changes in unemployment rates point in the same direction.

*Smaller dispersion in the unemployment rates in the USA*

*Weak growth  
the key  
problem*

Although the current debate is attaching considerable importance to growth differentials in the euro area, it appears more likely that the overall low cyclical momentum, particularly in larger member states, is the real reason for the widespread dissatisfaction with the economic development in the euro area. Growth differences are being perceived as rather alarming at the present time presumably because some of the countries with low aver-

age growth rates have, at times, been in danger of slipping into recession. Hence, it may be inferred that the current debate might not have taken place if the pace of expansion in the euro area as a whole, given a similar growth spread, had been between, say, 2 and 3 per cent instead of 1 and 2 per cent (and thus below the potential rate) as is currently the case.