Global and European setting

World economic activity

Strong global growth in second quarter, more evenly distributed across individual regions

The upswing in the world economy continued at a rapid pace in the second quarter of 2010. Global industrial output has now returned to pre-crisis levels. The growth forces also now seem to be more evenly balanced between the advanced and the emerging economies. However, growth appears to be slowing down in the current half of 2010. After having already, in some cases, shown initial signs of overheating following a period of torrid growth, the major emerging market countries tightened the reins of monetary and credit policy – with fiscal policy stimuli already weakening – and thus brought their economies onto a flatter growth path. This is especially true of China, where the conditions for loans to households and enterprises were tightened significantly. It must be noted, though, that the Asian emerging economies' industrial output was, at last report, one-fifth higher than in mid-2008.

Industrial countries growing as a group at persistently fast pace

Among the group of industrial countries, the United States economy, which had grown quite rapidly in the last three months of 2009 and first three months of 2010, expanded at a perceptibly more moderate pace in the second quarter; the Japanese economy stalled. By contrast, the euro-area economy grew visibly more briskly. Germany accounted for a considerable percentage of this growth; catching-up effects in construction following the weather-related output shortfalls in the winter also played a role. In the industrial countries, considerable expansionary stimuli continued to be delivered by monetary policy and, in part, by fiscal policy. Moreover, the inventory cycle gave economic activity a further boost. In the spring months, according to initial estimates based on provisional data for the majority of the major economies and the euro area, real gross domestic product (GDP) for this group of countries grew at a seasonally adjusted ¾% on the period, which was the same pace as in the winter months. Its year-on-year growth stood at 2½%; this was 2¾% off the cyclical peak reached in early 2008.

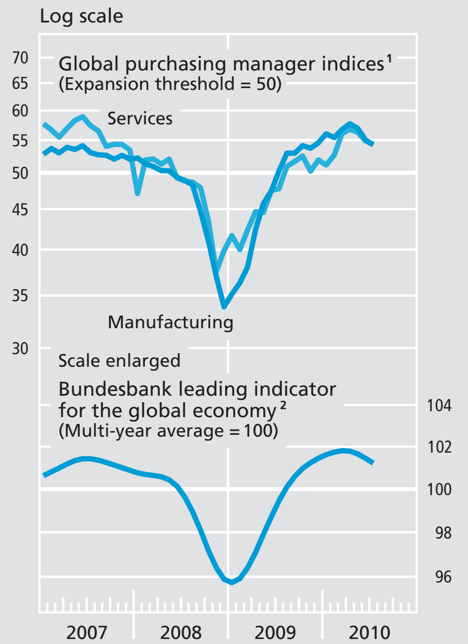
Renewed turbulence on financial markets has so far had no significant impact on real economy

Although the worsening of the debt crisis in Greece in early May and the contagion effects that rippled to other countries on the euro-area periphery led to considerable losses of confidence and a slowdown in economic activity in the affected countries, these renewed tensions in the financial markets failed to have any adverse impact on real economic developments in the euro area as a whole and the rest of the world. It must be noted that, in reaction to the turmoil, crude oil prices fell in early May.

Signs pointing to steady but moderate growth in second half of year

The world economy appears to have remained on a growth track after mid-year, though probably at a slower pace. The global purchasing managers indices for manufacturing and services, starting from a high level, sagged in the past few months. The Bundesbank leading indicator is likewise signalling that global economic activity might calm down in the second half. However, from today's vantage point the continuation of the global economic recovery is not in any danger.

Global economic indicators



1 Seasonally adjusted. Source: Markit Economics. — 2 Seasonally and trend-adjusted.

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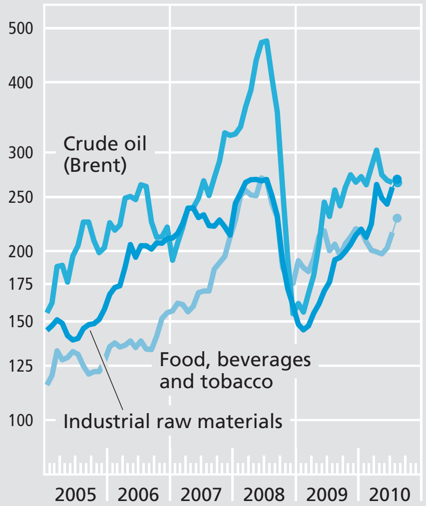
Renewed upward revision of IMF forecast

Because the world economy got the year 2010 off to such an unexpectedly good start and continued to grow at a strong pace in the spring, in early July the International Monetary Fund (IMF) once again revised upwards its global growth forecast for 2010, by one-half percentage point to 4.6%; it left its projection for 2011 unchanged at 4.3%. These figures reflect growth rates for the emerging economies of 6.8% and 6.4% respectively and for the advanced economies of 2.6% and 2.4% respectively. The IMF expects the euro-area economy to grow by 1.0% on average for the current year and the German economy by 1.4%. However, following strong growth in the spring, and given that the outlook for the current quarter remains quite positive, this may, especially with regard to Germany, be an overly pessimistic vision of

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 Reuters and HWWI. — • = 13 August and 16 August 2010 (crude oil) respectively.

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what may be achievable on average for 2010. According to the IMF, the outlook for real global trade rose by two percentage points to 9.0% in 2010 and by one-quarter percentage point to 6.3% for 2011. The year 2010 is set for considerably stronger growth in double-digit territory. Due, above all, to the danger of renewed turmoil in the financial markets, the risks to the recent growth projection are being assessed as much higher than the chances of a better result.

Crude oil prices stabilised following visible decline

Commodity prices reflected the increasingly jittery mood in the financial markets. In particular, the debt crisis suffered by some European countries and its potential implications for the real sector gave rise to a temporary correction in prices. After peaking for the year at US$89 in early May, the price of a barrel of Brent crude oil fell by nearly US$20 within three weeks. It then stabilised around the level of the period spanning the fourth quarter of 2009 and first quarter of 2010 of between US$70 and US$80. At last report, a barrel of crude oil was trading for a spot price of US$75, with the futures markets indicating slightly higher prices. Market uncertainty about the global economic outlook also caused the prices of industrial raw materials, especially non-ferrous metals, to fall considerably in May and June before rebounding noticeably. By contrast, hardly any falls had preceded the considerable increases in food prices in July. The price of cereals, in particular, rose sharply owing to weather-related crop failure.

Energy cheaper amidst muted overall consumer price inflation

The temporarily distinct decline in crude oil prices also had a marked impact on consumer prices in the industrial countries, with energy prices down on an average of the spring months by a seasonally adjusted 1.6% on the quarter following a 4.4% rise a quarter earlier. Since price inflation excluding the volatile categories of energy and food also remained exceptionally low, headline inflation held steady at its level of a quarter earlier. Year-on-year consumer price inflation fell from +1.7% to +1.5%.

Selected emerging market economies

Momentum in some parts of southern and eastern Asia tapered off from very high level

The south and east Asian emerging markets maintained their vigorous growth in the spring months. However, the exceptionally rapid pace of the first quarter has trailed off in some countries. In China, real GDP was 10¼% up in the second quarter compared with a year earlier, after rising by as much as 12% in the winter period. The subsiding stimuli from the government investment programme launched in November 2008 to stabilise the economy are likely to have contributed in key measure to the slowdown. By contrast, private consumption will probably have again risen considerably; at all events, nominal retail sales were up by nearly one-fifth on the year. Whereas Chinese export business was pointed steeply upwards in the spring, goods imports grew at a perceptibly more sluggish pace. This is probably a reflection of the diminishing investment boom. This caused the trade surplus to re-widen distinctly to stand at US$41.2 billion in the second quarter. Consumer price inflation rose noticeably, from 2.4% in March to 3.3% in July. Excluding food, it rose from 1.0% to 1.6%.

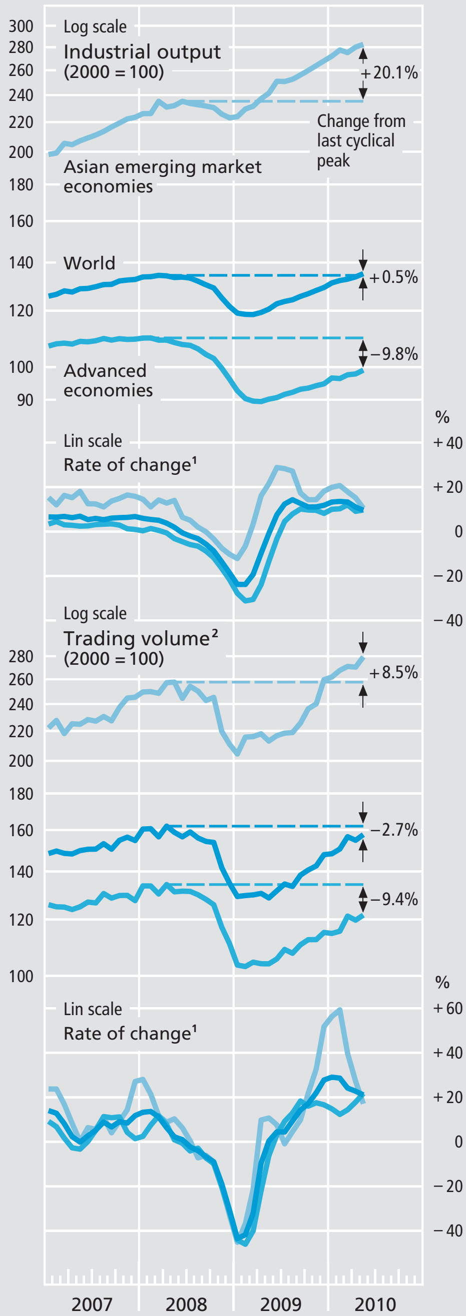
India's economy, which in the winter months saw real GDP grow by 11¼% on the year, seems to have only slowed down slightly, if at all, in the past few months. Although year-on-year industrial output growth fell from 15¼% in the first quarter to 11½% in the second, this is likely, in terms of overall output, to have been offset at least partly by an increased expansion of output in agriculture and in the services sector. Owing to an increase in the supply of food, consumer price inflation diminished slightly to 13.7% as this report went to press.

Developments in Latin America remain pointed upwards

Most Latin American countries saw their economic output rise distinctly once again in the second quarter of the year. In Brazil, the seasonally adjusted 1¼% period-on-period growth

Industrial output and trade volume

Seasonally and calendar adjusted



Source: Centraal Planbureau (CPB). — 1 Three-month moving averages; annualised change from the preceding three-month period. — 2 For advanced economies and Asian emerging market economies: export volume. For the world: average of import and export volumes.

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of industrial output was off somewhat from the preceding four quarters, however. This is probably due mainly to the expiry of tax incentives for purchasing consumer durables. The very positive trend in the Brazilian labour market continued. In June, just under 2.2 million new jobs were created on balance compared with a year earlier. Consumer price inflation slowed down somewhat in the past few months to stand at 4.6% in July. In Mexico, the cyclical recovery, which had sputtered in the first quarter of the year, made exceptionally good progress in the spring months; the services sector grew particularly strongly. As food price inflation continued to abate, the rate of inflation fell noticeably to 3.6% in July.

Accelerated business activity in Russia

In Russia, the cyclical recovery, which had been sluggish at the beginning of the year, picked up steam again. Real GDP was up in the second quarter by 5¼% on the year. The Russian economy received a demand-side boost from, in particular, private consumption, which had been kick-started by the introduction of a car scrappage premium, among other things. In addition, the continued improvement in the price climate has impacted favourably on households' purchasing power. In July, consumer price inflation stood at 5.5%, compared with 8.9% at the end of 2009 and 12.1% a year ago. A drought that was still ongoing as this report went to press caused major crop failures for seasonal food and cereals, which is likely to cause a perceptible resurgence of upward price pressure in Russia.

USA

Enterprises setting the pace of continued upswing

The US economic upswing continued on a sound basis in the second quarter. After adjustment for seasonal variations, real GDP in the spring months was up by just over ½% from the previous three-month period, and the year-on-year growth accelerated from a low level to nearly 3¼%. Overall growth was not able to maintain its rate of the winter quarter – which, according to revised figures, was just under 1%. However, domestic final demand picked up several notches, with enterprises, in particular, setting the pace. They increased their investment in machinery and equipment and software by a higher rate than at any time since the "New Economy" boom 12 years ago (for a comparison of the current upswing with earlier recoveries, see box on pages 18-19). This was surely aided in part by the ongoing recovery of their profit margins, which was due not only to preceding cost-cutting and productivity-enhancing measures but also to improved sales figures. Following massive cuts, commercial construction investment expanded in the spring for the first time in two years. In addition, enterprises continued restocking, although the growth stimuli from inventory movements were considerably weaker than in the preceding quarters. Government demand and housing construction likewise contributed to the growth of overall output. However, the imminent expiry of tax incentives for house purchase meant that demand in the real estate market was boosted only briefly; therefore, in the current quarter investment in residential construction may be expected to recede. The, on the whole, rapid growth rate of domestic demand was also reflected in a similarly strong import pull; real imports of goods and services grew by +6½%, and thus considerably faster than exports (+2½%). On balance, net exports subtracted three-quarters of a percentage point from GDP growth, whereas partner nations derived key stimuli from US import demand.

Growth of private consumption back on solid ground

In the second quarter, private consumption grew by just under ½%, roughly matching its first-quarter rate; in addition, it was restored to a more solid footing. The increase in employment expanded households' financial scope perceptibly. They were able not only to fund increased consumption but also to increase their saving ratio by three-quarters of a percentage point to 6¼%. On average over the April to July period, private non-farm employment was up by just under 450,000 from the winter quarter, representing an increase of ½% after seasonal adjustment. Consumer prices excluding energy and food picked up in the second quarter by a seasonally adjusted 0.2% from the preceding period, in which they had remained unchanged. On the year, though, they fell by 0.4 percentage point to +0.9%. Headline inflation fell even more sharply, especially owing to lower energy prices, from +2.4% to +1.8%.

Japan

Lull in growth despite brisk export business

Japan's economic output rose only minimally in the second quarter of 2010, after seasonal adjustment, following strong growth in the period spanning the fourth quarter of 2009 and first quarter of 2010. This was due chiefly to a slight decline in domestic demand. Inventories were once again increasingly reduced, and public investment, which had been expanded significantly under government economic stimulus programmes, contracted at an accelerated pace. Moreover, household consumption expenditure stagnated after having been stimulated in previous quarters by government purchase incentives. A role may have also been played here by the renewed rise in the standardised unemployment rate by 0.3 percentage point from the average of the first three months of the year to 5.2% in the spring months. Whereas residential construction investment was curbed, firms continued to expand their fixed capital formation. Their export business remained brisk, with exports up by a seasonally adjusted 6%. Admittedly, foreign trade contributed less to GDP growth because imports rose more strongly than a quarter earlier. The deflationary tendency in the economy persisted. Over the March to June stretch, negative consumer price inflation contracted by a further 0.4 percentage point to -0.7% on the year. Core inflation, by contrast, slid even further into negative territory, standing at -1.5% in June compared with -1.1% in March.

United Kingdom

Growth picked up considerably in spring

In the second quarter of 2010, the UK economy's total output, after seasonal adjustment, grew by a strong 1% on the period and by 1½% on the year. The second half of the year, however, holds more moderate growth rates in store – not least because of the new government's ambitious consolidation plans. The considerable increase in momentum in the spring is due, for one thing, to catching

The current economic upturn in the United States in comparison with earlier phases of recovery

The current upturn in the US economy is thought by many observers to be only moderate. In addition, concerns have frequently been voiced, particularly of late, that the upswing could lose momentum once the positive stimuli from the inventory cycle and the economic stimulus package subside. Some even warn of the possibility of a "double dip" recession. This box outlines the characteristics and drivers of the current upswing and draws comparisons with previous phases of recovery in the US economy. The National Bureau of Economic Research (NBER), which charts the cyclical highs and lows in the US economy, has not yet pinpointed a date for the end of the recession; however, as aggregate output has already been growing since the summer of 2009, this investigation will focus on the past four quarters. The seven growth phases since 1961 identified by the NBER are used for comparative purposes. As the upward movement is usually stronger at the beginning of a boom than in the later stages owing, not least, to the inventory cycle, the periods of comparison are likewise restricted to the first four quarters of each upturn.[1]

In fact, growth in real gross domestic product (GDP) in the past four quarters, at 3¼%, was significantly weaker than the average for the seven periods of comparison (5%). The phases of recovery following particularly severe economic slumps were all the more vigorous (1975–76 and 1983), with aggregate output rising by as much as 7% on average. At the same time, the current upturn is perceptibly stronger than those observed in the comparative periods 1991–92 and 2002, when GDP grew by an average of only 2¼% following relatively mild recessions. It must also be borne in mind that the growth path of potential output has flattened out considerably over time; according to recent estimates by the Congressional Budget Office (CBO), its increase since mid-2009 (1¾%) has been markedly lower than in the periods of comparison (3%). Consequently, most of the difference in the growth rate of actual output compared with the average of all seven periods of recovery could be due to weaker potential growth.[2]

Looking at the expenditure side of GDP, if we approximately calculate the mean of the annualised growth contributions of its individual components, as published by the Bureau of Economic Analysis (BEA), we can see that the rise in aggregate output was largely, but by no means exclusively, driven by changes in inventories. Taken together, personal consumption and corporate investment in equipment (including software) – with contributions of a similar size – matched the support to macroeconomic growth provided by changes in inventories. However, foreign trade and private construction spending (particularly spending on non-residential structures) had a noticeable dampening effect, while overall demand from the public sector had only a very minor impact. The growth in federal government expenditure was offset by cuts of around the same size by state and local governments, which were under great pressure to adjust their budgets to the fall in revenue. Another important factor in this respect is that a major part of the economic stimulus package put together in 2009 consisted in easing the burden on households through tax credits and increased transfer income, as well as providing support payments to the individual states.

The distinctive characteristics of the current upturn are made evident by the difference in the growth contributions of the expenditure-side components from those seen in the comparative periods. The fact that growth is currently more rapid than in 1991–92 and 2002 can be explained, in particular, by a stronger influence from the inventory cycle. However, as this impulse is not substantially different to those experienced during the sharp upturns, the disparity is probably due to the generally flat cyclical profile in the early 1990s and at the start of the new millennium. At that time, moreover, enterprises barely increased their expenditure on equipment and software, whereas the growth contribution of investment in equipment is now actually slightly larger than on average for 1975–76 and 1983. Nonetheless, a key driver of the rapid aggregate growth in these periods was private residential investment, which has not played a major part in the current upswing. A much more important factor, though, is that growth in personal consumption has been muted in the past few quarters; according to revised figures from the BEA, it contributed no more than just over one percentage point to GDP growth. That is only a fraction of the size of its contribution during the sharp upturns and is even somewhat smaller than in the two most recent periods of

1 The specific periods in question are 1961 Q2 to 1962 Q1, 1971 Q1 to Q4, 1975 Q2 to 1976 Q1, 1980 Q4 to 1981 Q3, 1983 Q1 to Q4, 1991 Q2 to 1992 Q1 and 2002 Q1 to Q4. — **2** Economists at the Federal Reserve Bank of San Francisco arrived at a similar conclusion in one study. See J Weidner und J C Williams (2010), The Shape of Things To Come, FRBSF Economic Letter, 2010-15. However, the members of the Federal Open Market Committee are currently still assuming a long-term growth rate of real GDP – which can be interpreted as a growth rate of potential output – of between 2½% and 2¾% (central tendency of expectations). — **3** This relationship can be illustrated using econometric esti-

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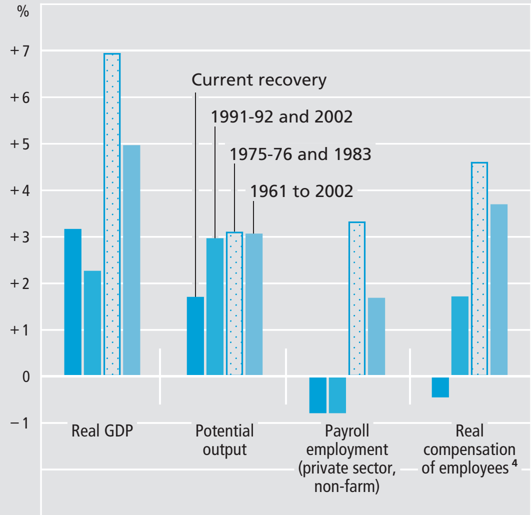
recovery. On an average of all the periods of comparison, moreover, government expenditure supported GDP growth more noticeably than in the recent past.

Overall, it can be said that corporate investment in inventories and equipment is almost exactly as strong as it was in earlier phases of recovery following a severe economic slump. To date, the impulses from both housing construction – which is still suffering from a real estate glut and thus from the effects of past excesses – and from personal consumption have been insufficient. This is likely to be closely connected with another marked characteristic of the current upturn, namely the ongoing difficulties in the labour market. In the second quarter of 2010, for example, private-sector employment was down by ¾% on the year. By contrast, at a comparable point during phases of strong economic recovery, employment had already grown by 3¼%. The weak labour market has also had an impact on employee compensation, the most important determinant for households' consumer spending.[3] In none of the other recovery phases observed here was there a decline in real employee compensation.

With regard to the labour market, the current upturn seems to share some similarities with the two most recent phases of recovery, which were often termed "jobless recoveries". However, the focus on the overall change in employment over four quarters obscures varying developments within this period. After large job losses were seen in the second half of 2009, jobs were already being created again in the first half of this year. By contrast, there was virtually no employment growth at that point in the two preceding expansionary phases. This is consistent with the fact that private investment in equipment, which is usually a good leading indicator for employment in the United States, was low at that time. All in all, there is much to suggest that, if the labour market recovery continues and gains strength, growth in personal consumption could intensify in the coming quarters. This means that there will not necessarily be a marked deceleration in aggregate growth owing, for example, to weakening impulses from the inventory cycle and the economic stimulus package. Moreover, the US economy is unlikely to slip back into recession in the near future.

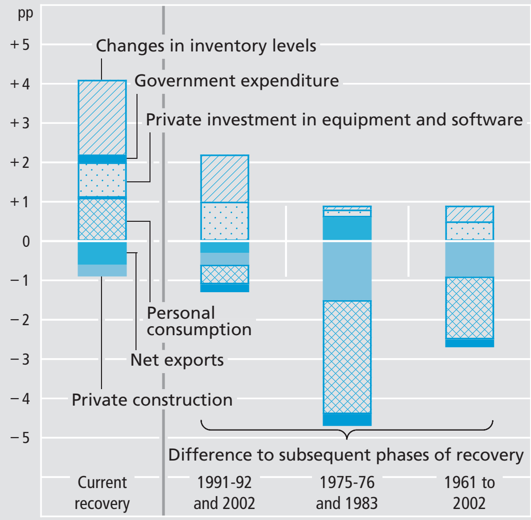
Growth of key macroeconomic variables in the United States

Seasonally adjusted, first four quarters of each growth phase



Average contributions to real US GDP growth

Seasonally adjusted and annualised



Sources: Bureau of Economic Analysis (BEA), Bureau of Labor Statistics (BLS), Congressional Budget Office (CBO) and Bundesbank calculations.

mates in which real growth in consumption is explained by changes in wage income, net transfers and taxes, as well as in net wealth and the unemployment rate. They show that, compared with other recovery phases, growth in consumption is currently being hampered, particularly by weak income growth and high unemployment, which is probably leading to precautionary saving. — **4** Adjusted using the Price Deflator for Personal Consumption Expenditures.

up in construction, which posted a 6½% increase in gross value added after seasonal adjustment. Another reason was that the services sector – supported by the financial industry and by business-related service providers – grew by 1%, as against +¼% in the winter. Manufacturing (excluding construction) continued its rapid growth. The cyclical upturn has now reached the labour market. In May, the standardised unemployment rate was 0.1 percentage point below its cyclical peak of 7.9% reached in early 2010. By contrast, the price climate has remained unfavourable through the end of the reporting period. Consumer price inflation (HICP) once again surpassed the 3% mark in July. Excluding energy and unprocessed food, it was similarly high in the preceding months. Plans to raise the standard rate of value-added tax (VAT) from 17.5% to 20% at the beginning of 2011 could mean that the Bank of England's inflation target of 2% will continue to be overshot next year.

New EU member states

Strong growth following weather-related interruption in winter

Real GDP growth in the new EU member states (EU-8), which had stalled in winter owing especially to weather-related reductions in construction output, will probably have regained momentum in the second quarter. Construction output rose, after seasonal adjustment, by not less than 15¾%, nearly fully recouping the losses in the first quarter. The industrial sector throughout the EU-8 once again grew strongly at 2¼%; in all countries, particularly the Baltic nations, its output tended distinctly upwards. The situation in the EU-8 labour markets has improved slightly for the first time since the outbreak of the economic crisis; the standardised unemployment rate fell between March and June by 0.2 percentage point to 9.7%. Consumer price inflation (HICP) averaged 2.8% over the April to July stretch.

Macroeconomic trends in the euro area

Strong economic growth in spring

After a sluggish start to the year, the euro area saw considerably accelerated growth. Total economic output in the second quarter of 2010 was up by a seasonally adjusted 1% compared with the winter months and was 1¾% up on its level of a year earlier, which marks the low point of the recent recession. One of the key factors behind the accelerated pace was the brisk rise in exports to non-euro-area countries. In addition, the construction sector in the northern member states saw catching-up effects following extensive weather-induced output losses during the winter. In addition, investment in new machinery and equipment is likely to have gone up perceptibly. With GDP rising by 2¼%, Germany has become the euro area's growth locomotive. The other large member states – France, Italy and Spain – saw much more moderate rates of economic growth, ranging between just over ½% and ¼%. In Greece, which must undergo a radical adjustment programme, the economy contracted by a seasonally adjusted 1½%. All other countries for which initial GDP estimates are available posted positive growth rates. The fast pace of growth in the euro area as a whole, however, will most likely not be sustainable in the second half of the year. One reason is that the economic upswing has trailed off somewhat in key destination countries. Another is that construction output will probably level off.

Catching-up effects in construction sector and lively industrial activity

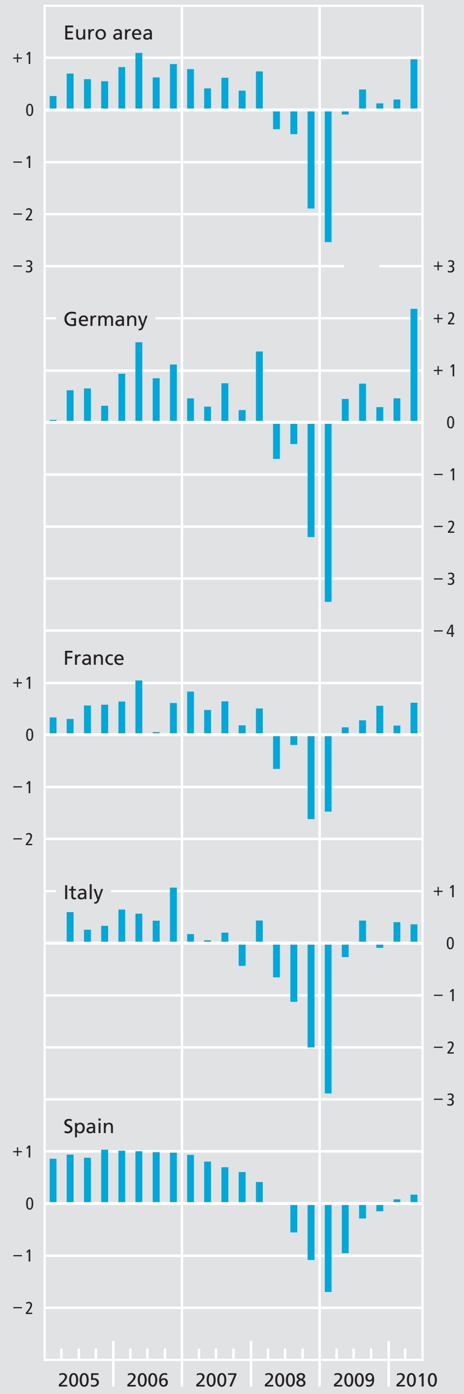
The strong economic growth in the second quarter was supported first and foremost by production. In the April-May period, construction output, owing to the aforementioned weather-related catching-up effects in the northern member states – as some southern member states were seeing continued contraction – rose by a seasonally adjusted 2¼% from the first quarter. Industrial production in the second quarter was 2½% higher than in the winter months and 9¼% higher than over the same period a year earlier. This includes, in the period under review, sharp rises in the production of intermediate (+4¼%) and capital goods (+3½%). By contrast, consumer goods output rose just marginally (+¼%). Energy production fell by ½% from its very high level of the winter months. Owing to increased industrial output, capacity utilisation continued its perceptible improvement during the April to July period, yet it still remained clearly below its long-run average. In the April and May period, orders received were up by 7%, seasonally adjusted, from the first quarter, which indicates continued output growth in the second half of the year. Sentiment in the industrial sector improved once again perceptibly around mid-year.

Strong export growth

The spring saw considerable demand from non-euro-area countries, especially the emerging market economies in south and east Asia and Russia. The euro area's exports, in

Growth trends in the euro area

Real GDP, seasonally adjusted, quarter-on-quarter percentage change



Sources: national statistics, Eurostat and the ECB.

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terms of value, rose during the reporting period by 7½% from the first quarter, after seasonal adjustment, and were up 24% on the year. Imports from outside the euro area rose considerably as well. However, as this was due in part to higher commodity prices and depreciation-related price effects, the net trade contribution to real GDP growth in the spring is likely to have been visibly in positive territory. Domestic final demand was uneven. Though the marked increase in the output of machinery and equipment and the expansion of construction indicate a considerable increase in gross fixed capital formation, household consumption, for its part, provided no growth stimuli in the second quarter, either. Real retail sales were down somewhat, and new car registrations down more significantly, from the preceding period, after seasonal adjustment. The inflated figures from a year earlier due to car scrappage schemes in some member states were undershot by as much as 10½%.

Signs that labour market is bottoming out

The brisk output growth in the spring has nurtured increasing signs that the labour market has passed the worst. Over the April to June period, unemployment growth, at an average of 13,000 per month, was significantly slower than in the winter (67,000) and the second half of 2009 (92,000). Growth in the rate of unemployment has come to a standstill; in June – as in the three preceding months – it stood at 10.0%. For instance, Spain's unemployment rate climbed by 0.6 percentage point since March 2010, whereas Germany's fell by 0.3 percentage point over the same period. The number of employed persons in the first quarter – more recent data are not yet available – remained unchanged since autumn 2009, when it had dropped by ¼%. Unit labour costs in the winter months likewise remained unchanged on the period.

Moderate rise in inflation

As the second quarter progressed, euro-area upward price pressures receded after having intensified perceptibly in the March-April period. Energy prices were the key factor: in March and April, they trended strongly upwards on the heels of higher crude oil prices and the weak euro in the foreign exchange markets before flattening considerably and heading downwards in June. Trends in the other components of consumer spending were much more restrained. Although food prices did rise more strongly than a quarter earlier – after seasonal adjustment – their fluctuations were relatively constrained. Owing to the euro's depreciation, the prices of other goods rose for the first time in quite a long time. By contrast, services appreciated at a similarly moderate pace to the preceding periods. Overall, consumer prices were 0.6% higher than a quarter earlier; the year-on-year increase of HICP widened from 1.1% to 1.5%.

This trend pattern was visible in nearly all euro-area countries, with only three countries reporting inflation of less than +1% in the second quarter. At the same time, in some smaller countries the 2% mark was surpassed yet again; the range of inflation rates even spanned just over seven percentage points. Although the weighted standard deviation of annual percentage changes rose slightly, at just around one percentage point it was only marginally above its average of the past few years. Euro-area consumer prices rose somewhat in July after seasonal adjustment. Year-on-year headline HICP inflation was up from 1.4% in June to 1.7%. A base effect resulting from the sizeable decline in energy prices in July 2009 was also a major factor in this increase.