Global and European setting

World economic activity

Strong global growth in the third quarter…

In the third quarter, the world economy once again grew strongly. One reason for this was the continued fast pace of growth in the emerging market economies (EMEs). Another was that growth in the euro area and Japan went back up appreciably after having been rather sluggish or even slightly negative in the second quarter owing to one-off factors. In addition, the US economy continued to expand vigorously. In the third quarter, the effects on the real economy of the financial market turmoil that had originated in the US subprime mortgage market were restricted to housing construction. The other components of private final demand and exports grew vibrantly. At +¾% after adjustment for seasonal and calendar-day variation, the growth of real gross domestic product (GDP) in the industrial countries as a whole was stronger than in the second quarter (+½%). Year-on-year growth stood at 2½%.

… yet a certain slowdown on the horizon

However, given the correction and adjustment processes now underway in the financial markets and the renewed price surge in the commodity markets, the overall picture no longer looks as rosy for the near future. From a global perspective, however, the oil price and exchange rate effects initially only represent the redistribution or redirection of income flows. As key economic areas are otherwise in a rather robust condition, it is still not clear whether this will result in frictional demand shortfalls. However, the necessary repricing of risk exposures for certain financial products will create a certain strain, at least in the short term, even though a risk-adjusted repricing would be quite conducive to the sustainability of the global growth process in terms of allocative efficiency. This aspect also needs to be borne in mind from a stability policy perspective, especially as the global price climate has been much less friendly for some time, a phenomenon that cannot be explained by statistical baseline effects or temporary swings alone.

South and east Asian emerging market economies (EMEs) still growing at fast pace but no uncoupling

In the third quarter, the global economy once again received considerable expansionary stimuli from the Chinese economy, though its overall output growth, at 11½% on the year, did not quite match its second-quarter growth (12%). At the same time, the price climate deteriorated further. Inflation averaged 6.2% over the months from July to October, compared with 3.6% in the second quarter and 1.5% in 2006. The sharp rises in food prices are the main factor behind the strong price surge. The cyclical dynamics also remained strong in the other south and east Asian emerging market economies (EMEs). Thanks to the boom in domestic activity, the looming slowdown in export growth – caused by the slumping demand, particularly from the USA – will probably initially do little to dampen overall growth in China and the other EMEs in the area. However, there are no signs at present that the region could uncouple structurally and cyclically from the industrial countries.[1] In particular, China's imports from the other south and east Asian EMEs are highly correlated with its exports to the industrial countries.

Still benefiting from the commodity boom: CIS and ...

The rapid growth in south and east Asia, which is relatively commodity-intensive, played a major role in the sharp rise in global demand for commodities (including energy) towards the end of the reporting period. The booming retail business and record spot prices benefited the countries of the Commonwealth of Independent States (CIS), which have already been on a steep growth path since 1999. Real GDP in Russia, having been up 7¾% on the year in the second quarter, probably rose slightly less rapidly in the third quarter; at all events, year-on-year growth of Russian industrial output was much more sluggish than in the two preceding periods. Because of the sharp upward pressure on wages given strong monetary expansion and the distinct rise in food prices, consumer price inflation went back up again as of late. Year-on-year inflation stood at 9.4% in September following 8.6% in August and 7.4% in March 2007. In October, the government agreed with the major producers and retailers to freeze prices for basic foodstuffs until early 2008 and reduced import tariffs on milk and dairy products. In addition, Russia has imposed an export tariff on wheat starting in November of this year to increase the domestic supply.

... Latin America

Also, most Latin American countries were able to achieve distinct gains in earnings from commodity exports. Brazil saw not only external impulses but also perceptible expansionary stimuli caused by the distinct reduction in central bank lending rates, which boosted not only investment but also private consumption. Inflation in September ran at 4.2%

1 See Asian Development Bank, Uncoupling Asia: Myth and Reality. Asian Development Outlook, 2007, Manila, pp 66-82.

IMF forecast for 2007 and 2008

Item	2005	2006	2007	2008
Real gross domestic product	Annual percentage change			
Advanced economies 1	+ 2.5	+ 2.9	+ 2.5	+ 2.2
of which				
United States	+ 3.1	+ 2.9	+ 1.9	+ 1.9
Japan	+ 1.9	+ 2.2	+ 2.0	+ 1.7
Euro area	+ 1.5	+ 2.8	+ 2.5	+ 2.1
Consumer prices 2				
Advanced economies 1	+ 2.3	+ 2.3	+ 2.1	+ 2.0
of which				
United States	+ 3.4	+ 3.2	+ 2.7	+ 2.3
Japan	− 0.3	+ 0.3	0.0	+ 0.5
Euro area	+ 2.2	+ 2.2	+ 2.0	+ 2.0
Unemployment	Number of unemployed persons as a percentage of the labour force			
Advanced economies 1	6.0	5.6	5.3	5.5
of which				
United States	5.1	4.6	4.7	5.7
Japan	4.4	4.1	4.0	4.0
Euro area	8.6	7.8	6.9	6.8

Source: IMF, World Economic Outlook, October 2007. — **1** Including Slovenia, Taiwan, Hong Kong, South Korea and Singapore. — **2** Consumer price index; for the euro area, HICP.

Deutsche Bundesbank

compared with 3.7% in June and 3.0% in April. Even though the Mexican economy received a strong boost from rising oil prices in the past few months, oil exports were impaired by terrorist attacks and hurricanes. The further outlook is strongly dependent on cyclical developments in the United States, which absorbs a large portion of Mexico's exports of goods. Consumer price inflation in the July-October period, at 3.9%, overshot the 3% inflation target quite distinctly. Against this background, the central bank recently raised its lending rates by 25 basis points to 7.5%.

Global leading indicators somewhat weaker; IMF forecast down for 2008

According to the OECD's Composite Leading Indicators (CLI), economic activity in the OECD area will weaken somewhat. By contrast, for the large BRIC (Brazil, Russia, India and China) EMEs, the CLI continued to trend upwards. In October, the IMF confirmed its forecast of global growth in 2007 vis-à-vis the interim forecast of July at 5¼% but reduced its forecast for 2008 by nearly one-half percentage point to 4¾%. The downside risk to this prediction was assessed much higher than in the past owing to the financial market turbulence. The projection for world trade growth was scaled back perceptibly for both years and is now at 6½% and 6¾% respectively. These corrections represent, in particular, a more prudent assessment of US economic activity; the mid-year prediction that growth would accelerate from 2¼% this year to 2¾% in 2008 has now made way for a forecast of just under 2% for each of the two years. Much smaller downward revisions were made for the industrial countries as a group. The IMF staff, having still assumed in July that the industrial countries would increase their growth next year by ¼ percentage point to 2¾%, has now forecast a weakening to 2¼%. Consumer price inflation for this group of countries, according to the IMF, will fall in 2007 by 0.2 percentage point to 2.1% and in 2008 to 2.0%.

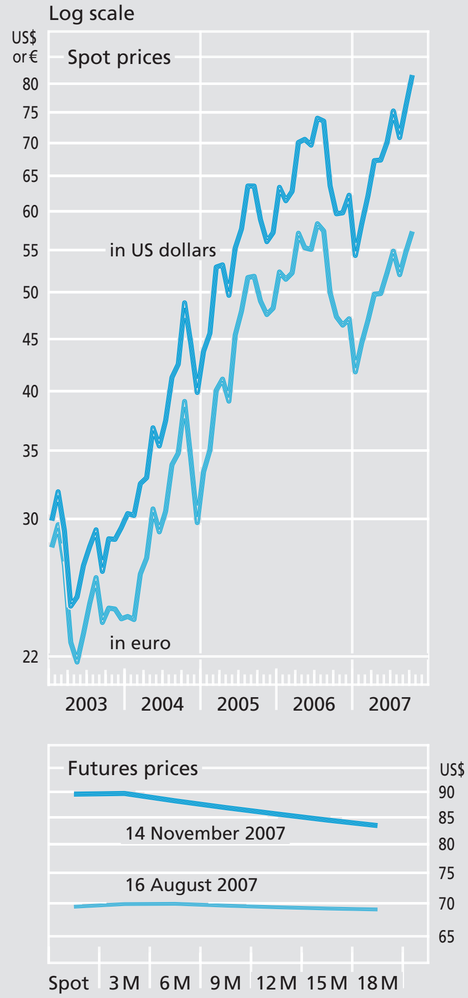
Oil price hit new peaks in early autumn

However, the IMF's price forecast for 2008 is still based on an oil price of US$75 for a basket consisting of Brent, West Texas Intermediate and Dubai oil. Oil prices have exceeded this price level by far in the past few weeks. It remains to be seen whether the growing downward disparity between forward and spot quotations, which is a signal of a certain calming in the oil markets for the near future, will actually materialise in the spot markets. Quotations for Brent crude oil, denominated in US dollars, went up by no less than one-quarter from early July to mid-November. After hitting a new all-time high of US$94¼ at the beginning of November, crude oil prices trended back down somewhat. The increase in euro terms following mid-year was not as strong (+15%) owing to the euro's distinct appreciation against the US dollar; a barrel of oil was 61¼ as this report went to press. One of the main reasons for the surge in crude oil prices was the continued growth in the demand for oil. The tight inventories in the United States and the – mostly weather-related – production stoppages in the Gulf of Mexico and the North Sea are other reasons. At last report, geopolitical factors, especially the danger of a military conflict in northern Iraq, have regained importance. In addition, speculative activity in the oil markets has risen.

Diverging trends for the remaining types of raw materials

World market prices for food, beverages and tobacco likewise continued their strong growth, going up between mid-year and early November by 14¾% in US dollar terms and 5½% in euro terms. This reflected the impact of, above all, the renewed surge in the price of grain, oilseeds and oils. By contrast, the upward pressure on prices of industrial raw materials has eased in the past few months. Denominated in US dollars, quotations in early November were somewhat lower on the month and 5¼% below their level in May, when they had peaked. In euro terms, the figure was 12%. The overall index of commodity prices (excluding energy), weighted appropriately for the euro-area member states, was at last report 7% lower (denominated in euro) than half a year earlier.

World market prices for crude oil*



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

Deutsche Bundesbank

Resurgent consumer price inflation

Developments in the oil markets have left a powerful mark on consumer price inflation in the industrial countries over the past few months. Inflation in August, given falling oil prices, decreased to 1.6%. After the turnaround in the oil markets and owing to the baseline effect caused by falling crude oil prices a year ago, consumer prices resurged in September, by 2.0% (or 2.4% excluding Japan). This tendency continued in October, as information already available for individual countries is showing. There are many signs that price pressure will continue to rise. This is mainly because the price of crude oil has continued to rise throughout the reporting period. In addition, the low refining margins of the third quarter seem to be returning to normal. Core inflation excluding energy and food held firm at 1.9% in September; excluding Japan, it went back down slightly to 2.1%.

USA

In the July to September period – according to preliminary calculations which, as experience has shown, are subject to major corrections – the US economy grew, after seasonal and calendar-day adjustment, by just under 1% on the second quarter, in which it grew at the same pace. It grew by 2½% on the year. The main factor behind the good provisional result was the buoyant growth in consumption, coming in at a seasonally adjusted ¾%; this, in turn, was buoyed by the strong growth in purchases of furniture and household appliances. This stands in stark contrast to the considerable decline in consumer confidence in the past few months. In addition, non-residential private fixed investments, especially construction, and the build-up of inventories boosted growth. Government expenditure likewise went back up distinctly. Moreover, at a seasonally adjusted 4%, real exports recorded the strongest growth in a long time, not least owing to the depreciating dollar. Given a relatively moderate rise in real imports, foreign trade made a positive contribution of one-quarter percentage point to growth. The only roadblock to overall economic growth was housing investment, the decline in which accelerated to a seasonally adjusted 5%; since last peaking at the end of 2005, its decline is now at nearly one-quarter. The current quarter is likely to see the US economy grow at a visibly slower pace. There is no end in sight to the adjustment process in housing construction. In addition, US consumption activity seemed to have lost some of its steam as this report went to press.

In September and October, consumer prices rose detectably over time (by 0.3% for each month) after having remained practically unchanged in the two preceding months. The visible rise in the prices of energy and food as well as of healthcare was the main reason. The increase in year-on-year consumer price inflation was particularly prominent owing to the marked decline a year earlier; it was up by 1.5 percentage points to 3.5%. The rise in the consumer price index excluding energy and food accelerated slightly in October to 2.2%; however, it had stood at 2.7% at the beginning of the year. The deflator for personal consumption expenditure, which has thus far been the US Federal Reserve's preferred instrument for price analysis, fell between January and September by 0.6 percentage point to 1.8%.

Japan

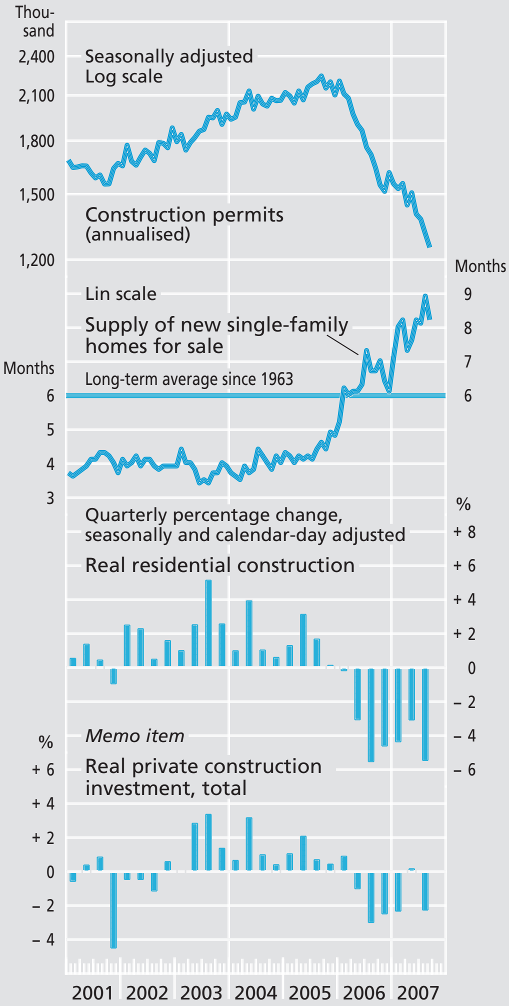
According to initial estimates, real GDP in Japan grew by just over ½% (after seasonal adjustment) in the third quarter after having shrunk in the second quarter by ½% under the influence of various special factors. Overall output rose by 2% on the year. The greater buoyancy of Japanese economic activity in the third quarter is due primarily to the strong growth in real exports, which were up by 3%

on their second-quarter levels. Given a relatively moderate increase in imports, the contribution of net trade to economic expansion stood at just under one-half percentage point, or two-thirds of overall GDP growth. At a seasonally adjusted +¼%, private consumption remained on the flat growth path onto which it had embarked in the second quarter. Commercial investment picked up again distinctly in the third quarter (+1¾%) after having fallen in the two preceding quarters. By contrast, the decline in housing investment accelerated to -7¾% on the second quarter and -11% on the year. This was linked mainly to the entry into force of new construction regulations for improving earthquake protection in June 2007, which led to a distinct slowdown in the construction approvals process and, as a result, to a contraction in housing starts. Although the permit backlog will probably dissolve soon, construction activity is expected to return to normal only gradually. Government investment likewise tended further downwards. The year-on-year consumer price inflation rate remained unchanged in September at -0.2%. The rise in crude oil price quotations was cushioned strongly by the yen's appreciation against the US dollar. In addition, consumer durables and mobile phone charges saw appreciable price reductions once more. Prices excluding energy and food were down 0.3% as this report went to press.

United Kingdom

The housing market in the United Kingdom seems to be calming down significantly. In September-October, house prices fell by a seasonally adjusted ¾% from July-August. Owing to a subsiding of construction activity

Residential construction in the United States



Sources: US Census Bureau and Bureau of Economic Analysis.

Deutsche Bundesbank

and negative wealth effects, this could put the brakes on the pace of growth in the overall economy in the coming months. There could be the added effect of slower business conditions in the financial sector due to the turbulence in the money and capital markets. In the third quarter, however, real GDP continued to grow strongly; according to initial calculations, it went up by ¾% (after adjustment for seasonal and calendar-day variations) on the previous period, in which it had grown by the same rate. The respective year-on-year growth was 3¼%. In terms of origin, the main stimuli were generated once again by the services sector, the real value added of which, at 1%, grew as dynamically as in the four preceding quarters. Construction output went up by ¾%. The value added of the manufacturing industry (excluding construction), by contrast, increased by only ¼%, and in agriculture, hunting, forestry and fishing, it was even -¾%, above all owing to the animal diseases that broke out in the third quarter. On the demand side, private consumption was probably the key pillar; at all events, real retail sales growth in the third quarter, at a seasonally adjusted 1¾% over the second-quarter months, was much more buoyant than in the first half of the year. Calmer price developments also contributed to this turn of events. For instance, the year-on-year rate of price increase fell from 2.6% in the second quarter to 1.8% in the third. Excluding energy and unprocessed food, this rate was down by one-half percentage point to 1.7%.

New EU member states

In the eleven new EU member states (excluding Slovenia, which joined the euro area on 1 January 2007), the strong economic growth persisted in the third quarter. After seasonal adjustment, third-quarter industrial output was an estimated 1½% up on the period and 7¾% up on the same period a year earlier. Among the major economies in this group of countries, Hungary saw a particularly sharp jump in industrial output in July-August (information is not yet available for September) on the second quarter. This provides evidence of a revival of GDP growth, which had flagged quite significantly in the first half of the year in response to the measures required in order to consolidate public sector budgets. Rising prices for energy and food caused an appreciable rise in consumer price inflation in the new EU member states, from 3.9% in August to 4.4% in September and 5.2% in October. As this report went to press, Latvia and Bulgaria were once again recording double-digit price increases, while inflation in Malta remained below the 2% mark.

Macroeconomic trends in the euro area

Third-quarter dip in growth overcome

Euro-area economic growth in the third quarter, seasonally adjusted, went back up to ¾% after having been rather low a quarter earlier, at ¼%, owing to special factors. Overall economic output was up by 2½% on the year. More buoyant activity in Germany and France made a key contribution to the vibrant activity in the summer months. GDP growth in Italy, too, was up on the second quarter, yet it remained short of the euro-area average. Spain's economy likewise grew sharply, albeit at a visibly more moderate pace than in the first half of the year. All in all, the financial market turmoil did not lead to any perceptible burdens on the real economy in the third quarter. For the current quarter, however, the available leading indicators are pointing to somewhat more subdued economic growth.

Sharper upturn in industrial activity in third quarter

In terms of origin, the stronger GDP growth in the third quarter is particularly the work of more lively growth of industrial output, which was up by a seasonally adjusted 1½% from its second-quarter figure. Producers of capital goods and consumer durables, as well as energy producers, fared better than average, whereas the production of intermediate goods and non-durable goods grew distinctly more slowly. Capacity utilisation in manufacturing was very high throughout the reporting period, which is consistent with a picture of brisk industrial activity. It is true that orders received in the manufacturing industry rose fairly sluggishly in July-August in terms of volume (+¼%) on the second quarter, in which an above-average number of large orders had been received.[2] However, excluding "other transport equipment", where the large orders have their greatest effect, the result is an increase of 2¾% in orders received (see also the box on page 20).

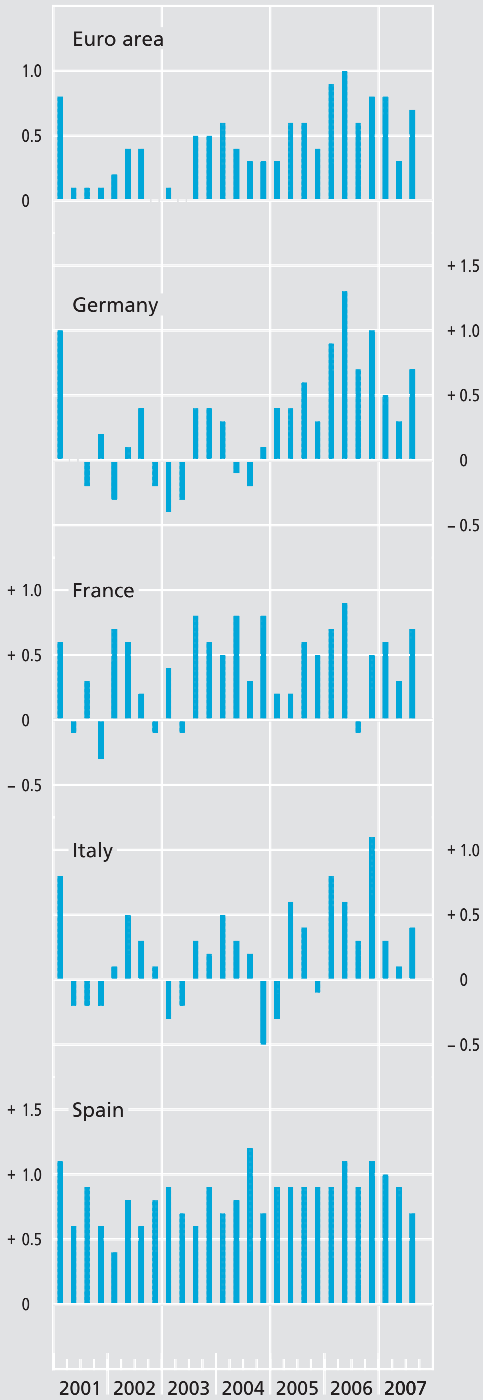
Survey results no longer as favourable

However, going by the results of important surveys of economic activity, the fast pace of economic growth in the industrial sector is not expected to continue. For instance, the Purchasing Managers' Index for the manufacturing sector fell in October for the third time in succession; at 51½ points, it stood at the lower edge of the growth zone, which begins at 50 points. Industrial confidence, measured in the EU survey, likewise continued its descent, yet it still remained distinctly above its multi-year average. This was due mainly to a somewhat less favourable assessment of order books and warehouse stocks, whereas production expectations continued to be assessed positively. The consumer sentiment indicator remained unchanged in October

2 The volume of new orders received was calculated by deflating the value of new orders received published by Eurostat with producer prices.

Growth trends in the euro area

Seasonally adjusted, quarterly percentage change



Sources: national statistics, Eurostat and the ECB.

Deutsche Bundesbank

The diverging tendencies in new orders and manufacturing production in the euro area

Industry in the euro area has been expanding since mid-2003. In the July-August 2007 period, output (including energy production but excluding construction output) was up 13¼% from the second quarter of 2003; according to the regularly published Eurostat figures, new orders increased by as much as 34½%.[1] The differences in the pace of growth were no smaller in Germany, although the underlying growth rate was stronger. Industrial output rose by 21¼% in Germany during that period, while new orders in the order-based manufacturing industry increased by as much as 42½% according to Eurostat figures.

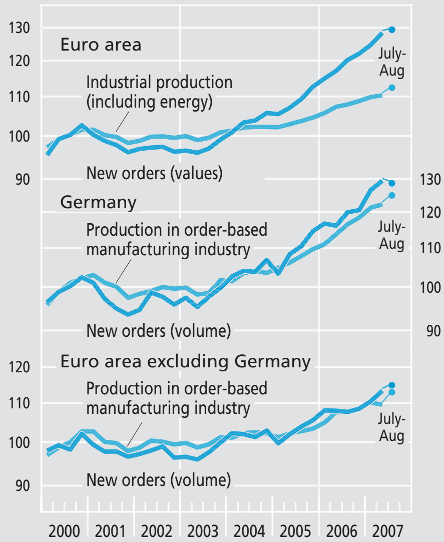
The marked and sustained divergence between new orders and production can initially be explained by conceptual differences. Unlike output, which is measured by the volume of goods produced, the demand indicator measures the value of the orders, meaning that its growth in the past few years also reflects price increases. In addition, only new orders in the order-based manufacturing industry, which has seen a somewhat more dynamic development in the euro area than overall industrial output, are recorded.[2]

A more consistent picture is obtained by deflating the value of new orders using producer prices. Furthermore, it would seem appropriate to compare price-adjusted new orders with output in the order-based manufacturing industry rather than with overall industrial output. However, Germany is not only maintaining its growth lead over its partners; it is increasing even more markedly in order volumes than in the corresponding values owing to lower rates of inflation in Germany. After price adjustment, new orders in Germany are growing significantly more dynamically than output in the order-based manufacturing industry. By contrast, leaving aside the usual lead/lag relationships, the two indicators for the euro area excluding Germany were largely parallel.

The backlog of orders being experienced by German industry indicates that Germany's lead will not be reduced and may even increase in the coming months. Admittedly, the available production capacity must also be taken into consideration. A more sustained growth in the volume of orders could lead to bottlenecks in processing. In the European Commission's most recent quarterly survey in October, more than half of German manufacturers surveyed stated again that capacity was not sufficient in view of the stock of orders. For the euro area as a whole, by contrast, the survey results indicate that production capacity is sufficient. It is therefore to be expected that non-residential investment in Germany, which, at an annual average rate of 5% in 2005-06, already rose by 1½ percentage point more than in the other euro-area countries, will continue to expand comparatively rapidly.

New orders and industrial production

2000 = 100, seasonally adjusted, quarterly, log scale



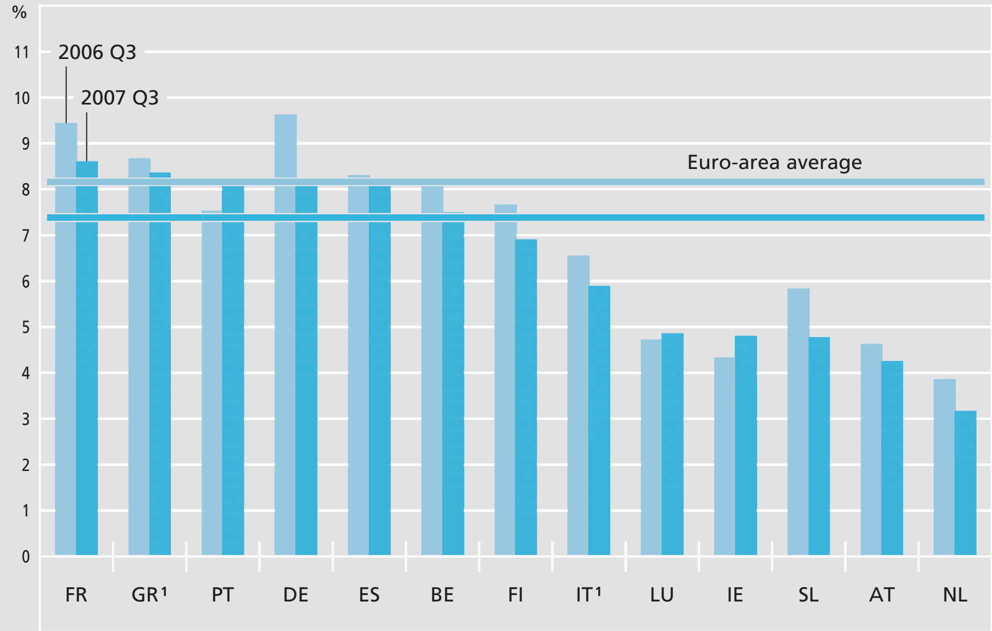
Source: Eurostat and Bundesbank calculations.

1 As the new orders data for the euro area are currently only available up until August, for comparability purposes only industrial output until August has been taken into consideration even though the data for September have already been published. This also applies to the two German series. — **2** However, the new orders index published on a monthly basis by Eurostat comprises only those economic sectors in which order-based production is significant. This "manufacturing working on orders", as Eurostat calls it, accounts for almost two-thirds of total manufacturing turnover in the euro area.

Deutsche Bundesbank

Unemployment* in the euro area

Seasonally adjusted



* Standardised unemployment rates as defined by the ILO. — **1** Figures available only for 2007 Q2.

Deutsche Bundesbank

after having sagged somewhat in the preceding months.

Lively aggregate demand in the third quarter

In the third quarter, aggregate demand – as far as can be told looking at the indicators available thus far – has been supported by, among other things, exports to non-euro-area countries; in terms of value, in July-August they were up by a seasonally adjusted 3¼% from their second-quarter figure. Although import growth, at 3%, was likewise quite strong, this is largely attributable to higher energy prices, which means that the price-adjusted rise will probably be lower than that of exports. Another key factor was that real retail sales (excluding vehicles) rose perceptibly again in the third quarter after seasonal adjustment (+¾%) after having gone up only slightly in the two preceding periods, especially owing to the consumer reaction to the increase in value added tax in Germany. In addition, new passenger car registrations increased again significantly. The moderate rise in construction output, moreover, is a sign of increased investment in new buildings.

Labour market recovery continuing

The calmer economic growth over the course of the current year compared with the very dynamic growth in 2006 has impacted on the labour market with a certain time-lag. Following decreases in unemployment by 396,000 and 252,000 after seasonal adjustment in the first and second quarters respectively, the third-quarter decline, at 161,000, was much more muted. In all, a seasonally adjusted 11.25 million people were out of paid work in the third quarter in the euro area. This was

1.03 million fewer than in the same period a year before. The unemployment rate fell from 7.6% in the first half to 7.4% in the third quarter.[3] Employment, for which figures up to mid-year are available, was up by 1.7% on the year in the second quarter. Although the labour market situation is still favourable in a longer-term comparison, wage growth in the second quarter remained moderate, at 0.7% after seasonal adjustment. Its year-on-year growth amounted to 2.5%. A perceptible acceleration is to be expected for the second half of the year, however.

Consumer price inflation decelerated somewhat

Euro-area inflation, which had temporarily slackened somewhat after mid-year – partly because of the intermittent decline in crude oil prices – picked up again in September as crude oil prices went up. In the third quarter as a whole, the Harmonised Index of Consumer Prices was up by 1.9% on the year – as in the second quarter. During the summer months, however, year-on-year growth accelerated from 1.8% in July to 2.1% in September. This was due in part to baseline effects resulting from crude oil price movements in 2006. Owing to the change in supply and demand conditions in the international agricultural markets, food prices, moreover, trended distinctly upwards, especially prices for milk products. In Germany, the increase was particularly sharp in September (see the explanatory notes on pp 53, 56). The prices of industrial goods (excluding energy) rose at a rate similar to that of the preceding quarters. The same applies to services. Euro-area inflation increased appreciably in October. Year-on-year HICP went up to 2.6%. One major contributory factor was that the prices of processed foods – albeit with a certain time-lag to Germany – also went up more strongly in other euro-area countries.

3 The data on euro-area unemployment were adjusted owing to new figures for Germany (for more see the explanatory notes on page 51 of this Monthly Report). Prior to the revision, euro-area unemployment had stood at 7.1% in the first half of 2007.