

Global and European setting

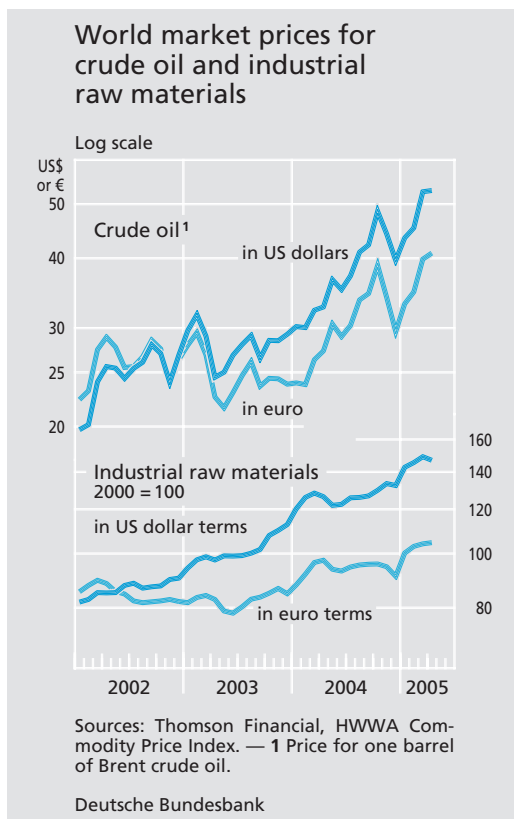
World economic activity

At the start of the year, the upswing in the global economy continued at a fairly rapid rate. However, according to the early economic indicators from the industrial countries, overall economic growth appears to have lost some momentum in the second quarter. This may have been due mainly to the fact that crude oil prices have remained at a very high level since the last quarter of 2004 except for a brief respite at the very end of last year. At the beginning of April they reached a record high of US\$57 (Brent crude oil); in mid-May they stood at roughly US\$50. Thus, in the period from January to April, crude oil prices were 55% higher in terms of US dollars than they had been in the same period of the previous year. In terms of the euro, which had appreciated considerably against the dollar during the twelve-month period, the increase amounted to 47%. Furthermore, industrial raw material prices continued to rise in the first four months of 2005. In US dollar terms, they were up 17% on the year, and in euro 10%.

Global economy remains on growth path but momentum has slackened

The ongoing surge in prices on the international commodity markets has been accompanied by considerable shifts in purchasing power away from the consumer countries in favour of the supplier countries. However, the upward thrust in prices witnessed since the beginning of 2004, especially on the oil markets, have so far had only limited negative impact on the global economy compared with the distortions in former times of sharply rising prices. The oil crises at the beginning of the 1970s and the early 1980s, for example,

Pressures from current surge in oil prices lower than in 1970s and 1980s



led to significant growth losses. First, inflationary pressures in the consumer countries increased dramatically, forcing monetary policy makers to counteract with restrictive measures. The main reason for this, aside from the higher energy-dependency of the manufacturing sector, was the rapid formation of wage-price spirals. Second, it was generally only after long delays that the supplier countries' soaring income was rechannelled back into the industrial countries in the form of rising demand for goods or increased capital exports. During the transition period, global output slowed down (see explanatory notes on pages 12).

In contrast to the situation at that time, the overall price climate has remained relatively relaxed during the current surge in prices on

the crude oil markets as second-round effects have been limited. In addition, recent analyses seem to indicate that revenue increases in the oil-exporting countries are now being channelled into purchases of goods abroad much more rapidly than was formerly the case. This is partly due to the fact that production capacities are nearly exhausted and consequently investment in the exploration of new sources and in conveying systems is being stepped up considerably. (By contrast, the oil crises in the 1970s and early 1980s were caused not so much by capacity shortages but rather by OPEC's output policy and by delivery disruptions following political unrest in the Middle East.) Moreover, owing to the generally weak revenue situation in the 1990s, in many oil-exporting countries pent-up demand has accumulated, particularly with regard to the public infrastructure, which can now be relieved. It should also be borne in mind that, as a result of the rapid population growth, above all in the Middle East, many oil-producing countries which had been low absorber countries since the 1970s have now become high absorber countries. According to IMF estimates, those emerging market economies which export energy commodities increased their real imports by 13% in 2004 compared with 3½% in 2003; a rise of 11½ is expected for 2005. At the same time, the current account surpluses in these countries will presumably also continue to rise.

The continuing favourable financing conditions on the capital markets have presumably also played a key role in enabling the global economy to successfully withstand the pres-

*Favourable
financing
conditions
and stable
economic
environments*

asures emanating from the commodity markets so far. The Latin American emerging market economies, in particular, are currently profiting from this with relatively low interest rate premiums. In this context, it is also worth mentioning that monetary policy in the industrial countries and in China is still taking an accommodating stance, albeit not to the same extent as in recent years. The south and east Asian emerging market economies are particularly affected by the increases in the crude oil prices because of the rather energy-intensive nature of their production – compared with that of the industrial countries – and their strong dependency on imports for energy commodities. However, a robust upswing is still under way in this region. Moreover, the underlying structural conditions have improved considerably since the financial crisis at the end of the 1990s.

Industrial output and price developments in the industrial countries

The differential in the growth rates of the industrial countries widened in the course of 2004. While the US and British economies continued to expand sharply in the second half of 2004, economic growth in the euro area and in Japan slowed down, at times considerably. Domestic economic activity in these two regions was unable to compensate for the weaker stimuli from abroad. The larger growth differentials, together with the higher commodity and crude oil prices, increased the external imbalances. Although GDP growth picked up again in the euro area (and most likely in Japan, too) in the first quarter of 2005, this was partly a reaction to the poor results of the previous quarter. In the industrial countries as a whole, seasonally-adjusted industrial output in the first quarter

of 2005 was up by 1% on the level of the previous three months and by 2% on the year. Consumer price inflation stabilised in the first quarter of 2005. Seasonally-adjusted prices were only slightly higher than they had been in the previous three months. The year-on-year rate of increase fell from 2.5% in the final quarter of 2004 to an average of 2.2%. This was due in part to the temporary easing of crude oil prices at the end of 2004, a development which was reflected, albeit after a certain delay, in the energy prices at consumer level. Base effects in the euro area also contributed to the decline in inflation. Excluding Japan, which is again experiencing slight deflation, inflation was at 2.5%.

According to the IMF's World Economic Outlook published at the beginning of April, the global economy will remain on a growth path throughout 2005 and 2006. It predicts that while the pace of growth, at almost 4½% in each case, will no longer be as fast as it was in 2004 when it reached just over 5%, it will remain well above the long-term average of 3½% (1985 to 2004). It is worth noting that the IMF's forecast for the world economy in 2005 is virtually unchanged from its forecast of spring 2004 even though the oil price assumptions on which it bases its prognoses were upwardly adjusted year-on-year from US\$27 in April 2004 to US\$37.25 in the fourth quarter of 2004 to currently US\$46.50. This would indicate that the global upswing is more robust than has been assumed for some time. According to the IMF forecast, the rather subdued global production activity is accompanied by world trade growth which is less vigorous than before;

IMF forecast

Has the recycling of oil revenues to the consumer countries accelerated?

If it is assumed that the price of oil will remain high for some time to come, the implications of this for the global growth process take on even greater importance. This notably includes the question of the likely impact on the worldwide demand for goods.

Given the relatively price-inelastic demand for oil in the short run and the fairly limited response of export prices of industrial products, an increase in the price of oil leads initially to additional (net) revenues for the oil-producing countries: real income is transferred from the oil-importing countries to the oil-exporting countries. To the extent that the states which benefit from the shifts in the terms of trade spend their extra revenues on additional imports of goods and services, the loss of purchasing power in the consumer countries due to higher oil prices results in lower real national income but does not lead to a decline in aggregate output. However, the demand profile changes, since lower real domestic demand is accompanied by higher exports. But experience suggests that the decline in real income and the consequent drop in demand in the consuming countries following an oil price shock occur faster than the expansion of demand on the part of the oil-producing countries.¹ This means that global demand falls *per se*, at least for a time.

Various indicators, especially the robust import growth of the oil-producing countries last year, suggest that the process of disbursement of such additional oil revenues has accelerated over time. This hypothesis can be tested using a structural vector-autoregressive (SVAR) model consisting of the oil price as well as the nominal

¹ In addition, part of the higher revenues are invested on the international financial markets, which tends to depress the interest rate level and may stimulate investment demand. In such a scenario, however, a stabilising effect on real value added is similarly likely only after time-lags and as a function of the interest rate elasticity of domestic

merchandise exports and imports of the OPEC countries.² The response of exports and imports to an identified oil price shock can be gauged from the corresponding impulse response functions. A change in the response behaviour can be observed by splitting the overall available observation period (1980 Q1 to 2004 Q3) into two sub-periods (1980 Q1 to 1990 Q4 and 1991 Q1 to 2004 Q3), which are then analysed separately.

The analysis shows that an unexpected rise in oil prices gives an immediate significant boost to the OPEC countries' nominal exports, but increases imports only with a time lag of around three quarters. After 14 to 16 quarters, the accumulated responses generally lose their statistical significance. The growth lead of OPEC exports over imports in response to an oil price shock can be derived from these accumulated responses.

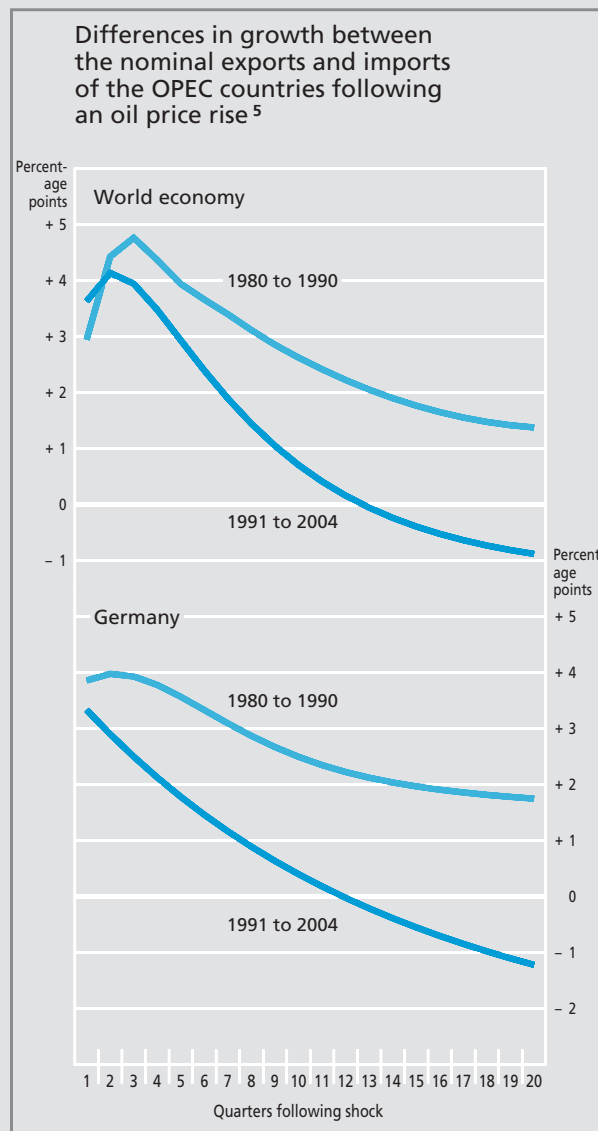
The chart on page 13 shows this growth lead for the aggregate trade of the OPEC countries vis-à-vis the world and vis-à-vis Germany separately for the two sub-periods. In general the export response initially exceeds the import response; as a rule, the difference expands up to the third quarter and steadily declines thereafter. It is noticeable that the curve for the second sub-period is shifted noticeably downwards, which indicates an acceleration in the recycling of the oil revenues. Twelve to 13 quarters after the oil price rise in the later period (1991 to 2004) the accumulated growth lead of exports is fully neutralised by the subsequent increase in imports, whereas in the earlier period exports were still ahead even after 20 quarters. Moreover, in Germany's case the difference now declines steadily from the outset;

demand. — ² The data used were taken from the IMF's Direction of Trade Statistics and – in the case of the oil price – from its International Financial Statistics. To identify the VAR, a simple recursive order is adopted using the stated – and theoretically specified – sequence of the variables so that the oil price does not depend contemporaneously

the curve no longer displays a “bulge” in the first few quarters.

This simple SVAR analysis comes up with findings similar to those of other studies. For example, the UK National Institute for Economic and Social Research (NIESR) estimates that the recycling velocity has doubled compared with the period prior to 1985. On the basis of simulations using its multi-country econometric model (NiGEM), the NIESR concludes that an increase in oil revenues is now reflected in an equally high rise in OPEC imports as early as after four years.³

In the context of simulations in NiGEM, Barrell and Pomerantz (2004) also compared the output effects of a permanent oil price rise in two alternative scenarios, which differ only with regard to the pace at which the oil revenues are disbursed.⁴ While the one scenario reflects the current situation, the other is based on the slow recycling velocity of the 1970s. Both scenarios produce almost identical output effects for the USA. By contrast, the output of the European economies, especially of the German economy, declines more sharply in the event of a slower disbursement of the oil revenues. This is because the oil-exporting countries import substantially more from Europe than from the USA. Given an unchanged structure of foreign trade, an increase in oil prices therefore implies a global shift in demand in favour of the European economies. A major role is also played in this context by the very close trade links with the oil-producing CIS countries – above all, Russia.

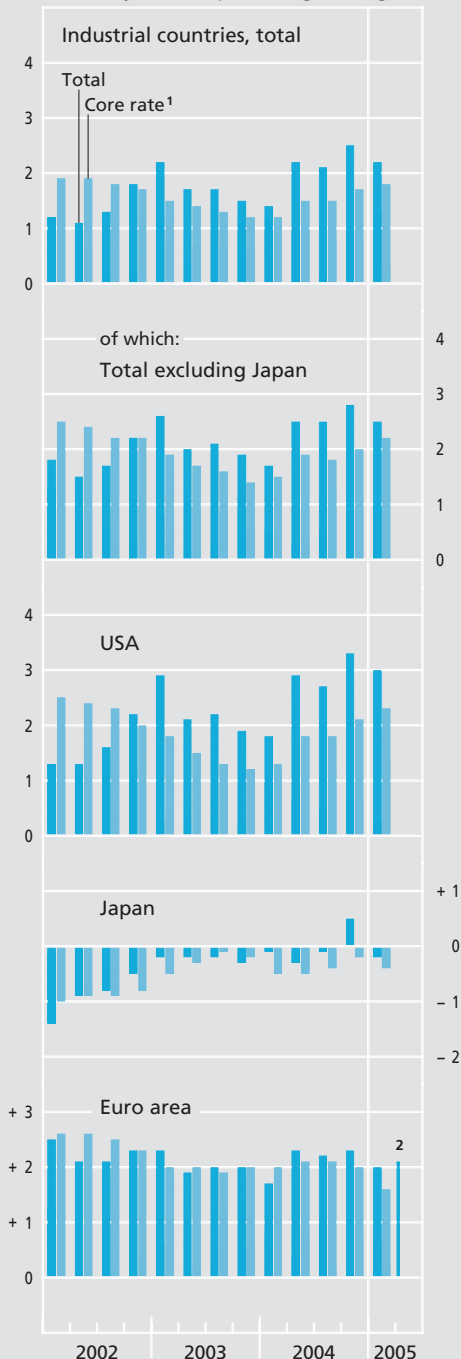


on the two other variables. — 3 See NIESR (2004), Oil Price Shocks and the World Economy Today, National Institute Economic Review 189, July 2004, p 14-17. — 4 See R Barrell and O Pomerantz (2004), Oil Prices and the World Economy, NIESR working paper, also published in Focus on European Economic Integration, 1/2004, OeNB, p 152-177. — 5 Dif-

ference between the cumulative growth rates of the nominal exports and imports of the OPEC countries vis-à-vis the world and Germany following an oil price rise of 10%; a positive sign indicates the cumulative growth lead of nominal exports.

Consumer prices in the industrial countries

Quarterly, annual percentage change



Sources: national statistics, Eurostat and Bundesbank calculations. — 1 Excluding energy and food; euro-area: HICP excluding energy and unprocessed food. — 2 Eurostat flash estimate for April.

Deutsche Bundesbank

following an increase of 10% in 2004, rises of 7½% are predicted for 2005 and 2006. However, this also means that Japan and the euro area, whose domestic economies are still marked by considerable weaknesses, can continue to expect external expansionary stimuli in the future.

Global economic growth is still being driven by the United States and China according to the IMF forecast. Both countries have, however, played a major role in the current external imbalances, which are repeatedly the focal point of the financial market debate about risk assessments. In 2004, the USA's trade deficit (goods) vis-à-vis China amounted to US\$162 billion compared with an overall deficit of US\$651 billion. The IMF forecast predicts that the US current account deficit will increase again this year and next year, not least as a result of the rise in oil prices. However, in relation to GDP, it will be no larger in 2006 – at 5.7% – than it was in 2004. The volatility of the oil markets and their high level of susceptibility to disturbances pose a further risk, especially for highly indebted and poor countries. The IMF estimates that a sharp increase in long-term interest rates in the USA could lead to a world-wide deterioration of the financing conditions which would probably also have a negative impact on the stock and property markets.

Major risks still present

According to the initial estimate, in the period from January to March 2005, real GDP in the USA rose by ¾% on the previous quarter after adjustment for seasonal and working-day variations. This means that the pace of growth slowed down only slightly compared

USA

with the two preceding quarters. Year-on-year growth was 3½%.¹ It seems likely that the robust upswing in the USA will continue even though the indicators available so far present a mixed picture for the second quarter of the year.

Given the demand structure of growth in the first quarter of 2005, it is striking that inventory investment, at ¼ percentage point, made a more significant contribution to the rise in overall output than it did in the previous quarter. In addition, the real external balance of goods and services went further into the red, depressing GDP growth by almost ½ percentage point. In the first quarter of 2005, final domestic demand increased by “only” ¾%, compared with 1% and 1¼% in the two preceding quarters. There was a shifting of emphasis here, too. While real expenditure on new residential buildings increased more sharply, the growth in commercial investment, at 1%, was much smaller than before, not least as a result of the expiry of the depreciation allowances at the end of 2004. Private consumption rose by almost 1%, which was almost as much as in the final quarter of 2004. However, given the fairly small rise in nominal disposable income, this was at the expense of saving. The private saving ratio in the first quarter of 2005 was ½% compared with 1½% in the preceding period, although it was then affected by special factors.

Price developments were somewhat calmer than they had been in the fourth quarter of 2004, which meant that the pressure on household budgets eased. The rate of increase in the consumer price index fell by 0.3

IMF forecast for 2005 and 2006 *

Item	2003	2004	2005	2006
Real gross domestic product	Annual percentage change			
Advanced economies 1	+ 2.0	+ 3.4	+ 2.6	+ 3.0
of which				
United States	+ 3.0	+ 4.4	+ 3.6	+ 3.6
Japan	+ 1.4	+ 2.6	+ 0.8	+ 1.9
Euro area	+ 0.5	+ 2.0	+ 1.6	+ 2.3
Consumer prices 2				
Advanced economies 1	+ 1.8	+ 2.0	+ 2.0	+ 1.9
of which				
United States	+ 2.3	+ 2.7	+ 2.7	+ 2.4
Japan	- 0.2	0.0	- 0.2	0.0
Euro area	+ 2.1	+ 2.2	+ 1.9	+ 1.7
Unemployment	Number of unemployed persons as a percentage of the labour force			
Advanced economies 1	6.6	6.3	6.1	6.0
of which				
United States	6.0	5.5	5.3	5.2
Japan	5.3	4.7	4.5	4.4
Euro area	8.7	8.8	8.7	8.4

* Source: IMF, World Economic Outlook, April 2005. — 1 Including Taiwan, Hong Kong, South Korea and Singapore. — 2 Consumer price index; for the euro area, HICP.

Deutsche Bundesbank

percentage point to 3.0% mainly as a result of the smaller year-on-year rise in energy prices. By contrast, the core rate (excluding energy and food) continued its upward trend and reached 2.3%, its highest level since the third quarter of 2002. However, the core rate of the personal consumption expenditure deflator, at 1.6%, shows that low home-grown inflationary pressures were unchanged in the first quarter of 2005.²

At the beginning of 2005, the Japanese economy overcame the economic slump which

Japan

1 The quarterly result will probably be revised upward, mainly as a result of the significant decline in the trade deficit in March, which was not known at the time of the first GDP estimate.

2 For the reasons behind the divergence between the two core rates, see Deutsche Bundesbank, The economic scene in Germany around the turn of 2004-05, *Monthly Report*, February 2005, pp 12-14.

had begun in the second quarter of 2004. During the period from January to March, seasonally adjusted industrial output increased on average by 2%, which was 1½% higher than a year previously. However, the economic indicators for the second quarter were, on the whole, disappointing. For example, the Bank of Japan's Tankan survey in March 2005 indicates that confidence among businesses has once again declined. Consumer confidence also fell in April. In the first quarter of 2005, consumer prices went down on the year by ¼%, having risen by ½% in the final quarter of 2004 as a result of rising energy and food prices.

China

In the first quarter of 2005, real GDP in China was 9½% higher than it had been a year earlier. This sharp rise at the start of 2005 means that the IMF forecast of 8½% for the year may even be exceeded. Assuming that domestic economic activity remains buoyant, the Chinese economy should also benefit from strong growth in textile and clothing exports owing to the abolition of the former system of quotas at the end of 2004. Despite the ongoing economic boom, inflationary pressures at consumer level declined. In March, the rate of increase in consumer prices was "only" 2.7%, having been almost twice as high in the third quarter of 2004. This supports the IMF's prediction that the inflation rate would decline from 3.9 % in 2004 to 3.0% this year.

United Kingdom

Real GDP in the United Kingdom rose again sharply in the first three months of 2005; however, the seasonally and working-day-adjusted result of ½% was not quite as high

as it had been at the end of 2004. There was a 2¾% rise on the year. The services and construction sectors were responsible for the quarterly rise in overall output. By contrast, industrial production declined. Although no data are yet available on the use of total output, private consumer demand, which was previously the main driving force behind domestic economic activity in the UK, seems to have lost momentum. In the first three months of the year, retail turnover rose only ¼% on the previous quarter after adjustment for price and seasonal variations. The stronger upward pressure on prices probably played a role in the more subdued consumption activity. The Harmonised Index of Consumer Prices (HICP) rose on average by 1.7% during the first three months of the year, compared with 1.4% in the previous quarter. In March, the HICP inflation rate, at 1.9%, came very close to the 2.0% ceiling set by the government. Measured in terms of the national Retail Price Index (RPIX), inflation reached 2.4% towards the end of the period under review. Moreover, the upward trend in property prices virtually came to a halt in the final quarter of 2004, which well nigh put an end to any stimulating effects on consumption from this direction.

In 2004, aggregate output in the new EU member states (and in the candidate countries Romania and Bulgaria) rose by 5½% compared with 2% in the euro area. However, over the course of 2004, economic activity slowed down in these countries, too. Seasonally adjusted industrial output grew, on average, by ½% in January and February 2005, which was less than in the previous

New EU member states

quarter. The IMF forecast predicts GDP growth of “only” 4¼% in both 2005 and 2006. Unemployment in the new EU member states continued to decline in recent months, reaching 13½% – as a percentage of the labour force – in March. The rate of consumer price increases slowed considerably at the beginning of 2005. The annual rate of increase was “only” 3.3% in the first three months of the year compared with 4.8% and 4.4% respectively in the third and fourth quarters of 2004. A further decline can be expected in the second quarter of 2005 as the hefty tax increases which came into force a year previously upon accession to the EU will now “drop out” of the inflation rate calculation. In March, inflation rates ranged from 1.2% in the Czech Republic to 6.6% in Latvia. The overall positive economic picture in the new member states is, however, clouded somewhat by the persistently large current account deficits. Overall (including the candidate countries), in 2004 they amounted to almost 5% of aggregate GDP. According to the IMF forecast, the latest oil price developments alone mean that no improvement can be expected this year.

Macroeconomic trends in the euro area

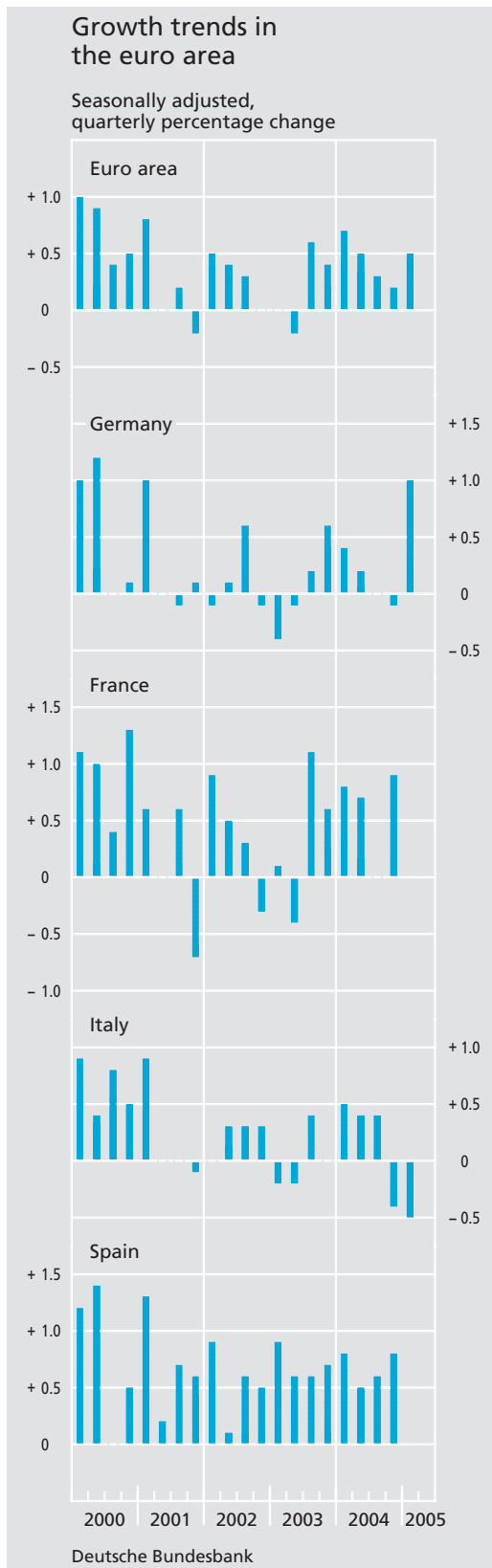
Stronger GDP growth in Q1

According to initial Eurostat estimates, in the first quarter of 2005, seasonally adjusted overall output in the euro area was up by ½% on the previous quarter and by 1½% on the year. The marked acceleration in growth compared with the final quarter of 2004 (+¼%) is particularly noteworthy given that production in the agricultural and construc-

tion sectors was severely impaired by the unusually cold winter weather in many parts of Europe for a time. The increase is attributable primarily to the higher growth rate in Germany which was, in part, a technical response to the decline in real GDP in the preceding period. All in all, the rather moderate cyclical recovery process in the euro area appears to have continued after the turn of the year. As yet, no further data are available on the output and expenditure components of real GDP in the euro area in the first three months of the year. However, the marked rise in nominal exports to non-euro-area countries – accompanied by stagnating imports – in January-February compared with the level in the last quarter of 2004 indicates that foreign trade was a source of major stimuli. In addition, consumer demand was slightly more brisk than previously; in the three-month period from January to March, seasonally adjusted real retail turnover, in any case, exceeded the level in the weak preceding quarter by ½%.

The higher GDP growth in the first quarter of 2005 was accompanied by more buoyant industrial production. In January and February, seasonally adjusted production in this sector rose again slightly (¼%) following a decline in the final quarter of 2004. At the beginning of 2005, it was up by 1¼% on the year. The growth in industrial production over the course of the year was driven by a greater output of intermediate and consumer goods as well as a sharp rise in energy production, which was attributable mainly to the cold winter weather in February. By contrast, the production of capital goods and durable consumer goods stagnated at fourth-quarter

Industrial activity more positive



levels. After adjustment for seasonal variations, industrial capacity utilisation in April was 1 percentage point below what it had been in January and, thus, at its lowest level since the third quarter of 2003.

At the beginning of the second quarter, however, the economy in the euro area deteriorated again. Industrial confidence fell perceptibly in March-April and was once again below its long-term average. The estimate for export expectations has been halved since October. Similarly, there was a sharp downward trend in the volume of new manufacturing orders in the first two months of the year. It should, however, be borne in mind that the comparable figure from the final quarter of 2004 was influenced by major orders in the aviation industry. Consumer sentiment has stabilised recently at a low level.

Weak economic indicators at beginning of second quarter

Unemployment in the euro area rose again slightly after the turn of the year, partly as a result of the unusually cold winter weather in February. According to preliminary data released by Eurostat, in the first quarter of 2005, a seasonally adjusted average of 12.75 million persons were without paid employment. This constitutes a year-on-year increase of ½%. The standardised unemployment rate persisted at 8.8%.

Labour market

Consumer price inflation in the euro area slowed down at the beginning of 2005. The seasonally adjusted and annualised rate of increase in the first three months of the year was, on average, just under 1½% compared with 2% in the final quarter of 2004. One key factor in the easing of inflationary pres-

Consumer prices

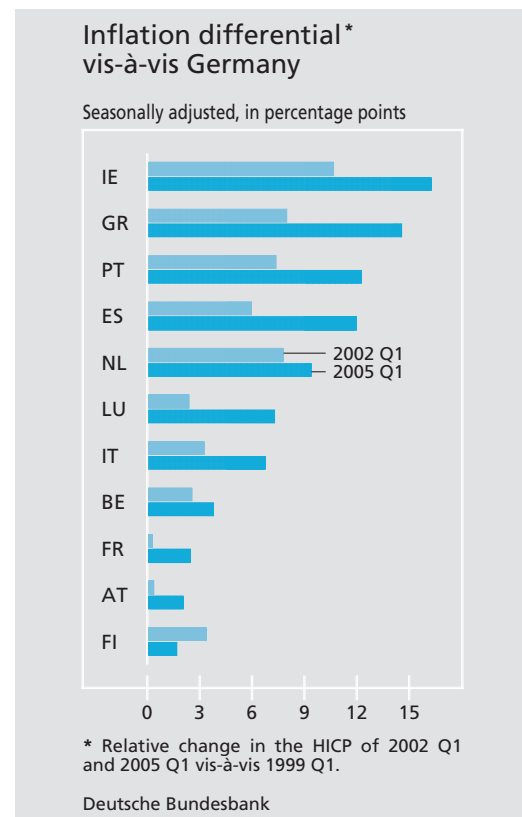
sure was the, at times, more subdued movements in crude oil prices. In addition to this, inflation in the core components declined. The prices for services increased less sharply than in earlier months, and the price of durable and non-durables goods (excluding energy) even fell slightly. This is partly attributable to the fact that the winter clearance sales in January and February had a somewhat greater impact than in previous years. The overall year-on-year HICP inflation rate declined from 2.3% in the final quarter of 2004 to 2.0%. According to preliminary data, the inflation rate in April was 2.1%.

The spread of inflation rates in the euro area narrowed further and in the first quarter of 2005 remained at a relatively low level in terms of the average over the past five years. However, there has been little change in the performance ranking of the countries with regard to price stability since the start of European monetary union at the beginning of 1999. Overall, Germany has remained the most price-stable country in the euro area despite considerable administered price hikes. It is also worth noting that only the Netherlands and Finland have since managed to slightly reduce the inflation differential to Germany which had built up by 2003. In Finland's case, this was largely owing to the cut in tax on alcoholic beverages in 2004.

Exchange rates

*Current trends
in the foreign
exchange
markets*

In the second quarter of 2005, the foreign exchange market was caught between a further tightening of monetary policy in the USA and



the ongoing debate about global economic imbalances. The changing influences were strongly reflected in the development of the euro-dollar exchange rate in particular.

While market participants appeared to view the US external position less anxiously at the beginning of the year, owing, in part, to an optimistic forecast from the Federal Reserve and the announcement of expenditure cuts by the US government, this estimation was modified somewhat in mid-February. Although there had been a surprisingly sharp reduction in the US trade deficit in December, this was due mainly to the lower oil price and the subsequently lower value of imports. Market developments were shaped far more by the debate which erupted at this time about possible additional burdens on the US

*Euro's
exchange rate
movement
against the
US dollar...*

budget, for example, as a result of military expenditure, which once again focused the market participants' attention on the USA's ongoing high financing needs and the associated external economic risks.

The resultant weakening of the US dollar was increased by news that some Asian central banks were planning to diversify their foreign reserves, which had hitherto been held predominantly in US dollars. Intense foreign exchange market intervention by central banks in Asia in recent years had meant that their US dollar reserve holdings had expanded considerably and had thus played a key role in meeting the USA's substantial financing needs. Even though these central banks may not have increased their foreign reserves with the aim of making a profit but rather, in general, in order to stabilise exchange rates, any valuation losses would still have to be borne by the economy concerned. Consequently, the markets feared that diversification efforts by individual central banks to avoid valuation losses could prompt other central banks to take similar measures, which would have a further adverse effect on the dollar rate. Despite statements issued by several Asian central banks that they were not planning to sell dollar holdings, the euro rose to US\$1.34 by mid-March. This was almost as high as its peak at the end of December.

However, reports of exceptionally large net inflows into the USA eased the pressure on the dollar. Favourable economic and labour market data for the USA and a further increase in interest rates by the Federal Reserve with an accompanying warning that infla-

tionary pressures were developing conveyed a picture of a solid upswing on the other side of the Atlantic and drew attention back to the United State's expanding yield advantage over the euro area, a scenario which tends to draw further capital imports into USA. As a result, the euro weakened against the US dollar. This was also partly due to the, in some cases, disappointing economic data from this side of the Atlantic, for example, the decline in the Ifo index and the weakening of the Stability and Growth Pact, which is potentially detrimental to the euro. As this report went to press, the euro was trading at US\$1.28, almost 6½% below its highest level at the end of 2004.

In the second quarter of the year, the euro-yen exchange rate remained for a time largely within a relatively narrow corridor of between ¥137 and ¥140 per euro. The lack of movement in the exchange rate may be due, in part, to the fact that in the past few months the Japanese economy has conveyed just as mixed a picture as that of the euro area. In particular, news of the decline in the Japanese trade surplus was seen as an additional risk for the Japanese economy, which had hitherto been materially bolstered by exports. However, speculation about possible changes to the Chinese monetary system also influenced the yen. Thus, at the end of April, the euro fell against the yen as speculation intensified about a forthcoming appreciation or flexibilisation of the renminbi. The markets assumed that this would mean that in other Asian countries, such as Japan, political resistance to an appreciation of their own currency would falter. Consequently, as this report

*... against the
yen ...*

went to press, the euro was trading at ¥136, almost 4% below its highest level at the turn of the year.

... and against the pound sterling

Following a weak period at the beginning of the year, the euro managed to gain against the pound sterling up to mid-March before depreciating again. As is so often the case, the euro-pound sterling rate mimicked the euro-dollar rate movements. Moreover, initial expectations of an interest rate cut in the United Kingdom were transformed in the course of the second quarter into speculation about an interest rate increase and this also played a role. In the light of renewed uncertainty about the British economy, the euro has recently gained ground again against the pound sterling. As this report went to press, it was trading at £0.68, which was approximately its level in mid-February.

New members in ERM II

At the beginning of May, three new EU countries – Latvia, Malta and Cyprus – joined the exchange rate mechanism (ERM II). The central rates against the euro were set at LVL 0.702804, MTL 0.429300 and CYP 0.585274. The exchange rates may fluctuate within a $\pm 15\%$ band around these central rates. Latvia has unilaterally undertaken to observe a smaller fluctuation band of 1%. When it joined ERM II, Malta relinquished its former peg to a currency basket. It has unilaterally agreed to maintain its currency's exchange rate at the central rate.

Effective exchange rate of the euro

The exchange rate movements against the US dollar and the pound sterling were key factors behind euro's appreciation, on average,



against the currencies of 23 trading partners – including the new ERM II members – up to mid-March, and its subsequent decline. As this report went to press, the euro was 4% below its highest level at the end of 2004. Overall, this balanced out the competitive losses suffered by euro-area suppliers last year as a result of exchange movements.