Global and European setting

World economic activity

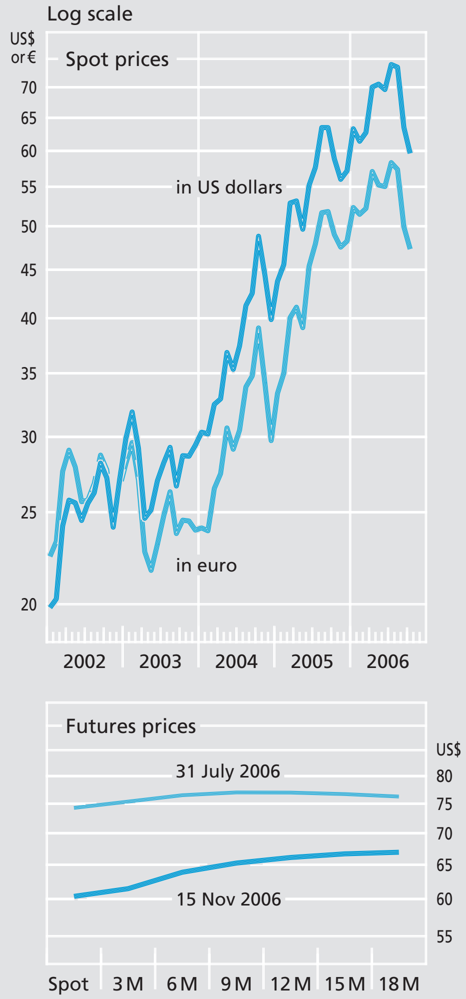
World economy growing somewhat more slowly …

While the world economy remained on its growth path in summer 2006, regional expansionary forces continued to shift. The pace, however, has slackened compared with the very strong spring performance. This applies particularly to the industrial countries. For instance, the third-quarter real gross domestic product (GDP) of the triad of industrial economies was ½% up on the period (after seasonal adjustment) following rises in the first two quarters of the year of 1% and ¾% respectively. One reason is that total output in the United States – where residential construction has continued to cool down sharply – grew much more weakly. In essence, however, the US economy continued to point upwards; private consumption, commercial investment and exports all picked up noticeably once again. The other is that euro-area growth, which was particularly buoyant in spring owing, among other things, to various special effects, fell off in the third quarter. By contrast, the Japanese economy remained on the flatter growth path which it had begun to follow in the second quarter.

… but still on a stable path

The preceding rise in short and long-term interest rates in the industrial countries is one factor that is likely to have helped make global growth more moderate in the third quarter. Another factor was the dampening impact of the sharp rises (which lasted into the summer) in energy prices. In the first eight months of 2006, the price of Brent crude oil, quoted in US dollars, rose by 28½%. The rising prices of industrial raw materials, which in fact increased by well over

World market prices for crude oil*



Sources: Thomson Financial Datastream and Global Insight. — * Price for a barrel of Brent crude oil.

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one-third over the aforementioned period, put an additional strain on the economy. The sharp falls in prices on the oil markets in August and September, however, lent additional support to the global economy in autumn. In addition, the favourable share price developments in some countries are likely to have positively influenced domestic demand. Above all, most of the current indicators point to a continuation of the process of global growth at a measured pace.

Continued fast pace of growth in emerging market economies

Economic developments in the emerging market economies continue to show a positive picture. In the south and east Asian emerging market economies, economic momentum seems to have slowed down only very little. Real GDP growth in China, for instance, was once again very strong (up 10½% on the year), yet failed to match its spring pace (+11¼%). The economies of the oil-producing countries in the Middle East and the Commonwealth of Independent States (CIS) continued to run at a rapid pace. Throughout the reporting period, most South American countries, especially oil producers Venezuela and Mexico, likewise profited from high commodity prices. However, the Brazilian economy was throttled in the third quarter by monetary policy which – despite numerous interest rate reductions – was still restrictive and by the preceding sharp appreciation of the real. This resulted in a reduction in consumer price inflation by three percentage points to 3.3% in the January to October 2006 period.

Oil markets calmer from the beginning of August

Oil market developments abruptly reversed themselves in the third quarter. Prices fell from their early August peak of US$78 to US$60 (for a barrel of Brent) in the second half of September. This represents a decline of one-quarter. In October and the first half of November, oil prices fluctuated around the US$60 mark. Euro-denominated prices fell at a similarly sharp rate in the past few months. As this report went to press, a barrel was trading at €47. Various factors which caused the high risk premium previously included in the quotations to shrink drastically were key to the distinct fall in oil prices. The easing of tensions in various Middle Eastern flashpoints was one such factor. Another was that the renewed severe hurricane season forecast for the Gulf of Mexico failed to materialise. Additional factors included quite ample inventory stocks in the United States and only relatively minor disruptions to oil supplies from Alaska, where oil pipelines had sustained damage during the summer months. Industrial raw materials, by contrast, traded at a new record high level on average for the month of October. This was due mainly to increased prices for non-ferrous metals, which were up by four-fifths on the year. As of late, cereal crop failure, in particular, has also caused a visible upturn in the global market prices for foods.

Price developments in industrial countries influenced by lower oil prices

The decline in oil prices has visibly curbed inflation in the industrial countries in the past few months. In addition, the year-on-year rate of change in consumer prices was pushed downwards by the sharp rise in energy prices in the third quarter of 2005, which was primarily attributable to the hurricane damage to the oil rigs in the Gulf of Mexico. Both factors, in concert, led to energy prices in the industrial countries being somewhat down on the year in the September to October period. Annual headline inflation therefore fell from 2.9% in August to 1.8% in September and 1.5% in October. Core inflation (excluding energy and food), by contrast, held steady at 1.8% in September (more current information is not yet available). On account of the slide in oil prices a year ago, among other factors, energy prices and thus the year-on-year rate of change in overall consumer prices appear to be heading back up in the November to December period.

Falling oil prices boosting the world economy

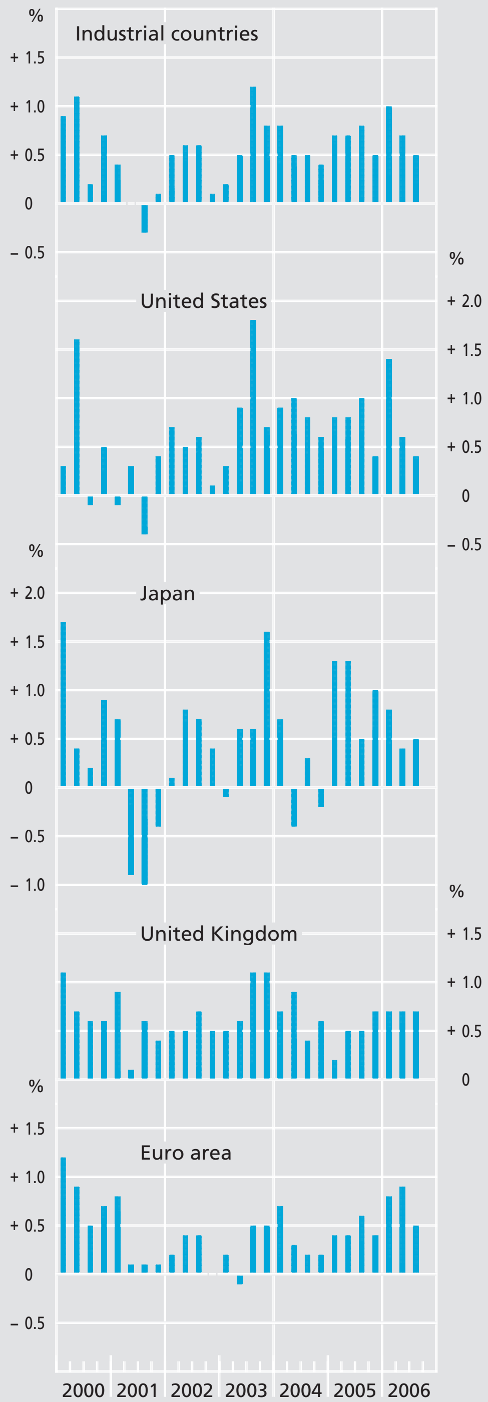
The current state of calm in the oil markets also represents a considerable gain in purchasing power for consumers in the oil-consuming countries. Enterprises have seen their cost pressures abate appreciably. Although this contrasts with a decline in the oil-producing countries' oil revenue, this is not likely to limit demand accordingly, at least not in the short term; a reduction in the high saving ratio is the more likely outcome. Forward quotations, however, appear to indicate that a renewed rise in oil prices should be expected in the medium term. This is also consistent with forecasts of a further increase in the global demand for oil.

IMF autumn forecast

However, were the oil price to hold steady at its current level of around US$60, this would protect the IMF's September 2006 global growth forecast – which had still assumed that oil prices would hit US$75½ in 2007 – against downside risks. The IMF projects a minimal decline in global GDP growth from just over 5% in the current year to just under 5% in 2007. Real global trade is expected to grow by 7½% in 2007 compared with 9% in 2006. The IMF's September forecast expects the advanced economies to see growth slow down from 3% to 2¾%. Consumer price inflation is forecast to fall by ¼ percentage point to 2¼% next year. Given the current state of oil prices, external price pressures are likely to be weaker than the IMF expects; by contrast, however, home-grown price pres-

Growth trends in industrial countries*

Seasonally adjusted, quarter-on-quarter change



* The United States, Japan, the United Kingdom and the euro area.

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sures could potentially become stronger given the cyclical stability, the rather high capacity utilisation in some sectors and favourable labour market developments. The falling oil prices will probably also either slow down or stop the rise in the US current account deficit that has been persisting since 2001. Nevertheless, the large external imbalances represent a significant source of risk to the global economy. The unpredictability in the oil markets is another factor. In addition, the corrections in the property markets of some industrial countries, most prominently the United States, could turn out to be larger than hitherto suggested.

USA

According to preliminary calculations, real GDP in the United States grew only moderately – by just under ½% – in the third quarter of 2006 after seasonal and working-day adjustment. It was up by slightly less than 3% on the year. The main reason for the slower pace of growth was that the decline in housing investment accelerated from -3% in the spring to -4¾%. The year-on-year decrease was 7¾%. Although the rapid adjustment of new housing construction to reduced demand for housing is currently putting a strain on US growth, it could help to stabilise the ailing property market and, in particular, to prevent a major slide in house prices, which would have more severe consequences for the US economy. The US domestic economy received a continued boost from private consumption and commercial investment in the third quarter. Real consumption expenditure once again grew faster than in the past, at a seasonally adjusted ¾%. Increased car purchases owing to new discount offers by US car manufacturers after the middle of the year had a significant impact. At -½%, the saving ratio remained virtually unchanged. Commercial investment grew by a seasonally adjusted 2% and thus at around double its second-quarter pace. Demand for buildings as well as for new machinery and equipment (including software) contributed in equal measure to this growth. The positive earnings trend and continued favourable financing conditions are particular indicators that investment activity will remain brisk.

An additional perceptible boost to growth was provided by exports which, after the elimination of seasonal influences, were up by a further 1½% on the period. However, this was offset by an acceleration in import growth from ½% in the second quarter to 2% in the third. This consequently led to a renewed expansion of the deficit in real net exports, which reached a new all-time high in terms of value. As in the two preceding quarters already, it made up 5½% of GDP.

Owing to the fall in energy prices, consumer prices in the USA were down in both September and October by 0.5% on the month after seasonal adjustment. On account of the inflationary surge in 2005 in connection with the hurricane damage sustained by the oil production facilities in the Gulf of Mexico, year-on-year headline inflation even went down from 3.8% in August to 2.1% in September and 1.3% in October. Core inflation (excluding energy and food), however, remained quite high, averaging 2.8% over the two months. This was due in large part to the sharp rise in rents (including imputed rents for owner-occupied housing) and the perceptible increase in private healthcare costs. By contrast, the core personal consumption expenditure deflator, which is the US Federal Reserve's preferred instrument for price analysis, fell slightly to 2.4% in September.

Japan

In the third quarter, growth in the Japanese economy was once again ½% higher (after seasonal adjustment) than in the previous period and thus slightly more than its potential rate. It was up by 2¾% on the year. The main reason for the increase in total output was the sharp rise in exports (by a seasonally adjusted 2¾%), which is also likely to have been connected with the perceptible depreciation of the yen. With imports remaining virtually unchanged, foreign trade contributed – on balance – nearly ½ percentage point to GDP growth. In addition, inventory stocks were increased significantly. By contrast, the net stimuli from domestic final demand were negative. The expansion of commercial investment, which continued to be quite strong, was offset by a significant decline in private consumption and government investment. Private sector expenditure on new residential construction stagnated. The decline in the GDP deflator slowed down from -1¼% in the second quarter to -¾% in the third. The most important outcome of the conversion of the consumer price index from the previous base year (2000) to 2005 was that the rate of inflation over the past few years was revised downwards considerably. For the second quarter of 2006, inflation was pushed down by ½ percentage point to +0.2%. On an average of the July to August period, however, inflation in Japan grew to 0.6%. It remained at this level in September, too. The fall in US dollar-denominated oil prices had a less pronounced impact on overall inflation than in other industrial countries owing *inter alia* to the yen's depreciation.

United Kingdom

In the United Kingdom, real GDP – which was up by ¾% on the period according to initial calculations and after seasonal and working-day adjustment – continued its brisk growth in the third quarter. It was up by 2¾% on the year. The services sector, which saw its real value added likewise go up by ¾%, again provided strong stimuli. Manufacturing output and energy production increased at the same pace. Construction output grew by ½%. The buoyant growth in real retail sales (excluding motor vehicles) in the third quarter – information on demand components is not yet available – suggests that private consumption continued to drive the UK economy. Headline inflation decelerated only slightly in the September to October period to 2.4%, thus remaining above the UK government's inflation target of 2%. In terms of the overall index, the sharp drop in energy prices was partly offset by an increase in core inflation (excluding energy and unprocessed food) from 1.4% in August to 1.6% in the September to October period. According to the Halifax index, house prices picked up again in seasonally adjusted terms after having fallen in May and June. In the August to October period, housing prices were 8½% up on the year. To stem the home-grown inflationary pressures, the Bank of England raised its bank rate by an additional 25 basis points to 5.0% in early November.

New EU member states

Economic activity slackened in the summer months in the new EU member states. For instance, industrial output slumped to 1½% in the third quarter, having stood at 2¼% and 4% respectively in the two preceding quarters; nevertheless, its year-on-year growth was 11¼%. This suggests that, in the third quarter, real GDP also no longer grew as strongly as in the two preceding quarters. Despite slower productivity growth, the new member states still continued to make good progress in reducing unemployment. In the July to August period, the unemployment rate, at just over 12%, was ¼ percentage point lower than in the second quarter. Headline inflation hit 2.8% in August, its highest level since the second quarter of 2005. Lower oil prices caused the inflation rate to go down to 2.5% in the September to October period. One of the main reasons why the decline was not more pronounced was that inflation in Hungary picked up from 4.7% in August to 6.1% in the September to October period owing to the depreciation of the forint as well as increases in administered prices.

Macroeconomic trends in the euro area

GDP growth down slightly in the summer quarter

Cyclical growth in the euro area continued to solidify in the summer quarter. Although it was not quite possible to keep up the fast second-quarter pace, output growth, at ½% after seasonal adjustment, was still more or less at its potential rate. Year-on-year GDP growth stood at 2½%. The somewhat slower pace is due chiefly to a slackening of overall output in Germany and a lull in growth in France. It must be borne in mind that the very rapid acceleration of euro-area GDP in the second quarter was influenced by special factors. Chief among these was the sharp rise in construction output in various member states following considerable weather-related disruptions in early 2006. For the fourth quarter of 2006 and the first quarter of 2007, the European Commission, in its short-term projection, presumes that the slowdown will continue, with a growth dip forecast for early 2007 owing to the expected decline in demand in Germany following the planned VAT increase.

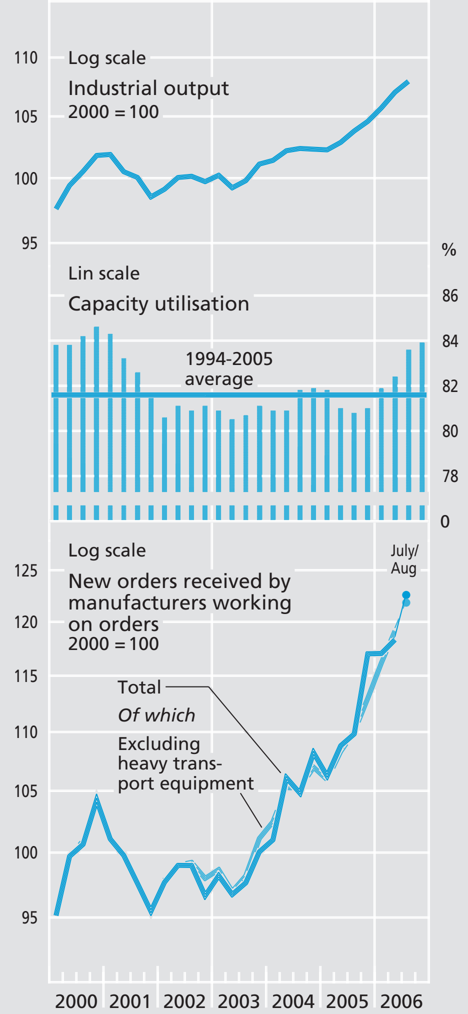
Industrial activity still lively

The expansion of industrial output once again made a significant contribution to euro-area countries' GDP growth in the summer months. On average for the July to September period, output was up by 1% on the quarter after seasonal adjustment and by 4% on the year. The production of non-durable goods stagnated over this time, whereas output growth in the other areas of production was above average. Compared with the first half of 2006, however, industrial output growth has lost some of its momentum. Capacity utilisation in manufacturing continued to rise after mid-year; in October, it had almost returned to its very high level of January 2001. Industrial orders received in the July to August period were up by 3½% on the quarter after seasonal adjustment and by 12% on the year. Excluding other transport equipment, where large orders (especially of aircraft) have a strong impact, orders were up by just over 2% after seasonal adjustment.

In the July to October period, manufacturing confidence once again tended to improve,

Selected indicators of industrial activity in the euro area

Seasonally adjusted, quarterly



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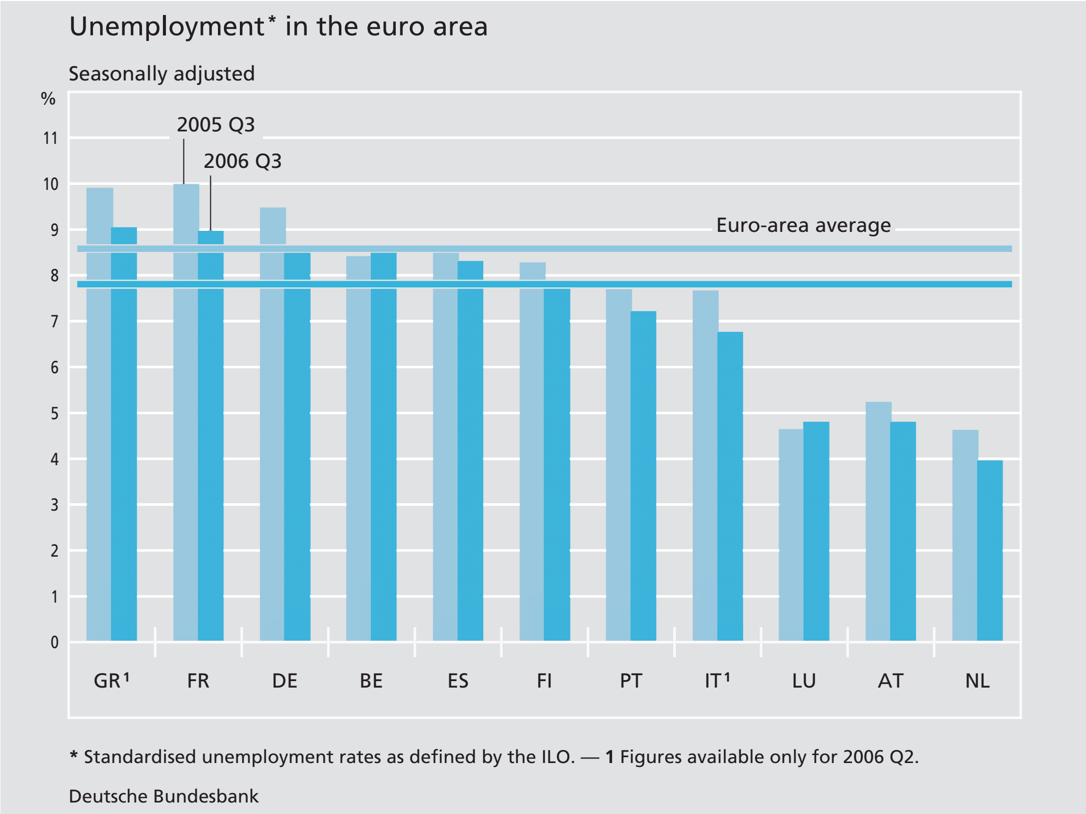
with the positive balance of responses standing at a level just slightly below the all-time high of May 2000; this is consistent with the image of a continuation of sound industrial activity. The favourable business climate was bolstered by all three sub-components: higher output expectations and an improved assessment of the orders situation and warehouse stocks. The export outlook, which forms part of the quarterly survey of firms,

Outlook still assessed favourably



was assessed with as much confidence in October as it had already been in July and April. The indicators of sentiment in the services sector, retail trade and construction industry likewise continued to rise after mid-year amidst, at times, perceptible monthly fluctuations. This contrasts to a degree with the lack of further improvement in consumer confidence between July and October, even though it remained higher than its average of the second-quarter months.

Buoyant domestic demand

From a demand-side perspective, domestic demand – according to the available partial data (information on the national accounts components is not yet available) – was probably once again the main driver of third-quarter economic growth in the euro area. For instance, real retail sales (excluding motor vehicles) in the euro area rose by ½% (after seasonal adjustment) in the third quarter following an identical rise in the second quarter. The year-on-year increase was 1¾%. Durables were in particular demand, while sales of food tended to be sluggish. The rather strong growth in demand in the retail trade sector contrasted with a visible decline in the demand for cars, however; in the July to October period, new registrations were down by 2% (after seasonal adjustment) on their second-quarter level and by 1½% on the year. According to the EU survey, euro-area construction investment remained on a distinct upward trend in the summer months.

High degree of momentum in foreign trade

Nominal exports grew quite sharply in the July to August period, up by a seasonally adjusted 1½% on their second-quarter level.

Buoyant foreign business thus remained a key pillar of euro-area economic growth throughout the reporting period. At the same time, however, imports rose by 5¼%; consequently, the balance of trade over the combined two-month period closed with a deficit of €5 billion after seasonal adjustment. The sharp increase in the value of imports is certainly largely attributable to rising energy prices, which hit a new all-time high in August. Real imports of goods, however, are also likely to have picked up distinctly.

Rising employment – falling unemployment

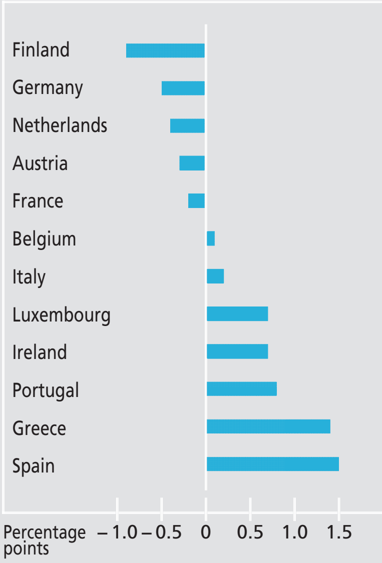
The economic upswing is having an increasingly positive impact on euro-area countries' labour markets. In the second quarter of 2006 – more recent information is not yet available – the number of employed persons rose by ½% after seasonal adjustment. Year-on-year growth stood at 1¼%. Although the decline in unemployment – which is measured using the international standard ILO definition – decelerated somewhat in the summer months, the unemployment rate in the third quarter, at 7¾% after seasonal adjustment, was much lower than a year earlier (8½%), however. Despite the improvement in labour market conditions, wage growth remained subdued. In the second quarter of 2006, the most recent period for which information is available, it stood at a seasonally adjusted ½%. Year-on-year wage growth held steady at 2½%.

Decelerating price increases

Following the relatively strong price surge in the early months of the year (+0.8% compared with the first quarter after seasonal adjustment), euro-area consumer prices again grew somewhat more slowly in the third quarter of 2006 (+0.5%). Year-on-year growth in the Harmonised Index of Consumer Prices (HICP) accordingly fell by 0.4 percentage point to 2.1%. The much weaker growth of energy prices was the chief reason for this decline. Although the rise in the prices of unprocessed food, which was exceptionally sharp for the season, formed a counterweight of sorts, it was not enough to offset the decline in the overall index. Excluding the relatively volatile energy and unprocessed food components, prices rose by a seasonally adjusted 0.4% in the summer months – a rate similar to that of the preceding quarters. The year-on-year rate of increase remained unchanged at 1.5%. The moderate price tendencies of the past few months persisted in the case of processed food, industrial goods and services alike. Year-on-year HICP infla-

Inflation differentials in the euro area*

2006 Q3



* Change in the Harmonised Index of Consumer Prices compared with 2005 Q3; deviation of the national rate of inflation from the euro-area average.

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tion, having already dropped to 1.7% in September owing to falling oil prices and the countervailing price movements of a year earlier, went down further to 1.6% in October. Over the somewhat longer term, however, this tendency is not expected to continue.