Global and European setting

World economic activity

Slight pick-up in world economic activity at start of year

The global economy accelerated somewhat at the beginning of 2012, although the strong rise in oil prices acted as a brake. A key factor behind the accelerated pace was stronger economic growth in Japan and a number of emerging market economies. In addition, economic activity in Thailand returned to normal after severe flooding had brought the local economy to a virtual standstill in the final quarter of 2011 and caused output losses in other countries as well. In seasonally adjusted terms, industrial output in Thailand in the first quarter of 2012 rose by no less than 39% quarter-on-quarter and in March was only 11% below pre-flooding levels.[1] After a weak start to the year, the Chinese economy was able to make up ground; however, average growth was not any stronger than in previous quarters. While real gross domestic product (GDP) in the United States maintained solid growth, the euro-area economy continued to stagnate. The negative confidence effects still emanating at the end of 2011 from the nervous financial markets on account of the sovereign debt crisis appear to have diminished somewhat. Overall, global industrial output picked up appreciably by a seasonally adjusted 1¾% in the first two months of the year as compared with the last quarter of 2011, in which it had risen by only ½%. Global trade, which had stagnated in the final quarter of 2011, grew at a similar rate at the beginning of the year.

Acceleration of GDP growth in industrial countries and emerging market economies

At an initially estimated ½% after seasonal adjustment, real GDP growth in the major industrial countries – the United States, Japan, the United Kingdom and the euro area – as a whole was slightly higher than in the final quarter of 2011. It rose by 1¼% on the year. Growth in aggregate output in the emerging market economies, which Bundesbank autumn 2011 estimates put at 1% after seasonal adjustment and thus at its weakest level since the major financial and economic crisis, gained considerable momentum over the first quarter of 2012 and has even reached average rates in the most recent cycle. The fact that momentum in emerging market economies is higher than in industrial countries is consistent with the decoupling of trend growth between these two groups of countries that has been in evidence since the mid-1990s (see the box on pages 12 to 14).

Momentum set to increase further

The global economy could pick up speed as the year progresses. This is suggested by easing pressure from the oil markets. In addition, the ifo indicator for the world economic climate improved again in the second quarter and is now only slightly below its long-term average. Moreover, monetary policy in the industrial countries is still exceptionally expansionary, and several emerging market economies have now also further loosened their policy stance. Nonetheless, the global economic revival remains fragile and is exposed to non-negligible downside risks. For instance, an intensification of the Iran conflict could drive up oil prices dramatically and thereby undermine the as yet muted expansionary forces. However, there are also opportunities. For example, the pace of economic activity in the emerging markets and in the United States could well exceed widely held expectations.

Upward revision of IMF growth and inflation forecast in April

Given the global economy's rather buoyant start to the year, the IMF increased its growth forecast slightly to 3.5% for 2012 and 4.1% for 2013, following a significant downward revision in January. This would put projected growth in 2013 well ahead of the average growth rate of the last cycle. The forecast for real world trade growth was raised by the same scale to 4.0% and 5.6%, respectively. Furthermore, on the whole, the rather cautious revi-

1 At 1%, Thailand's share in global industrial output is rather low; nevertheless, such a sharp change does result in a sizeable contribution to global economic growth of just under ½ percentage point.

Have the business cycles of emerging economies decoupled from those of advanced economies?

In international business cycle developments, for many years it was taken as read that "when the US economy sneezes, the rest of the world catches a cold". The United States, together with the other advanced economies, did indeed set the pace for international economic developments in the second half of the twentieth century. At first glance, the global economic downturn following the recent financial and economic crisis would seem to fit this pattern. However, closer inspection reveals that the advanced economies experienced a more severe slump than the group of emerging economies. In addition, a strong upswing had already begun in early 2009 in the major emerging economies, most notably China, whereas the recovery in many advanced economies was tentative or ground to a halt after a relatively short period of time, as was the case in some euro-area countries in the final quarter of 2011 and the first quarter of 2012. This two-speed recovery is cited as evidence backing the "decoupling hypothesis", which states that emerging economies' business cycles have become more independent of those of the advanced economies. This hypothesis does not by any means seek to deny that crises in the United States or the advanced economies as a whole usually have an impact on the emerging economies. The term "decoupling" is therefore understood to mean a loosening, not a full elimination, of the relationship between the business cycles.[1]

Increasing globalisation, involving ever-closer economic integration between advanced and emerging economies, is often put forward as an argument against the validity of the decoupling hypothesis. Yet decoupling and globalisation are not mutually exclusive: decoupling by emerging economies can go hand in hand with growing integration within their group of countries. There are signs, for instance, that China has become an engine of growth in South East Asia and is making increasing use of supply chains involving its neighbouring countries in particular. As China's economic power has grown, these countries appear to have increasingly aligned themselves with their dynamic neighbour. One indication of this change is that the four large euro-area economies (Germany, France, Italy and Spain) have increased their foreign trade with China very sharply in the past few years, while growth in their foreign trade with other countries in South East Asia has been very subdued.[2]

Comparing growth rates in the advanced economies with those in the emerging and developing economies is a good starting point for investigating whether emerging economies might have decoupled. Particularly since 2000, growth rates in these two groups of countries have moved almost entirely in the same direction, whereas in some previous phases they moved in completely opposite directions. In addition, growth rates in the emerging and developing economies were mostly close to those in the advanced economies until the mid-1990s, when the difference in levels of growth began to widen increasingly. However, the

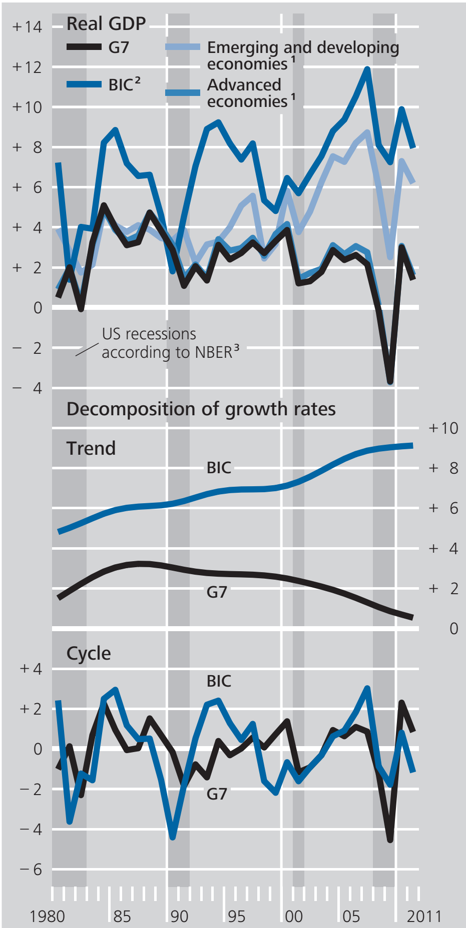
1 See IMF, Does Slow Growth in Advanced Economies Necessarily Imply Slow Growth in Emerging Economies?, World Economic Outlook, October 2010, pp 13-15.
2 See Deutsche Bundesbank, Developments in the exports of the four largest euro-area member states since the launch of monetary union, Monthly Report, July 2011, pp 15-34.

BIC countries (Brazil, India and China), the most important emerging economies,[3] were already recording much higher growth rates than the advanced economies in the 1980s.

This box discusses both trend decoupling, ie decoupling of long-term growth trends, and business cycle decoupling, which focuses on short to medium-term deviations in the business cycle. As including a larger group of countries is unlikely to noticeably improve our findings, our analysis focuses on the BIC countries and the G7. The adjacent chart clearly illustrates that growth rates in the G7 are extremely similar to those for the advanced economies as a whole and that the rates for the BIC countries have been correlated closely with those of the emerging and developing economies since the mid-1990s at least.

Comparison of economic growth in selected country groups

Year-on-year percentage change



1 According to IMF definition. **2** Brazil, India and China. **3** National Bureau of Economic Research.

Deutsche Bundesbank

To model a possible trend decoupling between the two groups, we decompose the GDP growth rates of both aggregates into trend and cyclical components using an HP filter. From 1980 to the mid-1990s, the trend growth rates for the two groups of countries largely co-moved and the growth rates for the BIC countries were, on average, just over 3 percentage points above those for the G7. From 2000, growth in the BIC countries gained substantial momentum while the G7's trend growth declined, increasing the difference between the two groups' growth rates to more than 8 percentage points by 2010. This indicates a clear trend decoupling between the BIC countries and the G7, which is primarily down to increased market liberalisation in the emerging economies and their intensified involvement in global trade. Moreover, most emerging economies are benefiting greatly from population growth and are generating far stronger output growth in the still ongoing recovery than advanced economies, which operate at the forefront of technology.

Business cycle decoupling is more complex than trend decoupling. A decoupling of business cycles can be understood to mean highly asynchronous growth rates irrespective of the level of the business cycle components (path decoupling) or, alternatively, a widening of cyclical growth gaps between

3 As IMF data for Russia's GDP growth are only available from 1993 onwards, we do not look at the BRIC group, which is often the subject of analysis.

the two country groups (amplitude decoupling).[4]

No significant path decoupling or amplitude decoupling can be identified in the past 30 years. Nor, though, has co-movement between the business cycles of the advanced and emerging economies under analysis generally increased. Instead, recessions seem to coincide with greater co-movement between the business cycles and fewer growth gaps than periods of recovery. Unlike in previous recessions, however, the BIC countries were sometimes able to decouple significantly from the advanced economies during the 2008-2009 economic crisis according to both measures of business cycle decoupling.

One explanation for this could be that, prior to the most recent recession, the emerging economies were better equipped to deal with external crisis effects than most of the advanced economies,[5] as the emerging economies' relatively large foreign currency reserves would suggest. Furthermore, financial institutions in Asia had become considerably more resilient as a result of the Asian crisis and, unlike many banks in the advanced economies, had little exposure to risky assets. Above all, most emerging economies also had greater fiscal policy leeway to take economic stabilisation measures during the crisis because their fiscal positions were comparatively strong before its onset. Notably, China's immense economic stimulus programme provided substantial support not only domestically but also for the world economy. There is also a theory that the recent economic slump in the advanced economies did not hit foreign trade between the emerging economies as hard as earlier recessions.

There are two caveats to this explanation, however. Firstly, only Asia, Latin America and Africa experienced a more moderate slump in foreign trade; in the CIS and the new EU member states in central and eastern Europe it was actually sharper than in the advanced economies. Secondly, China's pivotal role must also be borne in mind; its still very rigid capital controls largely immunised it against contagion from the US financial market, and this proved to be a clear advantage in the recent financial crisis.

All in all, there has been a very clear trend decoupling between emerging and advanced economies since the mid-1990s. By contrast, it seems that business cycle decoupling tends to occur in periods of recovery. Downturns usually entail strong contagion from advanced economies to emerging economies, although the group of emerging economies has remained relatively unscathed by the most recent crisis.

4 We use a modified form of the Pearson correlation coefficient as a measure of path decoupling and model amplitude decoupling using the absolute difference between the z-scores of the growth rates. This approach is based on J Yetman, Exporting recessions: International links and the business cycle, Economics Letters, 110, pp 12-14, 2011.
5 See IMF, How Did Emerging Markets Cope in the Crisis?, Strategy, Policy, and Review Department, 2010.

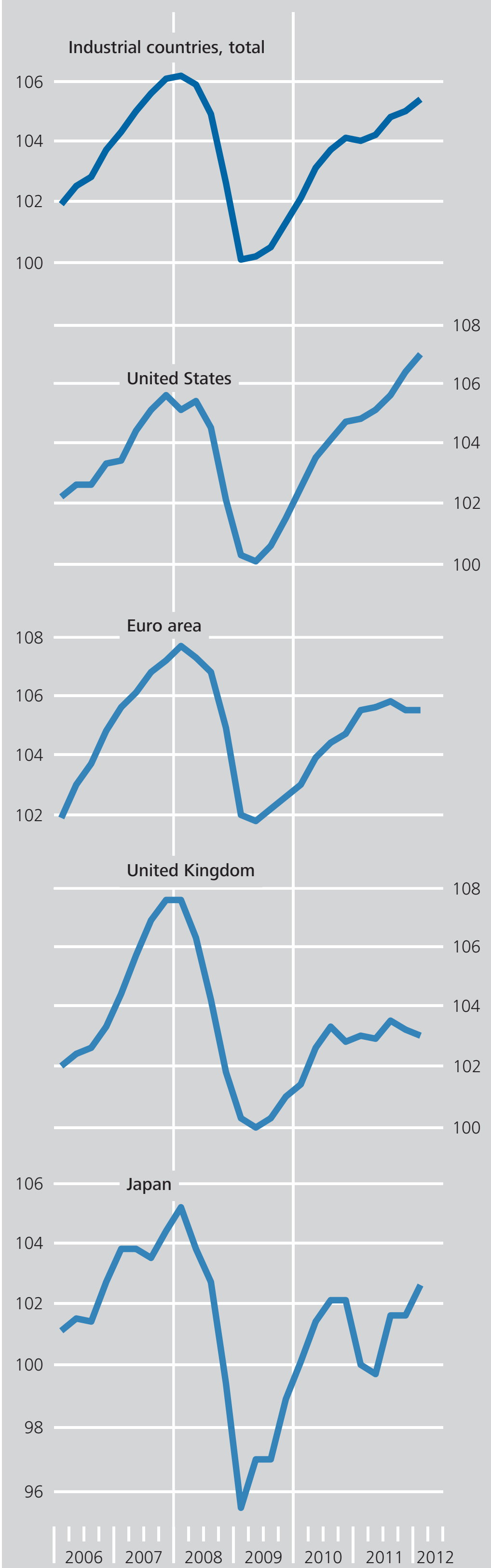
sions to GDP growth forecasts have been made quite consistently for the group of advanced economies, on the one hand, and for emerging and developing economies, on the other. Growth of 1.4% and 5.7%, respectively, is now expected for 2012. Within the G7, corrections ranged from +0.2 to +0.4 percentage point on rates of between -1.9% (Italy) and +2.1% (USA and Canada). The forecast for Germany of +0.6% after calendar adjustment means a rise of only 0.4% before adjustment. Given the perceptible overall economic growth recorded in the first quarter, this estimate appears to be extremely cautious. At 0.3%, the decline in euro-area real GDP included in the IMF's spring forecast is somewhat more moderate than in the January estimate (-0.5%). Furthermore, the rather sharp rise in crude oil prices that has been recorded since the beginning of the year occasioned an upward revision of inflation rates in advanced economies to 1.9% in 2012 and 1.7% in 2013, although the forecast for 2012, in particular, is still probably too low.

Renewed rise in oil prices …

Starting from an already high level at the end of 2011, crude oil prices soared again over the winter months. In March, the spot price for Brent North Sea oil was 16% up on its December level. Nevertheless, it continued to fall year-on-year owing to more unfavourable developments in the same period. As was the case back then, supply-side factors were the main drivers of prices – in particular, the expected shortages as a result of the EU's oil embargo against Iran, which will come into effect in the summer. Moreover, many market participants were concerned that the geopolitical dispute in the Persian Gulf could escalate further. Ultimately, other conflicts in Yemen, South Sudan and Syria caused smaller output losses. The supply situation began to ease in April following Saudi Arabia's announcement that it would significantly increase production. As this report went to press, a barrel of Brent North Sea oil was trading at US$107½, with oil futures still trading at considerable discounts. The US dollar prices of other commodities have gone up only moderately since the end of 2011, meaning

Aggregate output in industrial countries*

2005 = 100, seasonally adjusted, quarterly, log scale



Sources: National statistics, Eurostat and Bundesbank calculations. * The United States, euro area, United Kingdom and Japan.

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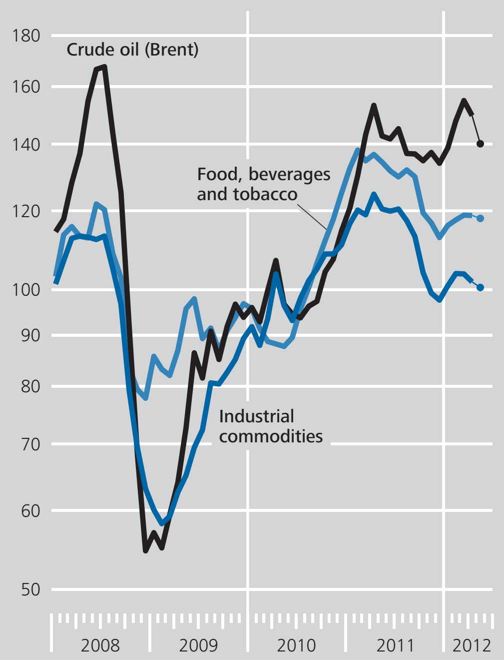
World market prices for crude oil, industrial commodities and food, beverages and tobacco

US dollar basis, 2010 = 100, monthly averages, log scale



Sources: Thomson Reuters and HWWI. • Average of 1 to 11 May or 1 to 18 May 2012 (crude oil).
Deutsche Bundesbank

that they were much cheaper in the first quarter of 2012 than one year previously. In contrast to crude oil, subdued global economic growth is likely to have had a greater impact on commodities.

… again pushes up consumer price inflation in industrial countries

The recent oil price surge has again pushed up consumer price inflation in the industrial countries. In seasonally adjusted terms, energy prices rose by 4.2% in the first three months of 2012; the basket of consumer goods as a whole went up by 1.0%. This puts year-on-year headline inflation at 2.5% in March, which is thus even somewhat higher than in December. Excluding energy and food, prices of other goods and services rose less sharply. In March, core inflation stood at 1.8% year-on-year.

Selected emerging market economies

Year-on-year expansion in China again slower

According to the seasonally adjusted estimate by China's National Bureau of Statistics, China's economic output rose by just under 2% in the first quarter, as it had done in the previous quarter. This constitutes an 8% increase on the previous year – the lowest growth rate since the beginning of 2009. The fact that growth remains moderate can be attributed to a number of factors. Exports experienced a further loss of momentum in the first quarter. Fewer goods were exported to the EU, China's most important trading partner, than last year. Although domestic demand in China was still high, the pace of expansion also slowed. Thus, in real terms, at +11% on the year, retail sales growth was only slightly lower than in the final quarter of 2011. Measures to cool the housing market, including restrictions on the purchase of second homes, have had a greater impact of late. The number of transactions for new and existing apartments fell by just under one-sixth throughout the country in the first quarter of 2012. In addition, house prices have fallen noticeably in many places. Irrespective of these developments, construction activities are still expanding at a rapid pace, largely due to supporting effects from public residential construction. In the previous months, consumer price inflation continued to trend downwards. It amounted to 3.4% in April, and was thus ¾ percentage point lower than in December 2011. Easing inflation and the muted economic outlook spurred the Central Bank of China into lowering the minimum reserve ratio in February and May.

Slack growth in India

The pace of growth in the Indian economy, which slowed perceptibly in the final quarter of 2011, appears to have remained on a rather flat upwards path at the beginning of 2012. This is indicated, first, by the inability to shake off the sluggishness of economic growth over the past few months and, second, by the persistently subdued pace of growth in the services sector, according to survey-based indicators. The Reserve Bank of India lowered the key interest rate by 50 basis points in April and thus initiated a change in interest policy. Although inflation has eased somewhat over the past few months, it is still rather high. As measured by the consumer price index relevant for industrial workers, it was 7.2% in the first quarter of 2012, compared with 8.4% in the final quarter of 2011.

Clear stimuli for Brazilian economy from domestic economic activity

Brazil's real GDP, which grew only marginally in the second half of 2011, is likely to have picked up the pace somewhat in the past few months. This is suggested by an exceptionally sharp rise in real retail sales in the first quarter (4% on the quarter after seasonal adjustment). Consumer demand is supported by a labour market that is still good, a sharp rise in wages – minimum wages were also raised significantly at the beginning of the year – as well as falling interest rates for consumer loans and mortgages as a result of the central bank loosening monetary policy. In the last two months alone, the Central Bank of Brazil has cut the key interest rate by a total of 150 basis points to 9.0%. However, the situation is yet to improve noticeably for industry, which is saddled with competitiveness problems; in the first quarter, production was down again on the previous quarter. As a result, the government took further action to promote this sector and to restrict imports. Over the past few months, inflation has taken another downward turn and, in April, stood at 5.1%.

Rate of expansion still high in Russia

According to a preliminary estimate by the Federal State Statistics Service, year-on-year real GDP growth accelerated from 4¾% in the final quarter of 2011 to 5% in the first quarter of 2012. Domestic demand was the chief driver of growth. Real retail sales were 7½% up on the year in winter. Overall, the outlook for Russia remains bright; given rising oil prices, many international organisations – including the IMF – have upped their growth forecasts for Russia considerably. In recent months, consumer price inflation has stabilised at a very low level by historical standards, reaching 3.6% in April.

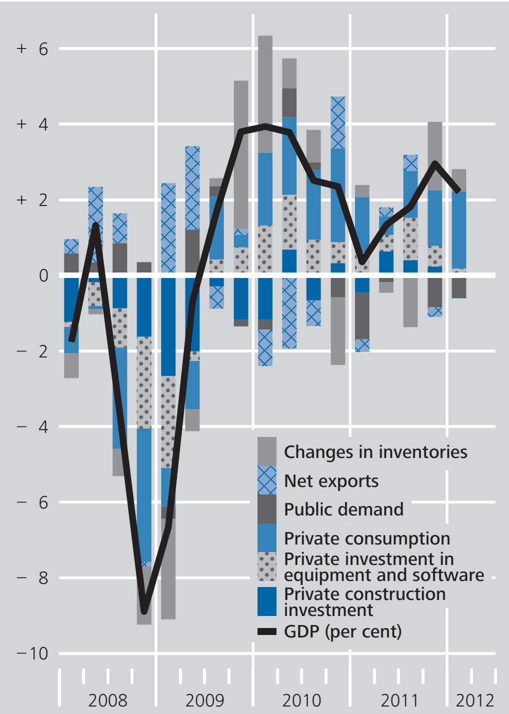
USA

Increase in employment and consumption safeguards macroeconomic growth

In the first quarter of 2012, the US economy continued on its solid growth path. With a quarter-on-quarter rise of ½% after seasonal adjustment, real US GDP growth at the beginning of the year was only slightly weaker even without a repeat of the sharp boost provided by inventory movements in the final quarter of 2011. Private consumption, which was up ¾%, was a major driver of growth. In particular, real spending on motor vehicles soared again, dispersing fears that the sharp rise in the previous quarter was a one-off catch-up effect following supply problems last spring. Thus, precisely in this spending category that is particularly susceptible to higher fuel costs, households have had to face strong headwinds. Higher petrol prices are the main culprits for a quarter-on-quarter rise in consumer prices, as measured by the Consumer Price Index (CPI), of close to 1% in March. However, on the year, they fell by 0.3 percentage point to 2.7%. Yet, in the meantime, perceptible broad-based inflationary pressure has emerged; core inflation (adjusted for energy and food) remained slightly over the 2% mark. Growth in private consumption has been aided by a clear recovery on the labour market. During the winter months, 688,000 non-farm jobs were created on balance (+½%) and the unemployment rate fell by 0.3 percentage point to 8.2% in March. In August 2011, this rate had still stood at 9.1%. This decline is likely to have been bolstered by major demographic shifts (see the box on pages 19 to 21). The fact that companies are continuing to create jobs and to invest more in new equipment and software shows their economic optimism; however, this did not prevent commercial construction from suffering a setback of late. Given a rather solid upturn on the whole in private consumption and investment in equipment and software, the overall economic recovery appears to be strong enough to shoulder the decisive fiscal consolidation. Even if the economy is then forced to cope with a temporary economic downturn, it is essential to push ahead with ambitious budget

Contributions to quarter-on-quarter growth in real US GDP

In percentage points, seasonally adjusted, in annualised terms



Source: Global Insight.
Deutsche Bundesbank

cuts to prevent an intensification of the crisis in the future and to ensure a sustained recovery over the medium term.

Japan

Expansionary forces clearly gain the upper hand

After a pause in growth in the final quarter of 2011, Japan's economy returned to a growth path at the beginning of 2012. In the first quarter, real GDP was up by a seasonally adjusted 1% on the quarter. This was due, first, to a resumption in supplies to the Japanese export industry as the situation in Thailand had started to normalise. Foreign trade was thus no longer an obstacle to real GDP growth. Second, the upward trend in domestic demand continued. Private consumption, in particular, recorded sharp growth, additionally spurred on by government incentives to buy new cars. The automotive sector had been hit hard by production stoppages in 2011, moderate growth in the global economy and the appreciation of the yen. The robust nature of domestic demand was reflected in stabilisation tendencies on the labour market and in price developments. In March 2012, the unemployment rate remained at its December 2011 level (4.5%). Furthermore, the fact that the basket of consumer goods had gone from being slightly cheaper on the year at the end of 2011 to slightly more expensive (+0.5%) in March was not down to higher energy costs alone. Excluding energy and food, consumer prices dropped in the twelve-month comparison by less than before, down from -1.1% to -0.5%.

United Kingdom

Renewed cyclical set-back

In the first quarter of 2012, the UK economy once again fell short of the seasonally adjusted level of activity recorded in the previous quarter. However, a renewed decline in real GDP of ¼% on the final quarter of 2011 was mainly due to a sharp reduction in construction output, which is generally rather volatile. Nevertheless, the much-needed momentum was also absent from the rest of the economy. The services sector, which accounts for three-quarters of overall economic output, was only just able to recoup the slight decline in real value added recorded in the final quarter of 2011. Output in manufacturing (excluding construction) continued to fall, albeit not as sharply as in the previous quarter. Earnings in this sector were bearing the brunt of the continued downswing in oil and gas production, in particular, whereas manufacturing output remained nearly steady. However, other indicators do not confirm the impression that there is a lack of an economic tailwind. While inflation – measured by the Harmonised Index of Consumer Prices (HICP) – slid by 0.7 percentage point during the winter months, at 3.5% in March, it again overshot the Bank of England's target of 2% by a long way. At 2.6%, core inflation was ½ percentage point below its end-2011 level. In addition, the situation on the labour market eased somewhat. The rate of unemployment fell from 8.3% in December to 8.1% in February, and the

The decline in labour force participation in the USA

Since last summer, the US unemployment rate has been on a clear downward trend. In April of this year, it stood at 8.1% after seasonal adjustment and was thus a full 1 percentage point below its most recent peak of August 2011. Often, an attempt has been made to place this substantial decline in the context of labour force participation, which is also decreasing. It is claimed that the lower unemployment rate is due solely to the fact that many persons have not found employment and thus, discouraged, withdrawn from the labour market. Relative solely to the most recent period, however, just a brief glance at the data is enough to reveal the limitations of this argument. In April 2012, two million more persons were registered as being in work than in August 2011, which means that the employment rate – the number of employed persons in relation to the working-age population – has, in fact, increased slightly. Moreover, it was during this period that the most broadly defined measure of underemployment – in which the Bureau of Labor Statistics (BLS) also includes persons only loosely connected with the working population or working part-time involuntarily – in fact showed the sharpest decline since its inception in 1994.[1]

Admittedly, the labour force participation rate – the percentage of employed and unemployed in the working-age population – has been pointing downwards for a long time; since the peak of the most recent macroeconomic cycle in December 2007, the participation rate fell by 2.4 percentage points to 63.6% in April 2012, its lowest level since the end of 1981. Nevertheless, what should be taken into account in this context is that demographic change has already profoundly altered US society. There has been a considerable shift in the population structure, especially due to the ageing of the "baby boomer" generation (persons born in the years of high birth rates between the end of World War II and the mid-1960s). Taking the figures which the BLS also uses to estimate the unemployment rate, the percentage of persons aged at least 55 years in the working-age population as a whole (from 16 years) has increased by just under 3 percentage points since the end of 2007. In line with this, the share of persons aged between 25 and 54 years has declined by 2¾ percentage points. This, however, has serious implications for the aggregate participation rate since labour force participation differs widely among these age groups (at the end of the period under review, the figures were 81.3% in the group of persons aged between 25 to 54 years, compared with 40.3% among older persons), even though they have been tending to converge somewhat.

In order to estimate the impact of population ageing, it is possible to calculate a hypothetical participation rate under the assumption of labour force participation in the individual age groups persisting at its December 2007 level. It thus reflects solely the effects of a shift in the relative importance of the individual age groups. Accordingly, 1.1 percentage points, or almost half of the overall decline in the actual participa-

1 The U6 rate fell by 1.7 percentage points between August 2011 and April 2012. Taking September as the reference point, the decline totals 1.9 percentage points.

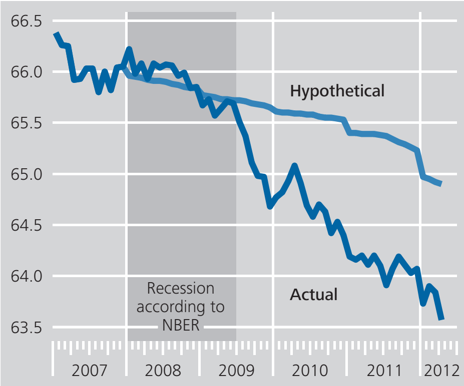
tion rate, can be attributed to this effect at the current end.[2]

The other half reflects the impact of the change in labour force participation in the individual age groups. This may be due in particular, but by no means exclusively, to cyclical effects. Although the drivers cannot be identified on the basis of the BLS data, it is at least possible to trace back the contributions of the individual age groups. Following a longer-term trend, the labour participation of the population aged 55 years and above has gone up further, cushioning the decline of almost ½ percentage point in the aggregate participation rate. The increase in labour force participation in this age group might have been even larger if the overall employment outlook had been more favourable.

One-half of the dampening effect of 1¾ percentage points that can be ascribed to the rest of the population is due to the lower labour force participation among the age group of 25 to 54 year olds. In the absence of pronounced longer-term trends, this is likely mainly to reflect cyclical effects. The other half is due to the group of 16 to 24 year olds. Although there was a particularly sharp decline in the labour market participation of this group, extending the observation period reveals a long-term downward trend that has progressed in waves rather than evenly. There has invariably been a sharp fall in the participation rate of younger persons during periods of economic downturn without any countermovement occurring in the ensuing recovery. Given this fact, it appears doubtful whether – or to what extent – the recent severe constriction in labour force participation is actually cyclical in nature in this case. A lower participation might, not least, be consistent with longer periods of education and training.

Actual and hypothetical participation rate

Per cent, seasonally adjusted



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If we compare the hypothetical participation rate, given constant labour force participation of the individual age groups, with the actual aggregate participation rate over time, we notice that there were no significant deviations during the last recession. It was not until the macroeconomic upturn that the actual participation rate slipped downwards compared with the hypothetical one. It should be remembered, however, that the reduction in employment lasted up to early 2010. Moreover, it is possible to imagine that it is only after they have been unemployed for some time that

2 The Congressional Budget Office (CBO) estimates on the basis of a similar calculation that demographic change between the end of 2007 and early 2011 depressed the participation rate by ½ percentage point. A more recent study by the Federal Reserve Bank of Chicago attributes merely one-quarter of the decline in the participation rate of persons aged between 16 and 79 years of 1.8 percentage points during the period from 2008 to 2011 to demographic factors. In contrast to these studies, our analysis also comprises the perceptible population shift at the beginning of 2012, which is due to the BLS data being adjusted to the results of the latest census and can be identified by the kink in the hypothetical labour participation rate. In the case of such changeovers, the BLS does not, as a rule, revise the historical data. See CBO, CBO's Labor Force Projections Through 2021, CBO Background Paper, March 2011, pp 10-11; D Aaronson, J Davis and L Hu, Explaining the Decline in the U. S. Labor Force Participation Rate, Federal Reserve Bank of Chicago, Chicago Fed Letter, No 296, March 2012.

persons turn away from the labour market and that there is therefore only a lagged "cyclical effect" depressing labour force participation. Since the middle of last year, in terms of the underlying trend there at least appears to have been no further increase in this effect in the wake of the upturn in the labour market.

In July 2011, the participation rate, at -1½ percentage points, reached the maximum deviation from its hypothetical value. In order to assess the scale of this discrepancy, an analogous calculation can be made for the preceding economic cycle. Taking, as the starting point, March 2001 – the previous cyclical peak according to the National Bureau of Economic Research – the hypothetical participation rate is undershot at most by ¾ percentage point; it is not until during 2005 that a perceptible improvement sets in. In order to put the relationships into perspective, it should additionally be considered that the downturn was much milder then, with the employment figure falling by just two million, while the last recession cost a total of 8½ million jobs. Thus, although the possible cyclical effect on labour force participation has been marked recently, it has not necessarily been out of the ordinary.

Finally, it should be noted that, in addition to economic activity, other factors also have an impact on the supply of labour. Economic policy interventions, such as the repeated extension of the period of receiving unemployment benefits and the lowering of the burden of income taxes, should be highlighted in this context. The impact of tax breaks is unlikely to have been confined to the labour force but probably extended to the number of working hours supplied per person employed. The expected withdrawal of these economic policy measures over the following years is likely to counteract the positive effect of the cycle on labour force participation.

All things considered, the fact that the baby boomer generation is reaching retirement age has probably already played a key role in the decline in labour force participation over the past few years. Despite a cyclical recovery, demographic change over the next few years will probably tend to lower the labour participation rate further. Neglecting this factor might encourage overestimating the degree of slack in the economy and thus underestimating the upward pressure on wages and prices.

number of recipients of unemployment benefits again trended slightly downwards of late.

New EU member states

Further slowdown in economic activity

In the new EU member states as a whole (EU-7),[2] economic activity – which had already slowed somewhat in the final quarter of 2011 – declined even further in the first quarter of 2012. Hungary and the Czech Republic recorded a perceptible quarter-on-quarter fall in economic output. In addition, indicators for Poland, for which national accounts figures are not yet available, suggest that GDP growth has slowed considerably. As a result, the labour market situation in many states worsened; at 10.1%, the aggregated unemployment rate in the first quarter of 2012 was slightly higher than one year previously. In this group of countries, consumer price inflation rose from 3.7% in the final quarter of 2011 to 3.9% in the first quarter of 2012. It ranged from 1.9% in Bulgaria to 4.2% in Poland and 5.6% in Hungary, where the increase in turnover tax from 25% to 27% came into effect at the beginning of the year.

Macroeconomic trends in the euro area

GDP stagnated in Q1

Economic activity in the euro area had been slack in the final quarter of 2011 and this carried over into 2012. In seasonally adjusted terms, real GDP stagnated in the first quarter of 2012 at the depressed level of the previous quarter and stood at the same level as one year earlier. This is mainly due to weak domestic demand, especially in the peripheral countries. Of the 13 member states for which initial GDP estimates for the first quarter of 2012 are already available, Finland and Slovakia recorded exceptionally strong quarter-on-quarter growth (+1¼% and +¾%, respectively). Aggregate output was up by ½% in Germany and Estonia, and by ¼% in Belgium and Austria. Real GDP in France and Portugal remained at the 2011 Q4 level, whereas it contracted again in seasonally adjusted terms in Italy and Spain. In Greece, where the Statistical Authority no longer publishes seasonally adjusted figures, the year-on-year rate was down to -6¼%. No data have yet been published for Ireland.

Recovery not expected until latter part of 2012

The survey-based economic indicators, such as those from the Purchasing Managers' Index and the EU survey on industrial confidence, that were published prior to April, give reason to believe that economic growth will remain weak in the second quarter. A renewed recovery of the euro area is not expected to start until the second half of the year, and this upturn is likely to get off to a slow start. For 2012 as a whole, the European Commission's spring forecast, in line with projections by other international institutions, foresees a decline in GDP of ¼%. However, growth of 1% is expected again for 2013.

Downward trends in the production sector

The stagnation of real GDP in the first quarter is largely attributable to the production sector. Construction output was 4½% down on the already depressed level recorded in the final quarter of 2011. This situation was aggravated by the persistently weak economy and weather-related restrictions due to the prolonged period of frost in the more northerly member states in February. Furthermore, industrial production was down by ½% in seasonally adjusted terms in the first quarter of 2012 after having already fallen by 2% the previous quarter. On an average of the first-quarter months, it has dropped by 2% on the year. Broken down by categories of goods, ¼% more capital goods were produced in the euro area in the period under review than in the final quarter of 2011. However, while the production of intermediate goods declined by ½%, the manufacture of consumer goods was even 2% lower than in the previous quarter. The fact that underutilisation of production capacities was again up slightly in the period from January to April is

2 This group comprises the non-euro-area countries that joined the EU in 2004 and 2007.

consistent with this picture. Only those energy producers that belong to the non-manufacturing industrial sector were able to increase their output by a seasonally adjusted 1% in the first quarter of the year. Orders received in the order-based manufacturing industry in January/February were 1¼% and 4¾% short of last quarter's and last year's level after seasonal adjustment. Even orders received from the euro area itself declined considerably.

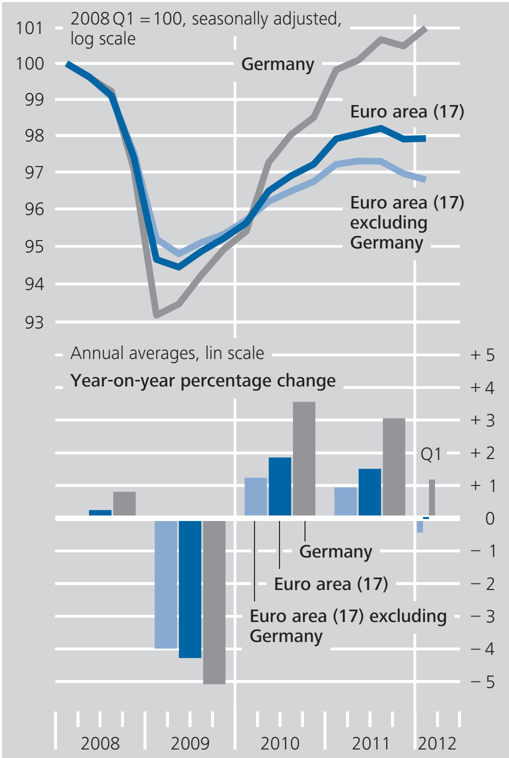
No growth stimuli from domestic demand

On the demand side, weak domestic activity was responsible for the economic standstill in the first quarter of 2012. The clear decline in construction coupled with a negligible rise in capital goods production indicates a lower level of gross fixed capital formation. Private consumption is likely to have remained in the doldrums. Real retail sales (excluding cars) managed to improve by ½% on the 2011 Q4 level; however, the number of new motor vehicle registrations plummeted (-6¾%). According to consumer confidence surveys, no noticeable pick-up in consumption is expected in the near future. However, in terms of aggregate economic growth, increased exports to non-euro-area countries are likely to have cushioned the contraction of private demand in the euro area. In January/February, the seasonally adjusted nominal exports of goods were 3% higher than in the final quarter of 2011. In nominal terms, imports of goods were more moderate than exports. Furthermore, a clear increase in the price of crude oil was behind this rise, meaning that growth in real imports is likely to have been even lower.

Outlook on labour market still gloomy

The situation on the labour market has deteriorated further over the first-quarter months. In seasonally adjusted terms, half a million more people were unemployed in March 2012 than at the end of 2011. Over this period, the unemployment rate rose by 0.3 percentage point to 10.9%. Of the euro-area countries, Austria (4.0%), the Netherlands (5.0%), Luxembourg (5.2%) and Germany (5.6%) had the lowest unemployment rates. However, in Spain and Greece, these rates were in excess of 20%. The number of persons under the age of 25 without employment (known as the rate of youth unemployment) was a worryingly high 22.1% in the euro area in March. The number of people in employment, which fell by a seasonally adjusted 0.2% in the third and again in the fourth quarter, is likely to have continued its descent in the first quarter of 2012.

Real GDP in the euro area



Deutsche Bundesbank

Sharp rise in consumer prices

Seasonally adjusted consumer prices in the euro area again rose sharply on the quarter in the first three months of 2012. Price pressures were only marginally weaker than at the beginning of 2011 meaning that year-on-year HICP inflation merely slipped from 2.9% in the final quarter of 2011 to 2.7%. The sharp rise in consumer prices continued in April. The year-on-year rate was down by only a little to 2.6%. The price surge in the first quarter of 2012 was broadly based; however, it was mainly determined by the higher price for refined petroleum products. This was chiefly due to much higher crude oil prices, the effects of which on consumer prices were further intensified by the continued depreciation of the euro against the US dollar. In addition, the prices for services rose considerably, partly as a result of some member states raising consumption tax rates.