Global and European setting

World economic activity

Global economy on flatter growth path

In the first few months of 2008, the global economy continued to grow, but it has lost some momentum. At the same time, the global price climate deteriorated significantly. The cyclical weakness in the United States was at the heart of real economic developments. US gross domestic product (GDP) increased only slightly in the first quarter of 2008 – as already at the end of 2007. One contributing factor was the continuing sharp decline in residential investment. The other was the only slight growth of private consumption, which had been the main driver of growth for a long time. As things now stand, it is quite likely that the US economy can avoid the slump into recession feared by some since, apart from monetary policy impulses, the economic programme adopted by the US government will probably already show first effects in the spring and come to fruition in the second half of the year. However, the question remains how soon it will be possible to completely overcome the economic slump. The pressure to adjust created by the turmoil on the US real estate market is still high, and the situation on the financial markets remains vulnerable despite some rays of hope.

By contrast, the growth of the Japanese economy in the first quarter was markedly higher than in the fourth quarter of 2007. The euro area also showed a high measure of resilience against the external retarding forces and also saw noticeably accelerated growth. In the industrial countries as a group, real GDP once again grew by an estimated ½%

(after seasonal and calendar adjustment) in the first quarter of 2008. The year-on-year increase was 2¼%.

Moderate loss of momentum in emerging market economies

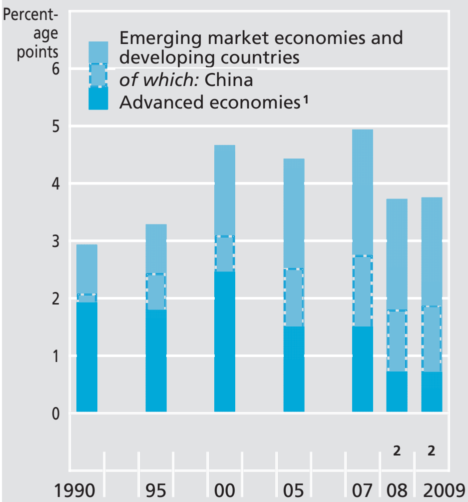
In the south and east Asian emerging market economies, the pace of growth seems to have slowed down somewhat since the beginning of the year, but it remained quite high compared with the industrial countries. The main reasons for the loss of momentum were the more moderate development of exports and the major erosion of consumers' purchasing power by the sharp increase in energy and food prices. At 10½%, the Chinese economy's year-on-year growth in the first quarter was no longer quite as strong as in the fourth quarter of 2007, when GDP growth was 11¼%. The weaker impulses from exports were offset by stronger growth in domestic demand. The weather-related production stoppages in the winter months are also likely to have contributed to the decline in growth. So far, there has been no easing of consumer prices; in March-April, the inflation rate was 8.4%.

The economies of Latin America have so far been affected very differently by the weakening of the US economy – depending on the strength or type of the economic ties. For example, Mexico and its Central American neighbours, including the Caribbean, were affected more than other countries, not only owing to slower growth of exports to the United States (which are mostly relatively significant) but also owing to a decline, or clearly slower rise in, workers' remittances, although from a macroeconomic perspective, the impact on Mexico was offset to a degree by the high oil prices. Other countries, such as Brazil, Argentina and Chile, continued to benefit from the higher prices for industrial raw materials as well as for food, beverages and tobacco. However, the picture for the whole economy in this region is often clouded by the strong rise in food prices. This also involves politically controversial redistribution effects since the poorer sections of the population in the cities lose much of their purchasing power owing to the heavy weight of basic foods in the basket of goods. Conversely, the rising income in the (partly neglected) agricultural sector also benefits small farmers. A positive aspect is that Latin America's vulnerability to financial market crises has clearly decreased, some of the reasons being that the dependency on foreign savings has been greatly reduced in recent years and that it was possible to build up a large volume of monetary reserves.

Signs of overheating in the oil-producing countries of the Middle East and in Russia

In the oil-exporting countries of the Middle East, the economic overheating in recent months has further increased, if anything. A crucial factor for this was that, owing to the pegging of their currencies to the US dollar, most member states of the Gulf Cooperation Council have virtually imported the recent interest rate cuts by the US Federal Reserve, even though the inflationary pressure has considerably risen there. In the Commonwealth of Independent States, the increase in domestic demand fuelled by the commodity boom together with the considerable increase in food prices likewise continued to place a burden on the price climate. In Russia, the inflation rate rose to 13.3% in March, compared with 7.6% twelve months earlier.

Contributions to global economic growth



Sources: International Monetary Fund, World Economic Outlook Database April 2008 and Bundesbank calculations. — 1 Industrial countries including Malta, Slovenia, Cyprus, Taiwan, Hong Kong, South Korea and Singapore. — 2 April 2008 IMF forecast.

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In the meantime, the central bank has started pursuing a more restrictive course; at times, administrative measures were also taken to dampen the rise in prices, although with little success.

Further downward revision of IMF forecast

The main reasons for the slowdown in the global economy include the absence of impulses from the United States, the significant broad-based rise in commodity prices and the fact that the turbulence on the financial markets, which has often led to high losses in the financial sector and a tightening of lending conditions both within the United States and beyond its borders, has not yet been overcome. Against this background, the International Monetary Fund (IMF) once again revised its forecast for the global economy downwards. The Fund now expects global growth to decline from an above-average result of 5% in 2007 to 3¾% in this and next year and thus fall somewhat below the multi-year average of 4%. Compared with 2007, the aggregate growth rate for industrial countries might be halved to 1¼% for both years, and the aggregate growth rate for the emerging market economies and developing countries might be reduced by a similar extent from 8% to well over 6½%. Owing to the continued large gap, the share of global growth generated by this group of countries will probably increase by one-tenth to eight-tenths in the 2007-09 period. In 1990, the emerging market economies and developing countries generated only one-third of global growth, rising to almost one-half in 2000. According to the IMF forecast, the expansion of real global trade will decline from 6¾% in 2007 to 5½% this year and 5¾% next year.

Sharp rise in prices for crude oil ...

So far, the slower pace of the global economy has not been able to dampen rising prices on the commodity markets. At the end of the period under review, crude oil prices reached a new high at US$124¾ per barrel of Brent crude oil, which was more than one-quarter above the level at the start of 2008 and nine-tenths above the level one year earlier. In euro, the year-on-year rise was 68% in mid-May, due to the euro's appreciation. One reason for the sharp rise in oil prices since the start of 2008 was OPEC's decision not to increase the production quotas. Another reason was that there were increasing indications that non-OPEC supply could develop less favourably than previously expected. Moreover, the geopolitical tensions in important oil-producing countries remained high; sometimes there were also production and delivery disruptions for technical reasons or because of strikes. In addition, the demand for oil, particularly from emerging market economies, is continuing to increase markedly.

... and for other raw materials since the beginning of the year

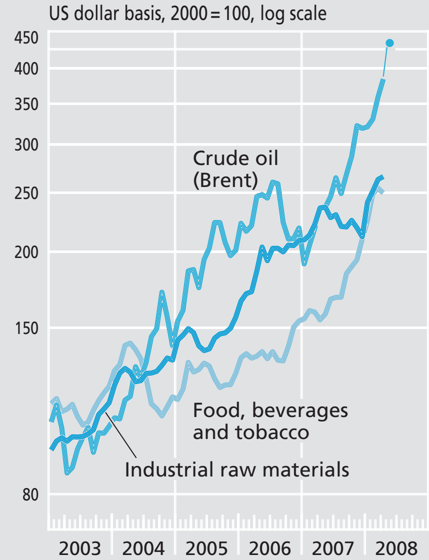
The prices (in US dollars) of other raw materials (excluding energy) remained virtually unchanged in April after a first-quarter increase of 17% on the period. This was mainly owing to slightly declining world market prices for food, beverages and tobacco, which, in turn, were fostered by lower prices for oilseeds and oils. While wheat prices clearly decreased recently, rice prices increased sharply. This has on various occasions already led to protests in the major cities of some emerging market economies and developing countries. In this context, it is worrying that a number of governments have reacted by adopting protectionist measures, such as export tariffs on basic foods or export limits for the improvement of domestic supply, or increased stockpiling, thus further adding to inflation on the global markets. A more efficient course of action would be to refrain from distortionary intervention and to let the higher consumer prices take their effect at the producer level to create incentives to quickly expand production. The prices for industrial raw materials, which had increased by 14½% on the quarter in the first quarter, rose by only 1% on the month in April.

Inflation up in the industrial countries

The continuation of the sharp rise in world market prices for crude oil and food since the beginning of the year has also had an impact on consumer price inflation in the industrial

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. — ● = 14 May 2008.

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countries. In the first quarter, headline inflation was 3.5% up on the year; this was the highest rate since the end of 1997. Excluding Japan, it stood as high as 3.7%. Core inflation (excluding the volatile components of food and energy) amounted to 2.5% for these countries, compared with 2.3% in the fourth quarter of 2007.

USA

According to provisional figures, overall economic output in the United States has risen only slightly in the first quarter after seasonal and calendar adjustment – as already in the fourth quarter of 2007. The year-on-year increase stood unchanged at 2½%. However, the structure of the growth took a turn for the worse in the winter months in that the greatest contribution, at ¼ percentage point, came from inventory investment, with domestic final demand sinking. Private consumption increased by merely ¼% (seasonally and calendar adjusted), following an increase of ½% in the final quarter of 2007. Housing construction continued its unbroken tailspin, falling by 7½%, and investment in non-residential structures, which had been a significant pillar of construction output in 2007, declined for the first time since the third quarter of 2005 (–1½%). Investment in machinery and equipment likewise tended slightly downwards. Real exports rose strongly in the first quarter of the year, by a seasonally and calendar adjusted 1¼%, but at the same time – in contrast to the previous quarter – imports picked up again somewhat; given the existing difference in levels between the two indicators, foreign trade ultimately made only a minor net contribution to growth.

Given that the winter months saw a massive accumulation of inventories and that the majority of leading indicators continued to be pointed downwards, overall output for the second quarter is expected to remain weak. However, now that the IRS has already begun to send tax rebate checks to households, which is likely to boost their demand already in May and June, a marked decline in real GDP is unlikely. All in all, however, private consumption faces significant strains, mainly through the considerable erosion of purchasing power, the decline in employment, stricter lending conditions and negative wealth effects. At 3.9%, the inflation rate was still at a very high level in April, despite falling by 0.4 percentage point since January. As before, the considerable price pressures stemmed mainly from energy and food. Core inflation (excluding energy and food) as measured by the Personal Consumption Expenditure deflator increased slightly to 2.1% in March.

Japan

In the first quarter, the Japanese economy grew by ¾% in seasonally adjusted terms, following an expansion of just over ½% in the fourth quarter. Real GDP was up by only 1% on the year, however, owing to a baseline effect. The accelerated period-on-period growth is largely due to the more lively growth of private consumption, which, at ¾%, was double its end-2007 result. Another factor was that the permit backlog in residential construction, which had led to a significant decline in activity in this area in the second half of 2007, diminished at least in part after the turn of 2007-08; expenditure on new residential construction increased by 4½%. Government investment was likewise expanded. By contrast, corporate investment noticeably declined (–1%). A further important driver for growth was real exports, which were up by a seasonally adjusted 4½% on the quarter. With import growth clearly weaker (+2%), foreign trade contributed ½ percentage point to GDP growth. Consumer prices, which had declined on the year in the third quarter of 2007, have shown a noticeable upward trend since then owing to the price increases for crude oil and food. Headline inflation was 1.2% in March. If energy and food are excluded, prices remained virtually unchanged.

United Kingdom

According to provisional figures, seasonally and calendar adjusted real GDP growth in the UK slowed down further in the first quarter to almost ½% on the quarter or 2½% on the year. One factor in this was that, owing to the ongoing financial market crisis, the value added in the "business-related services and finances" sector increased by only just under ½% in seasonally and calendar adjusted terms on the previous period, when it had increased by just over ½%; in the first three quarters of 2007, growth rates averaged 1¼%.[1] The overall economic output of the services sector increased by ½%. Moreover, the economic output of the production sector (excluding construction) stagnated at the level of the fourth quarter of 2007. By contrast, construction activity increased by ½%, favoured by the mild winter weather. However, the housing market is unlikely to have provided any further stimulus; house prices fell by 4¼% in the period from January to April. Nevertheless, year-on-year consumer price inflation increased markedly in this time, namely from 2.2% to 3.0%, owing to higher energy and food prices. Excluding these two components, inflation was 2.0% in April.

New EU member states

Industrial activity in the new EU member states (excluding Slovenia, Cyprus and Malta, which now belong to the euro area) remained lively in the winter months. In January-February, output exceeded the level of the fourth quarter of 2007, in which growth had declined somewhat, by no less than 6½% in seasonally adjusted terms and was thus 9¾% up on the year. A major demand-side driver was the increase in purchasing activity by households, which – in terms of nominal retail sales – rose by 11½% on the year in the first quarter. Wages and employment continued their robust growth, thereby fuelling individuals' propensity to consume. The average standardised unemployment rate in these countries fell to 7.2% in the fourth quarter. However, the positive production and labour market developments have been accompanied by a significant across-the-board rise in inflation. On an average of the first four months, consumer prices were a seasonally adjusted 2.3% higher than in the previous period and 6.7% up on the year. Individual figures in April ranged from 3.7% in Slovakia to 17.4% in Latvia.

Macroeconomic trends in the euro area

US and euro-area growth converging ...

The persistently weak economy in the United States, combined with robust macroeconomic development in the euro area, caused the euro-area economies to pull ahead of the USA in terms of growth in the 2007-08 winter half-year. On average over the 2005-07 period, the euro area's growth lag was already only just under ½ percentage point, compared with one percentage point in the period from 1996 to 2001 and 1¼ percentage points from 2002 to 2004. However, the closing of the gap was due primarily to a slowdown in the United States and not so much to stronger euro-area economic growth.

... yet prosperity gap still wide

Moreover, the prosperity gap between the United States and the euro area – in terms of per-capita income in purchasing power parities – is still as large as at the end of the 1990s (see explanatory notes on pp 18-19).

1 The even more narrowly defined financial sector is responsible for creating around 8% of the total gross value added in the UK, compared with 4% in Germany.

Growth and prosperity gap between the USA and the euro area – new trends

The growth differentials between the USA and the euro area, which increased substantially during the slump at the beginning of the current decade, have declined markedly in recent years. Following the bottoming out of the business cycle in both economic areas in the second half of 2001 after the "New Economy" boom, the US economy initially grew quite sharply, driven by monetary impulses and a strong fiscal policy stimulus, while in the euro area the recovery remained moderate until mid-2003. The sustained slump in Germany was a significant contributing factor. The average growth rates in the two economic areas for the period between 2002 and 2004 were 2.6% in the USA and 1.3% in the euro area, compared with 3.5% and 2.6% for the period between 1996 and 2001.[1]

However, from mid-2003 onwards the pace of growth in the euro area increased significantly; in 2006, at 2.8%, real GDP growth returned to almost the same level as overall economic output in the USA for the first time since the beginning of the upswing. In 2007, at 2.6%, the growth rate was even 0.4 percentage point higher. The main reason for this was that the decline in housing investment, which had started at the end of 2005 and subsequently accelerated considerably, was by itself enough to cause a 1-percentage-point drop in US GDP growth. By contrast, despite the strong appreciation of the euro in 2007, the pace of growth in the euro area declined relatively little. On an average of the period 2005-07, at 2.3%, euro-area growth was only 0.4 percentage point slower than that of the US economy. The pick-up in growth in Germany, from 0.3% in the period from 2002 to 2004 to 2.0% in the following years, played an important role.

This is consistent with a recent reduction in the labour productivity growth gap between the USA and the euro area following a significant increase, particularly in the second half of the 1990s.[2] Measured as real gross domestic product (GDP) per employed person, in the three-year period from 2005 to 2007 growth slowed in the USA to 1.2% from 2.6% in 2002-04, while in the euro area it increased from 0.9% to 1.2% (and in Germany from 1.3% to 1.6%).[3] Once again, therefore, the closing of the gap was due more to a slowdown in the United States than to stronger euro-area economic growth.

Moreover, it would be premature to infer a stronger co-movement of the underlying real trends from this finding, which is based on a relatively short observation period. It should be borne in mind that, particularly last year, the euro-area economy was still quite buoyant, while the US economy had already gone past its peak; to this extent, the closing of the gap described above was caused by the cyclical shifts. However, aggregate potential output estimates show that the convergence of US and euro-area growth rates over the past few years is not just a cyclical phenomenon. According to OECD calculations, since the end of the 1990s there has been a clear convergence of the potential growth path; actual growth convergence, particularly at the start of the current decade, was obscured by the aforementioned divergences in the first phase of the cyclical upturn. The main reason for the closing of the potential output growth gap was the marked slowdown in the United States from 3½% in the second half of the 1990s to 2½% in the period from 2002 to 2007, while for the euro area the OECD cites a more or less constant pace of around 2%. According to ECB staff estimates, euro-area potential output growth is estimated at 2% to 2½ at the current end. Thus, as a core area of the European Union, the euro-area countries are still a long way away from the goal, formulated in Lisbon in 2000, of increasing sustainable growth in the Community to 3% by 2010.[4]

A Solow decomposition of growth rates to examine the supply-side background behind economic growth in both economic areas shows clearly that the lower post-2002 annual average US GDP growth compared with the second half of the 1990s is due mainly to a noticeably weaker contribution from capital as a factor of production, with the reduction being more pronounced in the USA than in the euro area. Therefore, the disparity vis-à-vis the United States was significantly reduced. The main reason for this could have been that the capital-linked technological advances, which benefited the US economy in particular, lost momentum. During the 2002-04 period, labour's contribution to growth also fell in the USA – in relative terms on a similar scale to the euro area. However, in 2005-06[5] it returned to levels equivalent to those of the second half of the 1990s. Between 2002 and 2004, the empirical residual component, which is conceptually related to total factor productivity, grew considerably more strongly in the United States than in the euro

1 See Deutsche Bundesbank, Appendix: Discussing the growth and prosperity gap between the United States and the euro area, Monthly Report, May 2002, pp 34-38. — **2** See European Commission: The EU Economy: 2007 review – Moving Europe's productivity frontier, 2007. — **3** The data on productivity developments are based – owing to a lack of current data on work-load – on staff levels, converted to full-time equivalents, as published by the European Commission in its spring forecast at the end of April 2008. — **4** For more detail on potential growth in Germany, see specifically Deutsche Bundesbank, Advances in strengthening the economy's growth potential, Monthly Report, October 2007, pp 35-45. — **5** The data needed for a growth decomposition are only available as complete sets up to 2006. —

area, but thereafter the pace was equally strong in both economic areas.

An analysis highlighting prosperity aspects should fundamentally be based on net domestic product (NDP), which reflects distributable income in an economy more closely than GDP, which also includes the depreciations.[6] This is particularly the case in periods in which the weight of capital consumption changes, as, for example, in the United States during the second half of the 1990s. At that time the ratio of depreciations to GDP tended to increase significantly, not least due to increased depreciations in ICT investment, which characteristically have a relatively short useful economic life – on average the ratio increased by 0.4 percentage point per annum vis-à-vis 0.1 percentage point in the euro area. However, on an average of the period 2005-07 the national depreciation rate did not change in either the USA or the euro area. Therefore real NDP generally increased at the same pace as GDP.

Furthermore, it would seem appropriate to use a per-capita analysis to determine the prosperity gap between the two regions over time. A country with a rapidly expanding population must create stronger real income growth than a country with low population growth in order to maintain or increase the material standard of living of its population. In the period 2005-07, the US population grew by an average of 0.9% and thus about twice the euro area's rate. This is mainly due to higher birth rates in the USA and the long period of increased immigration. However, population growth resulting from immigration is likely to have slowed in the meantime as, for cyclical reasons, there is a reduced need for labour. Since 2005 real per-capita NDP has increased by an average of 1.8% per annum in both the USA and the euro area (in Germany it has even increased by 2.1%). This means a recent break in the growth of the prosperity gap between the USA and the euro area. However, the catching-up process that could have been expected given the current income disparity has not occurred, either.

If, to compare per-capita income levels, the figures are converted from euro to US dollars at market exchange rates, nominal per-capita NDP in the euro area has increased particularly sharply over the last seven years – by 11% per annum,

Real per-capita net domestic product (NDP) in the United States and the euro area

Percentages

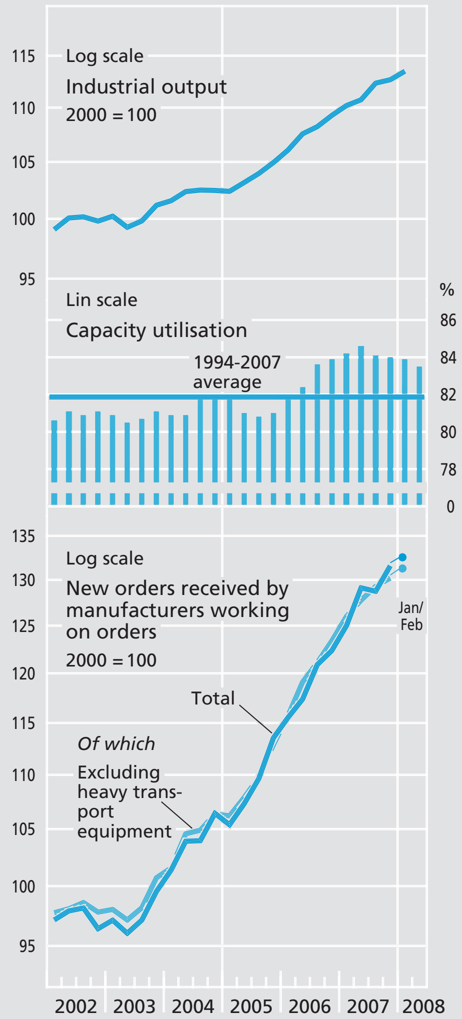
Item	Real per-capita NDP	Calculated from: Real GDP	Calculated from: Change in the depreciation rate[7]	Calculated from: Population
	Average change during the period			
Euro area				
1996-2001	2.1	2.6	0.1	0.4
2002-2004	0.4	1.3	0.3	0.6
2005-2007	1.8	2.3	[8] 0.0	0.5
USA				
1996-2001	2.0	3.5	0.4	1.1
2002-2004	1.6	2.6	0.0	1.0
2005-2007	1.8	2.7	0.0	0.9
Memo item				
Germany				
1996-2001	1.6	1.9	0.2	0.1
2002-2004	– 0.1	0.3	0.3	0.1
2005-2007	2.1	2.0	0.0	– 0.1
	Difference in percentage points			
Difference between USA and euro area				
1996-2001	– 0.1	0.9	0.3	0.7
2002-2004	1.2	1.3	– 0.3	0.3
2005-2007	0.0	0.4	– 0.1	0.4

compared with 4½% in the USA – during which the euro appreciated markedly. At just under US$33,000 in 2007, euro-area per-capita income was accordingly 18% below the US level. However, PPP exchange rates are generally preferable to market exchange rates when comparing per-capita income, as they take better account of the differences in price levels between the respective economic areas and enable disruptive short-term volatility in the exchange rate to be avoided. Calculated using PPP exchange rates, euro-area per-capita NDP in 2007, at US$28,200, was 30% below the US level; the gap is thus still as large as at the end of the 1990s. In Germany the income gap vis-à-vis the USA has also not decreased, holding steady at 27% at last report. Compared with the euro area, Germany is thus in a somewhat more favourable position.

6 Strictly speaking, the net national income (NNI) at factor cost (national income), which differs from NDP in terms of the balance of primary income to and from the rest of the world and is recorded without including taxes less subsidies on production and imports, should be used. However, national income is officially only published as a nominal variable. For simplicity, terms of trade-induced changes in real incomes were also disregarded, in particular as the positive and negative terms of trade effects of a country largely even out over a longer period of time. — **7** Real depreciation as a percentage of real GDP at previous year's prices; change in percentage points. The deflator of the depreciation for the euro area is estimated using data on seven euro-area countries. — **8** Figure for 2007 estimated.

Selected indicators of industrial activity in the euro area

Seasonally adjusted, quarterly



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Faster pace of growth again in first quarter

In the first quarter of 2008, GDP growth in the euro area increased by a seasonally adjusted ¾% on the period. However, this was partly owing to the mild winter weather which barely affected construction output. At 2¼%, year-on-year overall economic growth was as high as in the fourth quarter of 2007. In view of the relatively favourable output level in the construction sector in the first quarter, a technical reversal is expected in the second quarter, which will tend to dampen the rise in overall output. To a large extent, the sharp GDP increase in the first quarter is due to the very dynamic development in Germany and the noticeably faster pace of growth in France. The corresponding data for Italy are not yet available, but, in view of industrial output developments in January-February, growth is likely to have risen moderately again – unlike in the fourth quarter of 2007. By contrast, the Spanish economy has significantly lost momentum, mainly owing to the marked slowdown in housing construction.

Noticeable expansionary stimuli from industry

The robust macroeconomic upturn in the euro area in the first quarter was mainly sustained by the production sector. Excluding the special factors in the construction sector, the main stimuli came from manufacturing. Here, output increased by a seasonally adjusted 1¼%, after remaining unchanged in the fourth quarter. Energy production, by contrast, noticeably declined owing to the mild weather. Within the manufacturing industry, the producers of capital goods recorded the strongest growth. Nevertheless, the capacity utilisation of industrial enterprises further declined from January to April, yet remained clearly above its multi-year average at last report. While in a generally robust state, the outlook for industrial activity in the euro area has dimmed somewhat overall in recent months. Although the high amount of orders received in the fourth quarter was still exceeded by ½% in January-February, the Purchasing Managers' Index and the industrial confidence indicator are signalling a slowdown.

More buoyant demand

Data on the development of the major demand components are not yet available. The slight first-quarter increase in real retail sales – following the sharp decrease in the final quarter of 2007 – indicates, at most, a slight rise in private consumption. In addition, new car registrations declined by a seasonally adjusted 3¼% in the period from January to March. Moreover, consumer sentiment was significantly worse in the first four months of this year than in the fourth quarter of 2007. As already mentioned, construction investment probably increased strongly, owing not least to the mild weather, and enterprises' demand for machinery and equipment seems to have been buoyant again. The value of exports to non-euro-area countries surged at the start of the year; on the two-month average of January-February, they surpassed the level of the fourth quarter of 2007, in which they had remained virtually unchanged, by a seasonally adjusted 4½%. They were 11% up on the year. Nominal imports increased at a similar pace. However, since a greater part of this rise was price-related, foreign trade may have slightly supported overall growth.

Further improved labour market conditions

Unemployment in the euro area is still falling, although at a slowing pace. Compared with the average of the fourth quarter, it was down by 152,000 to 10.97 million, or 7.1%. Developments in the individual countries varied widely. While Germany recorded a decline of 220,000, Spain had an increase of 130,000. Employment growth also declined noticeably in the fourth quarter of 2007, namely from 0.4% in the third quarter of 2007 to 0.2%. However, there was still a 1.7% rise on the year. Hourly labour costs still increased moderately in the fourth quarter of 2007 by a seasonally adjusted 0.7% compared with the previous period and by 2.7% on the year, but are likely to have accelerated visibly at the beginning of 2008.

Euro-area consumer prices

Year-on-year percentage change

Item	2007 Q2	2007 Q3	2007 Q4	2008 Q1
HICP, total	1.9	1.9	2.9	3.4
of which				
Energy	0.5	0.7	8.2	10.8
Unprocessed food	3.3	2.4	3.1	3.5
HICP excluding energy and unprocessed food	1.9	2.0	2.3	2.5
of which				
Processed food	2.0	2.5	4.5	6.4
Industrial goods	1.0	1.0	1.1	0.8
Services	2.6	2.6	2.5	2.6

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Inflation still strong

Consumer price inflation continued to rise strongly in the first quarter of 2008. As in the final quarter of 2007, the prices for goods and services increased by no less than 1% on average in seasonally adjusted terms. Extrapolated for a full year, this results in an inflation rate of around 4%. The actual year-on-year increase grew from 2.9% to 3.4% on an average of the three winter months. The main price drivers were once again energy, the price of which rose by 3.4% on the quarter, and food, at 1.4%. By contrast, the price trend for goods was flat (+0.2%), and

Fiscal developments in the euro area

Fall in the deficit in 2007, particularly owing to favourable cyclical influences and revenue windfalls

At the end of April, Eurostat, the European Commission's statistical office, published the government deficit and debt figures of the EU member states that had reported these figures as part of the European excessive deficit procedure. According to these reports, the general government deficit ratio in the euro area decreased from 1.3% to 0.6% last year and thus reached its lowest level since the start of monetary union.[1] The debt ratio fell from 68.5% to 66.4%. Government revenue grew by 5.3%, primarily owing to exceptional increases in revenue from direct taxes, causing the general government revenue ratio to rise slightly by 0.2 percentage point to 45.6%. Growth in expenditure amounted to 3.7%.[2] The expenditure ratio fell by ½ percentage point to 46.3%, mainly as a result of favourable economic developments.

According to European Commission calculations, the structural deficit ratio, ie the deficit ratio after adjustment for cyclical influences and temporary measures, fell by ½ percentage point to 0.7%. It should, however, be borne in mind that this includes continued exceptionally high growth in revenue, particularly in the generally very volatile revenue from profit-related taxes. Overall, the fall in the structural deficit ratio thus hardly reflects any active fiscal policy consolidation in the member states. Instead, the quite marked decline in the deficit in 2007 was due mainly to favourable cyclical developments and unexpected increases in revenue.

Rise in the 2008 deficit ratio owing to discretionary measures

In its spring forecast, the European Commission expects the deficit ratio to increase to 1.0% in 2008. Cyclical influences and temporary measures play hardly any role, rather, according to the Commission, the rise in the structural deficit ratio is due mainly to discretionary cuts in taxes and social security contributions (particularly in Germany, France and Spain). Furthermore, following the revenue windfalls that many countries have experienced over the past few years, tax revenue is now expected to see a more normal development. Overall, revenue growth will therefore fall to 3.2% in 2008. According to the forecast, expenditure will increase by 4.1%. The expenditure ratio will thus remain largely unchanged, despite subdued growth in interest expenditure. Given a somewhat less favourable cyclical influence, the Commission forecasts a further slight deterioration in the euro-area budget balance in 2009. The downward movement in general government debt in relation to GDP, which began in 2006, is expected to continue until 2009. However, according to the forecast, at 64.3%, the euro-area debt ratio will then still be above the 60% reference value.

No euro-area country has a deficit ratio above 3%, but several countries have persistently high fiscal imbalances

In 2007, no euro-area country recorded a deficit ratio that exceeded the 3% reference value. However, the fiscal deficits reported by France, Portugal and Greece were close to this limit. Furthermore, Eurostat expressed reservations with regard to Greece's figures. The Greek deficit figures have already been revised upwards retroactively in previous years, sometimes significantly, and it cannot be ruled out that, ultimately, a figure exceeding the 3% limit will be recorded once more. A reliable statistical database is indispensable for credible budgetary rules. In this respect, both national authorities and the European institutions are required to provide a timely and sound basis.

While the European Commission expects Greece's deficit ratio to improve without the need for additional measures during the forecast period and Portugal's 2009 deficit ratio to be at least unchanged vis-à-vis its 2007 level, a further rise in the deficit ratio is expected for France. The Commission forecasts that, at 3% of GDP, France will by far have the highest deficit ratio of all the euro-area countries in 2009. Italy's already relatively high deficit also looks likely to increase further. Malta and Ireland are expected to record ratios between 1% and 2% in 2009. The deficits reported by Belgium, Slovenia, Austria and Germany are likely to be smaller than this, while balanced budgets or surpluses are expected in Finland, Luxembourg, the Netherlands, Spain and Cyprus. According to the Commission's forecast, the debt ratios in most euro-area countries will decline between 2007 and 2009. However, the reference value for the debt level of 60% of GDP will still be exceeded by Belgium, Germany, Greece, France, Italy and Portugal in 2009. The expected increase in Portugal and France is at odds with the Maastricht Treaty requirement that the debt ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Currently, Italy and Portugal are still in the excessive deficit procedure. The correction period granted to Portugal extends up to 2008, while the correction period granted to Italy expired in 2007. However, as both countries reported a deficit ratio below 3% in 2007, the Commission recommends that the ECOFIN Council should abrogate the procedure.

However, beyond compliance with the reference values, the Stability and Growth Pact envisages significantly more ambitious medium-term budgetary objectives. These country-specific objectives are set by the member states themselves. Viewed from a structural perspective, surpluses or, at most, a deficit ratio of 1% are to be achieved depending on poten-

1 In 2000, a balanced budget was achieved solely as a result of one-off proceeds from the sale of UMTS mobile telephone licences. After adjustment for these one-off proceeds, the euro-area deficit amounted to 1% of GDP. — **2** In 2007, expenditure growth was dampened by

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tial growth and the debt ratio. This is also intended to ensure that, in downturns, the 3% level is not exceeded if the automatic stabilisers are operating freely. The Pact also sets distinct requirements for the adjustment path: if the structural deficit exceeds the target value, it generally has to be reduced annually by 0.5% of GDP, whereby greater progress in consolidation is to be achieved during good times.

The reform of the Pact not least had the objective of pressing ahead with consolidation, particularly in good times. However, many countries have recently fallen short of this objective. Instead, in a favourable macroeconomic environment, they have often used revenue windfalls to finance cuts in taxes and social security contributions or additional expenditure. According to the Commission's calculations, in 2007, 8 of the 15 euro-area member states (Belgium, Germany, France, Greece, Italy, Malta, Austria and Portugal) failed to meet their medium-term budgetary objective. The forecast also shows that none of these countries will meet their objective by 2009. Furthermore, Ireland is also not expected to achieve its objective from 2008 onwards owing to a considerable structural deterioration. In both 2008 and 2009, only Malta will achieve the required regular reduction in the structural deficit by 0.5% of GDP without the need for additional consolidation measures. For Greece, this will be the case only in one of these two years. According to the forecast, all of the other countries listed will meet this requirement neither in 2008 nor in 2009.

In this context, occasional calls for active fiscal economic stabilisation measures are problematic. An expansionary fiscal policy in countries that fail to meet their medium-term budgetary objective would not be in line with the Pact's requirements. However, as the steps towards deficit consolidation are related to structural variables, the automatic stabilisers can work around this mandatory path. Achieving the medium-term budgetary objective ultimately ensures that, in normal downturns, the 3% limit is observed without the automatic cyclically-induced revenue shortfalls and additional expenditure having to be actively counteracted.

As has already been clearly shown in the past, an unsound basis and unfavourable developments in the macroeconomic environment can quickly lead to excessive deficits. Possible additional burdens resulting from the financial market turmoil are currently intensifying this risk. It is therefore crucial for countries with notable structural deficits to make serious efforts to rapidly draw closer to their medium-term budgetary objective. Although sufficient efforts have not been evident in all cases, the possible options for imposing sanctions envisaged in the preventive arm of the Stability and Growth Pact – early warning by the Council, policy recommendations from the Commission – have not been implemented since the reform of the Pact in 2005.

	Budget balance (as % of GDP) 3				Structural budget balance (as % of GDP) 3				Debt (as % of GDP) 3			
Country	2006	2007	2008	2009	2006	2007	2008	2009	2006	2007	2008	2009
Belgium	0.3	– 0.2	– 0.4	– 0.6	– 0.6	– 0.3	– 0.2	– 0.1	88.2	84.9	81.9	79.9
Germany	– 1.6	0.0	– 0.5	– 0.2	– 1.4	– 0.3	– 0.8	– 0.8	67.6	65.0	63.1	61.6
Finland	4.1	5.3	4.9	4.6	4.2	4.9	4.8	4.9	39.2	35.4	31.9	29.1
France	– 2.4	– 2.7	– 2.9	– 3.0	– 2.7	– 2.7	– 2.8	– 2.6	63.6	64.2	64.4	65.1
Greece	– 2.6	– 2.8	– 2.0	– 2.0	– 3.7	– 3.3	– 2.6	– 2.3	95.3	94.5	92.4	90.2
Ireland	3.0	0.3	– 1.4	– 1.7	2.9	0.2	– 0.8	– 0.9	25.1	25.4	26.9	28.8
Italy	– 3.4	– 1.9	– 2.3	– 2.4	– 2.8	– 1.5	– 1.9	– 1.6	106.5	104.0	103.2	102.6
Luxembourg	1.3	2.9	2.4	2.3	1.4	2.8	2.7	2.9	6.6	6.8	7.4	7.6
Malta	– 2.5	– 1.8	– 1.6	– 1.0	– 2.9	– 2.4	– 1.7	– 1.0	64.2	62.2	60.6	58.8
Netherlands	0.5	0.4	1.4	1.8	1.1	0.3	1.0	1.3	47.9	45.4	42.4	39.0
Austria	– 1.5	– 0.5	– 0.7	– 0.6	– 1.4	– 1.0	– 1.2	– 0.9	61.8	59.1	57.7	56.8
Portugal	– 3.9	– 2.6	– 2.2	– 2.6	– 3.2	– 2.2	– 1.9	– 2.2	64.7	63.3	64.1	64.3
Slovenia	– 1.2	– 0.1	– 0.6	– 0.6	– 1.3	– 0.7	– 1.1	– 0.7	27.2	24.1	23.4	22.5
Spain	1.8	2.2	0.6	0.0	2.0	2.4	1.1	0.9	39.7	36.2	35.3	35.2
Cyprus	– 1.2	3.3	1.7	1.8	– 0.7	3.5	1.9	2.0	64.8	59.8	47.3	43.2
EU 15	– 1.3	– 0.6	– 1.0	– 1.1	– 1.2	– 0.7	– 1.0	– 0.9	68.5	66.4	65.2	64.3

0.3 percentage point: in 2006, the Italian government had assumed part of the debt of the Italian railway company and this one-off expenditure-increasing measure was no longer applicable in 2007. — **3** Source: Economic Forecast Spring 2008, European Commission.

the prices of services (+0.7%) remained comparatively moderate. Energy prices increased by 10.8% on the year, processed food prices by 6.4% and unprocessed food (vegetables, fruit, meat and fish) by 3.5%. Among the euro-area countries, only the Netherlands recorded an inflation rate below 2%; in six countries, it was even above 4% (including Slovenia with no less than 6.5%). In April, the annual euro-area inflation rate decreased by 0.3 percentage point on the month to 3.3%; in this case, however, the early Easter date and the previously only incomplete transfer of the most recent rises in crude oil prices likely played a role.

Favourable development of public finances in 2007

Public finances in the euro area developed favourably last year. However, the noticeable decline in the deficit ratio was driven mainly by the good economic activity and windfall revenues. All countries were below the 3% reference value. For the future, some countries may be expected to fall well short of the requirements of the Stability and Growth Pact (see explanatory notes on pp 22-23).