Global and European setting

World economic activity

Global economic indicators still clearly pointing upwards; industrial countries on stable growth path

The strong upward trend in world economic activity persisted in the second quarter of 2007. Particularly those emerging market economies in the middle of a convergence process grew at a highly dynamic pace; this group has now come to represent an increasingly self-sustaining weight in the global growth pattern. The upturn in the industrial nations continued at a considerable pace. Overall economic output among those countries rose in the second quarter once again by an estimated ½% on the quarter after adjustment for seasonal and calendar variations, after having gone up by ¾% in the fourth quarter of 2006. Real gross domestic product (GDP) was up by 2¼% on the year. After starting the year on a very lacklustre note, the US economy distinctly regained momentum, despite residential construction continuing to be a drag on growth. By contrast, the Japanese economy decelerated after having expanded sharply in the 2006-07 winter half-year. GDP growth in the euro area likewise slowed down, albeit not as sharply as in Japan. One reason was that industrial production got off to a weak start in the second quarter owing to special factors. Another was that seasonally adjusted construction output fell markedly, especially because the customary second-quarter revival was weaker owing to the mild winter weather at the beginning of 2007.

Emerging market economies ...

Among the large emerging market economies, China, with year-on-year growth of +12%, once again showed the strongest second-quarter growth. It even improved on its first-quarter performance (+11%). This, however, was associated with a distinct increase in inflation to 5.6% in July. In order to contain inflation expectations, the Chinese central bank once again raised its key lending rates. The other east Asian countries (excluding Japan) likewise remained on a steep expansion path; their export growth has barely flagged thus far, even though demand from the USA was no longer as dynamic as it had been earlier.

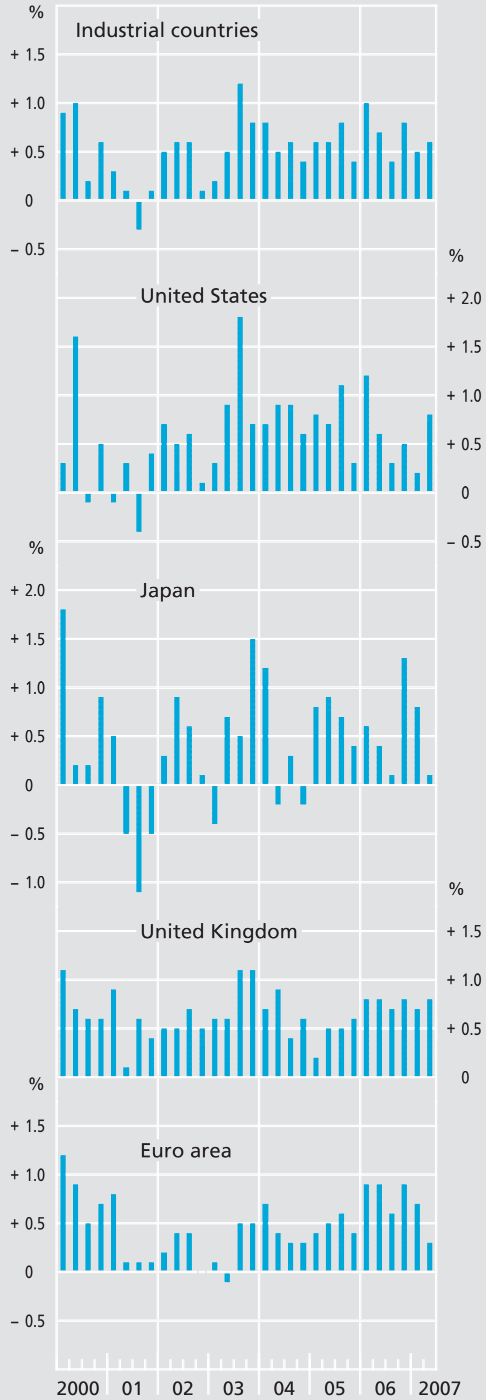
The majority of Latin American countries continued to benefit from high prices for crude oil and other raw materials. The Brazilian economy once again grew noticeably in the first quarter of 2007. The sharp cyclical upturn is likely to have persisted in the second quarter, as is indicated by the further improvement in the business climate. Consumer price inflation, however, went up from 3.0% in April to 3.7% in July. GDP growth in Mexico, by contrast, at a seasonally adjusted ¼%, was relatively sluggish in the first quarter, owing particularly to dampening stimuli from the USA. In the second quarter, however, the country is likely to have once again received a positive economic boost from the revival of US economic activity.

... and CIS still on a steep growth path

The Commonwealth of Independent States (CIS) is still in the midst of an economic boom which is being driven mainly by the high revenues from the export of energy commodities. In addition, however, Russia's economic growth has become more sustainable as investment has now also picked up, although, at 8.8% in July, inflation remained very high.

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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Global economic indicators and new IMF forecast

The continued outlook for the world economy is still being assessed favourably. At the mid-year juncture the OECD's composite leading indicators for both the industrial nations and the major emerging market countries pointed to a continuation of strong growth. This is also being signalled by the global Purchasing Managers' Index.[1] In addition, at the end of July the IMF revised its spring forecast for global GDP growth in 2007 and 2008 by ¼ percentage point to 5¼% for each of the two years. This means that the expected deceleration compared with 2006 (+5½%) is likely to remain within narrow bounds. A much more favourable assessment of the pace of expansion in the south and east Asian emerging market economies (especially China) and the CIS was the main reason for this. While, according to the IMF forecast, the considerable rise in oil prices in the past few months will have little impact on the cyclical growth forces worldwide, it will lead to additional price pressure in the oil-importing countries.

Increased global risks

All the same, the risks to global economic momentum have increased in the past few months. The correction process taking place on the US subprime mortgage market has amplified distinctly and has also spread to other segments of the financial markets both inside and outside the USA. In addition to the adjustment of what were previously, in some cases, very lax borrowing terms in the US mortgage market, there has been, in particular, a widening of the rather low risk premiums on corporate bonds and loans intended to finance mergers and acquisitions. In the major international equity markets, especially the shares of enterprises from the financial and real estate sectors sagged significantly. In addition, external imbalances still persist, although they have probably not intensified in the meantime. Moreover, the oil markets' high vulnerability to disruptions still poses a certain threat to the global economy and the general price climate.

Prices in commodity markets at record highs

Crude oil prices continued to rise in the second quarter. On a quarterly average, prices for Brent crude oil, denominated in US dollars, were 17% higher than in the first three months of this year. The upward trend initially persisted after mid-year. In the first half of August, however, the oil price eased; at US$70 per barrel when this report went to press, it stood at 5% below its level a year earlier. In euro terms, a barrel cost 9% less owing to currency appreciation. The strong increase in the price of crude oil in the past few months was linked, for one thing, to the reduction in production in the Middle East in the 2006-07 winter half-year, the at times considerable reductions in production in Nigeria and delivery shortfalls in the North Sea. For another, global demand for oil has continued to grow. Output shortfalls among US refineries also contributed in notable measure to the increase in the price of refined petroleum products in the second quarter. This also resulted in higher prices in Europe, particularly for petrol, because of increased purchases abroad by US mineral oil enterprises. Although a slight easing is expected on the crude oil futures markets over a time horizon of six to 18 months, oil prices will

1 This index is calculated from indices for the USA, Japan, Germany, France, the United Kingdom, Russia and China.

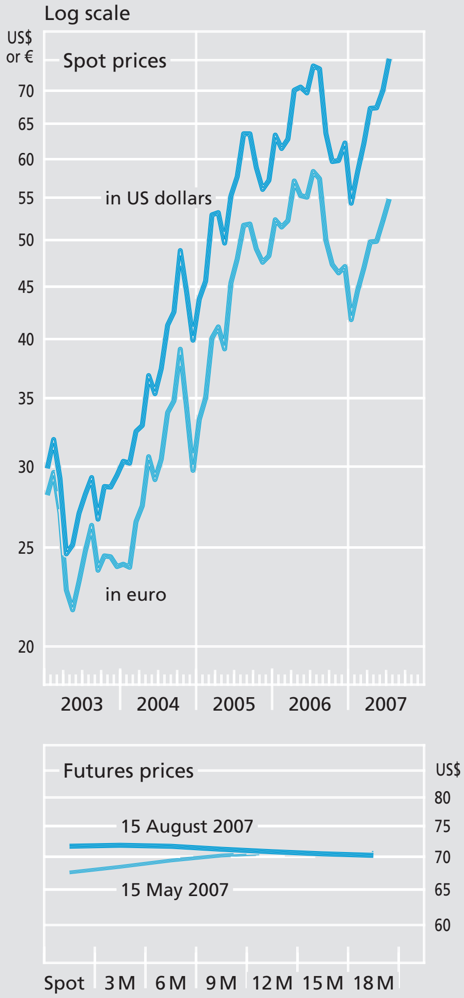
continue to trend upwards over the coming five years, according to the July 2007 forecast by the International Energy Agency. This reflects the expectation that the increase in oil supply, especially from the non-OPEC countries, will fail to keep pace with the growth of global demand.

On the whole, industrial raw materials were being quoted – in US dollars – slightly lower, after having once again risen sharply in April. In early August, however, they were still 11¼% higher than a year earlier. World market prices for food, beverages and tobacco continued to rise throughout the reporting period, reaching new peaks. Sharp rises in the prices of oilseeds and oils, which are increasingly in demand for the production of biofuels, were the main reason. The overall index of commodity prices excluding energy in early August was up by 15% on the year in US dollar terms and up by 7¼% in euro terms.

Price movements in industrial countries influenced by rising prices for oil and food

The continuing rise in the cost of energy and higher food prices had a clear impact on consumer prices in the second quarter. In the industrial countries, prices in the second quarter were up by a seasonally adjusted 0.9% from the first quarter, in which they had risen by 0.7%. The year-on-year rate remained unchanged at 2.1%, but this was solely because the corresponding price increase between April and June 2006 had been even greater. At 1.9%, core inflation (excluding energy and food) was only slightly lower than on average during the first three months of this year. In the industrial countries excluding Japan, where core inflation is still negative, it stood at 2.1%.

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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USA

The US economy grew by a seasonally and calendar-adjusted ¾% in the second quarter, according to the initial estimate, after having seen only a marginal increase in output in the first quarter. If both periods are taken together, US GDP expanded in the first half of the current year at an annualised rate of 2%.

Commercial investment lent an important boost to growth in the second quarter, increasing by 2% after seasonal adjustment. Business construction grew particularly sharply and more than offset the renewed 2½% decline in residential construction. Private consumption continued to rise, albeit, at +¼%, at a slower pace. It was chiefly underpinned by the continued sharp rise in employment. Domestic demand contributed a total of ½ percentage point to growth, and foreign trade ¼ percentage point. Real exports grew by a seasonally and calendar-adjusted 1½%, whereas price-adjusted imports fell by ¾%. This reflects – alongside the exceptionally strong first-quarter growth – particularly the moderate growth of private consumption and the dampening impact of the US dollar's depreciation.[2]

According to the US Federal Reserve's latest forecast, the US economy will continue to grow moderately in the second half of 2007, which means that GDP could grow between 2¼% and 2½% over the course of the year. In 2008, however, the pace of growth is expected to pick up slightly, lying in a corridor between 2½% and 2¾% between the fourth quarter of 2007 and the end of 2008. The Fed had given a somewhat more favourable assessment of the outlook in February. The IMF recently likewise recently revised its forecast for annual average growth in the United States in 2007 downwards to 2%; for 2008, however, it expects growth to rebound to 2¾%.

Consumer price inflation in the United States accelerated distinctly in the second quarter to a seasonally adjusted 1.5% vis-à-vis the first quarter, in which it had stood at 0.9%. Year-on-year inflation rose from 2.4% to 2.7%, despite a dampening baseline effect. Higher prices for energy and food were the main factors fuelling the strong price pressure. Excluding these two items, year-on-year inflation fell by 0.3 percentage point to 2.3%. In July the headline rate declined to 2.4%, whereas the core rate excluding the volatile components held steady at 2.2%. The core deflator of private consumption fell back below the 2% mark in June. In 2008 the Fed expects this deflator to continue to rise at a rate between 1¾% and 2%.

Japan

According to initial estimates, seasonally adjusted real GDP in Japan remained virtually unchanged in the second quarter after having gone up by ¾% in the first three months. It grew by 2¼% on the year. One reason for the sideways movement of economic activity between April and June was the smaller increase in private consumption, which halved to just under ½% on the quarter. A second reason is that real housing investment fell sharply (-3½%). Commercial investment, by contrast, grew more sharply, at a seasonally adjusted 1¼%. Real exports rose by just under 1% after having gone up in the first three months of 2007 by 3½%. Since imports

2 Along with the announcement of the second-quarter results, revisions to the national accounts data for the three preceding years were also published, as usual. According to these figures, average GDP growth for the years 2004 to 2006 has been revised downwards by ¼ percentage point to 3¼%. At the same time, the household saving ratio in 2005 and 2006, which had previously been reported to be negative, was revised upwards sharply by 1 to 1½ percentage points to ½% for each of the two years. In the second quarter of 2007 the rate likewise stood at +½%.

grew only slightly more slowly than exports, real net exports stayed at their level for the first quarter, in which – relative to GDP – they had risen by nearly ½ percentage point. Consumer prices in the April to June period were slightly below their previous year's level. Excluding energy and food, they fell by a further 0.3%. This was due in large part to the continued sharp reduction in the price of consumer durables in the areas of consumer electronics and household goods.

United Kingdom

In the United Kingdom, second-quarter overall economic output was up by ¾% on the first quarter in seasonal and calendar-adjusted terms, thereby continuing the steep path of expansion onto which it had embarked at the beginning of 2006. On the year, real value added rose by 3%. Growth was broadly based insofar as manufacturing production excluding construction, following a slight decline in the 2006-07 winter half-year, went up by just over ½%. Construction output grew by a seasonally adjusted 1% following +¾% between January and March. By contrast, the services sector grew a bit more slowly, at ¾%. On the demand side – as far as can be inferred from the available data – private consumption is likely to have once again been the mainstay. Real retail sales rose in the second quarter by a seasonally adjusted 1¼% following a perceptibly slower expansion in the first three months. Consumer price inflation fell from 2.9% in the first quarter to 2.6% in the second, although this is partly connected with the aforementioned baseline effect with regard to energy prices. In July, the rate, at 1.9%, had returned to slightly below the official inflation target of 2%. Excluding energy and unprocessed food, inflation stood at 1.8% as this report went to press. While the upward trend with regard to real estate prices slowed down in the second quarter, the year-on-year rate was still 10.7%.

New EU member states

In the new EU member states (excluding Slovenia) from the last two enlargement rounds, the cyclical upswing continued in the second quarter. While seasonally adjusted industrial output did not exceed its first-quarter level, this was largely attributable to the sharp decline in April which was, at least in part, due to exceptional factors. In May and June, industrial output rebounded noticeably, registering a year-on-year increase in the second quarter of 8%. The strongest growth rates were recorded in Slovakia (+14½%) and Bulgaria (10½%). The buoyant output growth, however, was accompanied by persistently strong price pressures. In the second quarter, consumer prices increased by a further 1.1% on the quarter after seasonal adjustment. The year-on-year increase accelerated from 3.3% in January to 4.0% in July, with the range of national inflation rates, as this report went to press, stretching from -0.2% in Malta to +9.5% in Latvia.

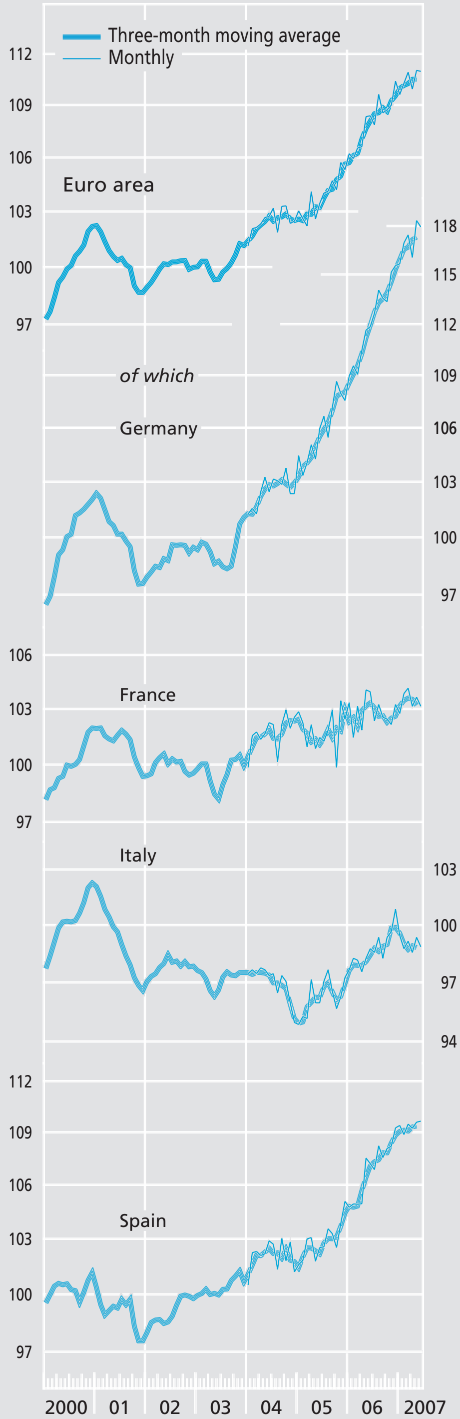
Macroeconomic trends in the euro area

More moderate GDP growth in the euro area owing to special factors

The euro-area economies grew by a seasonally and calendar-adjusted ¼% in the second quarter. This meant that the rate of expansion was nearly ½ percentage point below that in the first three months. Real GDP went up by 2½% on the year. The seasonally adjusted

Industrial output*
in the euro area

2000 = 100, seasonally adjusted, log scale



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

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average rate reflected a rather strong increase in aggregate output in Spain, Belgium and Austria. Output growth was somewhat muted in the three large member states of France, Germany and Italy, as well as in the Netherlands. In some euro-area countries, macroeconomic growth was handicapped not only by the sluggish pace of industrial activity at the start of the second quarter but also notably by the seasonally adjusted decline in construction output, representing a technical counterswing to the weather-related high level of activity in the first quarter. During the current quarter, these special factors will no longer play a role, which means that, *per se*, the manufacturing sector is likely to once again make a greater contribution to growth.

Industrial activity still rising despite weak output growth

At a seasonally adjusted ¼% in the second quarter, industrial output (excluding construction) grew much more slowly than in the first quarter (+¾%). This was due partly to the weak April outturn, which was marked particularly by output shortfalls owing to the "bridge holiday" at the end of the month and the strikes in some segments of the German car industry. As the chart on this page shows, since the beginning of 2004 industrial activity in Germany has been considerably more buoyant than in other major member states. This is consistent with the clearly more dynamic pace of German export growth, which is subjected to an in-depth comparison with France in the box on pages 20 and 21. The fact that capacity utilisation in the manufacturing sector in July was markedly lower than in April is consistent with the overall muted growth of industrial production; however, capacity utilisation remained well above its multi-year average.

If the negative exceptional influences are factored out, the underlying cyclical trend in the euro-area industrial sector continued to be clearly pointed upwards in the second quarter. Orders received by industry in April-May were up by a seasonally adjusted 2% from the first quarter and by 10¼% on the year. Excluding the manufacture of other transport equipment, in which large orders often play an important role, 1% more orders were booked than on average over the first three months. In addition, manufacturing enterprises, according to the results of the EU investment survey of March-April, are planning to increase their real expenditure on new plant and equipment as well as buildings this year by 6% after having increased their investment budgets to the same extent in 2006. Another indicator of a continued favourable outlook for the upswing in the manufacturing sector is that industrial confidence – despite the slight decline in July – remained at an exceptionally high level throughout the reporting period.

Aggregate demand sluggish in Q2

There are no detailed national accounts data on the demand side just yet. However, the sideways movement of exports to non-euro-area countries in April-May is consistent with the picture of slightly weaker overall GDP growth. In this two-month period, imports rose marginally in terms of value. However, this was caused mainly by higher energy prices rather than by an expansion in the volume of imports. On the whole, no notable contribution by foreign trade to GDP growth can be expected for the second quarter. Moreover, construction investment is unlikely to have boosted expansion much in view of the weak second-quarter revival in the construction sector. In addition, households showed restraint on the consumption front. Retail purchases (excluding vehicles) rose only slightly after seasonal adjustment (¼%) from the first quarter, and new car registrations remained at the previous quarter's depressed level. However, the continuing improvement in the labour market is heralding a greater propensity for consumers to spend in the second half of the year.

Labour market still vibrant

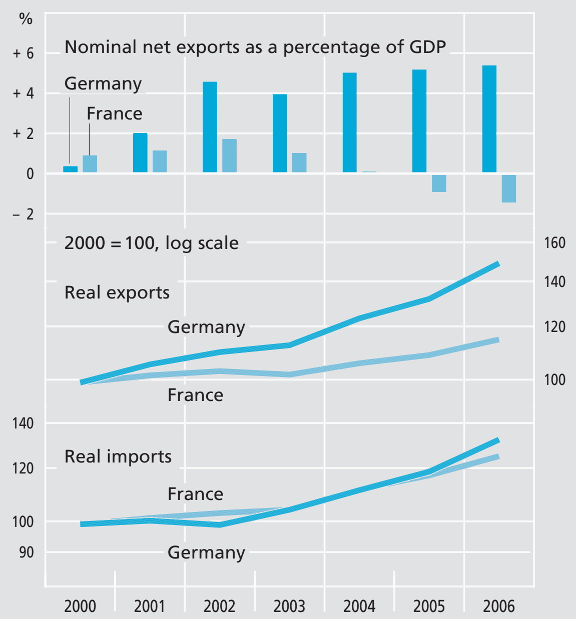
The upturn on the labour market continued in the second quarter of 2007. According to provisional Eurostat data, a seasonally adjusted 10.42 million people were without employment on average between April and June, or 0.37 million fewer than in the first three months of 2007 and 1.51 million fewer than in the same period a year earlier. The (standardised) unemployment rate fell from 7.2% in the first quarter to 7.0% in the second. Unemployment rates fell in nearly all member states; only in Ireland did the rate rise somewhat (no information for the second quarter is available for Italy and Greece). The decline in euro-area unemployment has been driven by a sharp expansion in employment. The number of persons in employment rose by a seasonally adjusted 0.4% in the first quarter of 2007 – more recent information is not available. The year-on-year rate of growth was 1.4%. In the case of wages, the year-on-year increase slipped slightly in the first three months to 2.3%. However, this aggregate figure masks a broad spectrum of

Diverging trends in French and German foreign trade

During the 1990s, France's trade with its euro-area partners and non-euro-area countries grew, at times, more dynamically than the German economy's cross-border trade in goods and services. Since 2001, however, the pendulum has swung back clearly in Germany's favour.

During the 1991 to 1997 period, France's nominal net exports – the balance of exports and imports as defined in the national accounts – rose from –1% to +3% of GDP.[1] It subsequently went back down to 1% in 2000. Germany's net exports-to-GDP ratio improved from 1991 to 1998 by 2 percentage points to 1½%, and thus not nearly as much as that of France. In the two following years, Germany's corresponding ratio likewise fell, by 1 percentage point to +½%. In 2001, Germany's surplus exceeded that of France for the first time in a long time. As the chart below shows, the divide grew in subsequent years, due both to the strong growth of the German surplus and also because France's balance diminished considerably in 2003-04 before then turning negative. In 2006, Germany's nominal net exports stood at +5½% of GDP, whereas the comparable figure for France was –1½%.[2]

Foreign trade in Germany and France



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The countervailing patterns of the two countries' external positions in the period from 2001 to 2006, which is the focal point of this analysis, were due mainly to sharp real export growth in Germany, which averaged 7% a year, coupled with the relatively slow growth in France (+2½%).[3] Not least because of the high import content of German exports, real imports in Germany likewise grew more sharply; however, at 5% a year, this rate was only 1 percentage point higher than that of France. The buoyant growth of French imports relative to exports is attributable particularly to the rather robust domestic demand during this period, which rose by 2% per year, whereas this figure shrank in Germany in 2001-02 and only rose by just under ½% on average over the following three years. In Germany, it was only in 2006 that it returned to its 2000 value, rising quite sharply by 1¾%.

The reasons behind the different export dynamics since the beginning of this decade are analysed below. The first obvious approach is to look at the growth of the two economies' sales markets. Contrary to assertions by some, German exporters turn out to have only a slight advantage in this respect. Whereas their sales markets grew by 6% a year in terms of volume, France's grew by 5½%. This is surprising insofar as Germany's economy has a stronger foothold in dynamically growing markets, particularly in China and eastern Europe. Ultimately, the diverging growth of sales markets explains only a very small part – less than one-tenth of the cumulative growth difference in real exports of 34½ percentage points in the 2001-2006 period. If, however, this finding is compared with the growth of the two countries' exports, the German economy turns out to have slightly improved its export performance during this period, whereas that of France deteriorated. In terms of overall world trade, Germany held its real share – despite the strong surge of the emerging market economies – at around 9%. In France, by contrast, the ratio fell by 1 percentage point to 3¾%, with the loss of influence on non-euro-area markets more strongly pronounced than in the euro area.

1 Owing to the changeover of real national accounts data to chain-linked indices, the net exports-to-GDP ratio can be expressed only at current prices. — **2** In bilateral foreign trade between France and Germany, which is not the main focus of this analysis, France has traditionally run a deficit (and Germany, correspondingly, a surplus). The French deficit widened distinctly in the second half of the 1990s and, since 2000, has fluctuated between –1% and –1½% of French GDP. — **3** It should be noted here that in France exports and imports are deflated only on the basis of average values whereas in Germany they are deflated on the basis of real price indices. When comparing real variables, this can lead to distortions which, however, are impossible to pin down precisely. — **4** See B Pluyaud, Modelling imports and exports of goods in France, Distinguishing between intra and extra euro area trade, in O De Bandt, H Herrmann and G Parigi (eds), Convergence or divergence in Europe, Growth and business cycles in France, Germany and Italy, Berlin, Heidelberg, 2006, pp 345–346, as well as C Allard et

Since, unlike market growth, export performance makes a clear contribution to explaining the divergence in exports between Germany and France, this raises the question of what role price competitiveness may have played in this regard. The relatively broadly defined indicator chosen here (calculated vis-à-vis 19 industrial countries based on the deflators of total sales) shows an improvement for both countries between the beginning of monetary union and autumn 2000; at a total of 10¼%, Germany's indicator grew more strongly than that of France (+7¾%). Since the end of 2000, however, the euro has appreciated markedly, causing the price competitiveness of the German and French economies vis-à-vis non-euro-area countries to fall by 16¼% and 21¼% respectively. Within the euro area, especially because of the less-than-average rise in wage costs, it continued to rise, however, by 7¾% and 1½% respectively. On the whole, ie compared with 19 industrial countries, the competitiveness of Germany and France fell between 2001 and 2006 by 2¼% and 6¼% respectively.

The diminished price competitiveness is likely to have slowed the increase in German exports by ¼ percentage point and that of French exports by 4¾ percentage points since 2001. The resulting 4½ percentage point difference represents one-eighth of the cumulative growth differential for exports. This means that a large percentage of the divergence of Germany's and France's export growth can be attributed neither to nominal exchange rate changes nor to national inflation differentials. Similar conclusions are reached by various studies which assert that traditional determinants, such as domestic demand in the buying countries and price competitiveness, are able to explain only a fairly small part of the export development of the major euro-area countries in the current decade. The econometric estimations accordingly all show relatively large unexplained residuals.[4]

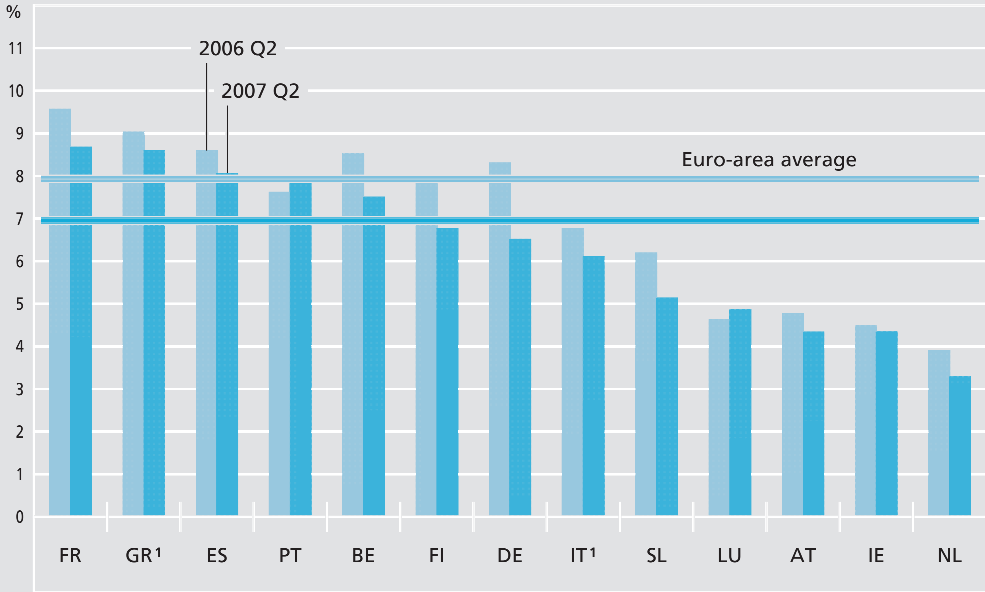
Reference is often made in this connection to the two countries' different range of exports. It is held that the global economic upswing benefited Germany's export sector more than France's by being more strongly focused on capital goods. Indeed, the share of capital goods (including cars) in Germany's exports in 2006, at 47¾%, was, in fact, nearly 10 percentage points higher than in France. In the case of intermediate goods, which last year accounted for 32½% of Germany's exports, Germany's edge over France was only 1¾ percentage points. Conversely, consumer goods and energy supplies, at 23½% and 5¼% respectively, were, respectively, 7 percentage points and 2½ percentage points higher in France's basket of exports than in that of Germany. Upon closer inspection, however, these differences in the range of goods did not make a meaningful contribution to explaining the differences in export growth.[5] This is partly because both the German and the French economies saw their exports of consumer goods, on an annual average over the 2001-2006 period, increase somewhat more strongly than deliveries of capital goods to other countries. Another remarkable thing to note is that, in all four categories of goods, the German economy achieved higher rates of export growth; the growth differentials – with the exception of energy – remained within a rather narrow band of between 3 percentage points (intermediate goods) and 4¼ percentage points (capital goods).

On the whole, it can be concluded that the diverging trends in German and French foreign trade can be explained only in part by differences in the development of sales markets and price competitiveness as well as product range effects. A more important factor could be that small and medium-sized enterprises (SMEs) in Germany have a stronger presence on overseas markets and have successfully tapped additional sales markets by using new business models and flexible offers. Thus, the percentage of German SMEs that export at all, at just over one-tenth, is well above that of French SMEs (4%).[6] This also indicates that microeconomic reasons, such as differences in products, technology or marketing, play a significant role. However, it is nearly impossible to determine the exact weight of these factors owing to a lack of suitable data. Moreover, there is reason to assume that owing, among other things, to sluggish domestic demand in the first half of this decade, German industry had a particular interest in increasing its export activity, whereas French companies benefited from much more robust domestic demand. Accordingly, with the convergence of domestic dynamics in both countries already under way, the discrepancies in foreign trade will, in future, tend to recede.

al, Explaining differences in external sector performance among large euro area countries, in: Spain Selected Issues, IMF Country Report No 05/401, October 2005, p 13. — **5** On this, see H Boulhol and L Maillard, Analyse descriptive du décrochage récent des exportations françaises, in P Artus and L Fantagné, Évolution récente du commerce extérieur français. Rapport pour le Conseil d'Analyse Économique, 2006. According to this report, only just under one-tenth of the French growth lag in exports between 1998 and 2003 was attributable to differences in the range of goods. — **6** See Deutsche Bundesbank, The export business of German enterprises according to size category and economic sector (box), Monthly Report, December 2006, pp 40-41 and Les PME françaises à l'export: une faiblesse structurelle, http://www.ifrap.org/0-ouvrirlesite/Dossier-aides-exportation.htm.

Unemployment* in the euro area

Seasonally adjusted



* Standardised unemployment rates as defined by the ILO. Changes in statistical methods could potentially have impaired comparability over time for individual countries – especially Germany. — 1 Figures available only for 2007 Q1.

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country results, ranging from 0% in Germany to around 4% in France and Spain to 6% in Portugal.

Price pressure driven by the volatile components

Euro-area price pressures continued to intensify in the second quarter of 2007, rising by 0.8% after seasonal adjustment following 0.5% in the first three months. The higher rate of inflation was caused mainly by the energy component in the wake of higher oil prices. Consumers had to pay much more for unprocessed food, too. Excluding these two comparatively volatile components, inflationary pressure, at a seasonally adjusted 0.5%, was on a par with the figure in the two preceding quarters. Whereas the prices for services went up by an average of 2.6% on the year, processed foods were 2.0% more expensive and commercial goods 1.0%. On balance, the year-on-year rise in the Harmonised Index of Consumer Prices (HICP) – like core inflation – remained unchanged at 1.9%. In July 2007, euro-area prices (seasonally adjusted) rose further owing to the increased oil prices. Year-on-year HICP inflation, however, fell to 1.8% by virtue of the especially sharp increases in energy prices in mid-2006.

Inflation differentials in euro area relatively low but persistent

National inflation differentials – as measured by the weighted standard deviation – had fallen once again as this report went to press. The ranking of countries, however, has remained relatively stable. Finland and the Netherlands have recorded inflation rates of under 2% for 20 and 15 quarters respectively. In Greece, inflation has receded to 2.6%, falling below the 3% mark for the first time in

12 quarters – yet it was still higher than in the other member states, Slovenia and Ireland excepted. The (cumulative) inflation divide vis-à-vis Germany has expanded slightly in nearly all euro-area countries.