Global and European setting

World economic activity

Moderate global growth in 2013 Q2 …

Global economic output is likely to have increased moderately in the second quarter of 2013. Although worldwide industrial production rose markedly in April-May compared with the first quarter (+½% in seasonally adjusted terms), the rate of growth remained well below the previous trend rate. Moreover, the global Purchasing Managers' Index for the services sector again indicated a moderate increase in activity during the second quarter. In regional terms, the subdued pace of global economic activity owed much, as in the first quarter, to the relatively flat expansion path in the emerging economies. Their slacker dynamics are largely due to structural problems, such as infrastructural constraints and – in China's case – the fact that its heavily investment and export-driven growth model is reaching its natural limits. Sluggish external demand also played a role.

Growth in the industrial countries as a whole accelerated distinctly. Aggregated real gross domestic product (GDP) across the United States, Japan, the United Kingdom and the euro area rose by just under ½% after seasonal adjustment. Their combined year-on-year growth was slightly larger. Breaking down the group of industrial countries, Japan's economic output lost momentum, while growth picked up slightly in the USA and accelerated markedly in the UK. In addition, the euro area's aggregate output improved distinctly on its subdued first-quarter level, which might signal the end of the recession that began in autumn 2011. This was driven by strong expansion in the German economy, a jump in French real GDP and a decelerating decline in Italy and Spain.

… and probably also in Q3

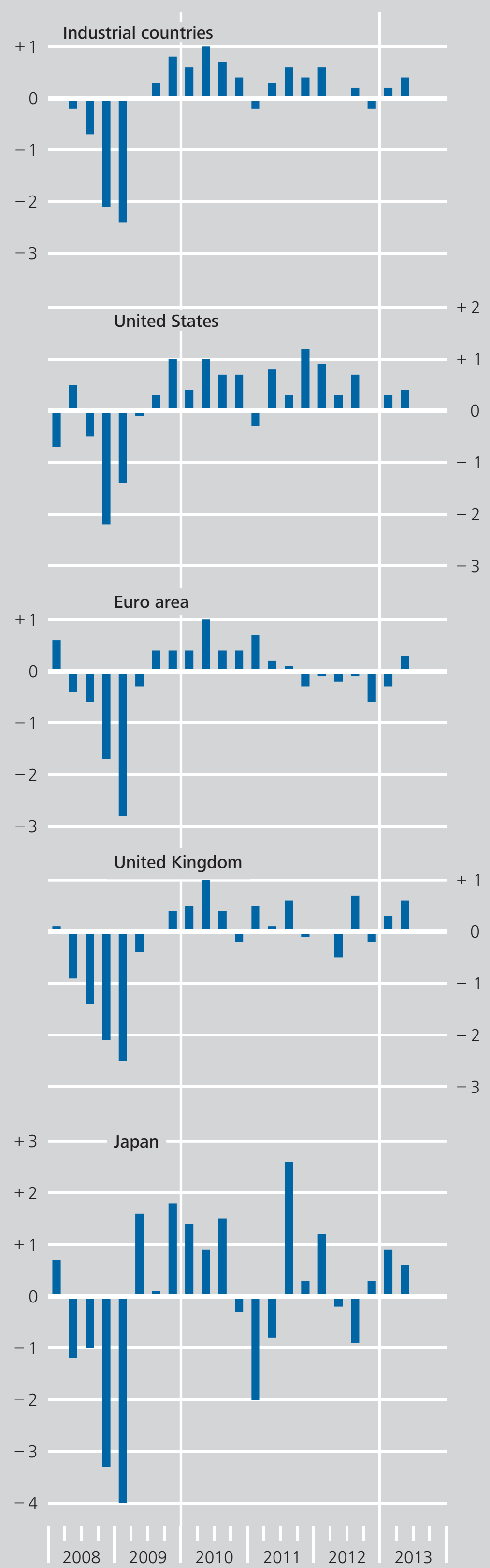
The global economy could remain on this upward path in the third quarter of 2013. The slight improvement in the global Purchasing Managers' Index for the manufacturing industry and the fairly sharp rise in the index for the services sector after mid-year suggest a moderate uplift in growth. However, a stronger recovery may be impeded by growth constraints caused by a slight pick-up in capital market yields and by the fact that the euro area is only gradually starting to improve. In addition, the large emerging economies still face structural growth problems. Another handicap could be that the central banks of several developing economies that require large capital inflows to fund their current account deficits have had to tighten their monetary policy stance in response to downward pressure on the currency. This was prompted by comments by the US Federal Reserve, which led the markets to expect that it might phase out its very expansionary monetary policy measures earlier than had generally been thought.

Further downward revision of IMF forecast

At the beginning of July, the International Monetary Fund (IMF) once more revised its growth outlook for the global economy downwards due to the deeper-than-predicted recession in the euro area vis-à-vis the IMF's spring forecast, the ongoing government spending cuts in the USA and, not least, the disappointing performance of the major emerging and developing economies. The IMF lowered its global growth projection for 2013 by 0.2 percentage point to +3.1%, matching the 2012 figure, and its projection for 2014 by the same amount to 3.8%. The downward revisions covered a wide geographical spread. Thus the IMF cut its predicted aggregate growth rates for the advanced countries for this year and next year by 0.1 and 0.2 percentage point to +1.2% and 2.1% respectively on the basis of adjustments made for the USA and the euro area, within which the IMF prognosis for German GDP growth was clipped to +0.3% for 2013 and +1.3% for 2014. By contrast, the IMF raised its projections for the current year for Japan, the UK and Canada. The expansion rates for the emerging market and developing economies based on the IMF's

Aggregate output in industrial countries*

Seasonally adjusted, quarter-on-quarter percentage change



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

Deutsche Bundesbank

projections for the individual countries were cut by 0.3 percentage point in both years to +5.0% and +5.4%. The IMF's downward revisions for Russia, South Africa, Brazil and Mexico were especially sharp. It lowered its assessment of the outlook for the Chinese economy by 0.3 percentage point to 7.8% in 2013 and by 0.6 percentage point to 7.7% for 2014. The projected increase in the volume of world trade during the current year was likewise reduced markedly to 3.1%. As before, the IMF considers that downside risks to growth prospects predominate. The new estimate is primarily based on the assumption that the increase in financial market volatility at the end of May and the accompanying rise in yields will partially reverse.

Across-the-board fall in commodity prices

Developments on the commodities markets also confirmed the impression that global economic expansion remained sluggish in the reporting period. As measured by the HWWI index on a US dollar basis, the prices of industrial commodities slipped by an average of 7¼% in the second quarter compared with the first three months, while prices for food, beverages and tobacco continued their previous downward movement and fell by 3¼%. Brent crude oil quotations simultaneously dropped by 8% on the spot market. As futures prices did not fall as sharply, forward discounts also narrowed markedly for a time. However, the intensification of the political crisis in the Middle East and lower oil production in the OPEC countries triggered a countermovement in July. As this report went to press, a barrel of Brent crude oil cost US$ 108½, which was just over US$5 more than the average price during the second quarter.

Consumer price inflation more stable of late

The decline in crude oil prices, in particular, initially further dampened the headline rate of consumer price inflation in the second quarter. In April, a price index covering the industrial countries showed the smallest year-on-year change since October 2009 (+0.9%). But looking at monthly changes, the seasonally adjusted index subsequently rose distinctly. At 1.6% in June, year-on-year headline inflation was again slightly higher than in March. The core inflation rate, which is based on the basket of consumer goods excluding energy and food, proved more stable, standing at +1.3% at the end of both the first two quarters of 2013.

Selected emerging market economies

Slightly slower growth in China

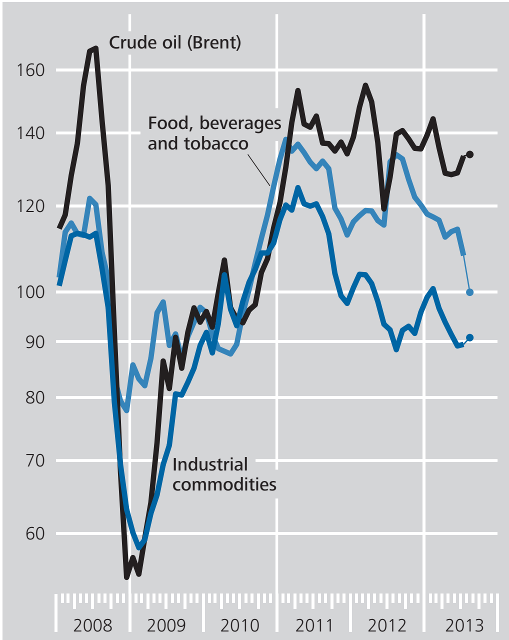
In the second quarter of 2013, real Chinese GDP was up 7½% on the year, marking the second slight fall in the year-on-year figure in succession. According to the official seasonally adjusted estimate, second-quarter output was 1¾% higher than between January and March, thus matching the first-quarter increase. On the supply side, the flatter year-on-year expansion rate was due chiefly to slower growth in industrial production. This is suffering, in particular, from weak export momentum, which almost came to a halt in the second quarter on a US dollar basis.[1] In addition to depressed growth in key sales markets, the fact that China's price competitiveness appears less favourable than in the past (see the box on pages 50 to 52) may also have played a role. The rise in Chinese domestic demand also seems to have slowed somewhat in recent months, but is still likely to have been fairly strong. Consumer price inflation remained moderate in the past few months; the inflation rate of 2.4% in the second quarter equalled the rate of price increase recorded in the first quarter.

India affected by subdued growth and marked currency depreciation

In India, real gross value added, which the Indian authorities use as the main measure of aggregate output, expanded in the first quarter of 2013 by 4¾% year on year. Although no national accounts data for the last quarter are available yet, the leading indicators show that growth is likely to have remained on a fairly flat path by India's standards. The rupee has depreciated sharply over the last few weeks in the wake of monetary policy statements made by the US Federal Reserve in conjunction with India's high current account deficit. The central bank responded by taking various measures to reduce liquidity, which may also slow the pace of economic activity. The central bank has not yet changed its policy rate, however. In the last few months, consumer price inflation showed a slight downward tendency from a high level and in July stood at 9.6%.

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 9 August or 1 to 14 August 2013 (crude oil).
Deutsche Bundesbank

Economic growth still moderate in Brazil

Economic output in Brazil is likely to have grown at a fairly subdued pace again in the second quarter, for which no official GDP data are yet available. Although industrial output increased by 1% in seasonally adjusted terms compared to the first-quarter average, various indicators for the services sector suggest that growth remains sluggish. Consumer price inflation increased again slightly in the second

1 China's foreign trade statistics indicate that, after rising sharply during the first quarter, the increase in exports year on year levelled off significantly. However, the official growth rates for the beginning of the year were probably strongly overstated as it is assumed that, during this period, exporters imported a large amount of capital into China by invoicing for goods that were not delivered in order to evade the capital controls currently in place.

quarter; the inflation rate rose to 6.6%, exceeding the central bank's upper tolerance threshold of 6.5%. It therefore felt compelled to maintain the tighter monetary policy stance it had introduced in April.

Growth dynamics in Russia still slack

Russia's macroeconomic momentum remained lacklustre in the second quarter. According to an initial estimate by the Russian Federal State Statistics Service, real GDP grew by 1¼% on the year, compared with +1½% in the first quarter. The monthly indicators appear to show that the rate of growth in private consumption diminished somewhat in the second quarter, while gross fixed capital formation, which was stagnant at the beginning of the year, may even have contracted slightly. In light of the persistent weak economic momentum, which has now spilled over onto the labour market, the government has recently announced various measures designed to stimulate the economy. These include additional funds for improving transport infrastructure and a subsidised loan programme for new car purchases. Given that inflation remains high – it stood at 7.2% in the second quarter – the Bank of Russia has left the key interest rates unchanged in the last few months. However, at the end of July, it began to conduct 12-month refinancing operations in order to improve the supply of liquidity to commercial banks.

USA

Slightly better picture following data revision

Following a comprehensive revision of the national accounts data, the US macroeconomic picture of the last few years appears somewhat brighter. First, the recent recession now seems a little less severe, and second, the subsequent recovery was stronger at times, particularly in late 2011 and the early part of 2012. On balance, real GDP in the first quarter of 2013 exceeded its level in the final quarter of 2007, the last cyclical peak, by 4% and not by 3% as previously thought. Furthermore, there are signs of a cyclical improvement at the current end. According to an initial estimate, aggregate output in the second quarter was ½% up in seasonally adjusted terms on the previous quarter, in which it grew by ¼%. This was driven by an upswing in fixed business investment that offset the first-quarter fall. Growth in private consumption remained robust. Overall, consumers coped well with the extensive increases in taxes and duties at the beginning of the year and proved flexible in terms of their saving behaviour. In the second quarter, households used their considerable income growth to markedly increase their saving ratio.[2] Notwithstanding the central government spending cuts, which came into force in March, there were barely any new retarding effects stemming from public demand. The previous substantial cutbacks may have exaggerated the underlying downward trend.

Continuing labour market upturn

The marked rising tendency in employment continued in the second quarter. Between April and June, 188,000 (non-farm) jobs were created on average, just slightly fewer than the number created in the first quarter (+207,000). Nonetheless, the decline in the unemployment rate, which is calculated on the basis of a separate survey, came to a halt over the course of the second quarter. In light of the labour market situation, which has been improving since late last summer, the US Federal Reserve announced a potential timeframe in mid-June for gradually tapering off its bond-buying programme. Moreover, participants at the meeting of the US Federal Open Market Committee revised their forecasts for the unemployment rate downwards. This rate fell to 7.4% in July, its lowest level since the end of 2008. Just as in most industrial countries, the US inflation rate measured by the consumer price index went up during the second quarter. Reaching 1.8% in June, it exceeded both the core rate (+1.6%) and its level of March 2013.

2 The level of the saving ratio increased markedly in the course of the revision of the national accounts as it had in previous revision rounds, rising from 2½% to 4% in the first quarter of 2013. In the following three-month period, it then rose to 4½%.

Japan

Economic activity remains buoyant

The Japanese economy's buoyant start to 2013 continued in the second quarter. Although, at just over ½% after adjustment for seasonal variations and inflation, GDP growth was distinctly slower than in the first quarter, final domestic demand accelerated slightly. The slower overall growth was in fact due to greater destocking of inventories and a weaker growth contribution from foreign trade. Private consumption increased substantially, although monthly indicators are already showing the first signs of a waning propensity to purchase. By contrast, enterprises again failed to lift their investment spending. However, the government's expansionary economic policy boosted public sector investment demand. Simulations carried out using the global macroeconomic model NiGEM suggest that while the package of monetary and fiscal policy measures may help to stimulate the Japanese economy in the short term, there is a risk that their positive impact may prove short-lived if these measures are not supported by profound structural reforms (see the box on pages 16 to 19). In June, buoyed by the current upturn, the seasonally adjusted unemployment rate fell to its lowest level since October 2008 (3.9%), though owing more to a decrease in the labour force than to an increase in employment. In the same month, the year-on-year rate of change in the consumer price index turned positive (+0.2%) due, in particular, to the rise in import prices for energy as a result of the yen's depreciation. By contrast, the core inflation rate remained negative in June (-0.2%), although less so than in March.

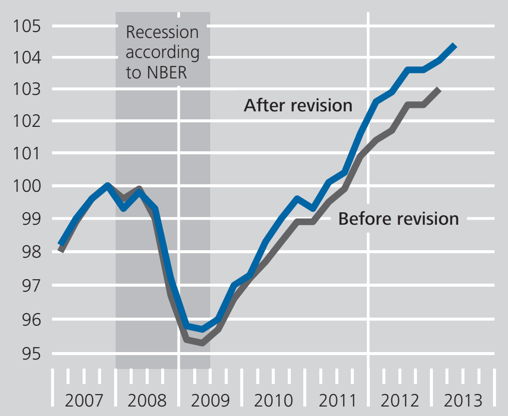
United Kingdom

Strengthening recovery

The upturn in the UK economy strengthened in the second quarter. After adjustment for seasonal influences, real GDP increased by ½% on the quarter, which was twice as much as in the first three months. The economy finally began to pull out of the subdued level of activity in which it had stagnated since summer 2011, though output still fell well short of the cyclical peak it reached in winter 2008. One encouraging sign is that the upturn evident in the reporting period was broadly based across the sectors. Not only services, which form the backbone of the British economy, but also manufacturing recorded a clear increase in output. Although gross value added grew even faster in the construction sector, this was due to a catch-up effect following the production stoppages caused by the inclement winter weather. Hence the pick-up in the construction industry should be seen more as marking the end of the downturn rather than the beginning of an upturn. However, this special factor had no impact on aggregate output. Buoyant retail sales figures indicate that it was chiefly private consumption that boosted GDP growth on the demand side. The outlook on the labour market brightened. Although the unemployment rate in the second quarter equalled the rate seen between January and March (7.8%), the number of recipients of unemployment benefits dropped markedly in the course of the second quarter. Year-on-year inflation as measured by the Harmonised Index of Consumer Prices (HICP) almost matched the first-quarter average (+2.7%). Even after stripping out energy and (unprocessed) food, the inflation rate did not ease (+2.4%).

Real GDP in the United States

2007 Q4 = 100, seasonally adjusted, log scale



Sources: Bureau of Economic Analysis and Bundesbank calculations.
Deutsche Bundesbank

Macroeconomic implications of Japan's new economic policy

Japan's economic policy was reoriented following the change of government in December 2012. The new policy mix was dubbed "Abenomics" in popular parlance. This term refers to a strategy comprising three components (or "arrows" as the Japanese administration also calls them) – a loosening of both monetary policy and fiscal policy, and measures to increase the growth potential of the Japanese economy.

A central plank of the new monetary policy is the 1 percentage point increase in the inflation target to 2%, announced in January 2013.[1] An open-ended asset purchase programme was concurrently established and then replaced by an even more expansionary policy of "quantitative and qualitative easing" from April 2013.[2] The second "arrow" is aimed at providing temporary fiscal support for the economy. Associated measures were put in train in February 2013 by the passing of a supplementary budget which envisages new expenditure totalling ¥13.1 trillion.[3] The resulting fiscal stimulus, after deducting regular elements and those not affecting demand and taking account of concomitant spending cuts, is likely to amount to just over 1¼% of Japanese gross domestic product (GDP).[4] Finally, the government presented a growth strategy in June 2013 through which it hopes to achieve a considerable increase in the Japanese economy's trend rate of expansion. This is to be attained through structural reforms as well as elements of industrial policy, for both of which quantified interim targets have been set.[5]

The keen national and international interest attracted by Abenomics doubtless derives to a significant extent from the ambitious goals for the domestic economy which Japan's new economic policy has set itself. However, with the yen depreciating sharply following the initial policy announcements, there are also widespread fears of negative spillover effects. But attempts to quantify the spillover effects solely on the basis of exchange rate reactions while disregarding the stimulus effects in Japan and other transmission channels would be incomplete. With this in mind, this article presents the results of a simulation analysis which takes these factors into account. The analysis is based on the NiGEM global economic model developed by the National Institute of Economic and Social Research (NIESR), which has the dual advantage of providing a detailed model of the Japanese economy and capturing international economic interdependencies. The simulated policy impulses are based on the monetary and fiscal measures taken by the Japanese authorities. Accordingly, the central bank's inflation target is permanently raised by 1 percentage point. It is also assumed that the quantita-

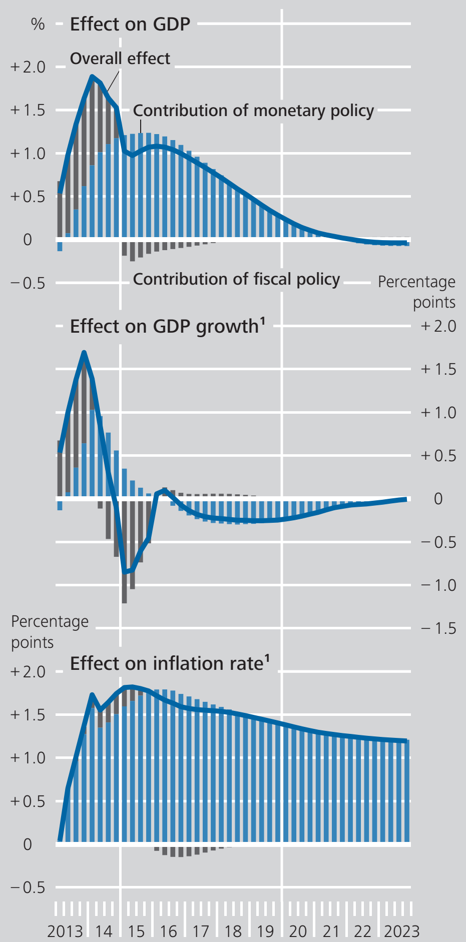
1 See Bank of Japan, Introduction of the "Price Stability Target" and the "Open-Ended Asset Purchasing Method", press release of 22 January 2013.
2 This policy entails the Bank of Japan significantly expanding its monthly asset purchases, increasing the average residual maturity of its bond portfolio and raising the share of riskier securities (ETFs and REITs). In addition, the monetary base has replaced the overnight money market rate as the operational target for monetary policy. See Bank of Japan, Introduction of the "Quantitative and Qualitative Monetary Easing", press release of 4 April 2013.
3 See Abe government, Emergency Economic Measures for the Revitalization of the Japanese Economy, Cabinet decision of 11 January 2013.
4 This estimate is in line with the IMF's analysis, which puts the size of the stimulus at 1.4% of GDP. See International Monetary Fund, Spillover Report 2013, pp 10-11.
5 See Abe government, Japan Revitalization Strategy – JAPAN is BACK, overview set out on 14 June 2013, http://www.kantei.go.jp/jp/singi/keizaisaisei/pdf/en_saikou_jpn.pdf.

tive and qualitative easing policy adopted will temporarily lower risk premiums.[6] On the fiscal policy side, the individual components of the stimulus package are apportioned to a two-year implementation period and then assigned to the government revenue and expenditure components modelled in NiGEM. By contrast, the growth strategy (the third "arrow") is not included in the simulation, not least because the likely effects of the measures announced on key macroeconomic variables are unclear.

Overall, the simulations suggest that the reorientation of Japanese policy is likely to provide a considerable temporary stimulus to the country's economy. On average over 2013, the GDP growth rate will be raised by almost 1¼% compared to the baseline. A positive, albeit smaller, growth effect is likely in 2014, too. But over the medium term this economic stimulus will peter out and will tend to weigh on the economy from 2015. However, a far more enduring impact is apparent for the headline inflation rate. A wage-price spiral sets in almost immediately, which means that, after initially overshooting the new target, inflation will be permanently 1 percentage point above the baseline rate.[7]

Effects of expansionary monetary and fiscal policy on Japan's economy

Deviations from baseline



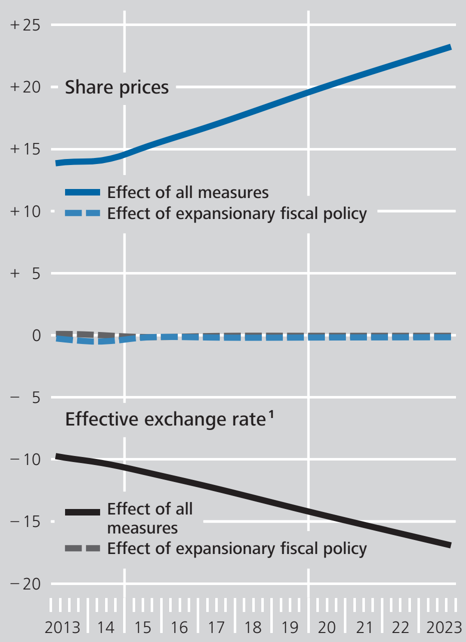
1 Year-on-year change.
Deutsche Bundesbank

If the stimulus effect is decomposed into its individual components, it becomes clear that fiscal easing is mostly responsible for the initial positive reaction in aggregate economic growth. In the short term, not only is government demand boosted but business investment increases as well on account of the subsidy components of the fiscal package. However, this effect reverses already in 2014 and then puts a marked brake on growth. By comparison, the impact of monetary easing is more gradual. *Per se* it lifts real GDP growth from 2013 for three years, before a counterswing sets in. The main boost to the economy comes initially from foreign trade, the growth contribution from which increases distinctly in response to the immediate depreciation of the yen. In addition, a sharp rise in share prices creates positive wealth effects, which are reflected in higher expansion rates in private consumption. It should be noted

6 Specifically, it is assumed, beginning in the first quarter of 2013, that looser monetary policy per se reduces for two years the yield spread between the long-term and short-term interest rate by 9.5 basis points and the spread between corporate and government bonds with the same maturity by 2.5 basis points.
7 The changes in the inflation rate which show up in the simulations do not reflect the inflationary effects of the planned increases in consumption tax, as these are already factored into the baseline rate.

Effects of the stimulus on equity and foreign exchange markets in Japan

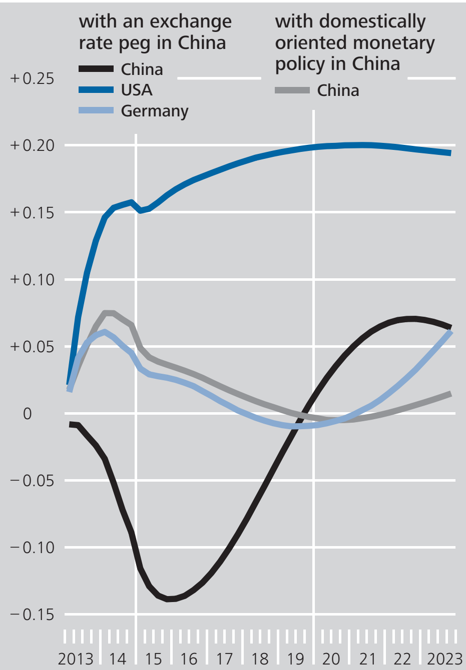
Deviations from baseline in %



1 Nominal. A downward movement indicates a depreciation of the Japanese yen.
Deutsche Bundesbank

Reaction of real GDP in selected economic areas to the stimulus in Japan

Deviations from baseline in %



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that the price movements on the financial and foreign exchange markets in the model, which in qualitative terms largely follow the pattern observed in reality, reflect the response of rational, forward-looking economic agents and not additional shocks or assumptions about irrational behaviour.[8]

In comparison to the considerable impact on the domestic economy, the international spillover effects from Abenomics shown by the NiGEM model are small. Despite a sharp depreciation of the yen, there is no marked drop in output in Germany or any other major economic area; in fact, the spillover effects are often positive. This is explained, first, by the fact that the dampening effect on exports caused by the change in the exchange rate is offset, at least in the short run, by an initial rise in Japanese import demand. Second, the appreciation of other countries' currencies lowers their import prices, leading to purchasing power gains and a boost to domestic demand. The effect is amplified by the endogenous policy reaction of central banks, which in the model respond to declining inflationary pressure by cutting interest rates. This boost to domestic economic activity is predominant in the United States, which has a relatively closed economy. In contrast, China experiences a fall in GDP, because the central bank, on the basis of the exchange rate target vis-à-vis the US dollar posited in the model, cannot sufficiently counteract the weakening of aggregate demand. Under an alternative assumption of a purely domestic monetary policy focus, China likewise shows positive spillover effects on balance. The simulation results indicate that German

8 The simulations also show a reaction in terms of long-term government bond yields, which rise immediately. This rise in yields reflects the expectation of a permanently higher level of nominal short-term interest rates resulting from the monetary policy response to a higher equilibrium inflation rate.

foreign trade is only moderately dampened by Japan's new economy policy, because in general the two countries are not close competitors.[9] However, this does not rule out the possibility of an appreciable stiffening of competitive pressure for German suppliers of specific products such as motor vehicles, particularly in third markets, and of losses in market share in these markets in the longer term.

All in all, it may be stated that, according to the simulation model, the measures taken by the Japanese government are well suited to aligning the inflation rate with the new inflation target in the long term and to stimulating the economy in the short term. As is usual in quantitative analysis, these results naturally reflect the model's structure. For instance, in NiGEM the assumption of unreserved credibility of monetary policy decision-makers ensures that inflation expectations can be anchored in line with the target. Thus, it rules out scenarios in which either the wage-price spiral is failing to operate or in which galloping inflationary processes set in. Whether these assumptions can be met in reality in Japan is by no means certain. First, it is open to question whether the requisite strengthening in Japanese wage growth can actually be generated within the space of a few years, in view of the relative weakness of the trade unions and the very high proportion of workers who are now employed under precarious employment contracts. Second, government influence on Japan's monetary policy stance might also lead to a shift in expectations on the part of economic agents. Historical experience shows that central bank independence is of crucial importance for lasting price stability and growth. Once this independence is thrown into doubt, the prevailing expectation formation processes (eg with regard to future inflation) may undergo fundamental change. This possibility is not captured in the NiGEM model. For this reason, too, the simulation results need to be interpreted with caution.

The decision to implement a fiscal stimulus programme can likewise be questioned, particularly given that the fiscal packages were decided upon at a point in time when there were already increasing signs of a self-sustaining upturn. In addition, the expected phase-out of the GDP-boosting measures coincides with the first stage of the increase in consumption tax, planned for April 2014. Overall, fiscal policy might therefore further magnify rather than reduce the cyclical swings. Furthermore, any positive effects on growth need to be weighed against increasing fiscal risks, which arise from a further expansion in the already very high level of public debt and which also reduce the scope for future expansionary programmes. This makes the success of the growth strategy (which was not incorporated into the simulations) all the more important. However, the very vague description of this strategy when it was presented in June 2013 disappointed general expectations. It remains to be seen whether more far-reaching reform measures will be announced, and, above all, swiftly implemented, now that the governing parties enjoy a stronger position following the elections to the upper house of parliament in July 2013.

9 This is also revealed in the fact that Japan has a weight of only 3.8% in the indicator of Germany's price competitiveness vis-à-vis 37 trading partners based on the deflators of total sales, which also cover competition on third markets.

New EU member states

Marked upturn

Business activity in the new EU member states (EU-7)[3] improved markedly in the second quarter. This was mainly due to stronger quarter-on-quarter growth in Poland's real GDP and the end of the recession in the Czech Republic. Both countries appear to have benefited significantly from positive stimuli from the euro area. However, the labour market remained difficult in many of the new EU states. The unemployment rate in the region as a whole remained high in recent months at 9.8%. Aggregate HICP inflation, which at the start of 2013 had already sunk to a multi-year low, fell further in the second quarter, ranging from -0.1% in Latvia and +0.6% in Poland to +4.4% in Romania. Given that inflationary pressure is declining and capacity utilisation remains low, several central banks in the region have lowered their key interest rates in recent months.

Macroeconomic trends in the euro area

Cyclical downturn halted

The recession that has dogged the euro area since the end of 2011 may have come to an end in the second quarter of 2013. Between April and June, aggregate output, which had contracted markedly at the beginning of the year, increased perceptibly on the first quarter after seasonal and calendar adjustment (+¼%). However, this was due in part to weather-related catch-up effects in the northern member states, where output in the first three months, especially in the construction industry, had been severely affected by the long, cold winter. At the end of the period under review, real GDP in the euro area was still ¾% down on the year and 1¼% lower than in summer 2011, before the latest downturn began. Broken down by country, the modest rise in output was mainly driven by Germany which, together with Finland, recorded the second-highest growth rate (+¾%) in comparison to the previous quarter after Portugal (+1%). France also reported a clear increase in macroeconomic activity (+½%). Among the crisis countries, Italy and Spain saw their fall in output decelerate considerably. In total, real GDP expanded in eight of the 12 member states which have already published preliminary seasonally adjusted data but continued to decrease in the remaining four. In Greece, where the Statistical Authority has ceased to publish seasonally adjusted figures until further notice, the economy contracted by 4½% on the year after shrinking by 5½% in the first quarter.

Signs of continuing growth in Q3

The latest survey-based indicators suggest that the economic upturn in the euro area continued into the second half of the year. The composite Purchasing Managers' Index for manufacturing was just above the expansion threshold in July. The output subcomponent jumped in the reporting month and is clearly in growth territory. Furthermore, business sentiment, as measured by a survey conducted on behalf of the European Commission, continued to improve, though it remained well below its long-term average. The new ECB indicator on euro-area industrial new orders[4] shows that the intake of orders in April-May was unchanged compared to the first quarter. The sub-indicator for new orders from non-euro-area countries has been pointing upwards since February, while orders from the euro area, taken together, declined up to the end of the reporting period.

Industry a growth driver

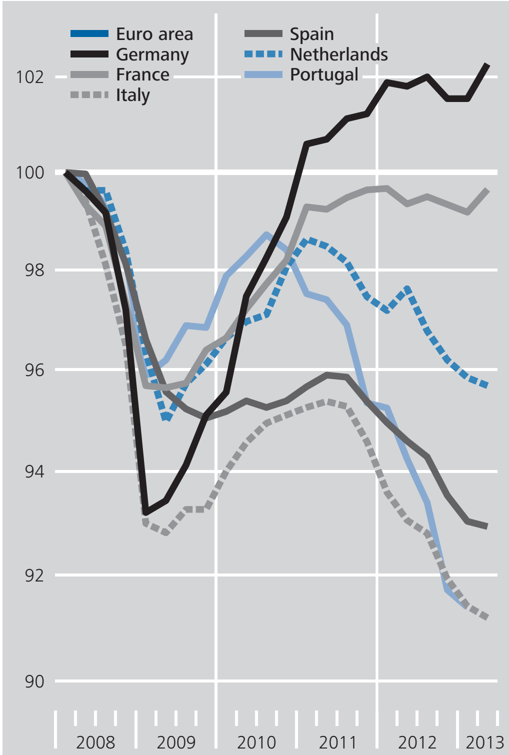
In sectoral terms, the strongest contribution to growth in the second quarter appears to have come from industry. Output in this sector between April and June rose by a seasonally adjusted 1¼% on the first quarter but was down ½% on the year. Manufacturers of capital goods recorded the highest expansion rate

3 This group comprises the non-euro-area countries that joined the EU in 2004 and 2007.
4 In March 2012, Eurostat stopped producing statistics on new orders in the euro area. In order to fill this gap, the ECB has developed a new monthly indicator on euro area industrial new orders. For information on the methodological approach, see Introducing the ECB indicator on euro area industrial new orders, Monthly Bulletin, July 2013, pp 65-68.

among the major branches of industry during the reporting period with a seasonally adjusted +3¼%. Energy producers also reported significant growth (+1%). Consumer goods production rose by ¼%, with non-durables expanding distinctly while the output of durables remained unchanged. The manufacture of intermediate goods grew by ½%. Capacity utilisation in manufacturing was markedly higher in July than in April but remained below its long-term average. Construction output in April-May was down ¼% on the first quarter, in which it had fallen by 3¾%. The aforementioned positive catch-up effects in some of the northern member states, including Germany, therefore merely served to slow down the pace of contraction in the euro area as a whole. It should also be noted that output in the construction sector has shrunk by an average of 1¼% per quarter over the last five years.

Real GDP in selected euro-area countries

2008 Q1 = 100, seasonally adjusted, log scale



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Exports up, private consumption stable

In the second quarter, exports are likely to have generated positive stimuli on the demand side. After adjustment for seasonal and calendar variations, (nominal) sales to non-euro-area countries in April-May were up 1¼% on their level between January and March and 4¼% up on the year. At the same time, imports fell by 1% in comparison to the first three months of 2013. Although falling commodity prices contributed to this, foreign trade may again have made a positive contribution to real GDP growth in the second quarter in statistical terms. Furthermore, it seems that private consumption stabilised at a low level in the second quarter. After adjustment for seasonal and calendar variations, real retail turnover was slightly up on the previous quarter, although they were still ½% down on the year. In addition, the number of new car registrations rose by 3% in the reporting period. The fact that consumer confidence has improved markedly from a low level in recent months also suggests that household consumption is beginning to strengthen. The slide in gross fixed capital formation appears to have slowed, at any rate. This is indicated both by the smaller contraction in construction output and the higher production of capital goods. However, it should be noted that, at least in April – up to when data are available – the corresponding exports increased markedly in comparison to the first quarter.

Unemployment rate unchanged since March

The fact that the standardised unemployment rate did not rise in the second quarter but remained at the same level as in March (12.1%) is consistent with the rise in aggregate output in the euro area. One especially positive sign is that unemployment has recently been falling in most of the crisis countries. It continued to rise sharply only in Greece and Cyprus. The erosion of employment in the euro area as a whole, which begin in the second quarter of 2011, persisted in the first quarter of 2013, the latest period for which data are available. The seasonally adjusted number of people in work receded by an average of ½% between January and March compared with the fourth quarter of 2012 and by 1% on the year.

The problem of high youth unemployment in the euro-area crisis countries

The high level of youth unemployment in many EU member states, especially the euro-area crisis countries, currently tops the economic policy agenda. At its meeting at the end of June 2013, the European Council endorsed the Youth Employment Initiative, a comprehensive package aimed at combating youth unemployment. One of its main components is the Youth Guarantee scheme, which promises all young people an apprenticeship, traineeship or a job within four months of leaving formal education or becoming unemployed. In addition, the quality of vocational training and work placements is to be improved and youth mobility promoted.

Although the Youth Guarantee scheme is likely to make a dent in the unemployment statistics, its effect is likely to be limited. Moreover, past experience has shown that such programmes rarely lead to new competitive jobs being created or to young people starting vocational training in areas where there is real demand.[1] Another problem is that the funds earmarked for the project are relatively small, and the crisis countries lack the budgetary resources to significantly extend the programme.[2] By contrast, the pledge to promote measures aimed at improving vocational training and mobility is likely to be more effective. However, reforming vocational training is a time-consuming process and needs to be underpinned by labour market reforms – as is explained below. In the short term, the most promising way of permanently reducing youth unemployment in the crisis countries is probably to promote youth mobility.

The statistical picture: youth unemployment rate versus youth unemployment ratio

In June 2013, 3.5 million persons aged between 15 and 24 were unemployed in the euro area; this represents slightly more than 18% of the total number of unemployed.[3] Youth unemployment has risen by 1 million, or nearly 40%, since its cyclical low in March 2008. Developments in the individual countries have been very heterogeneous. While the number of unemployed in this age group dropped to below its pre-global recession level in Germany, it experienced above-average growth in the peripheral countries as well as the Netherlands, Slovakia and in Estonia. At last count, the six crisis countries Italy, Spain, Portugal, Ireland, Greece and Cyprus – which are the focus of this article – alone accounted for 56% of youth unemployment in the euro area. The increase in this group of countries since March 2008 accounts for 71% of the total gain, although Germany was not included in the calculation because the num-

1 See K Brenke, Europäische Jugendgarantie: Enttäuschungen für junge Arbeitslose garantiert, DIW Wochenbericht, 30 2013, p 16.
2 As things currently stand, the Community budget will allocate a total of €26 billion to combating youth unemployment over the next few years.
3 Eurostat's unemployment figures are standardised rates intended to ensure international comparability. In all EU countries, information on employment status is gathered using standardised surveys (Labour Force Surveys, LFS). Whether a person is classified as being unemployed is based on the International Labour Organization (ILO) definition. In its monthly press releases, Eurostat quotes not only the overall unemployment rate, it also gives separate unemployment rates for men and women and for persons aged 15 to 24. It should be noted that in Spain persons must be at least 16 years of age to be counted towards the working-age population, while the threshold in the other euro-area countries is 15 years.

ber of unemployed young persons dropped there, as mentioned earlier.[4]

However, overall unemployment in the euro area has grown much faster, by 69%, than youth unemployment. This can largely be attributed to a surge in unemployment among 25 to 34-year olds and among 35 to 44-year olds in the peripheral countries. As a result, the share of young people in overall unemployment in these countries has either dropped slightly or remained unchanged since the onset of the crisis.

Since March 2008, the youth unemployment rate in the euro area has increased by almost 9 percentage points to 24%. At last count, the national youth unemployment rates in the crisis countries ranged from 26% in Ireland, 38% in Cyprus, 39% in Italy and 41% in Portugal to 56% in Spain and 63% in Greece. Youth unemployment was usually more than twice as high as the overall unemployment rate. The high youth unemployment rates in these countries are often interpreted as meaning that every third or every second young person there is out of work. That is not correct, however. The youth unemployment rate shows what percentage of the labour force aged 15 to 24 is jobless. However, the labour force only includes people who are available for work, ie the employed and the unemployed. It excludes many young people who are still in school or at university.[5] When interpreting youth unemployment rates, it should also be noted that the labour force as a percentage of the population may vary over the business cycle. If, for instance, young people opt to remain in education for longer during a recession as they see little prospect of finding work, this may represent hidden unemployment, which is not captured by the statistics. With the exceptions of Spain and Ireland, labour force participation did not, however, drop exceptionally in the crisis countries in the period 2007 to 2012. It should also be noted that there is an upward trend in the percentage of young people in secondary or tertiary education throughout the EU. Moreover, the sharp decline in labour force participation among young people in Spain and Ireland can be interpreted as something of a normalisation, as the participation rate was relatively high in both countries before the crisis and is now much closer to levels in the other crisis countries and also to the average of the other euro-area countries excluding Germany and Austria (see footnote 5) of 38%.[6]

In order to better assess the extent of youth unemployment in a country, it makes sense to look not only at the traditional unemployment rate but also at the number of unemployed young people in relation to the population in this age group; Eurostat

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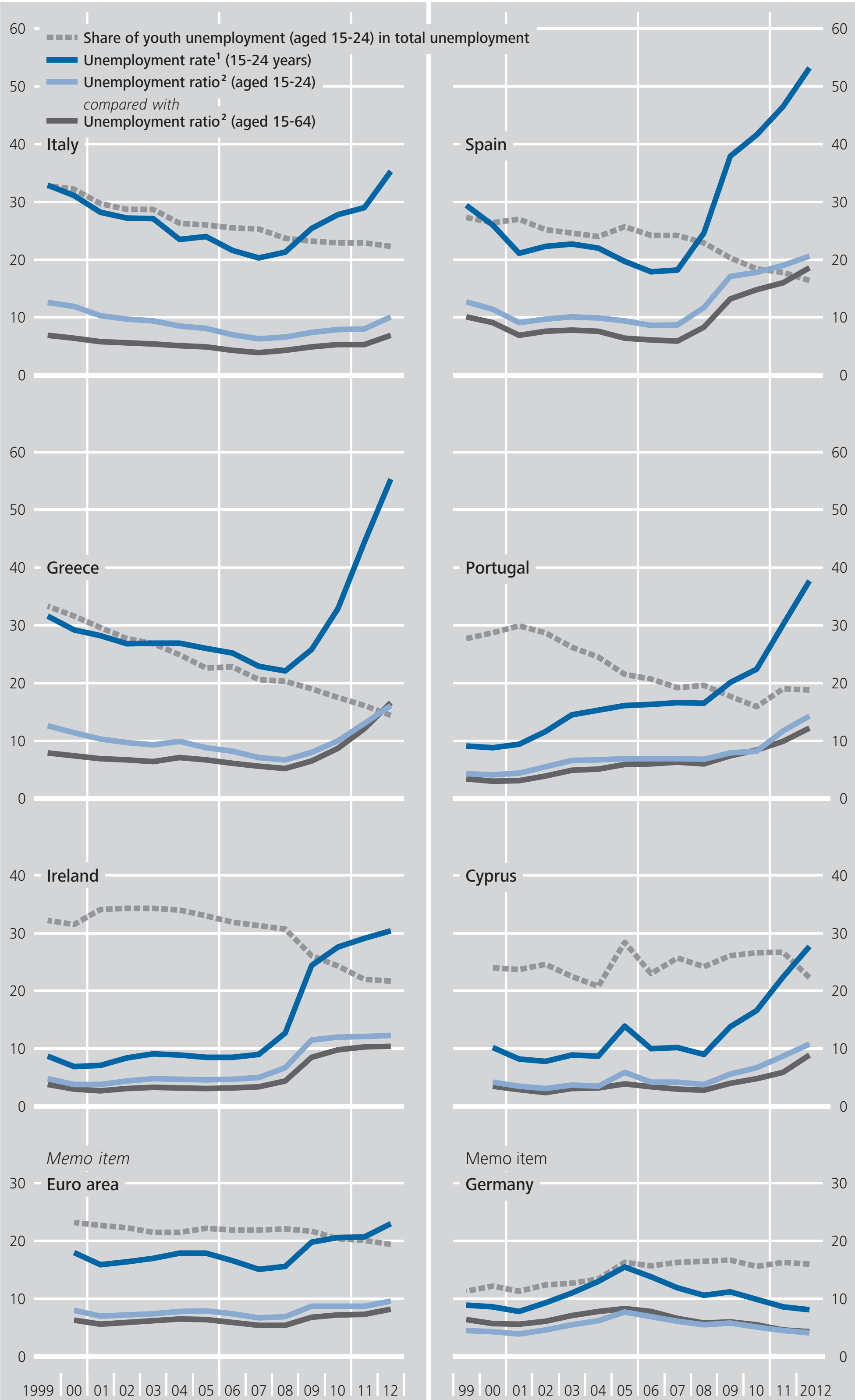
4 The crisis countries are responsible for as much as 79% of the increase in overall unemployment in the euro area (excluding Germany).

5 The labour force participation rate of young people, ie employed and unemployed as a share of the population in this age group, was just 42% in the euro area in 2012 compared with 72% in the working-age population as a whole. In the crisis countries, labour force participation by young people ranged from 29% in Greece and Italy to 41% in Ireland. It was thus similar in magnitude to other euro-area countries such as France (38%) and Belgium (32%). The markedly higher participation rates in Germany (51%) and Austria (60%) can be explained, for one, by their distinctly better overall labour market situation. Another factor is that apprentices in the two-track vocational training system, which is very common in these two countries, are counted as being employed, whereas young people in school-based vocational training, which predominates in other euro-area countries, are not. However, in the crisis countries, 6% of young people in training also work, meaning that they are counted as being employed.

6 Labour force participation in Ireland fell by 15 percentage points to 41% between 2007 and 2012, and dropped by 9 percentage points to 39% in Spain. A partial explanation for this could be that during the boom it was comparatively lucrative for young people in Spain and Ireland to start work in the construction industry or other sectors without lengthy vocational training. Now that the boom has ended, more young people are obviously again deciding to undertake vocational training or to study.

Youth unemployment in the euro-area crisis countries

%



1 Unemployment rate according to ILO definition. **2** Share of unemployed persons in the respective age group.
Deutsche Bundesbank

has proposed calling this ratio the "youth unemployment ratio".[7] Since the onset of the global recession, the youth unemployment ratio in the crisis countries has risen roughly in line with the unemployment ratio in the working-age population as a whole. Last year, fewer than 10% of all young people in the euro area were unemployed. Looking at the crisis countries, the ratio was slightly higher in Italy, Ireland and Cyprus, at between 10% and 12%, while 14% to 16% of all young people were jobless in Portugal and Greece. The ratio was significantly higher in Spain, at 21%.

Reasons for the high youth unemployment and possible reforms

Although the difference between the unemployment ratios for the age groups 15 to 24 and 25 to 64 is considerably smaller than the difference in the respective unemployment rates, it is still marked, except for Greece. The higher unemployment among young people, which can be observed in virtually all industrialised countries, can predominantly be explained by structural factors. In the southern euro-area countries, one of the main factors is the long-standing and pronounced segmentation of the labour market, featuring a high degree of job protection for older workers. As a consequence, a large proportion of young people are offered only temporary employment contracts, which are easy to terminate when economic activity slackens. (The same applies to 25 to 34-year olds entering the labour market for the first time after a lengthy education.) Moreover, legal or negotiated minimum or entry-level wages for young workers are often relatively high in these countries, which prevents apprentices from receiving a distinctly lower starting wage, as is customary in Germany. Another reason for the difficulties young people have finding a permanent job is that vocational training is primarily school-based and is often not tailored to the labour market's needs, which can result in long job hunting. At the same time, several of these countries still have a rather high percentage of low-skilled young people by European standards – although the level of education has risen considerably compared with earlier decades.[8] Whereas in the pre-crisis boom years many of these young people found a job or may even have deliberately foregone the opportunity to acquire higher education qualifications given the buoyant labour market situation, in the current recession their low skill level represents a particularly high hurdle to their rapid re-integration into the labour market.

In recent years, several peripheral countries have carried out reforms to improve the functioning of their labour market, which could potentially increase young people's employment prospects. These include reducing job protection for older employees in Spain and Portugal and significantly lowering minimum wages for young people in Greece. There is doubt, however, as to whether the reform efforts to date will be enough to bring about a significant drop in unemployment in general and youth unemployment in particular. In addition, the positive effect that these measures are expected to have is unlikely to have much of an impact on employment trends until the economy picks up. Even if the majority of crisis countries experience a cyclical recovery in late 2013/early 2014, as is generally anticipated, unemployment overall and

7 See Federal Employment Agency, Jugendarbeitslosigkeit in Europa: Vom Umgang mit unterschiedlichen Quoten, press release 031 of 29 May 2013, and Eurostat, The measurement of youth unemployment – an overview of the key concepts, press release of 12 July 2013.
8 See J R Garcia, Youth unemployment in Spain: causes and solutions, BBVA Research Working Paper No 11/31, September 2011.

among young people will probably be slow to come down.

In the current debate on reforming vocational training in the crisis countries, observers, especially in Germany, frequently stress the advantages of the two-track vocational training system – in which theoretical teaching alternates with practical training in enterprises – as this appears to ensure that vocational training is better tailored to industry's real needs than is the school-based vocational training prevalent in non-German-speaking countries. In addition, the fairly low wages paid to apprentices and trainees make it easier for young people to find a job. The effectiveness of the dual system is evident, not least, in the fact that youth unemployment in Germany, Austria and Switzerland is among the lowest in the entire OECD. It is open to debate, however, whether this system, which has a very long tradition and is deeply rooted in the above-mentioned countries, can be transferred to other countries to similar effect.[9] A key obstacle is that the network between enterprises, employment agencies and vocational schools necessary for an efficient organisation of the dual system would first need to be established. Another precondition for a successful implementation would be a substantial lowering of minimum wages for young people in some countries. Taking all this into consideration, it might be more promising and more cost-effective to match the existing school-based training in the crisis countries more closely to the actual requirements of the job market.

Migration as an alternative option

Important as they are, further reforms to the labour market and the education system, even if implemented quickly, could only improve the employment prospects for young people in the crisis countries in the longer term and would therefore come too late to help many of today's unemployed. In this situation, an alternative option for young people looking for work is to migrate to countries that need labour, at least for a time. This applies more to well-educated young people and less so for the low-skilled, for whom jobs tend to be scarce, even abroad.

In Ireland, the number of young emigrants has already increased sharply in recent years. In the years 2010 and 2011, ie after the onset of the sovereign debt crisis (more recent data are not yet available), net emigration amounted to 24,000 persons, or 4.2% of the population aged 15 to 24. This probably partly explains why the youth unemployment rate in Ireland is currently the lowest in the group of six peripheral countries. In the southern European countries, by contrast, emigration would have to swell markedly to ease the situation on the labour markets to any significant degree. In Spain, for instance, net emigration of young people in those two years was just 2,500, or 0.1% of that age segment of the population, though the number of young people leaving the country is likely to have shot up in 2012. Net emigration of young people from Italy in 2010-11 was even lower, at 1,500 (such data are not available for the other peripheral countries).[10]

Taking up work abroad generally not only improves the personal situation of young people who have been unsuccessful in their attempt to find a job in their home country

9 See H Dietrich, Jugendarbeitslosigkeit: Aktive Arbeitsmarktpolitik, Wirtschaftsdienst, volume 6 (2013), pp 358f.
10 Including young foreigners in the calculation, both Spain and Italy experienced net immigration totalling 62,000 and 147,000 persons respectively in 2010 and 2011. However, these figures probably include not only an influx of refugees but also many people entering the country to study.

but also eases the strain on public finances in their home country, by, for instance, cutting the volume of social transfers. There is little foundation for concerns that the migration of young people could damage a country's growth potential in the long term, as there is nothing to prevent them returning to their home country when economic conditions there pick up again. In fact, many returning emigrants are likely to bring with them valuable know-how from abroad. Stronger migration within the euro area would be desirable also because it can take on an important economic adjustment function in a currency union, which by its very nature precludes exchange rate changes. Overall therefore, there is much to be said for stepping up efforts to encourage youth mobility at national and EU level.[11] An important starting point could be promoting foreign language skills, as the low mobility within the EU – especially compared with the United States – is probably largely connected with Europe's plurality of different languages.

11 See M Barslund and D Gros, Unemployment is the scourge, not youth unemployment per se – The misguided policy preoccupation with youth, Centre for European Policy Studies (CEPS), Discussion Paper No 294, June 2013, pp 7ff, and W Eichhorst et al, Youth Unemployment in Europe: What to Do about It?, IZA Policy Paper No 65, July 2013.

Youth unemployment has various facets

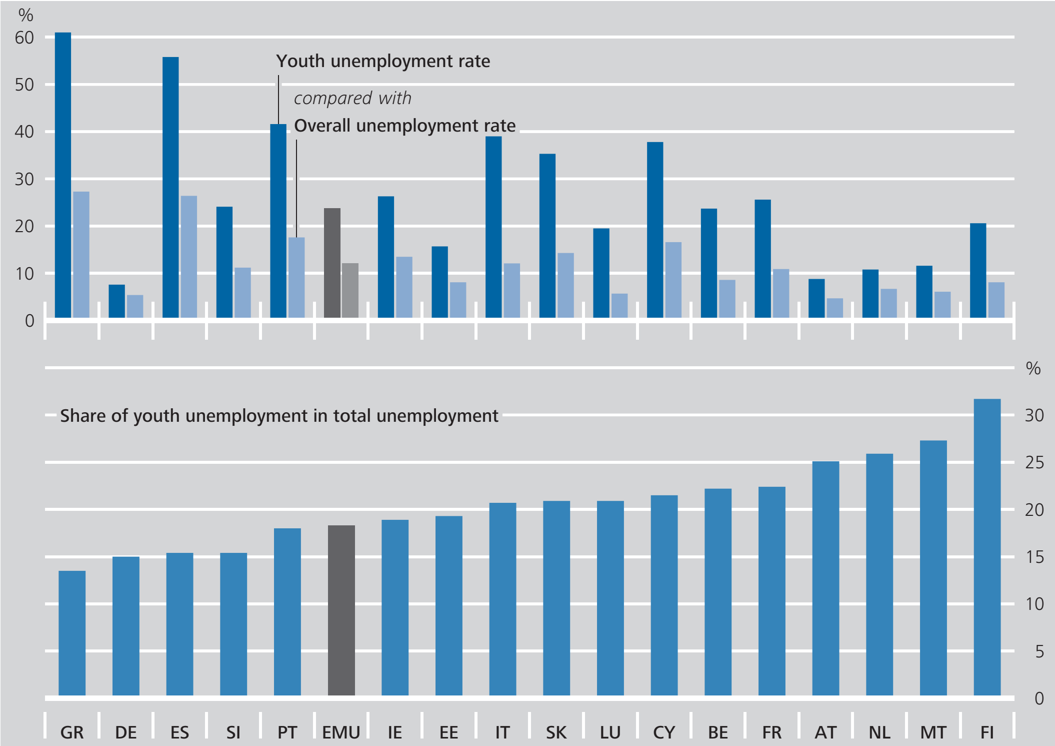
The high level of youth unemployment in the euro area is considered a particularly pressing problem. Since its cyclical low in March 2008, the standardised unemployment rate among 15 to 24 year-olds has risen by 8.8 percentage points to reach 23.9% in June 2013. This was primarily due to starkly negative developments in the crisis countries, where the corresponding jobless rates recently stood at 26.5% in Ireland, 56.1% in Spain and 62.9% in Greece (for a detailed analysis of this topic and the identification of potential policy measures to combat high youth unemployment in the crisis countries, see the box on pages 22 to 27). However, when interpreting the very high youth unemployment rates in these countries compared with the overall unemployment rates, it should be noted that the defined youth labour force with which the number of unemployed young people is compared is relatively small in relation to the total population in the 15 to 24 age group as many young people are not available for work. Furthermore, the high rates of youth unemployment in the crisis countries obscure the fact that the number of young people out of work in proportion to the total number of unemployed persons is not unusually high in comparison to other member states. In the second quarter of 2013, it was only marginally above the euro-area average of 18.3% in Ireland (18.9%) and moderately higher in Italy (20.7%) and Cyprus (21.5%). The percentage shares in some of the other peripheral countries were well below the average, with Greece at the bottom end of the scale at 13.5% (April-May). Finland was at the top with 31.7%.

Inflation slowed by energy and early Easter

Between April and June 2013, the rate of increase in consumer prices in the euro area largely came to a halt, with a quarter-on-quarter rise in the HICP inflation index of just 0.1% in seasonally adjusted terms. This was due to a significant decline in energy prices, especially in April and May. At the same time, the traditional spike in service prices over Easter was largely shifted from April into March as

Youth unemployment* in the euro area

As at 2013 Q2[1], seasonally adjusted



* Aged 15 to 24, unemployment rate according to ILO definition. **1** Data for Greece and Estonia up to May 2013.
Deutsche Bundesbank

Easter fell early this year. This partly explains the first-quarter jump of 0.4% in the inflation rate. The prices of unprocessed foods accelerated throughout the second quarter, partly because of the poor weather. By contrast, the prices of processed food and other industrial goods remained on a steady, moderate upward curve. Year-on-year HICP inflation fell from 1.9% in the first three months of 2013 to 1.4% in the second quarter.

Ongoing moderate price pressure in July

The generally subdued price movement seen in May and June continued into July. Food prices continued to rise, while energy prices increased fairly sharply for the first time in several months in the wake of the higher cost of oil. By contrast, the prices of other industrial goods fell slightly in seasonally adjusted terms. The year-on-year rate of increase in the HICP amounted to 1.6%, just as in June.