Global and European setting

World economic activity

World economy with less momentum in Q4 ...

Having expanded strongly in Q2 and Q3, the world economy suffered a noticeable loss of momentum at the end of 2007. This was due mainly to the distinct slowdown in growth in the industrial countries. This was particularly true of the US economy, where the housing construction sector is under even greater pressure to adapt and perceptibly weaker stimuli emanated from the other components of private final demand. Economic activity sagged somewhat in the euro area as well. In Japan, by contrast, overall output picked up sharply despite dampening effects emanating from residential construction owing to lively growth in exports and corporate investment. Real gross domestic product (GDP) in the industrial countries taken together is estimated to have grown in the fourth quarter by just under ½%, after adjustment for seasonal and calendar variations, on the third quarter, in which it had grown by as much as nearly 1%. It rose by around 2½% on the year. Output likewise grew by an average of 2½% in 2007 compared with 2¾% a year earlier.

... yet emerging market economies and commodity-producing nations still on steep growth path

In contrast to developments in the industrial countries, the economies of those countries exporting oil and other commodities continued to grow at a rapid pace in the fourth quarter of 2007. Some countries are now even showing increasing signs of an overheating economy; inflation in the Middle East's OPEC members has risen distinctly, and in Russia, it reached its highest level since 2005, coming in at 11.9% in December. According to available information, the south and east Asian emerging market economies likewise appeared to show strong growth in the final quarter of the year. However, there are signs that exports from this region to industrial countries, particularly the United States, have risen at a slower pace. Real GDP in China grew somewhat more moderately than in the third quarter, at 11¼% on the year. This is probably due in part to various braking measures initiated by the government. However, price pressure remained fairly high; in December, consumer price inflation stood at 6.5%.

Financial markets and oil prices as key negatives

The slowing of economic activity in the industrial countries is attributable partly to the real effects of the continued turmoil in the financial markets. This has had a particular impact on the United States, where both the housing market and the financial sector have come under increasing pressure, pulling private consumption into their wake via negative wealth effects and a tightening of credit standards. In other industrial countries, this turbulence has likewise left its mark on banks' profit and loss accounts and balance sheets, yet the impact on the non-bank sector has remained very constrained. As far as it is possible to tell, the effect on the emerging market economies has been minimal. However, additional key negatives that affected the world economy in the fourth quarter were the strong increase in oil prices and the continued rise in food prices. This led to a deterioration in the price climate and sharply diminished consumers' purchasing power, especially in countries with lower average incomes. With regard to the global economy, experience has shown that such terms of trade effects tend to act more quickly than the expansionary stimuli caused by higher revenues in the commodity-producing countries.

Downward revision of IMF forecast

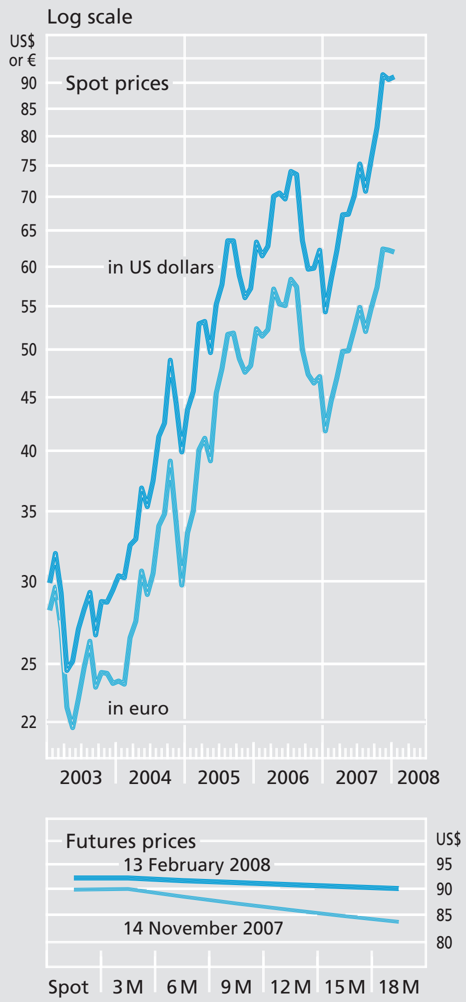
In the light of the macroeconomic trends and the problems that the United States is undergoing, the International Monetary Fund (IMF) revised its global forecast for 2008 by a visible margin at the end of January. Global growth is now forecast to weaken from nearly 5% in 2007 to just over 4% in 2008. After recalculation using a methodologically comparable basis,[1] the forecast for growth was revised downward by ¾ percentage point from 2007 to 2008 compared with just under ½ percentage point in the autumn 2007 forecast. The US forecast was downgraded from nearly 2% to 1½%. The revisions for developing countries and emerging market economies, at -¼ percentage point to just under 7%, were fairly moderate by comparison. In the case of China, the growth rate of 10% for 2008 projected in October has even remained unchanged.

Oil prices still at high level throughout reporting period following sharp rise

Despite the dampening of global growth and the more modest outlook, oil prices once again rose sharply in the fourth quarter of 2007, by nearly one-fifth from their summer

1 The IMF recently recalculated global GDP based on updated purchasing power parity (PPP) terms. The weights of fast-growing emerging market economies, especially China and India, have declined noticeably, which means that global growth rates are now much lower. Growth of 4.4% and 5.0% has now been reported for 2005 and 2006, respectively, compared with pre-revision figures of 4.8% and 5.4%, respectively. The autumn 2007 forecast of +5.2% now corresponds to an increase of +4.7%. However, during the latest adjustment to the forecast, this figure was revised upwards to +4.9%. The end-January update of the forecast for the world economy, the main economic regions and major industrial countries is based on the recalculated actual figures.

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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levels denominated in US dollars (Brent crude oil). At the beginning of January, a new high was marked at US$98¼. Owing to the euro's appreciation, the rise in the euro-denominated price of oil from the third to the fourth quarters, at 12½%, was much smaller; oil prices peaked in January at €66½. However, the past few weeks have seen an easing of sorts in the market owing to the more downbeat news about the economy and the temporary subsiding of the geopolitical turmoil. Falling futures market prices are signalling only a slight easing in the near future. In the light of new political risks, spot prices have nevertheless latterly gone back up to US$95 or €65. The US dollar-denominated prices of other raw materials likewise rose markedly – by 8¼% – between October and early February. Continued upward pressure on the prices of food, beverages and tobacco, which increased by 29¼% during this period, were the main reason. By contrast, the prices of industrial raw materials tended to move sideways. Non-energy commodities were up 14¾% on the year in US dollar terms and 2¼% in euro terms.

Increased inflation in the industrial countries

The prices being quoted on the markets for crude oil and food once again sharply drove up consumer prices in the industrial countries in the past few months. Year-on-year inflation rose from 2.0% in September to 3.2% in December; excluding Japan, the year-on-year rate rose from 2.4% to 3.6%. This owed not only to the recent rise in oil prices but also to a base effect, since consumer prices, after seasonal adjustment, had fallen slightly at the end of 2006. Core inflation (excluding energy and food) rose in autumn from 1.9% to 2.1% at year's end. Headline inflation, averaging 2.2% in 2007, was 0.2 percentage point lower than in the two preceding years. At 1.9%, however, core inflation reached its highest level since 2001; excluding Japan, it came to 2.3%.

USA

According to an initial estimate, real US GDP growth slowed down in the final quarter of 2007 to +¼% after adjustment for seasonal and calendar effects. For 2007 as a whole, GDP was up by 2¼%. One of the main reasons for the sluggish fourth-quarter growth was the accelerated decline in residential investment, by 6½% on the period. Another was that the depletion of inventories resulted in a ¼ percentage point loss in growth. Moreover, the remaining demand components showed weaker growth. Private consumption was up by only ½%, and corporate investment, at 1¾%, did not grow as strongly as in the two preceding quarters. The growth rate of real exports, to close the list, dropped distinctly to 1% after adjustment for seasonal and calendar effects. Since imports remained virtually unchanged, foreign trade as a whole, however, still made a slight contribution to GDP growth.

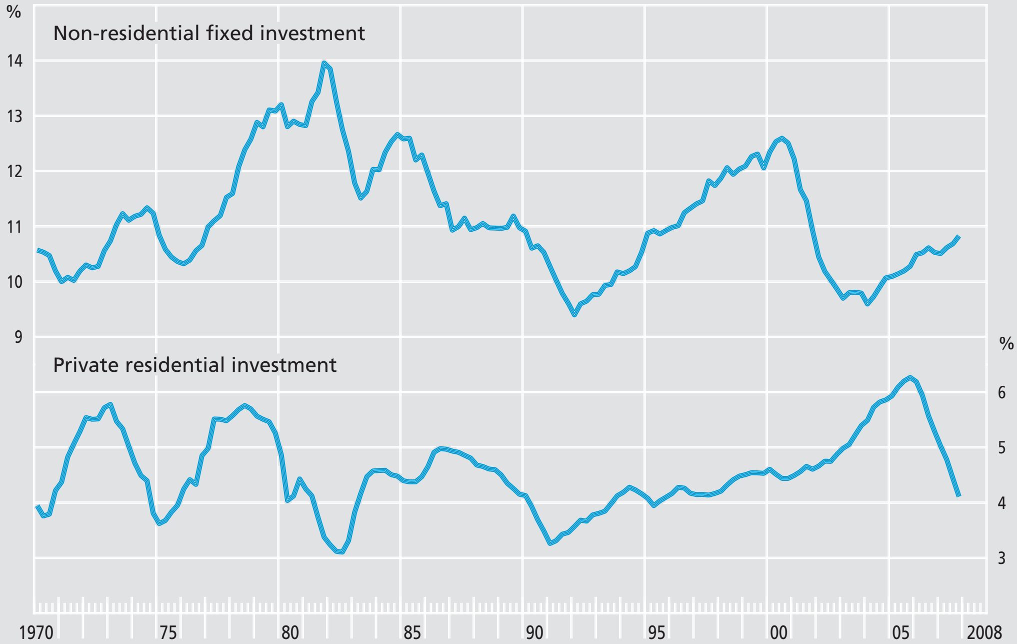
The acceleration in the rise of consumer prices was one of the key factors putting the brakes on private consumption in the fourth quarter. The rate of inflation, at 4.0%, was 1.6 percentage points higher than in the third quarter. Energy prices, which shot up by 17.8% on the year, accounted for the lion's share. Some relief is in sight for the winter months given the slight easing of oil prices, yet this is being offset by an import price-driving depreciation effect. Excluding energy and food, inflation stood at 2.3% in the fourth quarter, which also corresponds to the annual average of core inflation. The personal consumption expenditure (PCE) deflator, excluding these volatile components, rose by 2.1%.

The latest economic indicators suggest that 2008 has got off to a weak start. The business sentiment in industry continued its slide. New orders of durables fell in the fourth quarter by 1¼% after seasonal adjustment. Consumer confidence has now fallen to its lowest level since October 2005. Excluding sales at petrol stations, seasonally and calendar-adjusted retail sales were hardly any higher in January than in December in terms of value. The labour market figures for January were likewise poor, with the number of non-farm employed persons falling – if only slightly – for the first time since the summer of 2003. At 4.9%, the unemployment rate was ½ percentage point above its last low in March 2007.

There are still no signs that residential construction and the real estate market will bottom out. Sales of new and older owner-occupied homes in the USA continued to fall in the fourth quarter. However, because the number of houses up for sale is now smaller, the supply has only risen marginally. The median prices for new and older owner-occupied housing were 10½% and 6% down on the year respectively. The number of construction permits fell visibly once again in the fourth quarter. Nominal residential investment in the United States – as a percentage of GDP – fell from 6¼% at the peak of the construction boom at the end of 2005 to 4¼% in the fourth quarter of 2007 and was thus slightly below its long-term average of 4½%. If the housing glut and earlier cyclical troughs are any measure, further considerable downward adjustments are in the offing (see chart on page 16). With regard to construction activity, the sharp decline in residential construction in the past few years has, on

Private sector investment in the United States

Percentage of nominal GDP, quarterly, after seasonal and calendar adjustment



Source: US Bureau of Economic Analysis.

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the whole, been cushioned by the significant increase in investments in non-residential properties. It remains to be seen to what extent the contractionary forces emanating from the housing market will be mitigated by the US Federal Reserve's latest interest rate cuts.

Japan

Total output in Japan, following a rather weak result in the third quarter of 2007, once again rose significantly more sharply in the fourth quarter according to initial calculations, by a seasonally and calendar-adjusted 1% on the quarter. Lively export activity and favourable investment demand from enterprises were the main factors behind this good result, with real exports up by an unchanged strong rate of 3% on the quarter, while imports grew by only ½%. Just under half of GDP growth can therefore be attributed to foreign trade. Corporate investment was likewise up by 3%. By contrast, private consumption, at +¼%, continued to move along the flat growth path onto which it had embarked in the second quarter. The continued sluggishness of wage and salary growth may have had a dampening effect in this respect. In connection with a permit backlog caused by new construction regulations for earthquake protection, the decline in residential investment accelerated once again (–9%). It was down 21½% on the year. Driven by the sharp increase in oil prices, which was exacerbated by the depreciation of the yen against the US dollar, consumer prices rose in the fourth quarter by a seasonally adjusted 0.4%, more clearly than in a long time. The year-on-year rate of price increase went up to 0.5%, compared with –0.2% in the third quarter. Excluding energy and food, however, the slight decline in the price of consumer goods in Japan continued (–0.2%).

United Kingdom

In the final quarter of the year, the UK economy grew by an estimated ½%, after adjustment for seasonal and calendar effects, on the previous period, in which it had grown by ¾%. This rather minor letup conceals the sharp slowdown in the banking and insurance sector in connection with cooling real estate markets and the turmoil in the financial markets. Real value added in the markets for business-related and financial services was up by only just under ½%, with growth rates of mostly 1% to 1½% having been the norm both in the preceding quarters and in preceding years. This was offset, however, by accelerated growth in value added in other services sectors as well as in the production sector. Various special factors were at work here, such as in mining, which includes oil production, and in agriculture, where a sharp decline in the summer owing to animal diseases was followed by a positive turnaround. On the demand side, for which detailed national accounts data are not yet available, the stimuli from private consumption are likely to have subsided considerably; at all events, real retail sales were up by only ½%, after seasonal adjustment, on the third quarter, in which they had grown by as much as 1½%. This is consistent with the fact that seasonally adjusted real estate prices in the fourth quarter fell by ¾% from their third-quarter levels. By contrast, the annual rate of change in the national Consumer Price Index rose by 0.5 percentage point to 2.2% in the September-January period.

New EU member states

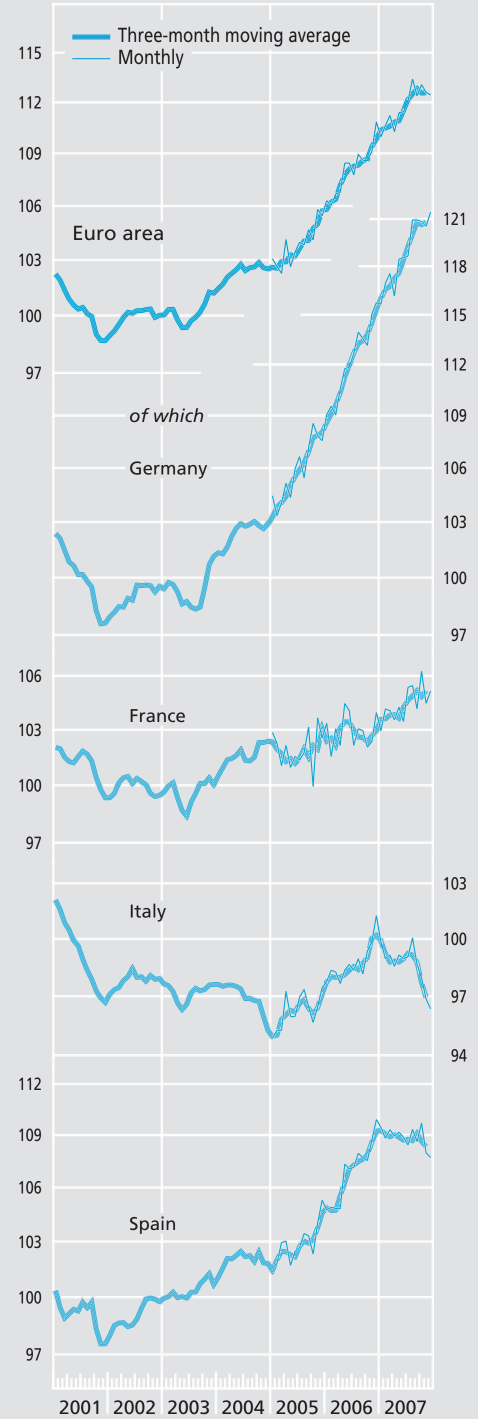
In the 11 new EU member states (excluding Slovenia, which acceded to the euro area on 1 January 2007), economic activity also seems to have slowed down in the fourth quarter; at all events, industrial output growth, at a seasonally adjusted ¾% on the period, was significantly slower than its average over the first three quarters of 2007 (+1¾%). However, it was still 6% up on its level of the fourth quarter of 2006. As growth was once again strong in 2007 and migration to the west European EU member states persisted, unemployment continued to decline. In eight of the eleven countries, the December unemployment rate was already under the euro-area average of 7.2%. The positive overall picture of economic activity, however, is dimmed by the increase in price pressures, with inflation continuing to rise from 4.4% in September to 5.8% in December, once again widening the distance to the euro-area HICP inflation rate. Sharp increases in the price of energy and food, which have a considerably larger weight in the basket of household goods in the new member states than in the euro area, were the main reason for this. In addition, the price increases, particularly in the case of food, were in many cases a great deal stronger than in the old EU member states.

Macroeconomic trends in the euro area

Total euro-area output growth in the fourth quarter of 2007, at just under ½% after sea-

Industrial output*
in the euro area

2000 = 100, seasonally adjusted, log scale



Sources: Eurostat and national statistics. — * Excluding construction.

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sonal adjustment, was slower than in the third quarter, in which it had grown at a rate of ¾%. Real GDP growth averaged 2¾% in 2007. The more moderate pace of growth in the euro area, in terms of the contribution of individual countries, was primarily due to the slowdown in growth in Germany and France. By contrast, the Spanish economy was able to maintain its rapid clip. No information was yet available for Italy as this report went to press. According to the available leading indicators, only rather tepid growth in the euro area may be expected for the current quarter.

Weaker GDP growth in the fourth quarter

Industry less robust

In a sectoral view, it was particularly industry which produced weaker stimuli in the final quarter of 2007; seasonally adjusted industrial output barely increased, compared with 1½% in the third quarter. This was caused by a decline in the production of consumer goods and virtual stagnation in the manufacturing of capital goods, while energy production rose significantly. The renewed slight decrease in capacity utilisation in the manufacturing industry over the October-January period is consistent with the sideways movement of industrial production. Mixed signals have been emanating from industrial production since the turn of 2007-08. Orders received in October-November were up by 3¼% in terms of value from their third-quarter levels. Excluding the manufacture of other transport equipment, where large orders have a major effect, the increase remained at 1%. In January, the Purchasing Managers' Index for industry held steady at the previous month's level. This was offset, however, by a further deterioration in industry confidence, even though the balance of positive and negative responses is still well above the long-term average.

Demand mostly subdued

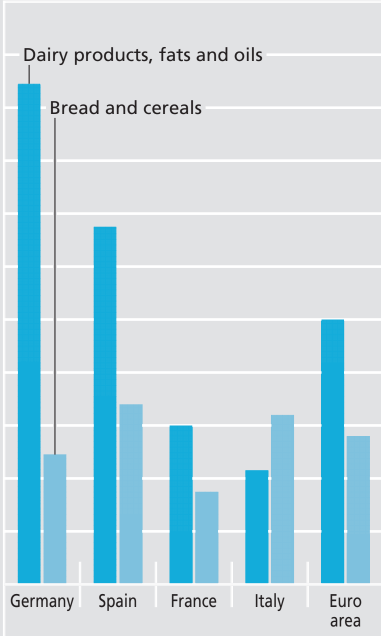
On the demand side (as far as can be gleaned from the patchy information available to date), the slowdown in economic activity in the fourth quarter is reflected in a decline in real retail turnover by a seasonally adjusted 1% on the quarter and ¾% on the year. This was offset in some measure by purchases of new motor vehicles which, in the fourth quarter, surpassed their third-quarter level by 2¾%. This was abetted by a very sharp rise in vehicle registrations in France in connection with the introduction of a government subsidy for the purchase of low-carbon vehicles with effect from early December 2007 and the entry into force on 1 January 2008 of a special tax on the purchase of high-CO_2 vehicles. Not only did consumer demand subside, but construction investment – and probably residential construction in particular – was also subdued. By contrast, corporate demand for machinery and equipment seems to have remained lively, and exports to non-euro-area countries remained on their growth path, surpassing their third-quarter level by a seasonally adjusted 1% in October-November. At the same time, imports remained unchanged; foreign trade is thus likely to have contributed positively to overall economic growth.

Labour market recovering further

The situation in the euro-area labour market has continued to improve. The unemployment rate fell from 7.3% in the third quarter to 7.2% in the final quarter of 2007. The figure one year earlier had been as high as 7.9%. Around two-thirds of the total decline

Price increases for selected foods

April to December 2007, percentage change



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in unemployment – by 192,000 on the quarter – was accounted for by Germany and one-third by France. In Spain, by contrast, unemployment rose perceptibly. In most of the other countries, it changed only little. The number of persons in work rose in the third quarter – the last period for which information is available – by a seasonally adjusted 0.3% on the quarter and 1.9% on the year. The rise in hourly labour costs, at a seasonally adjusted 0.6% during this period, was a bit more subdued, with the year-on-year rise remaining unchanged at 2.5%.

Consumer prices affected by energy and food

Euro-area price pressures, however, picked up sharply in the fourth quarter. The seasonally adjusted consumer price inflation rate was 1.0%, following 0.6% in the third quarter. Energy prices increased more sharply again, and food also became distinctly more expensive. Owing to rising commodity prices throughout the world, consumers had to spend more on milk and dairy products, in particular. Trends varied widely among the individual countries, with the prices of milk products (including fats and oils) already starting to increase in Germany in the second quarter and continuing to rise significantly in the summer months, whereas price pressures for these products became evident in France and Italy only in the fourth quarter. The trend showed that prices tend to increase more strongly in those countries that, according to Eurostat, had had lower-than-average price levels in 2006.[2] On the whole, the price of dairy products has risen by between 14% and 20% in Germany, Slovenia and Austria but by less than 5% in Finland, France and Italy. The figures for cereal products ranged from 1.0% in Finland to 4.9% in Germany to 15.5% in Slovenia. For industrial goods (excluding energy and food) and services, by contrast, price trends hardly changed. The overall year-on-year rate of increase in the HICP grew from 1.9% to 2.9%. A base effect resulting from the fall in energy prices at the end of 2006 also played a role.

2007 annual average and initial estimate for January 2008

At 2.1%, average consumer price inflation for 2007, despite relief-providing revaluation effects and weaker rises in energy prices (+2.6% compared with +7.7%), was similar in scale to a year earlier, in which it had stood at 2.2%. However, various fiscal measures adversely affected prices. The increase in the standard rate of VAT in Germany on 1 January 2007 was in itself enough to contribute around 0.4 percentage point to average annual euro-area inflation. The sharp rise in food prices in the second half of the year was another contributory factor. According to results for individual euro-area countries, prices continued to go up in January 2008. Year-on-year HICP inflation rose to 3.2% from 3.1% in December 2007.

2 See Eurostat, Eating, drinking, smoking – comparative price levels in 37 European countries for 2006, Statistics in Focus, 90/2007.