Global and European setting

World economic activity

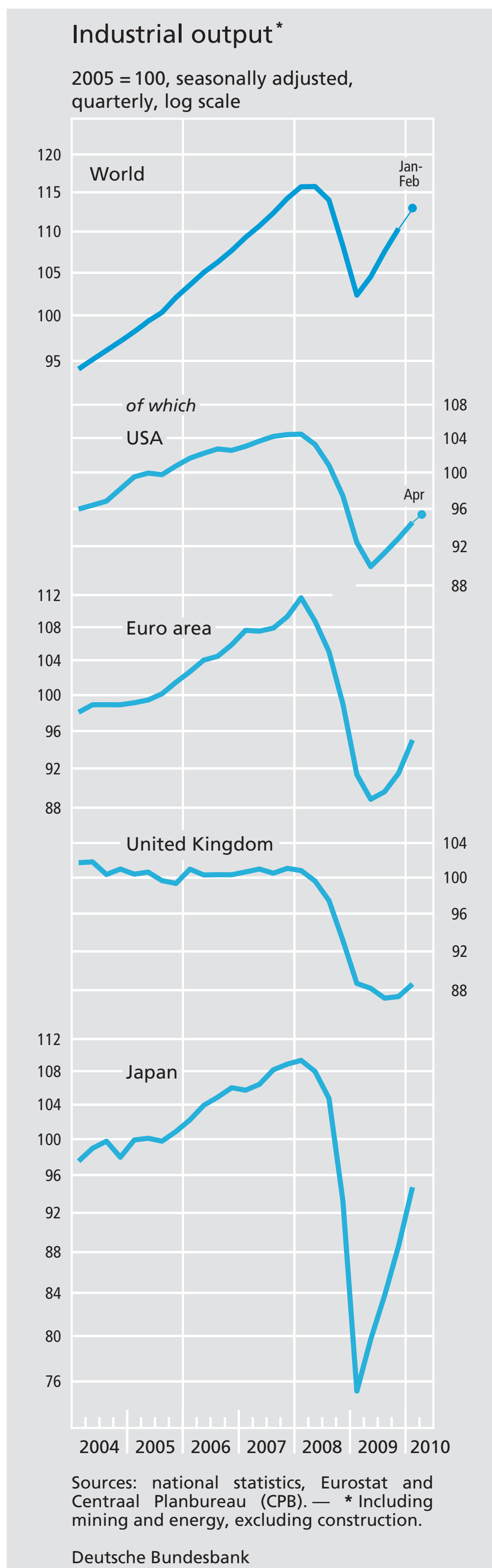
World economic activity still improving, ...

The global upswing became increasingly entrenched starting from the beginning of the year. Monetary policy and the inventory cycle continued to provide strong stimuli, whereas the expansionary fiscal policy effects abated. In addition, continued sharp price rises in the equity markets lasting into April indicated growing confidence in a sustained global upswing. In the past few weeks, however, the financial markets have been dominated by the debt crisis in Greece, which caused contagion effects that spilled over to other countries. The heightened uncertainty in the international equity and bond markets has not, so far, impacted on the real economy. However, it represents a risk, particularly to the euro area.

Global industrial output was up in January–February by 2¼% from the fourth quarter, in which it had risen by 2½%. Following a year marked by recession, its year-on-year growth was no less than 10¼%. In the current quarter, it may well already return to its cyclical peak from the second quarter of 2008. The volume of world trade, having experienced continuous buoyant growth in the past few months, has not recovered fully yet; in January–February it was still 6¼% down on the first quarter of 2008.

... though regional differences still considerable

The great differences in growth rates between the individual regions which had opened up in 2009 persisted throughout the reporting period. In the meantime, the economies of some east Asian emerging markets and Brazil are again facing the threat of over-



Sources: national statistics, Eurostat and Centraal Planbureau (CPB). — * Including mining and energy, excluding construction.

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heating. In several countries, central banks have therefore raised their interest rates in the past few months; China has imposed administrative restrictions on lending. The industrial countries, on the whole, maintained their much more moderate rate of economic growth in the first-quarter months. Of those countries, it was Japan that saw the strongest growth in economic output. The United States, too, saw good progress in its cyclical recovery. By contrast, overall output in the euro area grew only sluggishly. However, account needs to be taken of the adverse weather-related effects which affected, above all, construction output in the northern member states. Real gross domestic product (GDP) for the United States, the EU and Japan taken together rose by ½% after seasonal adjustment, which was not quite as strong as a quarter earlier; it was up by 1¾% on the year.

Positive signals for the Q2–Q3 period

The leading indicators for the world economy are pointing to a continuation of the strong recovery in the second and third quarters of 2010. The forward-looking components of the global Purchasing Managers' Indices for manufacturing and services went up once again in the first-quarter months. A new leading indicator developed by the Bundesbank is pointing in the same direction (see box on pages 18-19). In addition, according to the ifo institute, the global economic climate has of late improved once again, owing mainly to a much more favourable assessment of the current situation and continued optimism regarding future expectations. The indicator has pulled away even further from its multi-year average. This is due in particular to

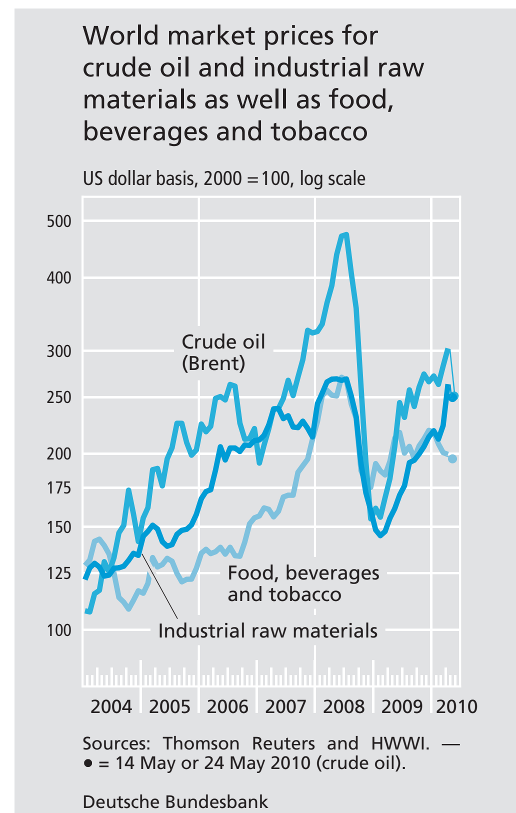
developments in Asia and North America, whereas western Europe has made virtually no progress.

Favourable IMF spring forecast

Owing to the extremely buoyant global economic activity, in April the International Monetary Fund (IMF) revised its forecast of global growth for 2010 upwards by 0.3 percentage point from its January forecast to 4.2%. In spring 2009 its forecast had been as low as 1.9%. The latest correction applies to the industrial countries and emerging markets alike; output growth in these regions is now expected to run at 2.3% and 6.3% respectively. Of the emerging markets, the forecasts were increased particularly sharply for the central and east European countries (to 2.8%), India (to 8.8%) and Brazil (to 5.5%). China, however, still leads the pack at 10.0%. For 2011, the forecast for the global economy from the beginning of the year (+4.3%) has been retained. World trade is forecast to grow this year and next by 7.0% and 6.1% respectively. With respect to consumer prices, the IMF expects them to rise moderately in the industrial countries at an annual rate of 1½% during the forecast period. In the emerging markets, however, inflation will pick up perceptibly for cyclical reasons to 6.2% in 2010 but recede to 4.7% next year. On the whole, though, the IMF regards the risks to growth as being on the downside, with particular emphasis in this context resting on the significant growth of public debt in the industrial countries.

The price of Brent crude oil fluctuated in the three first-quarter months in a corridor of between US$70 and US$80 per barrel. In early April, however, it picked up rapidly and was then hovering over the US$85 mark. Amidst the financial market turmoil, however, the price of oil retreated sharply in May, to US$71¼ as this report went to press. Owing to the euro’s depreciation, the price of crude oil in euro did not fall quite as heavily; at the end of the reporting period a barrel was selling for €57¾. Since the fourth quarter of 2009, global demand for oil has been going back up owing, above all, to the surge in demand from the emerging markets, particularly China. However, the supply of oil is also on the rise; owing to an increase in deliveries by Iraq, OPEC production in February was at its highest since the fourth quarter of 2008. The relatively moderate mark-ups in the forward markets indicate a slightly rising price trend for the rest of 2010 and 2011. Develop-

Prices of crude oil and industrial raw materials initially continued to rise



Constructing a new leading indicator for the global economy

After plummeting almost synchronously across countries in the last few months of 2008 and the first few months of 2009, the global economy has rapidly regained momentum and has been on a remarkably dynamic growth path since the second quarter of 2009. Since then, the strongest stimuli for the global recovery have been coming from the emerging market economies in South and South East Asia, particularly China, whereas the cyclical recovery in the industrial countries, which were hit much harder by the financial crisis, began later. The cyclical recovery in Germany, which has again been more export-driven of late, is benefiting from a rise in demand both from industrial countries and from the emerging market economies. Leading indicators of global economic development, which by definition provide early signals of changes in economic activity, are therefore of particular interest when analysing and forecasting macroeconomic momentum in Germany.

Leading indicators are generally used to observe economic activity in a given economic area over time and, in particular, to identify cyclical turning points *ex ante*. Usually, however, there are a large number of variables with leading indicator properties available that exhibit a fairly high level of individual volatility. These individual indicators are, therefore, often compiled into composite leading indicators (CLIs) using statistical methods. For some time now, the OECD's cyclical composite leading indicators have been attracting much attention. The staff at the OECD construct country-specific CLIs which usually draw on between six and eight individual indicators that differ from country to country.[1] After detrending, these indicators are aggregated into a composite indicator using statistical data reduction methods. Additionally, the OECD generates aggregate composite indicators for selected economic regions from the country-specific CLIs. The indicator for 29 OECD countries and the six BRIICS countries[2] is of particular interest. Over 80% of worldwide GDP is generated by this group of countries, which indeed makes it a global leading indicator. It serves below as a benchmark for the properties of a new Bundesbank indicator for the global economy (BBk indicator).

The Bundesbank's global leading indicator was essentially modelled on the OECD's methodology, but with one fundamental difference. Instead of first calculating leading indicators for individual countries and then aggregating these, global series were used directly, the availability of which has been steadily increasing. This approach has the dual advantage that it covers a broader range of countries and, compared with the OECD indicator, also allows greater emphasis to be placed on components with timely and frequent availability.

Various statistical data reduction methods are available for constructing a composite indicator from a number of time series.[3] Principal component analysis is the method used here. The basic idea behind this method is that each variable contains partial information which is not contained in other time series. This "new" information constitutes the element of a variable that is independent of the other variables or, put differently, it has an uncorrelated or orthogonal relationship to these other variables. In principal component analysis, the orthogonal elements of the various individual variables are calculated first and then, in a second step, a small number of informative linear combinations – the principal components – are formed. The first principal component explains the bulk of the variation in the data, while each additional component successively explains as much of the remaining variation as possible. This allows a small number of uncorrelated components to be generated from several correlated individual variables. The indicator presented here is generated from the first principal component.

The individual variables for principal component analysis were chosen partly on the basis of statistical performance analyses. The timeliness and frequency of the data also played a role in the selection process. A total of 14 global (seasonally adjusted) time series were considered. After detrending, smoothing and normalisation, the variables were examined over the entire estimation period (January 2003 to April 2010) in terms of their statistical leading indicator properties in relation to the reference series, namely global industrial production.[4] Nine time series indicate a high cross-correlation with global industrial production – which was also stable during the estimation period – and they were thus included in the following principal component analysis. Overall, it turns out that, compared with alternative modelling schemes for the nine time series under consideration, the leading indicator with the best leading indicator properties and which can most accurately forecast cyclical turning points is the one produced from the following six time series:

1 The OECD leading indicator for Germany is computed from six indicators: four indicators of the Ifo institute (business climate, demand situation, level of export orders, level of inventories), orders received in manufacturing and an (unspecified) interest rate margin. — **2** BRIICS: Brazil, Russia, India, Indonesia, China and South Africa. — **3** See "Handbook on Constructing Composite Indicators" OECD, 2008. — **4** Global

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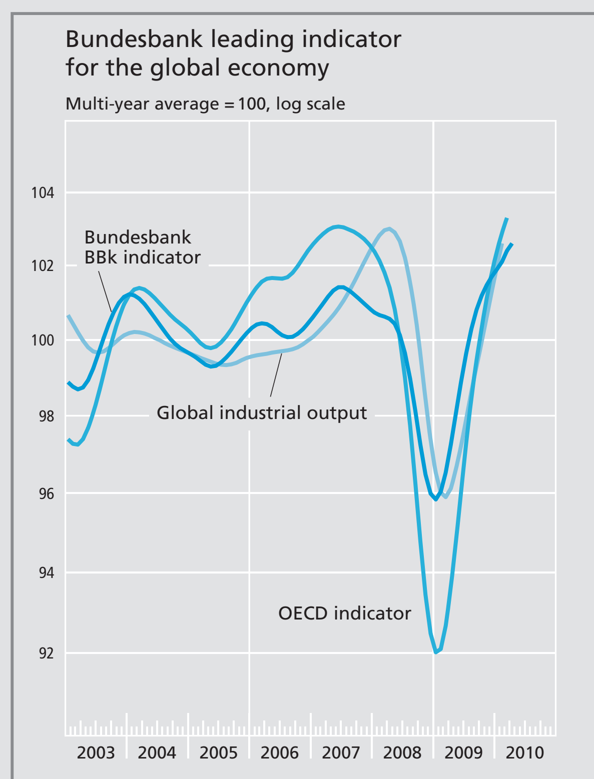
the global Purchasing Managers' Index (PMI) for manufacturing, where, in addition to the overall indicator, the sub-component "assessment of new export orders" was also taken into consideration; the global PMI for the services sector; the Sentix consumer climate "current situation index";[5] the Sentix consumer climate "expectations index" (six months) and the S&P Global 1200 share price index.

As in the case of the OECD leading indicators, the Bundesbank's BBk indicator has been optimised so that it can predict cyclical turning points in a timely and accurate fashion. However, the detrending required for this means that only qualitative comparisons with the trended reference series, namely global industrial production, are possible. This is why the OECD assesses the quality of its CLIs exclusively in terms of their forecast quality for cyclical turning points and not in terms of their predictive property with regard to the reference series. The descriptive method applied by the OECD was used to compare the Bundesbank's BBk leading indicator with the OECD indicator.[6] The results indicate that, for the time period under consideration, the average leading indicator property of the Bundesbank's BBk indicator for cyclical turning points is slightly greater and is subject to somewhat less dispersion. At the same time, the Bundesbank's BBk indicator has a higher cross-correlation with the reference series. However, the greatest advantage of the index as a leading indicator is its timely availability. While the OECD indicator is generally published 1½ months after the reporting period, the indicator presented here is available as soon as the third working day of the following month and therefore around six weeks earlier. Nevertheless, the relatively short estimation period of the Bundesbank's BBk indicator constitutes a significant drawback at present. It is likely to become less significant over time, however.

When interpreting the indicator, the focus is on momentum and the respective cyclical phase. In line with the OECD's methodology, a distinction is made between four cyclical phases: 1. Expansion (indicator increasing and above 100); 2. Downturn (indicator decreasing and above 100); 3. Slowdown (indicator decreasing and below 100); 4. Recovery (indicator increasing and below 100). When the value for February 2009 was published, both the Bundesbank's BBk leading indicator and the OECD indicator signalled an imminent cyclical bottoming-out in the recent recession.[7] The fundamental difference, however, was that the February value of the Bundesbank's BBk indicator was available six weeks earlier (beginning of March). The Bundesbank's BBk indicator for the global economy signalled the changeover from a "recovery" phase to an "expansion" phase as early as August 2009, whereas the OECD indicator did not exceed 100 until October 2009.

The positive trend of the Bundesbank's BBk indicator continued up to the end of the period under review, even though the upward curve has since become somewhat flatter compared with the steep slope in the second and third quarters of 2009. Given its function as a leading indicator, it is to be expected that the upturn in the global economy, which made good progress in the first quarter of 2010, will continue at a rapid pace in the second half of the year.



industrial production according to CPB estimate. — 5 See www.sentix.de/index.php?pagename=documentation/ecowin.htm. — 6 See "Predicting the Business Cycle - How good are early estimates of OECD Composite Leading Indicators?" OECD Statistics Brief, February 2008. — 7 Recursive estimations of the indicator have shown that cyclical turning points did not have to be revised ex post.

ments were highly uneven with regard to other commodities. The prices of industrial raw materials advanced once again in April, especially those of non-ferrous metals and agricultural raw materials. However, they receded distinctly in May amidst heightened uncertainty in the financial markets and a dampened outlook for demand from China. The prices of food, beverages and tobacco, however, remained stable in April and May after having fallen perceptibly in the first quarter.

Energy more expensive but price climate in industrial countries generally calm

Consumer prices in the industrial countries were up once again in the first quarter of 2010, by 0.6% on the period after seasonal adjustment. This is the average of a distinct rise around the turn of 2009–10, largely as a result of higher energy prices and the renewed value-added tax hike in the United Kingdom, and a more moderate development in February and March. Since December, year-on-year inflation has fluctuated between 1.5% and 1.8%. At 1.7% on average for the quarter, however, it was around twice as high as in the last quarter of 2009, the beginning of which had even been marked by a slight decline in prices. Core inflation (excluding energy and food) averaged 1.1% over the first-quarter months. Excluding Japan, both rates are each 0.3 percentage point higher. In April, for which no data for Japan were available as this report went to press, overall consumer price inflation, at 2.0% year-on-year, remained unchanged from the first quarter. Core inflation fell further to 1.0%.

Selected emerging market economies

Continued strong expansion in south and east Asian emerging markets ...

The south and east Asian emerging markets maintained their vigorous growth in the first-quarter months. First-quarter real GDP in China was up by 12% on the year. According to an estimate by the Chinese central bank, economic output rose by 3% on the quarter after seasonal adjustment. Government investment, which was sharply increased under the fiscal programme adopted in November 2008, once again contributed to maintaining the strong cyclical growth. Household consumption also provided positive stimuli, with nominal retail sales in the first quarter up by 18% on the year. Sales of cars, which continued to be buoyed by a tax cut for environmentally friendly new cars, even shot up by 77% over the same period. Owing to lively growth of domestic demand and higher commodity prices, imports rose more sharply in terms of value than exports, which meant that China had only a relatively low trade surplus in the first quarter. According to the leading indicators, the rapid pace of economic expansion in China is set to continue in the coming months, which will probably also cause the risks of an overheating economy to increase further. Since the beginning of the year, consumer price inflation has picked up significantly, owing especially to weather-induced increases in food prices; in April it stood at 2.8%. Excluding food, however, inflation was still moderate, at 1.3%.

India's economy, according to available data, remained on a steep expansionary track in the first quarter. Owing to a slight easing of

food prices, inflation fell slightly at last report, to 14.9% in March.

... and in many Latin American countries

Many Latin American countries likewise saw their economic output rise distinctly once again in the first quarter of the year. Industrial output in Brazil was 3% up on its level of the fourth quarter of 2009 after seasonal adjustment. Positive demand stimuli came, above all, from household consumption. Real retail sales in the first quarter were up by 5% on the period after seasonal adjustment following a 3% rise a period earlier. Consumer price inflation accelerated further from the beginning of the year to 5.3% in April.

In Mexico, however, the cyclical recovery has begun to sputter. Real GDP, after seasonal adjustment, even fell slightly on the quarter. This, however, is probably only a temporary lull in growth against the background of the very lively expansion in the second half of 2009. An easing of the rise in food prices caused the rate of inflation to fall noticeably to 4.3% at the end of the reporting period.

Russian recovery weaker

In Russia, the cyclical recovery that had begun in the second half of 2009 diminished in the first quarter of 2010. Although real GDP rose on the year again for the first time since the end of 2008 (+3%), this improvement is likely to be due to a base effect following a severe slump in economic output in the same period a year earlier. Investment, in particular, has not yet gained any momentum, according to the available data. At least household consumption, however, appears to have recovered perceptibly, if one uses real retail sales as a benchmark. In addition, Russian export revenue remained on a steep upward path owing to higher intake from deliveries of crude oil and natural gas. Disinflation continued throughout the reporting period. Consumer price inflation stood at 6.0% in April, its lowest level since July 1998.

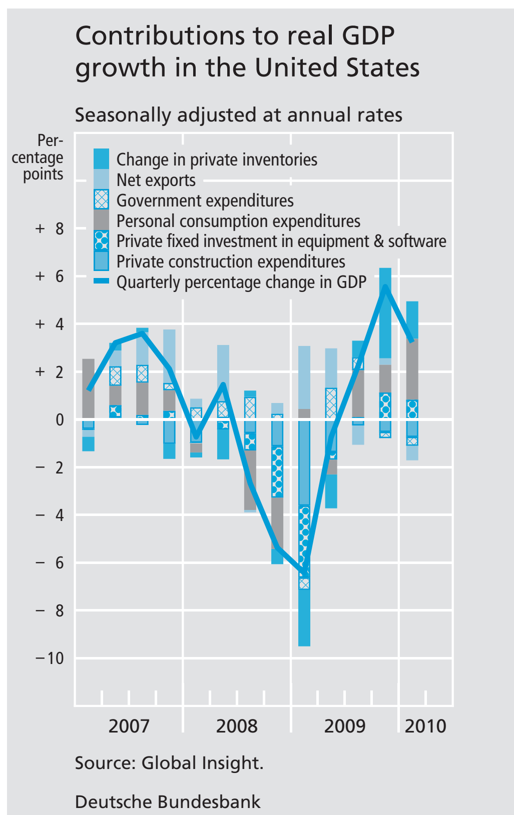
USA

Strong growth ...

The engine of the United States economy continued to run at an accelerated pace in the first three months of the year, with overall economic output up by ¾% on the quarter after seasonal adjustment, though it failed to match the pace of the final quarter of 2009 (+1½%). That was because inventory movements in the first quarter provided a much smaller boost than previously, contributing only just under ½ percentage point. Domestic private final demand, by contrast, accelerated perceptibly.

... supported by households

In the first quarter of 2010, it was households that made the greatest contribution to overall economic growth. Higher advance tax payments tightly confined the growth of households' disposable income yet failed to keep their consumption from surging. At nearly 1% on the period, price-adjusted consumer spending growth was twice as strong as in the last quarter of 2009. In return, admittedly, the household savings rate was reduced from 4% to 3%. The continued improvement in the labour market, in particular, is likely to have fuelled consumer spending. Following a 6% decline in total employment, the first quarter saw a slight period-on-period increase in non-farm employment for the first time in two years. In the second-quarter



months, the census currently in progress will lead to the creation of a large number of temporary jobs in the public sector. However, the private sector, too, has increasingly become a net creator of new jobs. The unemployment rate, which in October 2009 had peaked at 10.1% and held steady at 9.7% in the first-quarter months, climbed back up to 9.9% in April. This was mainly because many people who had exited the job market during the latest recession are now actively seeking employment. The continued decline in inflation provided additional relief to households. CPI inflation in April, after adjustment for seasonal factors, was only 0.2% higher than at the end of 2009; excluding energy and food, it even remained unchanged. The corresponding year-on-year inflation rates fell considerably to 2.2% and 0.9% respectively at the end of the reporting period.

... and enterprises

Not only households but also enterprises continued to drive the overall economic recovery. Although investment in machinery and equipment, on the whole, was no longer quite as strong as in the fourth quarter, it was specifically spending on machinery and other industrial equipment which halted its two-year slide. However, commercial construction, which lags the cycle, plummeted almost unhindered. The fragility of the recovery in the real estate market to date, moreover, is documented by a renewed decline in residential housing construction. Foreign trade flows were calmer in the first quarter of 2010 following strong growth a quarter earlier. Amidst a perceptible recovery of domestic private final demand, imports grew more strongly than exports. Apart from foreign trade, demand from the public sector also dampened overall economic output. At the downstream levels of government, in particular, spending is increasingly being adjusted to reduced revenues. Although the economic stimulus programme adopted early last year may initially continue to have a supporting impact, its focus was not only on tax relief but also on transfer payments to regional and local governments and households, as a large part of the programme is designed as a substitute for the automatic stabilisers, which tend to be relatively unimportant in the United States.

Japan

Foreign trade recovery continuing ...

Japan's cyclical recovery progressed by leaps and bounds in the first quarter of the year. According to a preliminary estimate, real GDP, seasonally adjusted, was up by 1¼% since the final quarter of 2009, in which it had risen by 1%. Year-on-year real GDP growth was 4½%; however, overall economic output was still 4¾% less than its level of the first quarter of 2008. The buoyant recovery, like the severe slump that preceded it, is being supported mainly by foreign demand. Industrial output was up in the first quarter by just under 7% on the period after seasonal adjustment, thereby keeping up with the rapid growth of real exports as defined in the national accounts. Because imports grew at a rate of 2¼% and, hence, by less than exports, foreign trade once again made a considerable (¾ percentage point) contribution to GDP growth.

... but also signs that domestic activity is stabilising

Although a slowdown in the destocking of inventories was the main reason for the increase in the rate of quarter-on-quarter overall economic growth, domestic final demand seems to have regained its footing as well. Private housing investment pointed upwards for the first time since the fourth quarter of 2008. In an environment of improved earnings and growing confidence, enterprises once again stepped up their gross fixed capital formation distinctly. In addition, households once again increased their real consumption, which had already risen sharply owing to government purchase incentives. They are now also being given relief by an improvement in the labour market situation. Employment grew perceptibly in the first quarter compared with the final quarter of 2009, and the unemployment rate in March, at 5.0%, was ¼ percentage point lower than in December. Lastly, the deflationary tendencies in consumer prices seem to be slowly ebbing. Negative year-on-year inflation according to the consumer price index contracted from -1.7% in December to -1.1% in March. Core inflation (excluding food and energy) stood at -1.1% at the end of the reporting period, as compared with -1.2% at the end of the past year.

United Kingdom

Still on path of moderate recovery at beginning of year

The UK economic recovery which got under way in the fourth quarter of last year continued at a muted pace in the first quarter of 2010, with real GDP, according to the latest estimates, up by a seasonally adjusted ¼% on the period after increasing by ½% in the fourth quarter. Disparities among the major sectors persisted. In the manufacturing sector (excluding construction), real gross value added rose sharply (+1¼%). Activity in the services sector – which was supported by the financial sector and the business-related service providers – grew by only ¼%. By contrast, construction activity contracted – probably due in part to weather conditions – by ½%. The standardised unemployment rate climbed by 0.2 percentage point to 7.9% in the first two months of 2010. However, following a trend turnaround in the fourth quarter, the number of people claiming unemployment benefits fell significantly throughout the reporting period. Consumer prices were 3.7% higher in April than a year

earlier. Inflation was thus holding steady above the Bank of England's target range of one percentage point on either side of the 2% mark. Not only the renewed value-added tax hike at the turn of 2009–10 and the surge in oil prices but also the downstream effects of the pound sterling's depreciation are likely to have contributed to the price increases.

New EU member states

Economic picture positive overall

The moderate cyclical upturn in the new EU member states (EU-8) picked up momentum in the first quarter, though the positive overall picture continues to mask disparate developments in the individual member states. Whereas overall economic output continued to recover in Poland, the Czech Republic and Hungary, it does not appear to have bottomed out yet in the Baltic states of Estonia and Lithuania and the Black Sea countries of Bulgaria and Romania. It is questionable whether the slight GDP growth in Latvia marks the beginning of a sustained recovery. Industrial activity in the EU-8 is growing at an accelerated pace. In this group of countries, industrial output in the first quarter was up by 5¼% on the quarter after seasonal adjustment. Retail sales (excluding cars) likewise expanded perceptibly, by 1¾% on the period. The labour market situation remained tense, though. The number of unemployed persons rose in the winter months – partly as a result of weather-related effects – by some 165,000 to 4.1 million. Since its cyclical low in September 2008, the number of unemployed persons has risen by more than 50% and the standardised unemployment rate by 3.2 percentage points to 9.5%. Harmonised Index of Consumer Prices (HICP) inflation was running at 2.9% in April after falling to a new low of 2.6% in March.

Macroeconomic trends in the euro area

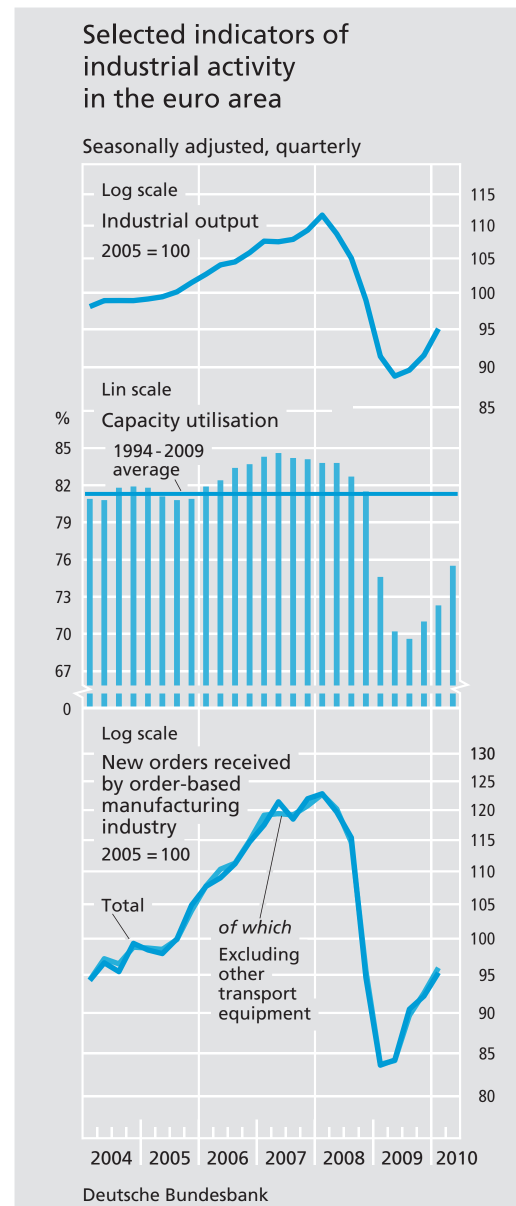
Muted growth at beginning of year ...

The cyclical recovery in the euro area, which had begun to stall in the fourth quarter of 2009 amidst, among other things, the influence of temporary strains, remained listless in the first-quarter months. Real GDP rose by only ¼% after seasonal adjustment and was thus ½% above its low level of a year earlier. Of the major member states, Italy saw the strongest growth (+½% after seasonal adjustment), followed by Germany at ¼% and then France and Spain, which grew only minimally. The damage to construction output in Germany and other member states caused by the harsh winter put a visible damper on the euro area's result. The catch-up effects in construction alone will probably be enough to spur faster euro-area growth in the second quarter. Despite the fact that the fiscal assistance packages are expiring and the stimuli provided by the inventory cycle are subsiding, the underlying trend in business activity is likely to maintain its moderate upward tilt as 2010 progresses. The escalation of the debt problems in some periphery countries and the announcement of additional consolidation measures by the affected countries against that background, however, will probably tend to curb euro-area growth for the time being. In its spring forecast, the European Commission is expecting growth of 0.9% in 2010 and 1.5% in 2011.

... supported by the industrial sector

GDP growth in the first quarter was generated in great measure by the industrial sector (including energy production). Production in this sector rose by 3¾% after seasonal adjustment; although it was up 4¼% on the year, it was still 9½% lower than before the beginning of the crisis. The quarter-on-quarter rise is attributable in part to a substantial increase in energy production. This reveals a positive weather effect which is making itself felt particularly in France, Germany, the Netherlands and Finland. With regard to overall economic growth, however, this effect contrasts with adverse weather-related impacts on construction activity. The production of intermediate goods and consumer goods each rose by 1½% in the first quarter, whereas the manufacture of capital goods went up only slightly. As industrial output increased, capacity utilisation in the manufacturing industry showed a visible further improvement in the January to April period, though it was still perceptibly below its long-run average.

The leading indicators point to a continuation of the upward trend in manufacturing at a somewhat accelerated pace. Industrial confidence has improved considerably in the past few months and has now nearly returned to its long-term average. Among its components, production expectations have brightened considerably, and pressure on inventories is regarded as minimal. The assessment of the orders situation is less gloomy than before, yet the balance of responses is still deep in negative territory. Fittingly, new orders in the first quarter were more than one-fifth lower than their early 2008 peak. Admittedly,



orders in the first quarter were up by 3½% on the quarter; excluding the manufacture of other transport equipment, which is usually strongly characterised by large orders, the increase amounted to 3¾%.

Exports buoyant but domestic demand weak

The primary meaningful stimulant of demand at the beginning of the year was exports to non-euro-area countries, which in the first quarter were up by 9¼% on the quarter after

Fiscal developments in the euro area

After a drastic deterioration in 2009, euro-area budgetary developments still expected to be unfavourable

At the end of April, Eurostat published the general government deficits and debt figures of the EU member states that had reported these figures as part of the European budgetary surveillance process. According to these reports, the euro-area deficit rose dramatically last year from 2.0% of GDP to 6.3%.

Developments were decisively shaped by the financial and economic crisis. The European Commission's calculations show that roughly half of the rise in the deficit ratio is due to the economic downturn. The effect of discretionary fiscal policy measures, such as those taken as part of the European Economic Recovery Plan, was also felt. Furthermore, revenue in some member states fell more sharply than would be expected on the basis of legislative changes and the decline in GDP alone. Revenue decreased by a total of 4% and the revenue ratio fell by 0.5 percentage point to 44.4%. By contrast, expenditure rose by 5% and the expenditure ratio increased sharply by 3.9 percentage points to 50.7%. The debt ratio also soared from 69.4% to 78.7%. This jump was largely due to high primary deficits, rising interest expenditure and falling GDP. In addition there were government support measures for financial institutions, such as bank recapitalisations, that did not affect the deficit but did push up the debt level. By contrast, guarantees and support measures similar to guarantees, which were also deployed during the financial crisis, are mainly not shown in the figures if they have not (yet) been taken up.

In its spring forecast, the European Commission expects the euro-area deficit ratio to continue to rise slightly, reaching 6.6% in 2010 – the highest level since the launch of monetary union. This deterioration is driven not by cyclical influences but by additional tax cuts. Overall, revenue is expected to increase by approximately 1% and expenditure by just under 2%. The revenue ratio will thus slip to 44.2% while the expenditure ratio will remain at a high level of 50.8%. The European Commission forecasts a slight decline in the deficit to 6.1% of GDP in 2011, which is attributable in virtually equal parts to the phasing out of temporary stabilisation measures and to a slight improvement in the cyclical impact. Stronger revenue growth (2½%) than in 2010 is expected, meaning that the ratio will remain more or less constant. With no year-on-year change in expenditure growth, the expenditure ratio will fall by approximately half a percentage point. According to the Commission's forecast, between the end of 2009 and the end of 2011, general government debt in the euro area relative to GDP will again shoot up by roughly 10 percentage points to just under 90%. This sizeable increase is due primarily to high deficit ratios.

Most countries are in clear breach of the reference values for the deficit and debt ratios

The European Commission estimates that all euro-area countries will overshoot the 3% deficit limit in 2010. At around 12%, Ireland is forecast to record the highest deficit ratio, followed by Spain and Greece, both with almost 10%. Portugal, Cyprus and France are expected to record deficits of between 8½% and 7% of GDP. However, as is standard practice, calculations are based on the laws applicable at the time of estimation, meaning that consolidation measures which had been planned but not yet implemented were not included in the calculations. Spain and Portugal have since provided details of additional consolidation measures as agreed in the package of measures approved by the Ecofin Council on 10 May. Greece has also implemented the additional measures set out in the support package from the beginning of May.

An excessive deficit procedure has already been initiated for most euro-area countries,[1] and the forecast shows that many of these countries have a considerable need for action if they are to meet the minimum budgetary requirements stipulated in this procedure. Given that the deficit ratio in Cyprus was well in excess of 3% in 2009 and that Finland is planning to overstep the reference value this year, the Council is soon likely to rule that an excessive deficit exists in these countries, too. Subsequently, with the exception of Luxembourg, all euro-area countries would be in an excessive deficit procedure.

According to the Commission's forecast, the debt ratios will rise in all euro-area countries up to 2011, and in some cases this increase will be dramatic. Compared with 2009, the debt ratio in Ireland, Spain and Greece is forecast to climb by around 20 percentage points, followed by Portugal, Cyprus, France and Finland with a plus of between 14½ and 11 percentage points. In 2011, only four countries (Luxembourg, Slovenia, Slovakia and Finland) are likely to comply with the reference value of 60% for the debt ratio.

Critical escalation in some countries

In the past few years, Greece has repeatedly failed to meet its obligation to provide reliable statistics. Furthermore, its budgetary and economic policies were inappropriate given the stability requirements of a single currency area and it grossly breached European commitments and rules. In February 2010, the ongoing excessive deficit procedure was stepped up and Greece was instructed to correct its excessive deficit by 2012 at the latest. During a visit by a delegation from the European Commission, ECB and IMF to Greece this March, additional consolidation steps were agreed to ensure that the deficit can be corrected as planned. In spite of implementing consolidation measures, the funding of government borrowing requirements on the capital

1 For information about the excessive deficit procedure, see also Deutsche Bundesbank, Excessive deficit procedure against 13 euro-area member states, Monthly Report, November 2009, pp 64-65. — **2** See the statement by Professor Axel Weber, President of the

market was in serious jeopardy at the end of April. In the current very fragile situation, a sovereign default would have posed a considerable threat to the stability of the financial system and of monetary union. As a result, the IMF, European Commission and ECB agreed at the beginning of May to provide Greece with extensive loans to safeguard its solvency. These loans are to bear interest on the basis of three-month EURIBOR rates, and an additional charge of 300 to 400 basis points will be applied. In return, the Greek government has committed to an additional consolidation and reform programme. Overall, measures amounting to 7½% of GDP in 2010, 4% in 2011 and 2% both in 2012 and in 2013 are to be implemented to reduce the deficit ratio so that it reaches 2.6% of GDP in 2014. The loans will be paid in instalments and are conditional on the strict implementation of the conditions agreed, in particular the extensive consolidation measures that have already been stipulated. In light of the fact that economic developments in Greece are now estimated to be significantly more unfavourable and of the additional measures to be taken in 2010 as well as the further consolidation measures already stipulated, it is justifiable that Greece's deadline for correcting the excessive deficit has been delayed until 2014.

Tensions in the markets for some other countries' government bonds also increasingly escalated at the beginning of May on an unexpected scale. Given the serious and immediate danger, the EU finance ministers decided to set up a European financial stabilisation mechanism.[2] At the same time, they pledged to reform the fiscal rules and accelerate the consolidation of public budgets, especially in the countries facing a serious threat. In this context, the latest additional consolidation measures in Portugal and Spain are a welcome development. Portugal has stated that it plans to reduce its deficit sooner than envisaged in the stability programme and to curb its rising debt ratio. In addition to bringing forward consolidation efforts as announced previously, further measures are to be implemented so that the deficit ratio now planned for 2010 (7.3%) is brought down one percentage point below the previous plan. It is then to be cut to 4.6% in 2011 (compared with the previously planned figure of 6.6%). According to information from the Spanish government, additional measures are to further reduce the deficit ratio by 0.5 percentage point in 2010 and 1.5 percentage points in 2011. Spain's deficit ratio is therefore expected to amount to 9.3% in 2010 and 6.0% in 2011.

Without decisive counter steering, there is – as observed in Greece – a danger of a spiral of increasing risk premiums and rising debt which may give rise to negative growth effects. The current crisis has shown just how important it is to comply with the reference values specified in the Treaty on the Functioning of the European Union. Efforts to strengthen the rules and ensure adherence thereto, which are now underway, are thus vital. This is not just a matter of rapidly correcting excessive deficits. A greater focus has to be placed on achieving and maintaining a sound budgetary position in the first place (preventive arm of the Stability and Growth Pact) than has previously been the case. Moreover, the debt level has to be expressly incorporated into surveillance and correction procedures, with the possibility of sanctions in the event of infringements. Another task will be to complement the weakened non-liability clause of the Treaty on the Functioning of the European Union with suitable provisions that substantially increase incentives for a sound fiscal policy at national level.

	European Commission, Economic Forecast Spring 2010								Stability programme, beginning of 2010		
	Budget balance as % of GDP				Government debt as % of GDP				Budget balance as % of GDP		
Country	2008	2009	2010	2011	2008	2009	2010	2011	2010	2011	2012
Austria	– 0.4	– 3.4	– 4.7	– 4.6	62.6	66.5	70.2	72.9	– 4.7	– 4.0	– 3.3
Belgium	– 1.2	– 6.0	– 5.0	– 5.0	89.8	96.7	99.0	100.9	– 4.8	– 4.1	– 3.0
Cyprus	0.9	– 6.1	– 7.1	– 7.7	48.4	56.2	62.3	67.6	– 6.0	– 4.5	– 3.4
Finland	4.2	– 2.2	– 3.8	– 2.9	34.2	44.0	50.5	54.9	– 3.6	– 3.0	– 2.3
France	– 3.3	– 7.5	– 8.0	– 7.4	67.5	77.6	83.6	88.6	– 8.2	– 6.0	– 4.6
Germany	0.0	– 3.3	– 5.0	– 4.7	66.0	73.2	78.8	81.6	– 5½	– 4½	– 3½
Greece	– 7.7	– 13.6	– 9.3	– 9.9	99.2	115.1	124.9	133.9	– 8.7	– 5.6	2.8
Ireland	– 7.3	– 14.3	– 11.7	– 12.1	43.9	64.0	77.3	87.3	– 11.6	– 10.0	– 7.2
Italy	– 2.7	– 5.3	– 5.3	– 5.0	106.1	115.8	118.2	118.9	– 5.0	– 3.9	– 2.7
Luxembourg	2.9	– 0.7	– 3.5	– 3.9	13.7	14.5	19.0	23.6	– 3.9	– 5.0	– 4.6
Malta	– 4.5	– 3.8	– 4.3	– 3.6	63.7	69.1	71.5	72.5	– 3.9	– 2.9	– 2.8
Netherlands	0.7	– 5.3	– 6.3	– 5.1	58.2	60.9	66.3	69.6	– 6.1	– 5.0	– 4.5
Portugal	– 2.8	– 9.4	– 8.5	– 7.9	66.3	76.8	85.8	91.1	– 8.3	– 6.6	– 4.6
Slovakia	– 2.3	– 6.8	– 6.0	– 5.4	27.7	35.7	40.8	44.0	– 5.5	– 4.2	– 3.0
Slovenia	– 1.7	– 5.5	– 6.1	– 5.2	22.6	35.9	41.6	45.4	– 5.7	– 4.2	– 3.1
Spain	– 4.1	– 11.2	– 9.8	– 8.8	39.7	53.2	64.9	72.5	– 9.8	– 7.5	– 5.3
Euro area	– 2.0	– 6.3	– 6.6	– 6.1	69.4	78.7	84.7	88.5	.	.	.

Deutsche Bundesbank, at the public hearing of the Budget Committee of the German Bundestag on 19 May 2010 on pages 12-13 of this report.

seasonal adjustment. Imports, however, rose even more strongly in terms of value (+10½%), which was attributable mainly to higher energy import volumes and also to price increases. If the deterioration in the terms of trade is taken into account, the contribution of foreign trade to GDP growth is likely to be minimal at best. Domestic final demand was probably likewise very muted in the first quarter of the year. Real retail sales (excluding cars) remained virtually unchanged, after seasonal adjustment, in the first quarter. In addition, the reduction or expiry of environmental premiums in some countries at the end of the year caused a 7¼% period-on-period decline in new car registrations in the first quarter. Consumer confidence was also still at a relatively low ebb as the second quarter began. According to output figures, investment in new buildings is likely to have contracted sharply in the first quarter on account of the weather and the lack of demand for capacity extension. According to the data on production, there has been no increase in expenditure on machinery and equipment, either.

Labour market collapse abated

The labour market situation in the euro area worsened only slightly in the first-quarter months. Owing in part to the unusually cold winter weather, the seasonally adjusted unemployment rate rose slightly from 9.9% in December 2009 to 10.0% in March 2010. The individual euro-area countries' rates, however, ranged very widely, from 4.1% in the Netherlands to 19.1% in Spain. The number of employed persons fell in the fourth quarter of 2009 (more recent data are not available) by 0.3% on the period after seasonal adjustment following a period-on-period decline of 0.5% a quarter earlier. Whereas Slovenia (at -1.0%) and Spain and Greece (-0.8% each) saw higher-than-average falls in employment, the number of employed persons remained unchanged in Germany and Portugal, whereas in Austria and Luxembourg there was even a slight trend increase in employment. The decline in hours worked in the euro area likewise abated in the fourth quarter of 2009. Owing in part to the decline in short-time work, the number of hours worked even increased in Germany (0.4%) and Italy (0.1%) on the quarter.

Distinct rise in energy and food prices

Euro-area consumer prices rose by 0.5% in the first quarter after seasonal adjustment, the largest increase since the third quarter of 2008. Much higher energy prices as a result of crude oil price hikes were the main reason. The price of unprocessed food, however, likewise rose again for the first time in a year, especially owing to the unusually cold winter weather. Processed food prices, however, remained unchanged, as did the prices of industrial goods excluding energy. Of the core components, only services saw prices increase, though not as sharply as in the preceding quarters. Excluding energy and unprocessed food, annual HICP inflation, at +0.9%, was slightly lower than in the fourth quarter of 2009 (+1.0%). Overall year-on-year HICP, by contrast, saw a quite strong rise of 0.7 percentage point to +1.1%. This was due mainly to a substantial increase in upward price pressures in nearly all euro-area member states. Ireland is now the only country left with negative year-on-year inflation, and only five other countries have an inflation

rate of less than 1%. In some of the smaller member states, inflation has already passed the 2% mark. Euro-area consumer prices also rose slightly in April after seasonal adjustment. Annual HICP inflation overall was +1.5% following +1.4% a month earlier.

Deterioration of public finances

In the past year, the development of euro-area public finances was characterised to a significant degree by the financial and economic crisis. The euro-area member states' government deficits and debt levels soared. An excessive deficit procedure has been launched against nearly all of these countries. The European Commission forecast underscores the need for substantial action in order to meet the envisaged correction targets (see also box on pages 26-27).