Global and European setting

World economic activity

Global economy under considerable strain in Q2

The continuing deterioration in the global price climate triggered by a renewed surge in the price of oil and a strong rise in food price inflation in the spring months placed a considerable burden on the world economy. The real estate markets in the United States and several European countries also exerted a dampening effect. Global growth is therefore likely to have slowed further, with economic momentum in a number of emerging market economies also being more subdued of late. The accelerated rate of price increase not only reduced consumers' purchasing power, it also clouded expectations. Several central banks responded by raising interest rates. Nevertheless, in view of strong inflationary pressures, real interest rates can still be regarded as low across the entire maturity spectrum; in some countries, they are even likely to have slipped into negative territory.

The situation on the international food markets has eased considerably since mid-year and crude oil prices have dropped sharply since mid-July. However, consumer price pressure is likely to remain high for the foreseeable future as some price pressures on upstream sectors of the economy have not yet been passed on to consumers. Moreover, higher prices for commodities and primary materials are likely to aggravate indirect effects in several countries. In some cases, second-round effects are also becoming more of an issue, particularly in emerging market economies, developing countries and the Commonwealth of Independent States (CIS), where inflation expectations are generally less well anchored. In addition, the international financial markets exerted a dampening impact on global economic activity in the second quarter. Despite making noticeable adjustment progress, these markets are still in a fragile condition, as evidenced by the renewed flare-up of the crisis on the US mortgage market in July.

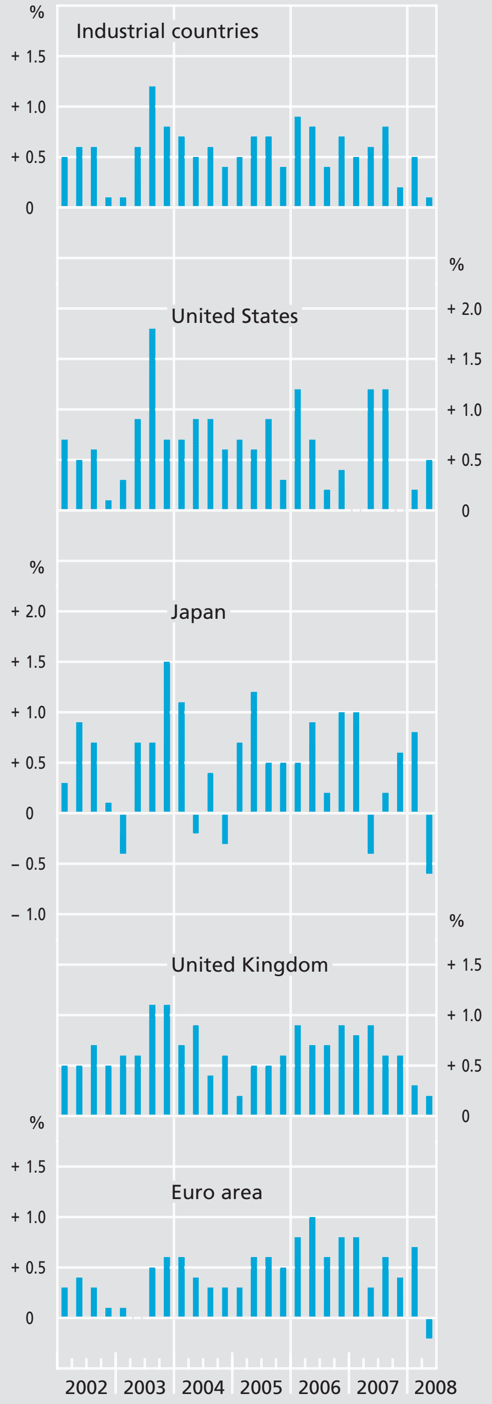
Given the confluence of serious disruptive factors impacting the global economy at present, economic momentum is likely to slow down further in the second half of the year. Nonetheless, the risk of drifting into a global recession appears very limited at present, not least as the key economic areas are at different stages of the economic cycle and are being affected by current developments to varying degrees. The International Monetary Fund (IMF), in its forecast of mid-July – which will be reviewed in greater depth in the following – predicts that expansionary forces will gradually come to dominate again in 2009.

Weaker growth in industrial countries ...

Overall, real gross domestic product (GDP) in the industrial countries grew only marginally in seasonally adjusted terms in the second quarter compared with +½% in the first quarter of the year. The year-on-year increase was 1½%. Special factors, among others, put a brake on growth. For example, overall economic output in the euro area declined by ¼%, partly as a result of technical counter-reactions to the mild weather in the winter months. Real GDP in Japan witnessed an even more marked decline after expanding strongly in the first quarter, not least because the backlog of residential building permits

Growth trends in industrial countries *

Seasonally adjusted, quarter-on-quarter change



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

Deutsche Bundesbank

was cleared in that period. By contrast, US economic growth was noticeably faster than in the final quarter of 2007 and the first quarter of 2008, when gains had been small. This can be explained largely by very buoyant exports and the expansionary stimuli from the government's economic programme, which supported private consumption.

... and somewhat slower pace in emerging market economies, too

Growth in the south and east Asian emerging market economies also slowed down in the second quarter, although it still remained comparatively high. This development was attributable to both the weakening import pull from the industrial countries and the increasing erosion of household purchasing power as a result of higher energy and food prices. The hefty increase in commodity prices on the markets was a contributory factor here as was the fact that several governments raised the administered prices for refined petroleum products as the fiscal cost of subsidising these products had become too great for the government budget or state-owned monopoly enterprises. However, cereal prices, especially the price of rice, dropped significantly during the spring months, thus reducing consumer price pressure of late. For example, Chinese inflation fell from 8.5% to 6.3% between April and July. However, it should be borne in mind that, despite recent increases in the price of petrol and diesel, the country still has in place a number of price controls, which could result in suppressed inflation. In a year-on-year comparison, the pace of economic growth in China slipped slightly from 10½% in the first quarter to 10% in the second quarter.

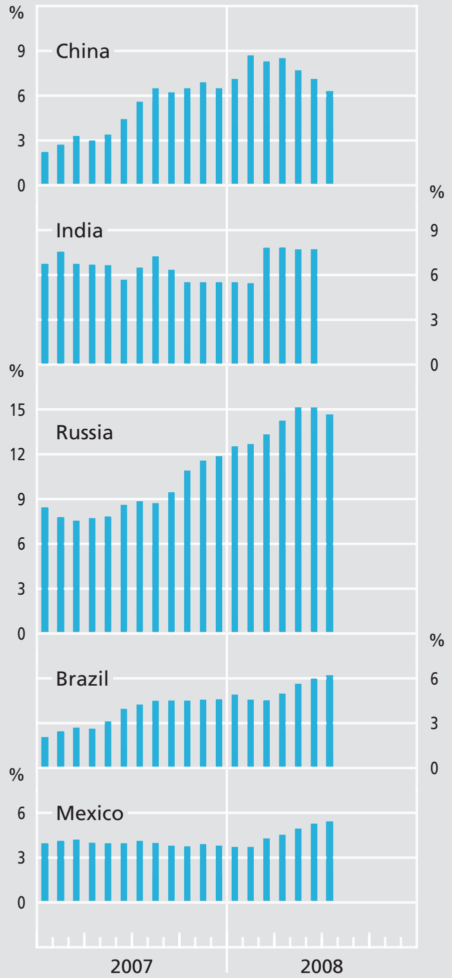
The Latin American economies were on a somewhat flatter, but still striking growth trajectory in the second quarter. The cyclical retarding effects stemming from the USA, which were especially noticeable in Central America, were still offset by expansionary stimuli from the ongoing commodities boom. However, the sharp rise in inflation marred the picture here too, with higher food prices generally having a stronger impact than energy price hikes as food is given a relatively large weighting in the basket of goods. In Brazil, the rate of inflation has risen by 1.7 percentage points to 6.2% since March 2008, while in Mexico it has increased by 1.7 percentage points to 5.4% from its last low at the beginning of the year. In recent months, the central banks of several Latin American countries have hiked interest rates, in some cases significantly, in order to contain inflationary pressures.

High inflation in the CIS

Sharp price increases currently also represent a major challenge for economic policy in the CIS. The situation is particularly strained in Ukraine, where inflation stood at 26.8% at the end of the period under review. Russia recorded consumer price inflation of 14.7% in July, up from 8.8% a year earlier. Here again, the greatest pressure is emanating from food. The price outlook is likely to remain unfavourable for some time to come if the government implements its – basically laudable – plans to bring its still relatively low administered energy prices more into line with west European levels over the next few years. Besides high inflation, a number of other indicators suggest that the Russian economy is at imminent risk of overheating.

Consumer prices in selected emerging market economies

Year-on-year change



Sources: national statistics and OECD.

Deutsche Bundesbank

As industrial production expanded apace in the second quarter, GDP growth is likely to have been fairly strong too, and capacity overutilisation is likely to have further intensified.

Updated IMF forecast

In its mid-July update of its April World Economic Outlook report, the IMF raised its global growth projection for 2008 by 0.4 percentage point to 4.1%. This was the result of the significant upward correction of the fairly pessimistic spring forecast for the USA by 0.8 percentage point to 1.3%.[1] In addition, the forecast for the euro area was revised upwards by 0.3 percentage point to 1.7% in response to strong first-quarter growth, which the IMF had underestimated. By comparison, the Fund raised its forecasts for Japan, the UK and the emerging market economies and developing countries only marginally.

However, these corrections do not alter the general tenor of the IMF's spring forecast, namely that the global economy will cool off in 2008, particularly in the second half of the year. Real GDP is forecast to be 3.0% up on the year at the end of 2008, compared with a 4.8% rise in 2007. However, growth could reach 4.3% again next year. The annual average rates of change were generally revised upwards slightly for 2009, with the IMF now expecting the global economy to expand by 3.9% (up from +3.8%). Of the larger industrial countries, only Spain saw its growth forecast lowered, by 0.5 percentage point to 1.2%. Overall, the growth forecast risks are regarded as balanced. It is noteworthy that the IMF now predicts higher global economic growth for 2008 and has virtually confirmed its 2009 projection even though oil prices have risen considerably since the spring. For instance, the price assumption for a basket of various types of oil was raised by US$21 to

1 The Fed also adjusted its growth forecast for 2008 upwards in June. US real GDP in the fourth quarter is now expected to be up by between 1.0% and 1.6% on the year; in April, a figure between only 0.3% and 1.2% had been anticipated. The corresponding estimate for 2009 remained unchanged at 2.0% to 2.8%.

US$116½ for 2008 and by US$30½ to US$125 for 2009.

Renewed oil price surge in Q2 ...

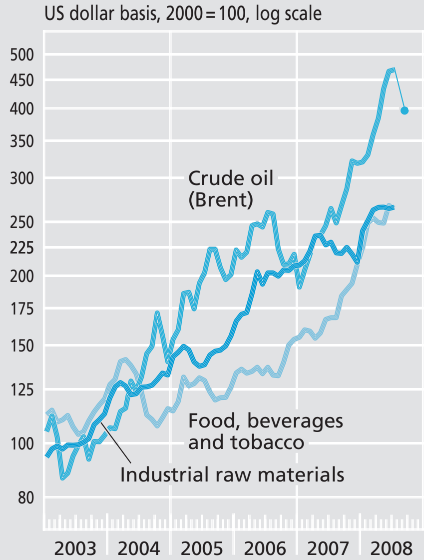
The price of Brent crude oil reached a new high of US$146½ per barrel in the first half of July. It subsequently tended to fall again distinctly, however, and was trading at US$113½ in mid-August. Nevertheless, the prices denominated in US dollars were still 13½% higher at the end of the period under review than at the beginning of April and 60% up on the year. In euro terms, these increases were 19% and 46% respectively. Geopolitical factors, such as the unrest in Nigeria – which led to a considerable reduction in output there – and the escalation of the conflict with Iran regarding nuclear resources, contributed to the renewed surge in oil prices in the spring months. Moreover, there is growing scepticism as to whether oil supply will be able to keep up with the expected further strong growth in demand going forward. Recent markdowns can be attributed largely to the emerging slowdown of the world economy.

... and further price increases for other commodities

The prices of other commodities picked up again perceptibly overall in the second quarter; however, they too have tended to fall again since mid-year. At the beginning of August, industrial raw materials were hardly more expensive in US dollar terms than they had been in February; in euro terms, they were even slightly cheaper. Prices for food, beverages and tobacco meanwhile soared, especially in June, as flooding in the Midwest of the USA was originally estimated to have caused very large crop losses. Prices have, however, declined considerably since the beginning of July. As this report went to press, they were nevertheless still 39% (in US dollars) and 24% (in euro) up on the year.

World market prices for crude oil and industrial raw materials as well as food, beverages and tobacco

US dollar basis, 2000 = 100, log scale



Sources: Thomson Financial Datastream and HWWI. — ● = 13 August 2008.

Deutsche Bundesbank

Further rise in inflation in industrial countries

The significant rise in the prices of energy and agricultural commodities, which has been in evidence for some time now, sent consumer prices soaring in the industrial countries in the second quarter. The year-on-year rate rose by 1.1 percentage points to 4.6% from March to July. The core inflation rate (excluding energy and food) rose slightly to 2.3%. The IMF has responded to the high inflationary pressure by upping its price forecast significantly by an average of 0.8 percentage point to 3.4% this year and by 0.3 percentage point to 2.3% next year for the industrial countries. The IMF forecast now puts inflation in the emerging market economies and developing countries at 9.1% and 7.4% in 2008 and 2009 respectively, which in each case is 1¾ percentage points higher than expected in April.

USA

According to initial estimates, economic growth in the USA picked up again noticeably in the second quarter; real GDP expanded by a seasonally adjusted ½% compared with the preceding period, having virtually stagnated in the fourth quarter of 2007 and the first quarter of 2008. Year-on-year growth was 1¾%. The fact that growth was higher than in the previous two quarters was due largely to the strong expansion in real exports by a seasonally adjusted 2¼%. As this was accompanied by a significant drop in imports, foreign trade contributed just over ½ percentage point to overall economic output growth. In addition, private consumption, which was ½% higher than in the winter months, provided positive stimuli. The substantial tax rebates as part of the government's economic programme are likely to have been key here. Ultimately, however, consumer outlays made up only a small percentage of the roughly US$80 billion in funds that had been distributed by the end of June. The lion's share went into savings, at least in the short term, sending the seasonally adjusted household saving ratio up by 2¼ percentage points quarter on quarter to 2½% in the second quarter. It can be assumed, however, that a larger part of these rebates will be spent on consumer goods in the second half of the year. By contrast, overall gross investment placed a considerable damper on GDP growth. This was particularly pronounced in the case of inventory investment, which declined by ½% of GDP. In addition, real residential building investment was again curtailed, although the decline of 4% was no longer as marked as before. By contrast, commercial spending on new buildings, plant and equipment, and software rose by ½%.

Of the various factors that hit US private consumption in the second quarter, the strong rate of price inflation should be highlighted. This was again due to the sudden increase in energy and food prices. In the second quarter, prices were up by a seasonally adjusted 1.2% on the preceding period and 4.4% on the year. In July, the rate of price increase accelerated further to 5.6%. The core rate, calculated by excluding these two components, stood at 2.5% when this report went to press. The core deflator, the Fed's preferred indicator, stood at 2.2% in the second quarter and was thus as high as in the preceding period. In June, the Fed significantly raised its April forecast for an increase in the overall deflator for personal consumption expenditure this year, but it left its estimate for the core deflator in the fourth quarter of 2008 unchanged at 2.2% to 2.4%.

Japan

In the second quarter, the Japanese economy shrank by a seasonally adjusted ½% on the preceding period, in which it had expanded by ¾%. Year-on-year growth was 1%. All of the major demand components were on a downward trend except for government consumption, which virtually stagnated at its first-quarter level in seasonally adjusted terms. Private consumption dropped by ½%, largely as a result of the decline in real labour income, also by ½%. Commercial and public investment slipped by ¼% and 5¼% respectively. It is noteworthy that price-adjusted expenditure on new residential construction fell sharply again (-3½%) after considerable expansion in the first quarter as the backlog of building permits that had built up in the second half of 2007 was cleared. In addition, real exports declined by 2¼% in seasonally adjusted terms as cyclical momentum in key customer countries waned. However, imports were slightly harder hit (-2¾%) owing to weak domestic and foreign demand. As imports are smaller in volume than exports, however, their positive contribution to growth just offset the negative export effect.

In the second quarter, rising energy and food prices again drove up seasonally adjusted consumer prices sharply (+0.5% quarter on quarter and +1.4% year on year). In June, inflation even reached its highest level since 1998 (+2.0%). The index excluding energy and food remained unchanged year on year in the second quarter, as it had in the first quarter, too. The GDP deflator fell by 1½%, however, which is another indication that the vast majority of price impulses were external.

United Kingdom

The UK was still beset by the sluggish growth that had become very apparent after the turn of 2007-08. According to initial calculations, in the second quarter, real GDP again increased by just ¼% on the quarter in seasonally adjusted terms, which means that it was 1½% up on the year. The weak economic development was evident in many sectors. In the production sector (including construction), seasonally adjusted output was cut back by ½%, while real value added in the services sector increased by only just under ½% after averaging almost 1% per quarter in 2006 and 2007. The "business-related services and finances" sector, which was particularly hard hit by the financial market turmoil, made virtually no contribution to growth. House prices slid further and were 11% down on the year in July. By contrast, consumer price inflation continued to accelerate, rising from 2.5% in March to 4.4% in July (as measured by the Harmonised Index of Consumer Prices (HICP)). Core inflation (excluding energy and unprocessed food) rose by almost 1 percentage point to 2.6% over the same period.

New EU member states

The new EU member states experienced waning economic momentum in the second quarter. This was particularly pronounced in the industrial sector, where output in the three-month period from April to June was ¾% lower than in the first quarter. However, it should also be borne in mind that the March result was relatively low while the April figure was correspondingly high as Easter was early this year. Nonetheless, annual growth still came in at 6½%. The weakening of expansionary forces was particularly pronounced in Estonia and Latvia. The overall slower pace of economic activity in the new EU member states was driven, for one, by weaker growth in demand on their sales markets in western Europe. For another, households' purchasing power has been badly eroded by, for the most part, exceptionally high inflation over the past few months. The average rate of price increase was 7.1% in July, a level not witnessed since the second quarter of 2002. However, this figure masks very large differences between countries, with recent inflation data ranging from 4.4% in Slovakia to 16.5% in Latvia.

Macroeconomic trends in the euro area

GDP decline in Q2 ...

In seasonally adjusted terms, overall economic output in the euro area was ¼% lower in the second quarter than in the first quarter, in which it had expanded quite strongly (+¾%). Nevertheless, output was still 1½% up on the year. The expected technical counter-reactions to the strong construction activity – buoyed by the mild winter weather – in the northern part of the euro area were a key factor in the fall vis-à-vis the first quarter of the year, as was the sharp increase in industrial production in Germany at the beginning of 2008. In addition, economic momentum has diminished in recent months. This is particularly true of exports and private consumption, which received a significant damper as a result of the latest surge in inflation. Germany's significant country weight meant that the sizeable decline in its real GDP compared with the first quarter lowered the euro-area result. The French and Italian economies also shrank, albeit not as much as the German economy. Spain's overall economic output increased only marginally up to the end of the period under review.

... largely as a result of negative stimuli from the production sector

The decline in overall economic output in the euro area was largely attributable to the retarding effects in the production sector. The fall in output was particularly pronounced in the construction sector, where it dropped by a seasonally adjusted 2% in the April-May period compared with the first quarter of the year. This can be explained by the aforementioned technical counter-reactions as well as the fact that housing construction activity continued to weaken in several euro-area countries. Industrial production also eased in the second quarter, falling by ½% on the winter months in seasonally adjusted terms. Moreover, the fact that Easter was early this year meant that the March production figures were more affected and the April figures were less affected by holidays than usual. The second quarter saw 1% year-on-year growth. The decline in industrial output vis-à-vis the preceding period went hand in hand with a noticeable reduction in capacity utilisation by 1 percentage point; nevertheless, it was still well above its multi-year average. The volume of incoming orders in April and May was down by ½% on the first quarter in seasonally adjusted terms. In addition, the industrial confidence indicator signalled a significantly slower pace of growth for euro-area industrial activity; it has dropped by 6 points since April and, in July, was below its long-term average for the first time since the fourth quarter of 2005.

Weak demand

Private consumption in the second quarter was probably noticeably curtailed by the increase in inflation. This is suggested by the decline in real retail sales by a seasonally adjusted 1% on the quarter and the fact that new passenger car registrations remained on a steep downward trend – more precise data on private consumption and other major demand components are not yet available. In addition, consumer confidence has once again fallen markedly below its long-term average. While construction investment has slumped – as explained earlier in connection with construction output – spending on new plant and equipment is likely to have held up better. Although nominal exports to non-euro-area countries were up by a seasonally adjusted 1¾% on the first quarter in the April-May period, the early timing of Easter this year means that – as with industrial production and incoming orders – the strong gains recorded for April have to be relativised. It is worth noting that – despite the renewed surge in energy prices – a relatively slow increase in value of ¾% was reported for imports on a seasonally adjusted basis on an average of the first two months of the second quarter; in price-adjusted terms, imports are even likely to have declined.

Labour market

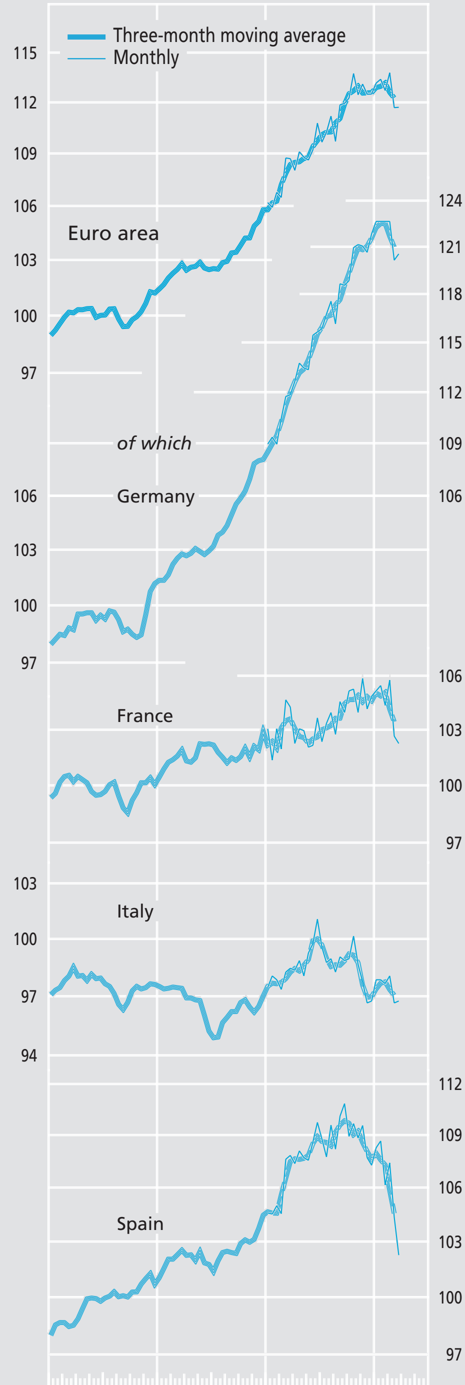
The seasonally adjusted number of unemployed persons in the euro area rose somewhat in the second quarter of 2008, the first such increase to be recorded since the second quarter of 2005. The standardised unemployment rate rose marginally to 7.3%. In regional terms, this development was overwhelmingly driven by unemployment in Spain, which started on its uphill path in mid-2007. Euro-area employment increased by 0.3% in the first quarter of 2008 – more detailed information is not yet available. This translates into a 1.6% rise on the year. Hourly labour costs were up by a seasonally adjusted 0.8% on the quarter and 3.3% on the year.

Acceleration in the rate of price increase

As a result of the sharp increase in the prices of crude oil and agricultural products, seasonally adjusted consumer prices in the second quarter of 2008 were up by no less than

Industrial output*
in the euro area

2000 = 100, seasonally adjusted, log scale



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

Deutsche Bundesbank

Euro-area consumer prices

Year-on-year percentage change

Item	2007 Q3	2007 Q4	2008 Q1	2008 Q2
HICP, total	1.9	2.9	3.4	3.6
of which				
Energy	0.7	8.2	10.8	13.6
Unprocessed food	2.4	3.1	3.5	3.7
HICP excluding energy and unprocessed food	2.0	2.3	2.5	2.5
of which				
Processed food	2.5	4.5	6.4	6.9
Industrial goods	1.0	1.1	0.8	0.8
Services	2.6	2.5	2.6	2.4

Deutsche Bundesbank

1.1% on the previous period. This corresponds to an annualised rate of 4½%. The actual year-on-year rate swelled from 3.4% in the first quarter to 3.6% in the second quarter. Energy prices were 6.0% higher than in the first quarter, while food prices also accelerated sharply again at a seasonally adjusted rate of 1.1%. The prices of services and industrial goods, however, had only a moderately negative impact, rising by 0.6% and 0.2% respectively. Energy and overall food prices were up by 13.6% and 5.7% respectively on the year. By contrast, the annual rate of inflation for services amounted to 2.4% and to 0.8% for other goods. The strong upward pressure on prices is therefore to date affecting mainly the commodity-dependent categories of goods, namely energy and food. However, the price pressures on the upstream sectors of the economy have grown significantly over the past few months. Industrial producer prices for consumer durables rose by 2.4% on the year in the first six months of 2008 after having risen by 1.9% in the second half of 2007. In July 2008, the latest month for which data are available, consumer price inflation stood at 4.0% and was thus well above the price stability benchmark defined by the Eurosystem.