

## Global and European setting

### World economic activity

---

The world economy continued to grow strongly in the fourth quarter. Its pace picked up again after having slackened in the summer months, particularly in the industrial countries. This was due chiefly to the visibly stronger growth in the United States, Japan and the euro area towards the end of the year. Owing to similarly buoyant developments in all three of the aforementioned economic regions, growth differentials in the fourth quarter were lower than they had been for a long time. All in all, real gross domestic product (GDP) in the industrial nations rose by an estimated 1% after seasonal adjustment from its level in the third quarter, in which it had risen by ½%. This results in a rate of increase of 3% for 2006 as a whole compared with 2½% in 2005.

*World economy remains on growth path*

It must be noted that the 2006 fourth quarter results for the United States and the euro area were influenced by the exceptionally mild weather, which benefited construction output, in particular. In addition, the anticipatory effects of the increase in value added tax in Germany also had a positive impact on foreign trade partners via higher imports. Moreover, employment continued to increase at a rapid pace worldwide, thus lending even more stability and continuity to the upturn. Global growth received an additional boost from the decline in oil prices, which began in August and, thereafter, visibly bolstered the purchasing power of consumers in the oil-consuming countries while relieving enterprises of a cost burden. The sharp share price rises in the industrial countries are also likely

to have stimulated household demand. Both effects combined to form a counterweight – especially in the United States – to the extremely sluggish market for residential property, which led to a renewed distinct decline in construction output. Against this background, the risks of a housing market-induced sharp downturn in US growth, which would certainly also hit the global economy as a whole, are now being assessed as much smaller than just a few months ago.<sup>1</sup>

*Continued favourable outlook for 2007*

The generally positive global economic outlook is also reflected in a further increase in the OECD's composite leading indicators for the OECD area and the major non-OECD countries at the end of 2006. In a similar development, the International Monetary Fund, in January, confirmed its September 2006 forecast anticipating a further 5% increase in global GDP for this year. The world economy is therefore in one of its most dynamic phases of growth since the 1950s. Owing, in particular, to the rapid growth of the emerging market economies, the average growth rate over the 1998-2007 period, at just over 4%, is  $\frac{3}{4}$  percentage point higher than over the 1988-1997 period.

*Emerging market economies still very buoyant*

The emerging market economies maintained their strong upward trend throughout the reporting period, especially the South and East Asian regions. Real GDP in China in the fourth quarter of 2006 was up by 10½% year-on-year. Output growth averaged 10¾% for the year. The slight slowdown in growth over the course of the year is attributable particularly to government measures to curb the investment boom. Consumer price

inflation, which had accelerated to 2.8% year-on-year at the end of 2006, was much more moderate again in January (2.2%). The growth curve of the oil-producing countries in the Middle East and the Commonwealth of Independent States continued to point sharply upwards throughout the reporting period. The decline in export income associated with the lower oil prices does not yet seem to have dented overall economic growth in the two groups of countries. In the short term, the more likely scenario would appear to be a fall in the high aggregate saving ratio.

Latin American oil producers Venezuela and Mexico continued to experience robust growth, supported by persistently high crude oil revenues. Other countries in the region once again received a strong boost from exports of industrial raw materials and food. Commodities account for an average of around 40% of Latin American exports. Brazil, the region's largest economy, regained momentum in the autumn quarter after having grown by only ½% on the period in the summer quarter. At all events, industrial output grew perceptibly towards the end of the reporting period.

*Oil markets steady*

Oil prices remained exceptionally calm in the fourth quarter – in contrast to the preceding periods. Brent crude oil traded in a relatively tight band around the US\$60 mark from early October until well into November. Following OPEC's decision to further reduce production with effect from 1 February 2007, oil prices rose to as much as US\$64½ per barrel at the

---

<sup>1</sup> See Deutsche Bundesbank, Financial Stability Review, November 2006, pp 14-16.

end of November and in early December. However, oil prices receded as of mid-December. At the beginning of the year, prices began to fall even faster, tumbling to US\$51½ by mid-month. However, they subsequently turned around, rising to US\$56½ by mid-February. In euro terms, the price for a barrel of Brent crude oil stood at €43 as this report went to press. The further price decline following the turn of the year was due mainly to the mild weather in Europe and the north-east of the United States as well as – in a related development – the abundant inventory stocks in the USA. In addition, the first OPEC decision to cut production, which had entered into effect on 1 November 2006, was probably implemented only in part. Throughout the past few months, quotations on the futures markets have consistently exceeded spot prices. This means that crude oil prices are expected to go back up in the medium to long term.

*Continued bullishness in the case of other commodities*

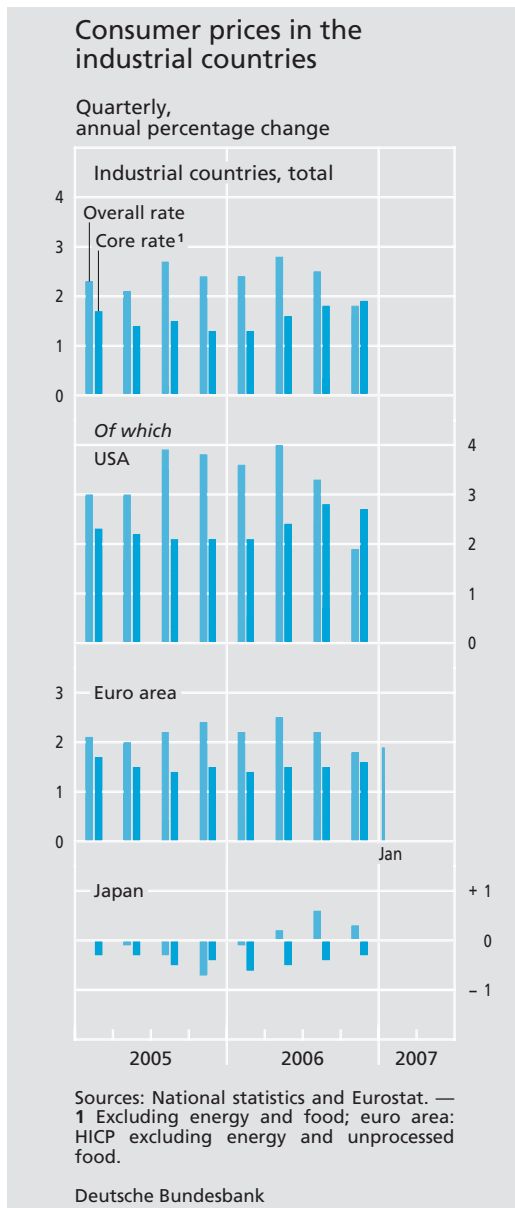
By contrast, the prices of industrial raw materials, denominated in US dollars, have continued their upward trend in the past few months, reaching an all-time high at the end of January. However, owing to a base effect, the year-on-year increase fell from 46½% in July 2006 to 26%. In the autumn months, the world market prices for food, beverages and tobacco likewise rose sharply, particularly in connection with the short supply of cereals. At the beginning of the year, prices continued to rise at a slower pace. In January, US-dollar-denominated cereal prices were 47½% higher than a year earlier.

Owing to the fall in oil prices in the last third of 2006, consumer price inflation in the in-



dustrial countries slackened noticeably. At 1.8% year-on-year in the fourth quarter, consumer price inflation was ¾ percentage point down on the summer quarter and around 1 percentage point below the second quarter rate. Annual average inflation – as in the preceding year – stood at 2.4%. By contrast, domestically generated price pressures continued to rise in the last months of 2006. Core inflation (excluding energy and food)

*Calmer price movements in industrial countries*



stood at 1.8% in December compared with 1.3% in early 2006. For the year as a whole, core inflation rose slightly to 1.7%. Year-on-year consumer price inflation in the industrial countries is likely to have diminished in January owing to the sharp fall in oil prices.

According to initial calculations, GDP growth in the USA accelerated to just under 1% in the fourth quarter of 2006 after seasonal and

calendar adjustment, after having slumped to ½% in the two preceding periods. Output was 3½% higher than in the autumn 2005 quarter. The growth rate for the year as a whole was likewise 3½%. A considerable increase in household demand for consumer goods (+1% after seasonal and calendar adjustment) was the main reason for the more dynamic end-of-year activity. There was an increased demand for non-durable goods and furniture, while real expenditure on cars fell slightly. The greater propensity to purchase was fostered by a strong rise in real disposable income. This also reflects oil price-related gains in purchasing power. At the same time, the saving ratio improved from -1¼% to -1%. Demand from the government also provided considerable expansionary stimuli. Unlike in preceding quarters, however, commercial investment showed no further growth as this report went to press, and investment expenditure on housing construction fell once again by around 5% on the quarter and 12½% on the year. Exports, which grew by 2½% after seasonal adjustment, formed another key pillar of economic activity alongside private consumption and public expenditure. Real imports decreased by ¾% at the same time and so the external deficit fell sharply. This led to an imputed growth contribution of just under ½ percentage point.

Around the turn of 2006-07, the economic indicators in the United States were largely positive, which means that the outlook for a “soft landing” of the US economy has become entrenched. For instance, consumer confidence rose significantly, employment continued to grow, and new orders received

by industry picked up distinctly once again in the November-December period. The more favourable signals recently sent out by the housing market and the construction sector are also noteworthy. Among other things, the number of housing construction permits went back up in December for the first time in a long while, and sales of new dwellings likewise picked up. However, the mild winter weather in the north-east of the United States may well also have been a factor in this development.

US consumer prices in the fourth quarter of 2006 were 0.5% down on the summer quarter after seasonal adjustment, due mainly to the sharp fall in energy prices. Year-on-year inflation stood at 1.9% following 3.3% in the third quarter. The rate of price increase for 2006 as a whole was 3.2%. Excluding energy and food, seasonally adjusted prices still rose in the fourth quarter, albeit much more slowly than in earlier quarters. At 2.7%, core inflation was somewhat down on the third quarter. At 2.5%, however, overall inflation for 2006 was higher than at any time since 2001. The sharp rise in housing rents (including imputed rents for owner-occupied homes) and the continued rise in healthcare costs were major contributing factors. The core personal consumption expenditure deflator fell from 2.4% in the third quarter to 2.3% in the fourth.

*Japan*

The Japanese economy grew at a considerably faster pace in the fourth quarter of 2006 after having slowed down sharply in the summer half of the year. Real GDP was up by a seasonally adjusted 1¼% on the period and

2% on the year. In 2006 as a whole, overall economic output rose by 2¼% compared with 2% in 2005. In the fourth quarter, total production was driven particularly by private consumption, which was up by a seasonally adjusted 1% on the third quarter, in which it had decreased at the same rate. In addition, private gross fixed capital formation accelerated far more strongly than in the summer quarter. General government demand also had a positive impact on GDP growth at the end of 2006; it was up by a seasonally adjusted ½% after having fallen noticeably in the preceding quarters. Total domestic demand contributed 1 percentage point to growth. Real exports in the fourth quarter were a seasonally adjusted 1% up on their already high level. With imports remaining unchanged, foreign trade made a net contribution of ¼ percentage point to GDP growth.

Average fourth-quarter consumer prices were 0.3% down on the preceding period after seasonal adjustment. Year-on-year consumer price inflation fell from 0.9% in August to 0.3% in December owing to the decline in oil prices in the last third of 2006. Excluding energy and food, prices continued their year-on-year decline in the last quarter of the year but, at 0.3%, they fell at a somewhat weaker pace than in the summer half of the year.

According to initial calculations, real GDP in the UK grew in the fourth quarter of 2006 – the fifth period in succession – by ¾% on the period after seasonal and calendar adjustment. Its year-on-year growth was 3%, with annual average growth standing at 2¾%. UK growth in the fourth quarter was supported

*United  
Kingdom*

by the services sector and construction, the real value added of each of which grew by 1% after seasonal adjustment. By contrast, the performance of the production sector (excluding construction) and agriculture fell slightly. On the demand side, private consumption – data on the individual components are not yet available – is likely to have once again been the main driving force. At all events, real retail sales (excluding motor vehicles), at a seasonally adjusted 1¼%, grew more strongly than in the summer quarter. They were 3¾% up on their end-2005 level. The continued buoyancy of consumption has now begun to be reflected in increased price pressures. This led the Bank of England to raise the Bank Rate further to 5¼% in January. Consumer price inflation (HICP) hit 3.0% in December, its highest level since the end of 1995, although the increase in mineral oil tax at the beginning of the month figures prominently here. Consumer price inflation fell to 2.7% in January, however. Core inflation (excluding energy and unprocessed food) stood at 1.8% following 1.9% in December.

*New EU  
member states*

In the new EU member states (those of the 1 May 2004 enlargement round), business activity in the final quarter of 2006 seems to have maintained the somewhat more moderate yet still rapid pace that it had adopted in the summer months. At all events, industrial production, which was up by a seasonally adjusted 1½% on the summer quarter, grew more or less as strongly as before. Its year-on-year rise was 9¼%; its average growth for the year 2006 was actually 10½%. The – for the most part – strong growth in new orders received in the October-November period

suggests that the pace of industrial activity could well accelerate again. This somewhat more subdued growth in industrial production in the new EU member states in the second half of the year went hand in hand with a slowdown in unemployment reduction. At 11.9% in October, the seasonally adjusted unemployment rate was only ¼ percentage point lower than its mid-year level after having fallen by as much as ¾ percentage point in the first half of the year. Owing to the fall in oil prices, consumer price inflation diminished from a seasonally adjusted 1.3% in the third quarter to 0.5% in the fourth. The year-on-year rate was 2.5% in the last quarter of the year and the overall rate for 2006 was 2.4%.

### Macroeconomic trends in the euro area

Euro-area growth picked up distinctly again in the fourth quarter. Real GDP rose by just under 1% after seasonal adjustment following +½% in the preceding period. The main contributory factors were that total production in France, which had stagnated in the summer months, grew by well over ½% after seasonal adjustment, and that the Italian economy picked up speed considerably. Euro-area GDP grew by 3¼% from its autumn 2005 level. For the year as a whole, growth amounted to 2¾%, the highest rate since 2000.

*Faster pace of  
expansion  
in 2006 Q4*

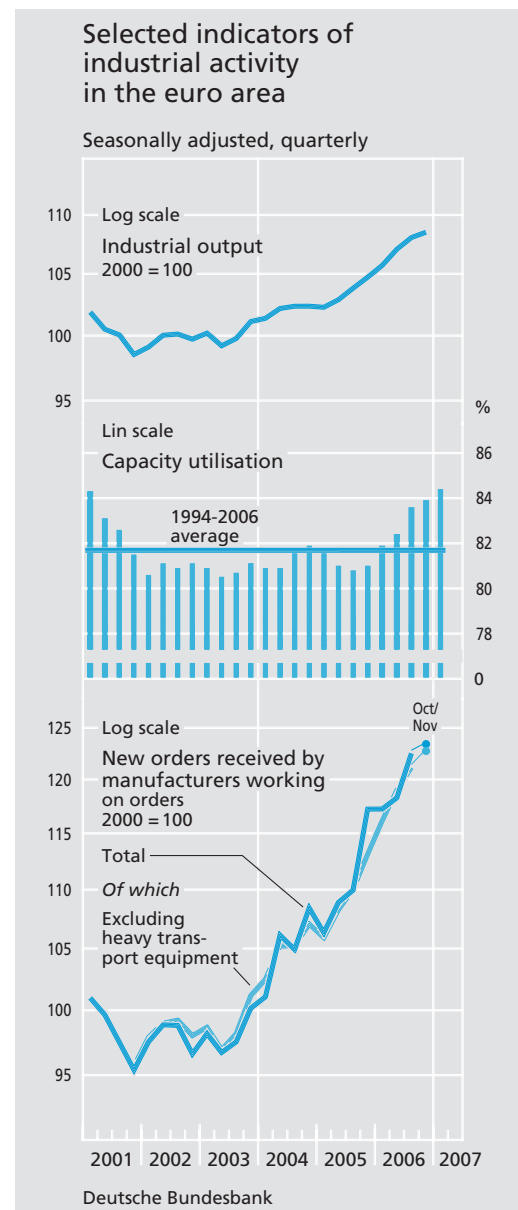
Looking at individual sectors, construction – in which activity was propelled not only by unabated demand but also by the mild weather conditions – generated considerable

*Construction  
output strong  
and industrial  
activity still  
buoyant*

stimuli in the fourth quarter. Industrial production likewise rose perceptibly. In the fourth quarter, it was a seasonally adjusted ½% higher than in the preceding period, in which it had grown by 1%. In 2006 as a whole, industrial production increased by 3¾%. Capacity utilisation in the manufacturing industry continued to grow during the October 2006-January 2007 period, thus coming very close to its autumn 2000 peak. Orders received in industry were up in October-November by a seasonally adjusted ¾% on the summer quarter, in which, however, large orders had been placed. The year-on-year increase stood at 9½%. New orders excluding the manufacture of other transport equipment, which are much less influenced by large orders, were a seasonally adjusted 1¼% higher in the two autumn months than in the third quarter of the year.

*Survey data remain favourable*

There are strong indications that the euro-area industrial sector will remain on a growth path during the current year. One is that industrial confidence hit a new all-time high in November-December. Survey data for January were only slightly less favourable. The very high expectations for production, in particular, give cause for optimism. Inventories and the orders situation were also assessed more favourably in the past few months. The results of the investment survey for October-November also suggest that investment activity in the manufacturing industry will remain buoyant in 2007. Consumer sentiment likewise continued to brighten in the November-January period, although the indicator is still far removed from the levels reached in the second quarter of 2000.



According to the available detailed data – aggregated information on the demand components in the national accounts is not yet available – overall demand in the euro area grew exceptionally vibrantly in the fourth quarter. Although real retail sales (excluding motor vehicles) rose by only ¼% on the period after seasonal adjustment and thus by 1½% on the year, seasonally adjusted purchases of cars rose sharply – especially be-

*Vibrant consumer demand and strong export growth*



### Euro-area consumer prices

#### Annual percentage change

Item	2006			
	Q1	Q2	Q3	Q4
HICP, total	2.3	2.5	2.1	1.8
<i>of which</i>				
Energy	12.2	11.6	6.3	1.5
Unprocessed food	1.4	1.6	3.9	4.1
HICP excluding energy and unprocessed food	1.4	1.5	1.5	1.6
<i>of which</i>				
Processed food	2.0	2.2	2.1	2.2
Industrial goods	0.3	0.7	0.7	0.8
Services	1.9	2.0	2.0	2.1

Deutsche Bundesbank

cause of the anticipatory effects linked to the value added tax hike in Germany. The number of new passenger car registrations in the last three months of 2006 was 5% up on the year. Construction investment also grew vigorously. In addition, nominal exports once again saw strong growth in October-November; they were a seasonally adjusted 4% higher than in the third quarter and 17¾% higher than a year earlier. At the same time, imports, in terms of value, did not exceed their summer months' level; this was largely connected with declining oil prices. All in all, net exports are likely to have made a noticeable contribution to GDP growth in the last quarter of 2006.

#### Labour market

The decline in euro-area unemployment continued in the last quarter of 2006. According

to provisional Eurostat figures, on average over the autumn months, after seasonal adjustment, 11.18 million people were unemployed, 200,000 fewer than in the summer 2006 quarter. The year-on-year decline in unemployment amounted to 1.29 million. The unemployment rate fell from 8.4% at the end of 2005 to 7.6%; this is the lowest figure since the beginning of the statistical series in early 1993. The favourable unemployment development was aided by strong growth in employment. In the third quarter of 2006 – more recent information is not yet available – the number of employed persons was a seasonally adjusted 0.4% up on the quarter. Year-on-year growth stood at 1.4%. Labour market developments were particularly favourable in Germany, Finland and France. In Spain and Luxembourg, by contrast, the standardised unemployment rate rose somewhat. Despite the improvement in the euro-area labour market situation, wage growth remained moderate. At 0.5% after seasonal adjustment in the third quarter of 2006, it was actually slightly lower than in the preceding quarters. Year-on-year growth decelerated slightly to 2.2%.

After euro-area inflation had already clearly slowed down to 0.5% in the third quarter after seasonal adjustment (from +0.8% in the second quarter), prices came to a virtual standstill in the autumn months. At 1.8%, year-on-year HICP inflation fell below 2% for the first time since the first quarter of 2004. The sharp quarter-on-quarter drop in energy prices (-4.2%) was the key factor in this development. However, unprocessed food prices also rose less steeply than in the third

*Consumer prices in Q4...*



quarter. Excluding these two relatively volatile components, prices rose by 0.5% after seasonal adjustment in the fourth quarter, a minimally faster pace than in the preceding quarters. One likely contributory factor was that, in Germany, the prices of tobacco products, which are counted as processed food, were already raised sharply in October owing to the VAT increase which took effect on 1 January 2007. By contrast, the calm price trends of the past few months continued for industrial goods and services alike. Year-on-year HICP inflation excluding energy and unprocessed food rose from 1.5% to 1.6%.

... and on  
average for  
2006

On average for 2006, consumer price inflation stood at 2.2% – as in 2005 already. The somewhat weaker rise in energy prices (7.7% following 10.1%) contrasted with an accelerated rate of increase in the price of unpro-

cessed food (+2.8% following +0.8%). Excluding these two components, prices increased at a rate of 1.5%, which was similarly moderate to the preceding year. The slight abatement of price pressures in services was offset by a minute acceleration in the rate of price increase for non-energy industrial goods.

In January – for which an initial estimate based on existing country results and information on energy price movements is available – year-on-year inflation remained at a moderate 1.9%. This was mainly the result of the continued drop in oil prices. In addition, the increase in value added tax in Germany has not yet completely made its way into consumer prices. Without the VAT effect, the HICP rate would have been an estimated  $\frac{1}{4}$  percentage point lower.

*Initial estimate  
for January  
2007*