

## ■ Global and European setting

### ■ World economic activity

*Moderate global growth in the fourth quarter of 2013*

The global economy progressively improved during 2013 after getting off to a slow start. In the final quarter of 2013, the world economy probably just about maintained the moderate pace of growth it had generated up to then. This was due mainly to the strong performance of major industrial countries. In the United States and the United Kingdom, for instance, real gross domestic product (GDP) in the fourth quarter grew as robustly as in the third quarter. The euro area's aggregate output expanded slightly more strongly in the fourth quarter than in the previous three months. No official growth estimates for the fourth quarter were available for Japan yet as this report went to press. According to commonly used indicators, economic growth was considerably stronger than in the previous period, in which it had been only moderate. However, anticipatory demand in advance of the increase in the consumption tax, which is due to take effect on 1 April 2014, may have contributed to this increase. The generally quite favourable economic activity in key industrial countries also made itself felt in the labour markets: unemployment rates have fallen, in some cases markedly. By contrast, the emerging markets as a whole did not, it seems, quite maintain their previous growth rates in the final months of 2013. This is suggested by preliminary official reports from some Asian countries, including China. The financial market turbulence that some emerging markets encountered in the summer of 2013 has had no serious impact on the real sector of the economies concerned.

*Vibrant growth of industrial output and world trade*

Somewhat stronger momentum was generated in autumn by the industrial sector, with global output in October-November up by a seasonally adjusted 1% compared with the summer quarter. At the same time, world trade picked up; its volume grew by 2% in the same period. This brisk growth was regionally broadly

based, with exports by the advanced economies and the emerging economies alike on a pronounced upward trajectory.

Global growth momentum could strengthen further during the current year. A key contributory factor is that fiscal policy is likely to have less of a dampening effect on the overall economic recovery in the industrial countries than last year. The global purchasing managers' indices for manufacturing and services, which in January were able to maintain their December level above the expansion threshold, suggest at least a continuation of the moderate global economic growth in the new year. The mild temperatures could well have a beneficial impact on Western Europe's economic performance in the current quarter; however, experience shows that such effects are usually offset in subsequent quarters. Following the increase in the consumption tax rate in April, the Japanese economy will probably be put to a serious test. Mixed economic signals emanated from the emerging market economies at the beginning of 2014. Whereas the Chinese economy still appears to be on a relatively smooth path, several countries, some of which had already been at the epicentre of financial market turbulence in the second and third quarters of 2013, experienced at times significant capital outflows and currency depreciation following the US Federal Reserve's decision in December to "taper" its previously very expansionary monetary policy. In the meantime, many central banks have responded by pushing up interest rates, in some instances substantially. Although this may dampen GDP growth in the countries concerned, their small global weight means that this is unlikely to hamper the global economic recovery to a marked degree.

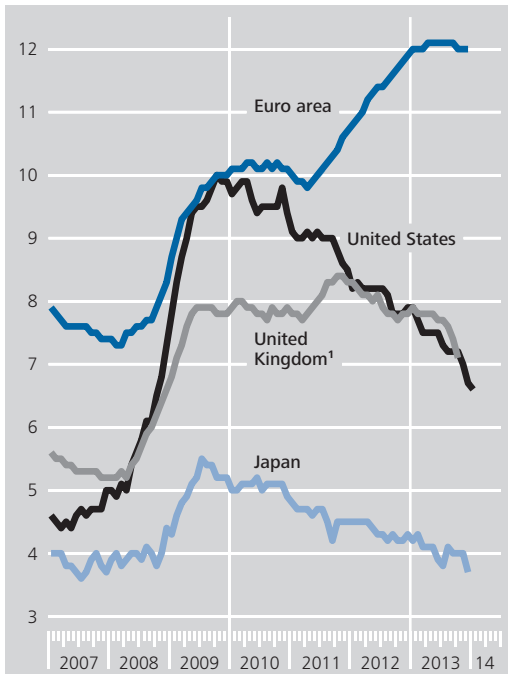
According to estimates by the International Monetary Fund (IMF), global economic growth in 2013 was, with aggregate output up 3.0% (calculated at purchasing power parities), still

*Outlook for the world economy predominantly favourable*

*Slight upward revision of IMF forecast for 2014 in January*

### An international comparison of standardised unemployment rates\*

%, seasonally adjusted

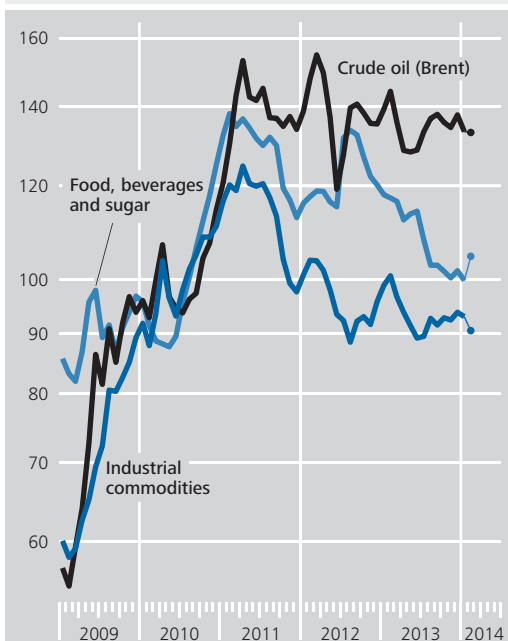


Source: national data. \* Number of unemployed as a percentage of the labour force. <sup>1</sup> Centred three-month moving average.

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

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



Sources: Thomson Reuters and HWWI. • Average of 1 to 7 February or 1 to 12 February 2014 (crude oil).

Deutsche Bundesbank

considerably below its long-term trend growth rate of 3¾%; however, it improved progressively during the year. Against this background, the IMF staff revised its growth forecast for 2014 slightly up in January to 3.7%, while maintaining its autumn projection for 2015 (+3.9%). The adjustment for 2014 was based on a slight upward revision of the growth rate for the group of advanced economies to 2.2%, the most prominent component of which is a more favourable assessment of the outlook for Spain, Japan and the United Kingdom. The projection for the group of emerging market and developing economies was confirmed at +5.1%. Noteworthy developments here, however, are positive revisions for China and India, contrasting with a strong downward revision for Russia. Although the IMF expects global trade to grow much more strongly in the current year, at 4.5%, than in 2013, it has markedly reduced its projection compared to the autumn forecast. The IMF still sees risks to financial stability in the industrial countries. In addition, it emphasises the risks associated with low inflation, and has raised the likelihood of deflation following an adverse shock. As regards the emerging market economies, the IMF particularly stresses the risks of increasingly volatile capital flows, which it sees in connection with monetary policy decisions, specifically in the United States.

In autumn 2013, the international commodity markets remained largely calm. As measured by the HWWI index on a US dollar basis, the prices of commodities (excluding energy), on an average of the last quarter of the year, remained virtually unchanged on the quarter. Whereas industrial commodity prices picked up slightly amid stronger growth in the global manufacturing sector, food, tobacco and sugar prices still fell noticeably. In addition, the spot price per barrel of Brent crude oil fluctuated around the US\$110 mark. Specifically, expectations that oil production would return to normal in Libya caused prices to fall somewhat at the beginning of the year. As this report went to press, the spot market price for a barrel of

*Commodity markets in calm waters*

Brent was US\$108½, whereas oil futures continued to trade at perceptible discounts.

*Industrial countries' consumer price inflation stabilised*

At the same time, consumer price inflation in the industrial countries stabilised during the final quarter of 2013. After falling from +1.7% in July to +1.0% in October, the annual inflation rate calculated from the aggregate index climbed back up to +1.3% by December. The main reason behind the turnaround was that weak developments in the 2012 reference period caused annual energy price inflation to return to positive territory. Core inflation, which relates to the basket of consumer goods excluding energy and food, was similarly muted at the end of 2013 as in the preceding months (+1.3%). There is therefore still nothing to suggest that the group of advanced economies as a whole is facing any imminent deflationary tendencies.

## Selected emerging market economies

*China maintains year-on-year growth rate*

According to the initial estimate presented by the National Bureau of Statistics of China, the year-on-year growth rate of real GDP in the final quarter of 2013 was +7¾% and thus just as high as in the third quarter. Looking at the official seasonally adjusted data, economic activity has weakened somewhat as of late, however. Real GDP growth for full-year 2013 likewise amounted to 7¾%. Nominal value added in the services sector surpassed that of the production sector (industry and construction) for the first time. With regard to the expenditure components of GDP, however, no tangible progress seems to have been made towards the authorities' goal of rebalancing the Chinese economy. The relevant national accounts data are not yet available, but official estimates of the contributions made by various demand components to GDP growth indicate that real gross investment again outpaced aggregate consumption last year. Net exports were once again a drag on overall economic activity, in statistical terms. This was because a significant

increase in exports was more than offset by even livelier import growth. Consumer price inflation, which had climbed to 3.2% in October, tailed off again towards the end of the year, with CPI inflation reported at 2.5% in December. Average inflation for 2013 is roughly the same level.

Along with several other emerging market economies, India experienced heavy financial market turbulence in the summer months. Although the turmoil has flared up again in many places over the past few weeks, the situation in India has remained relatively calm. In the third quarter, the most recent quarter for which national accounts data are available, India's economic growth accelerated moderately despite the tensions in the financial markets at the time. Nonetheless, growth of real gross value added – India's preferred indicator of aggregate output – was just 4¾% on the year, a rather low figure by historical standards. The pace of growth does not appear to have changed fundamentally in the quarter ended. Although harvests are likely to have been bountiful following a high-precipitation monsoon season, this is offset by the fact that, following a mild recovery, the industrial sector lost momentum again. The average inflation rate for the fourth quarter rose once again, to 10.4%. For this and other reasons, the Reserve Bank of India has further tightened its monetary policy in recent months.

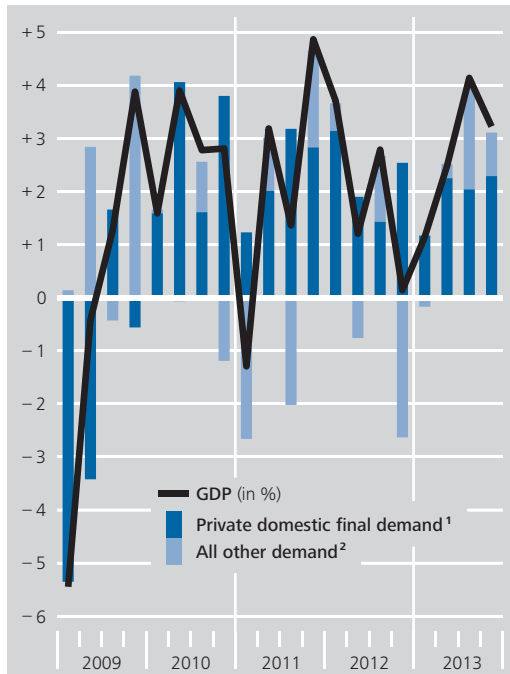
*Aggregate growth in India probably relatively low throughout reporting period*

In the third quarter of 2013, the latest period for which GDP data are available, economic output in Brazil shrank by a seasonally adjusted ½% compared with the preceding three-month period. However, the weak performance needs to be seen in the light of the very strong growth in the second quarter (+1¾%). According to the relevant indicators, GDP growth in the final quarter of the year showed a moderate upward tendency, most likely returning to the underlying trend of the second and third quarters. Marked growth in value added in services is likely to have been offset by a significant drop in industrial value added. Consumer price

*The underlying pace of economic growth in Brazil appears to have remained moderate*

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

In annualised percentage points, seasonally adjusted



Source: Bureau of Economic Analysis. <sup>1</sup> Private consumption and private gross fixed investment. <sup>2</sup> Public demand, inventory changes and net exports.  
 Deutsche Bundesbank

## United States

The US economy grew at a fairly rapid clip again in autumn 2013, though it was not quite able to maintain its fast pace of the summer months. According to an initial estimate, seasonally adjusted real GDP was up by ¾% compared to the third quarter, in which it had risen by 1%. The weak performance in the fourth quarter of 2012 and first quarter of 2013, in particular, depressed average growth for 2013 to 2%, following an increase of 2¾% a year earlier. The noteworthy acceleration of growth in the second half of last year was attributable to a great degree to special factors which do not appear to be infinitely repeatable. Aggregate growth was boosted primarily by increased restocking in the third quarter. In the fourth quarter, meanwhile, it was propelled by strong export growth. As of late, however, public demand fell significantly, partly due to the temporary government shutdown in October. The return to normalcy of government activities will accordingly probably lend a slight boost to GDP growth in the current quarter. In general, fiscal policy is likely to have less of a dampening effect on aggregate growth this year than before. In the fourth quarter, the political squabbling over the federal government budget did not make a dent in private domestic final demand, which remained on a moderate growth trajectory. Although consumer spending showed its strongest growth in three years, private gross fixed capital formation faltered because there was a lull in the recovery in construction activity. Non-farm employment continued to grow unabated. In December, the unemployment rate even slid to 6.7%, its lowest level since October 2008, and continued to trend downwards at the beginning of the new year. In the light of the improvements in the labour market thus far, the US Federal Reserve has begun to taper its asset purchase programme. CPI inflation rose to 1.5% in December, whereas core inflation was unchanged at 1.7%.

*Fairly rapid aggregate growth*

inflation trended slightly downward since the middle of the year but, at 5.9% in December, remained above the monetary policy target of 4.5%. This, in conjunction with the high outflows of capital, led the central bank to hike its policy rate perceptibly once again in the past few months.

*Russian economy listless throughout reporting period*

According to the available indicators, economic activity in Russia seems to have remained listless in the final quarter of the year. No official GDP figures are available yet, however. Nonetheless, the Russian Federal State Statistics Service has already released a flash estimate for full-year 2013, according to which economic output grew by 1¼%, following growth of 3½% a year earlier. The latest weakness affected a wide range of sectors, with the exception of financial services, where output rose exceptionally strongly (+12%) – as in the previous year. Consumer price inflation remained high in December, at 6.5%.

## Japan

*Economic activity probably picked up in run-up to consumption tax hike*

As this report went to press, no official figures for Japan's GDP in the last quarter of 2013 had been published yet. However, according to key economic indicators, activity is likely to have accelerated significantly again, following seasonally adjusted GDP growth in the summer of last year of only ¼%. One of the key factors is likely to have been a temporary uptick in household demand in advance of the consumption tax hike scheduled to take effect in April of this year. Experience shows that this affects, in particular, easily deferrable expenditure on "big-ticket" consumer durables. As a case in point, new car registrations skyrocketed in the final quarter of the year. Since corporate property sales are also subject to sales tax in Japan, private residential investment is also likely to have benefited from anticipatory demand. A further major reason for accelerated economic growth is likely to be that foreign trade was less of a drag on growth than in the third quarter. According to the monthly indicators, growth in real goods exports almost matched that of imports in the fourth quarter. What is astonishing is that the volume of exports remains below pre-crisis levels despite the depreciation of the yen. So far, Japanese exporters seem to have adjusted their foreign currency prices to only a limited degree, which means that the yen's depreciation has mainly boosted profits (see the box on pages 16 to 18). In real terms, it remains to be seen whether the improved profitability will encourage firms to invest more at home. The economic recovery has already made itself felt in the labour market, with the number of people in jobs rising significantly on average in the fourth quarter. At the same time, the unemployment rate fell to 3.7% in December, putting it only marginally above its trough prior to the global recession. Consumer price inflation rose to 1.6% by year-end, its highest level since October 2008. Core inflation stood at 0.7%, a level last seen in August 1998.

## United Kingdom

The UK economic upswing remained buoyant in the last quarter of 2013. According to an initial estimate, GDP grew by ¾% on the quarter after adjustment for seasonal factors and price changes, matching its spring and summer growth levels. It was up by an annual average of just under 2% compared to 2012, its strongest growth since 2007. In addition, the expansion remained broadly based across sectors in the fourth quarter in that real gross value added in the production sector (excluding construction) continued to grow at a pace similar to that in the services sector. Only construction output fell off slightly following the growth spurts in the second and third quarters of the year. The labour market seems to be deriving particular benefit from the economic recovery: according to the UK Office for National Statistics, the standardised unemployment rate over the September to November period stood at 7.1%, more than ½ percentage point lower than in the preceding three-month period. The number of recipients of unemployment benefits continued to trend downwards up until the end of the year, although the decline has flattened out. At the same time, in December, inflation as measured by the Harmonised Index of Consumer Prices (HICP) was no longer above the monetary policy target rate of 2.0% for the first time since November 2009; core inflation (the basket of consumer goods excluding energy and unprocessed foods) dropped to 1.9%. In the light of the favourable labour market developments, the Bank of England recently modified its forward guidance on interest rate policy, which had hitherto been linked to the unemployment rate.

*Persistently buoyant upswing*

## Japanese goods exports in the aftermath of the strong yen depreciation

Recently, representatives of Asian countries, in particular, have repeatedly expressed concern that Japanese exporters could gain a greater share of the world market at the expense of their own industries due to the sharp depreciation of the yen in the period spanning the fourth quarter of 2012 and first quarter of 2013. Concerns have also been voiced by some in the German business sector, which has a similar degree of export specialisation.<sup>1</sup> The increase in Japan's nominal exports, which has received a great deal of public attention, may indeed have initially given this impression. In price-adjusted terms, however, there are few signs so far of a strong upturn in Japan's export sector. Japan's real goods exports rebounded markedly in the first half of 2013 from their previous downward slide but failed to return to their original levels.<sup>2</sup> There seems to have been no major upward boost since then. Demand for Japanese products on the world markets has thus by no means become more dynamic of late than demand for similar products from other countries, although the yen has lost just over 25% of its value in effective terms since the third quarter of 2012.<sup>3</sup>

One reason for the relatively subdued growth of real exports of Japanese goods is likely to be that they have not become nearly as cheap on the global markets as the nominal exchange rate would suggest. According to US statistics, for example, prices for US imports of Japanese goods were only 3¼% lower than in summer 2012, while the US dollar/yen exchange rate fell by 24%.<sup>4</sup> Furthermore, the sharp rise in yen-denominated Japanese export prices (+17¼%) suggests that the scope for price reductions associated with the yen depreci-

ation has only been partially used in other markets, too.<sup>5</sup>

The literature contains different, non-mutually-exclusive explanations for the empirically established evidence that, for numerous countries, there tends to be only a loose relationship between exchange rate movements and sales prices in foreign currencies. On the one hand, this loose relationship may indicate that prices are fundamentally geared to specific export markets. Varying exchange rates between domestic and foreign currencies would therefore only

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<sup>1</sup> According to Riad et al (2012), Japan's product-specific export specialisation most closely resembles that of Germany. Among its Asian neighbours, only South Korea is competing with Japan in the world market to a similar degree. See: N Riad, L Errico, C Henn, C Saborowski, M Saito and J Turunen (2012), Changing Patterns of Global Trade, IMF Strategy, Policy, and Review Department, Departmental Paper No 12/1.

<sup>2</sup> The slump in Japanese goods exports during the second and third quarters of 2012 should be considered in the light of the subdued global industrial activity during this period. However, Japanese exporters also lost a considerable share of the Chinese market in the period up to the end of 2012 due to geopolitical tensions between the two countries.

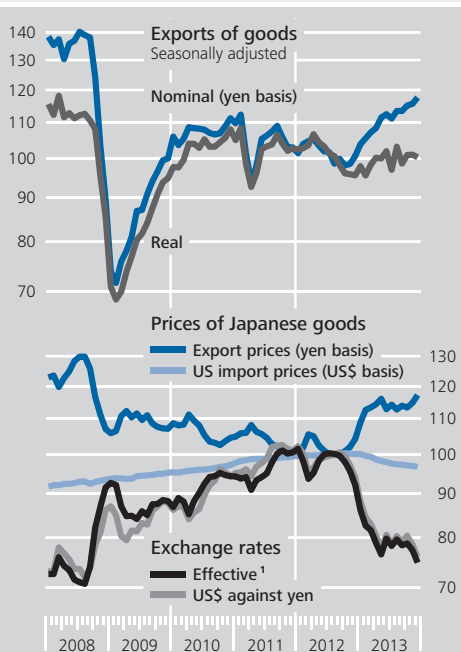
<sup>3</sup> This can be seen, for example, by comparing Japan to South Korea, whose export specialisation is also similar to Japan's in regional terms. Despite the yen's sharp depreciation, both countries' goods exports expanded similarly in real terms by about 5% each in the course of 2013.

<sup>4</sup> Since the entire US import price index fell by 1¼% during the same period, the moderate fall in prices is likely to have made Japanese goods only slightly cheaper in comparison to competitor products.

<sup>5</sup> The marked difference between the percentage change of the nominal effective exchange rate and the percentage change of export prices can be seen as an indicator that the export prices calculated in a foreign currency have fallen more sharply in other sales markets than in the United States. One reason for this heterogeneity could be the fact that invoicing is predominantly carried out in US dollars for exports to the United States. Changes in the exchange rate can then only be passed on to US buyers by specifically adjusting the price in US dollars, whereas if exports are invoiced in yen, the prices in a foreign currency are adjusted automatically, while yen export prices remain unchanged.

### Japanese foreign trade indicators

2012 Q3 = 100, log scale

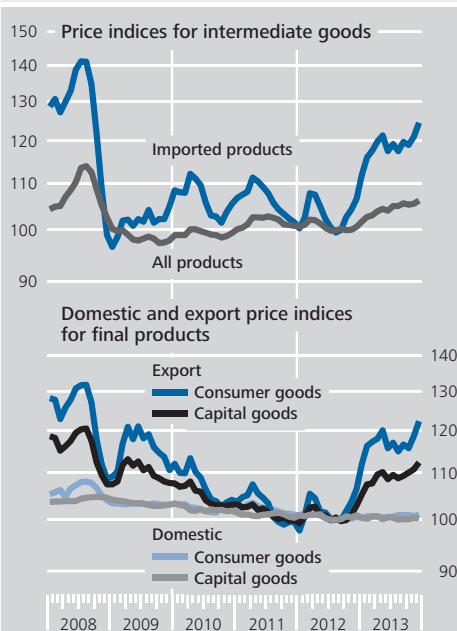


Sources: Bank of Japan, Ministry of Finance Japan, US Bureau of Labor Statistics, BIS and Bundesbank calculations. <sup>1</sup> Against the currencies of 56 trading partners.

Deutsche Bundesbank

### Prices of Japanese intermediate and final goods according to the corporate goods price index

2012 Q3 = 100, yen basis, log scale



Sources: Bank of Japan and Bundesbank calculations.

Deutsche Bundesbank

lead to disproportionately small price adjustments on these markets and would instead be reflected predominantly in fluctuating profit margins, defined as the ratio of sales prices to marginal costs. On the other hand, the costs of imported intermediate goods, in particular, are not immune to exchange rate movements. If, as was recently the case in Japan, depreciation is followed by only a slight decrease in foreign currency prices and therefore an increase in prices in domestic currency, this could also be a reflection of a rise in production costs.<sup>6</sup> The relative explanatory power of the different approaches has considerable implications for the analysis of current developments in Japan. On balance, the domestic consequences will tend to be negative if the higher yen prices of Japanese exports were primarily a reflection of higher production costs, because these also place a strain on companies that only produce for the domestic market. By contrast, growing

profit margins in the export sector could boost their investment and support domestic demand in the medium term, for example.<sup>7</sup>

Although there are certainly exceptions to this rule at the firm level, macroeconomic indicators signal that the recent increase in the yen prices of Japanese export goods predominantly reflect higher profit margins. Whereas the prices of imported intermedi-

<sup>6</sup> Overviews of the literature on the relationship between exchange rates and import and export prices can be found in P K Goldberg and M M Knetter (1997), Goods Prices and Exchange Rates: What Have We Learned?, *Journal of Economic Literature* 35 (3), pp 1243-1272; and A Burstein and G Gopinath (2013), International Prices and Exchange Rates, *Handbook of International Economics IV*, forthcoming.

<sup>7</sup> Especially in the short term, the cost effect that dampens investment demand appears to dominate across all sectors after a change in the exchange rate in a panel of OECD countries. See S Landon and C E Smith (2009), Investment and the Exchange Rate: Short Run and Long Run Aggregate and Sector-Level Estimates, *Journal of International Money and Finance* 28, pp 813-835.

ate goods rose considerably in Japan in the wake of the depreciation, overall, at the corporate level, the prices of intermediate goods rose considerably less rapidly than export prices. Because unit labour costs have also continued to fall throughout the reporting period, Japanese enterprises' costs are likely to have risen moderately on the whole, if at all. As this increase in costs places a strain on the profitability of both domestically oriented and exporting enterprises, an increase in the export sector's relative profit margin can be inferred from the upward momentum of final product prices for exported goods and stagnating domestic prices.<sup>8</sup> This is consistent with the fact that, according to Japanese corporate balance sheet statistics, profits in the manufacturing sector, which has a stronger international focus, recently increased significantly more sharply in relation to costs than those of non-financial corporations.<sup>9</sup>

Although the recent depreciation of the yen has tended to have only a moderate positive impact on export volume growth so far, all in all, it is certainly possible that, depending on how they are used, the higher profits generated by export enterprises will help to strengthen Japanese economic growth in the medium term.

<sup>8</sup> See T Klitgaard, Exchange Rates and Profit Margins: The Case of Japanese Exporters, FRBNY Economic Policy Review, April 1999.

<sup>9</sup> Japanese corporate balance sheet statistics do not differentiate between exporting enterprises and enterprises focused on domestic sales. It is therefore not possible to infer any direct conclusions about profit margins in the export sector from this data.

## New EU member states

*Economic recovery stabilised*

In the group of new EU member states (EU-8<sup>1</sup>), economic output grew quite strongly again in the final quarter following a quarter-on-quarter rise of ¾% in the third quarter after seasonal adjustment. According to initial estimates, GDP growth was strongest in Romania (+1¾%), followed by the Czech Republic (+1½%) and Lithuania (+1¼%). Aggregate output in Poland grew by ½%. As the economy has improved, many countries' labour markets have gradually recovered. In this group of countries as a whole, the unemployment rate stood at 9.5% in autumn, compared with 10.1% at the beginning of 2013. Aggregate HICP inflation, which had already reached a multi-year low in the third quarter, fell further to 0.6% in the final quarter of the year. However, from today's perspective this downward trend is not expected to continue. At all events, the European Commission's autumn forecast predicts that infla-

tion in most of the region's countries will pick up again in the current year.

## Macroeconomic trends in the euro area

The economic recovery in the euro area gained some momentum in the last quarter of 2013. Aggregate output increased by a seasonally adjusted ¼% as compared to the summer quarter, in which it had risen only marginally. At +½%, it recorded year-on-year growth for the first time since the beginning of 2012. Although real GDP contracted once again in 2013 on an annual average (-½%), the euro area entered the new year with a statistical growth over-

*Slight uptick in growth at end of year*

<sup>1</sup> This group comprises the countries that have acceded to the EU since 2004 and which, in the fourth quarter of 2013 (the reporting period), were not yet members of European monetary union (thus including Latvia, which did not join the euro area until 1 January 2014).



hang of ¼%, thanks to improved economic activity over the course of 2013.

*Recession overcome in majority of crisis countries*

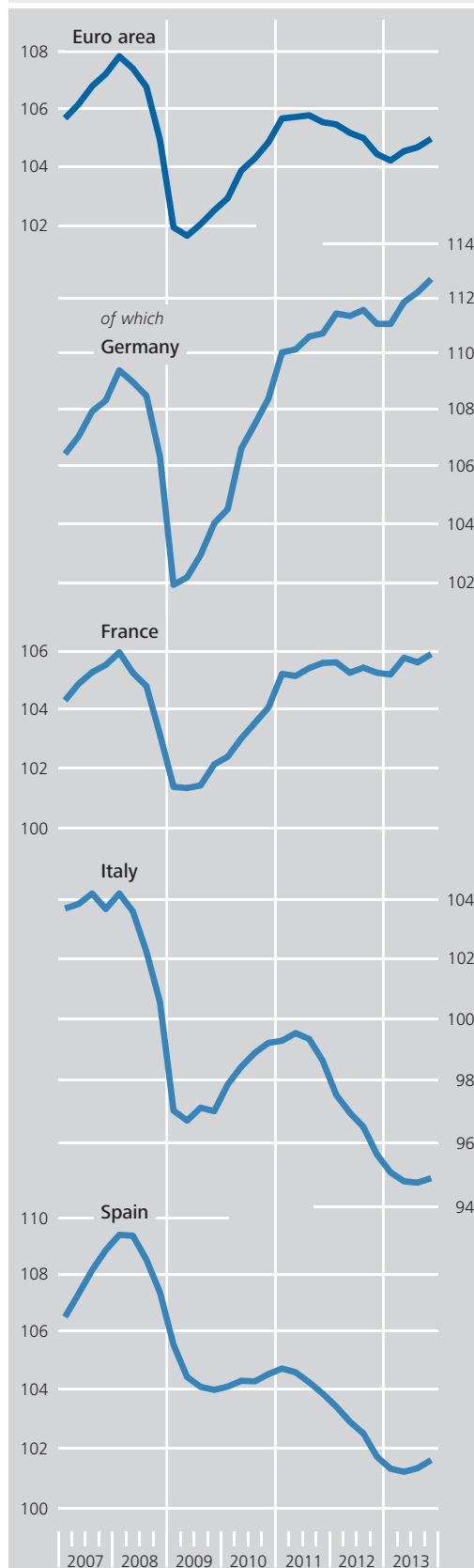
The upswing was regionally much more broadly based in the fourth quarter than in the two preceding periods, in which it had been supported by just a few countries. Of the 12 euro-area member states which have so far published initial seasonally adjusted GDP growth figures, nine recorded an increase in GDP, and only three countries saw a contraction in aggregate output. Even France was able to return to moderate growth (+¼%). The highest expansion rate was recorded by the Netherlands (+¾%). Germany and Belgium each saw real GDP rise by ½%. Among the periphery countries, Portugal put in the best performance, with seasonally adjusted growth of +½%. GDP growth in Spain, which overcame the recession in the summer, was ¼%. Italy lifted its economic output marginally for the first time since the second quarter of 2011. Only in Cyprus did the economic slump continue. In Greece, where the statistical authority has ceased to publish seasonally adjusted figures until further notice, real GDP contracted by 2½% on the year, following -3% in the summer months. However, the fact that annual growth rates have become less negative for the fifth consecutive period is a sign that the business cycle may have bottomed out.

*Diminishing growth differentials*

The growth differentials in the euro area, which had widened sharply in 2010 and 2011 owing to the sovereign debt crisis in the periphery countries, on the one hand, and the continued vibrancy of the economic recovery in some northern countries, on the other, have diminished markedly since then. The significant slow-down of growth in those northern countries was a major contributory factor. In addition, GDP contraction in the southern European crisis countries, with the exception of Cyprus, was no longer as pronounced in 2013 as in the previous year. The unweighted standard deviation and the weighted standard deviation (by member states' GDP shares) of real GDP growth rates in the euro area, which had reached their

### Aggregate output in the euro area

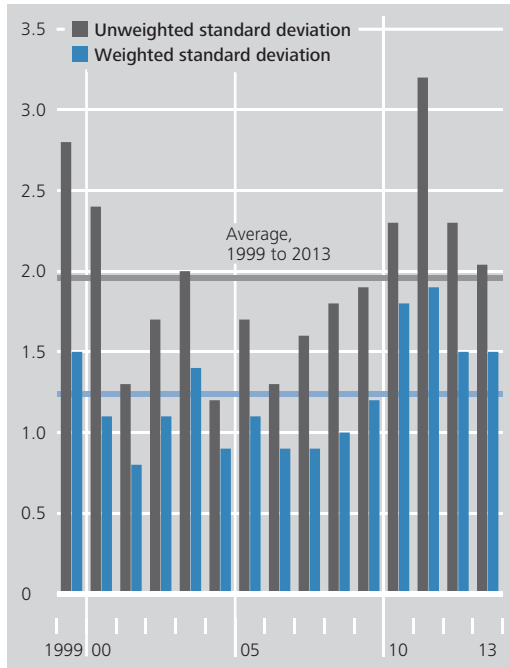
2005 = 100, seasonally adjusted, quarterly, log scale



Source: Eurostat.  
 Deutsche Bundesbank

### Weighted and unweighted standard deviation of real GDP growth rates in the euro area\*

Percentage points



\* Weighted by nominal GDP in the respective year. Data for 2013 refer, in some cases, only to the first three quarters.  
 Deutsche Bundesbank

highest values since the beginning of the third stage of monetary union in 2011, at 3.2 and 1.9 percentage points respectively, dropped to 2.0 and 1.5 percentage points respectively by 2013. As this report went to press, both measures of dispersion were still somewhat above the average for the 1999 to 2013 period.<sup>2</sup> The growth gap will continue to diminish markedly in the current year, judging by the growth rates projected in November 2013 by the European Commission.

*Continued economic revival at beginning of year*

At the beginning of 2014, the leading indicators were pointing to a continued revival of euro-area economic activity. The purchasing managers' index for manufacturing, which has been back above the expansion threshold since mid-2013, rose sharply in January, reaching its highest level since spring 2011. The industrial confidence indicator eased slightly after improving significantly in the preceding months but remained well above its long-term average. Both production expectations and firms' assessment

of order books and inventories trended downwards slightly. However, according to the monthly survey on behalf of the European Commission, household sentiment continued to brighten in January; this was also the case in a number of periphery countries. December's improvements in consumer confidence were not maintained in Greece and Cyprus, though; in addition, the indicator for both countries stood at a very low level. The sentiment indicator also sagged slightly in Ireland, yet it remained well above its long-term average.

On the output side, the production sector gave a moderate boost to economic growth. After getting off to a slow start in the last quarter of the year, industrial output then recovered markedly; looking at the quarterly average, it rose by a seasonally adjusted ¼% on the quarter and by 1¼% on the year. The manufacturers of intermediate goods saw quite strong growth compared to the summer quarter (+1%), whereas growth in the output of non-durable consumer goods and capital goods (+½% in each case) was more muted. By contrast, energy production (-1¾%) and the production of durable consumer goods (-1¼%) contracted. Nonetheless, capacity utilisation in manufacturing rose quite significantly from October to January and was just slightly below its long-run average. Construction was a drag on the economy in October-November, with seasonally adjusted output down by 1½% from the third quarter and by 2% on the year.

*Production sector made moderate contribution to growth*

On the demand side, foreign demand appears to have provided a considerable impetus to growth in the reporting period, with nominal goods exports to non-euro-area countries up in October-November by 3¼% (after seasonal adjustment) compared with the third quarter. At the same time, imports remained unchanged. In real terms, net exports are expected to make a perceptible positive contribution to growth,

*Exports higher but domestic demand muted*

<sup>2</sup> When calculating this measure, the average growth rate over the first three quarters was used for those countries for which no annual figures for 2013 are available yet.

## Distinctive features of unit labour cost developments in Spain

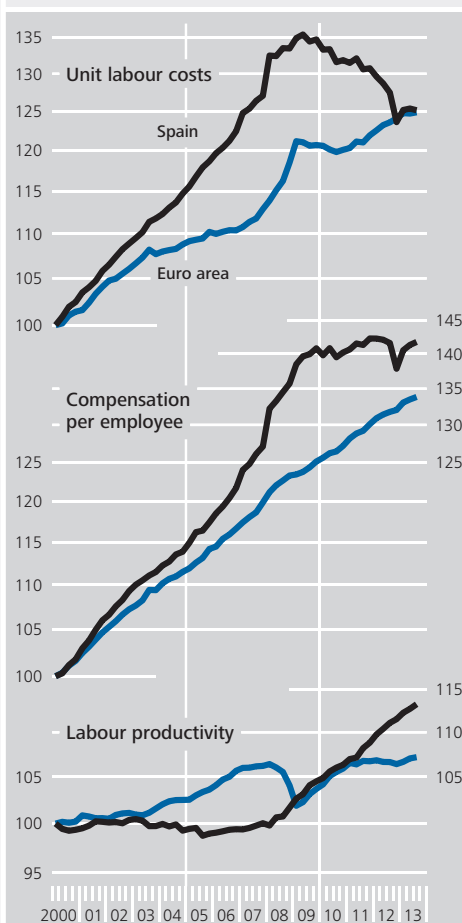
Taking account of developments in productivity, wage cost pressures in Spain decreased considerably in the wake of the global recession and the subsequent sovereign debt crisis. The key indicator in this context is the index of national unit labour costs.<sup>1</sup> Compared with its peak in spring 2009, which was as much as 35½% higher than in early 2000, the index in Spain indicated an overall seasonally adjusted decline of 7½% in unit labour costs (ULCs) by the third quarter of 2013 compared with an increase of 3¼% in the euro area.<sup>2</sup> Thus, the rise in ULCs in Spain in the period from 2000 to 2013 was no longer any greater than the increase in the euro area as a whole. Although the decline since mid-2009 was somewhat weaker than in Greece (-17¼%) and in Ireland (-11¼%), it was stronger than in Portugal (-3%), with ULCs in Italy generally continuing to grow in the crisis years. The reduction in ULCs in Spain played a decisive role in the marked improvement in the country's price competitiveness as measured by commonly used indicators, which shored up domestic and foreign demand for tradable goods from Spain.<sup>3</sup>

On the surface, this appears consistent with the significant rebound in Spanish exports following the cyclical downturn in the last

quarter of 2008 and the first quarter of 2009, with growth in the sales markets largely remaining fairly weak. In summer 2013, Spain's exports exceeded the price and seasonally adjusted pre-crisis peak by no less than 16¼%, compared with 11% in Germany and 6% in the euro area. However, it is important to note that Spanish exports performed relatively well in the years before the crisis despite indicators showing a sharp deterioration in price competitiveness; this has given rise to the term "the

**Unit labour costs, compensation per employee and labour productivity in Spain and the euro area**

2000 Q1 = 100, seasonally adjusted, log scale



Source: ECB and Bundesbank calculations.  
 Deutsche Bundesbank

<sup>1</sup> Unit labour costs are defined as the ratio of compensation per employee to output per employee, with output measured as gross domestic product (GDP) at the macroeconomic level and as the gross value added of each economic sector at the sectoral level.

<sup>2</sup> Under the current European system of national and regional accounts (ESA95, 2005 revision), data are available for Spain from the first quarter of 2000. Therefore, this is taken as the base period for the pre-crisis years and not the launch of the monetary union at the beginning of 1999.

<sup>3</sup> Deutsche Bundesbank, "Real economic adjustment processes and reform measures", Monthly Report, January 2014, pp 19-38.

Spanish paradox” in public discussion.<sup>4</sup> On the one hand, this development points to robust non-price competitiveness, which, however, is difficult to measure. On the other, enterprises in the industrial sector, which produce most of the country’s export goods, were better able to curb ULCs, even prior to the crisis, than enterprises in other sectors geared more toward domestic demand. The recent improvement in price competitiveness is starting to bear fruit, it seems, as growth in Spanish exports following the crisis-induced slump in 2008-2009 is not only on par with the robust pre-crisis level, but is even exceeding it. Furthermore, there are indications that Spain has regained its attractiveness as an investment location, in particular to foreign car manufacturers.<sup>5</sup>

Growth in productivity – the indicator’s denominator – has been a much greater factor in the decline of the national ULCs in Spain than in any other euro-area periphery country. From the beginning of the recession in the second quarter of 2008 up to summer 2013, Spain’s productivity rose by 13½%, compared with increases of 6½% in Ireland and 5% in Portugal and declines of 4½% in Greece and 5% in Italy. This upward trend in Spain was relatively steady – unlike in the euro-area as a whole, where productivity fell sharply in the wake of the recession and, following a short recovery, levelled off somewhat above pre-crisis levels. When viewed in isolation, however, compensation per employee – the numerator – has further pushed up ULCs in Spain since the onset of the global financial and economic crisis. In the third quarter of 2013, compensation per employee was 7¼% higher than at the beginning of 2008. This was attributable to strong growth in compensation per employee in 2008 (+6¾%) followed by a significantly slower rise in the subsequent years, thus allowing

the dampening influence of productivity on ULCs to progressively increase.

The considerable rise in aggregate productivity in recent years should be considered in light of the flat, and, at times, even slightly negative growth trend seen prior to the global financial and economic crisis, with Spain being something of an exception in international terms even back then. Taking the first quarter of 2000 as the base period, time series show that Spain’s productivity growth significantly trailed that of the euro area until the end of 2008. Subsequently and up until the end of 2010, the trend in Spain moved in parallel with euro-area developments. Only after this did productivity growth in Spain exceed that of the euro area. From 2000 to 2013, aggregate productivity in Spain rose by 1% on average per year, but only ½ percentage point more than in the euro area, which is not much of an advantage for a “catching-up” economy.

Some commentators put the sharp fall in Spain’s ULCs following the crisis into perspective by suggesting that it was overwhelmingly caused by drastic job cuts, which sped up productivity growth, and was less related to wage adjustments. However, this ignores the fact that the strong increase in ULCs before the crisis was in no way solely attributable to excessive wage increases but rather to the increase in the recruitment of employees with a relatively low level of productivity in the tight labour market at the time, particularly in construc-

<sup>4</sup> See G Braunberger, Das spanische Paradoxon: Warum steigen die Exporte, obwohl die Wirtschaft (angeblich) nicht wettbewerbsfähig ist?, Fazit – das Wirtschaftsblog, Blog from 3 December 2012; <http://blogs.faz.net/fazit/2012/12/03/das-spanische-paradox-warum-steigen-die-exporte-obgleich-die-wirtschaft-angeblich-nicht-wettbewerbsfaehig-ist-663/> (only available in German).

<sup>5</sup> See G Oster, Spaniens Automobilsektor im Umbruch, Germany Trade & Invest, 18 February 2013 (only available in German).

tion.<sup>6</sup> Given the normal remuneration in Spain – as in other industrial countries – which tends to make little distinction between the different output levels attributable to employees in the same wage group, this therefore stalled productivity growth and drove up ULCs. Furthermore, enterprises tend to be more remiss about cost management in economic upturns, which means that inefficiencies spread more easily. In this respect, the surge in productivity and the decline in ULCs in Spain over the course of the current crisis are a direct response to imbalances during the boom period.

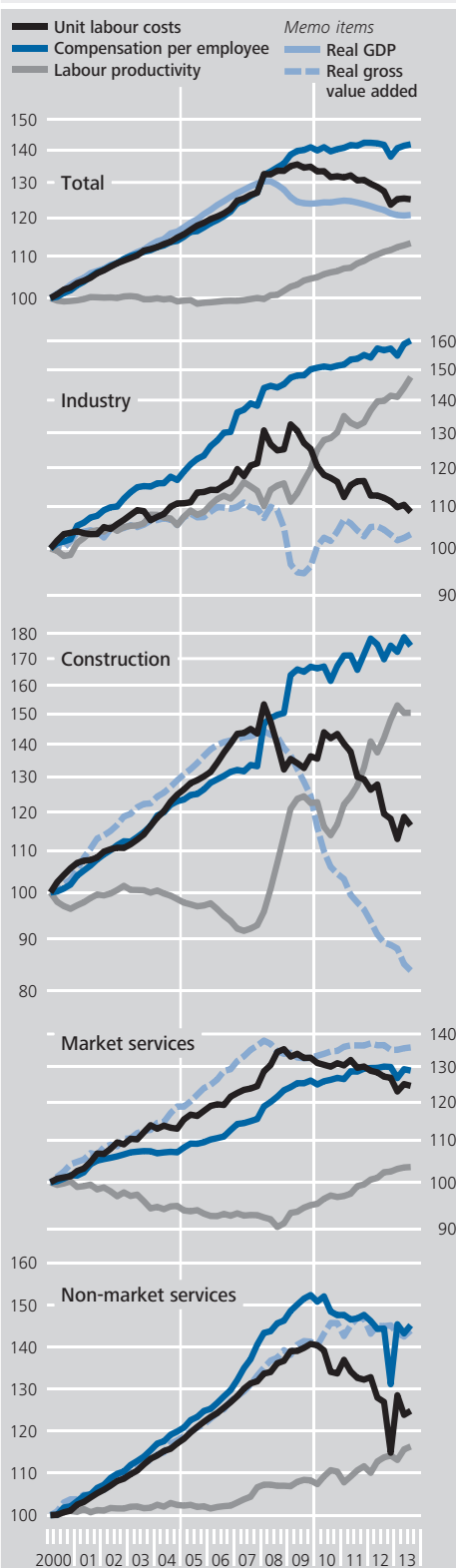
The divergence in patterns of aggregate productivity growth between Spain and the euro area can be seen in the majority of sectors, albeit to varying extents. Between 2000 and 2007, productivity growth in industry in Spain was considerably less buoyant than in the euro area as a whole, whereas from 2008 to 2013, it clearly surpassed that of the euro area. Productivity in the construction sector, on the other hand, declined both in Spain and in the euro area as a whole in the years before the crisis, with the fall in Spain (-5¾%) being significantly greater than the euro-area average (-1½%). From 2008 onwards, however, productivity in the Spanish construction sector grew by 64%,<sup>7</sup> whereas the euro-area reported only slight growth (+1%). The

<sup>6</sup> One indication of this is that during the boom years a very large volume of immigrants, who were often low-skilled workers, were employed in the construction sector. In 2008, approximately one in four persons employed in this sector was a foreigner. Unfortunately, there are no data available for previous years. The sharp contraction in employment in the subsequent years affected this group in particular, with numbers falling by more than 453,000 to 152,000 by 2013. Last year, only one in seven workers in the construction sector in Spain was a foreigner.

<sup>7</sup> A clear shift away from building construction, which has declined particularly sharply, towards civil engineering, where per capita value added is just over 40% higher, also contributed to the considerable increase in labour productivity in the construction sector.

### Unit labour costs and their components in Spain by sector

2000 Q1 = 100, seasonally adjusted, log scale



Source: ECB and Bundesbank calculations.  
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structural change in the Spanish construction sector in recent years has had a relatively strong impact on aggregate productivity, partly because – despite a decline of 6 percentage points since 2007 – its share of the total gross value added, at 7¾% most recently, was still perceptibly higher than the euro-area average (5½%).

The opposing development in aggregate productivity is also attributable to the sharp decline in the market services sector<sup>8</sup> in Spain before the crisis and the considerable expansion following the onset of the crisis, while the euro area as a whole recorded a moderate increase which levelled off from 2008 onwards. This clear turnaround in Spain can, in part, be attributed to the real estate bubble in the years prior to 2008 and the subsequent adjustment process as this category, on the one hand, includes real estate-related services such as estate agent services, housing administration and the leasing of land, and on the other, construction-related services, such as those provided by architects and structural engineers. However, the fact that the decline in productivity in the retail and wholesale trade, transport and storage sub-sectors between 2001 and 2007 was transformed into substantial growth in the wake of the crisis had an even greater impact. Productivity in non-market services, including public administration, education and healthcare, has also seen marked growth in the past few years. This, however, is difficult to account for and, amongst other things, could be related to the distinctive procedures for calculating productivity in the public sector.

The weak growth in labour productivity in Spain before the crisis is consistent with the fact that the 26% increase in real GDP from 2000 to 2007 was accompanied by similar growth in employment. By contrast, the surge in productivity in recent years was the

result of very extensive job cuts (-17%) combined with a considerably slower fall in GDP (-6%). For instance, just over 60% of jobs in the construction sector were cut, while real gross added value fell by 40%. In industry, employment figures fell by one quarter, while gross value added fell by only 7%. In market services, almost one tenth of jobs were lost, while output swiftly returned to pre-crisis levels following a slight slowdown.

All in all, the excesses during the boom were greatest in those sectors which produce mainly for the domestic market and which are less active at an international level. Correspondingly, this is where the need for adjustment was greatest. Against this backdrop, many Spanish enterprises saw the fall in demand from 2008 onwards as being mainly structural, leading them to cut jobs extensively. It was relatively easy and cost effective for enterprises to make these staff adjustments due to the distinctive features of the Spanish labour market. Long-term averages show that just under one third of workers in Spain (compared with only 15½% in the euro area overall) are employed on temporary contracts with relatively weak protection against dismissal.<sup>9</sup> In the past, Spanish companies therefore responded to cyclical fluctuations in demand mainly by recruiting and laying off temporary staff.<sup>10</sup> Cyclically adjusting working hours, by contrast, has never played much of a role up to now,

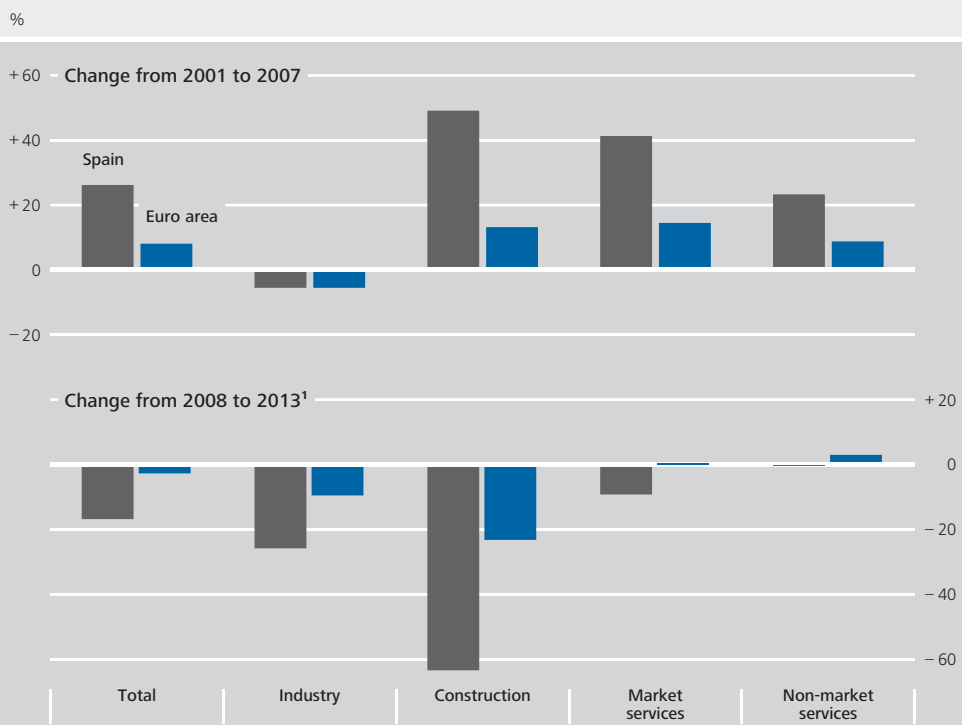
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<sup>8</sup> The market services sector includes the sub-sectors wholesale and retail trade, transport and storage; information and communication services; services of credit and insurance institutions; real estate services and professional services.

<sup>9</sup> Conversely, severance payments for employees on permanent contracts are very high by international standards. This is still the case – albeit to a lesser extent – even after the 2010/2012 reforms which led to a reduction in severance payments.

<sup>10</sup> Ministry for Employment and Social Security (2013), Report evaluating the impact of the labour market reform, p 7; und Bentolila et al (2012), Reforming an insider-outsider labor market: The Spanish experience, IZA Journal of European Labor Studies, 1(4), p 3.

### Employment by sector in Spain and the euro area



Source: ECB and Bundesbank calculations. <sup>1</sup> Data for 2013 only available for Q1 to Q3.  
 Deutsche Bundesbank

which was most likely due, in part, to the rather restrictive regulations on short-term work.<sup>11</sup> This cyclical behaviour of hiring and firing was more pronounced in the construction sector. At the peak of the construction boom, 1.2 million workers – more than half of those employed in the sector – were hired on a temporary basis. By 2012, enterprises had trimmed back the number of temporary employees to one quarter, meaning they then accounted for just over one third of workers in the construction sector. The cyclical fluctuation in employment before and after the crisis was not quite as dramatic in the other industrial sectors.

Productivity continued to grow rapidly in Spain in the first three quarters of 2013. However, the European Commission expects this to slow down significantly in 2014 and 2015. This assessment is probably based on the expectation that job losses will soon come to a halt and employment numbers

will increase moderately. Consequently, if compensation per employee continues to stagnate, as predicted in the Commission's forecast, ULCs will not fall as strongly as they did on average from 2010 to 2013.

In light of the very high unemployment rate in Spain, which, to a large extent, has already become structurally embedded, and against the backdrop of productivity growth returning to normal levels, compensation per employee should not increase over the medium term, but should at least remain stable to ensure that ULCs continue to fall. This is necessary to reduce the rate of unemployment through even more employment-intensive growth. Moreover, this would help boost Spain's price competitiveness.

<sup>11</sup> However, the prerequisites for introducing short-time work have now been improved such that working hours can be reduced by up to 70%, compared with 30% in the past.

### Consumer prices in the euro area

Year-on-year percentage change

Item	2012 Q4	2013 Q4
Headline HICP	2.3	0.8
<i>of which</i>		
Energy	6.3	-0.9
HICP excluding energy	1.8	1.0
<i>of which</i>		
Unprocessed food	4.3	1.3
Processed food	2.4	2.1
Industrial goods	1.1	0.3
Services	1.7	1.2

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albeit partly as a result of lower import prices after currency appreciation. In autumn, domestic final demand is, however, likely to have risen only marginally, if at all. The decline in construction output, in conjunction with the modest increase in capital goods output, would suggest that the moderate increase in gross fixed capital formation recorded in the two previous quarters has flattened again. Moreover, household consumption is unlikely to have had much of a positive impact on demand. Real retail sales (excluding cars) fell by ¾% on the period in the last quarter of 2013, after seasonal adjustment. In contrast, however, new car registrations were up significantly, by 5%. This was partly because fourth-quarter demand for cars rose sharply in Germany and Spain,<sup>3</sup> among other countries, and also swelled noticeably in France. However, on the whole 2013 was once again a poor year for euro-area car manufacturers: the number of new registrations was down by 4½% from the previous year's already depressed level and 27¼% below its all-time high of 2006.

*Signs of stabilisation in the labour market*

There were mounting signs of a stabilisation in the euro-area labour market in the second half of 2013. As in the second quarter, employment no longer decreased in the third quarter. By December, the seasonally adjusted number of unemployed had already fallen 241,000 from

its last high in September, and the standardised unemployment rate was, at 12.0%, somewhat lower in the fourth quarter than in the second and third quarters. Among the periphery countries, Spain, Portugal and Ireland saw their unemployment rates fall moderately to 26.1%, 15.5% and 12.3% respectively, whereas unemployment rose further in Italy and Cyprus; in Greece, it likewise rose further in October, the most recent month for which data are available, to 27.8%. The sharp rise in unemployment in some periphery countries since the onset of the crisis should not, however, detract from the, in some cases, very sizeable productivity gains driven by structural change, as well as from the pronounced decline in unit labour costs (for more information, see the box on Spain on pages 21 to 25).

Over the second half of 2013, euro-area consumer price inflation eased perceptibly. Annual HICP inflation consequently fell to 0.8% in the final quarter. A year earlier, it had been as high as 2.3% despite a weak economy and high unemployment. The disinflation process affected not only the more volatile HICP components but also components whose prices are generally more stable. Whereas energy and unprocessed food account for around two-thirds of the HICP decline, all other factors account for the remaining one-third. External factors such as the euro's appreciation and the preceding slump in global industrial activity are likely to have played a major role in diminishing industrial goods price inflation. The difficult economic situation afflicting a number of euro-area countries impacts services with a certain time-lag. This is particularly evident in the case of Greece, where consumer prices fell by 2.2% year-on-year. In Cyprus, prices fell by 0.8%. Some other countries reported very low rates of inflation. By contrast, countries whose econ-

*Perceptible decline in consumer price inflation*

<sup>3</sup> Since summer 2012, the Spanish government has offered scrappage premiums to promote sales of new cars. To this end, it has provided several limited funding programmes which were often used up quickly, including the €70 million injection provided in October 2013. The scheme was expanded by €175 million in January 2014.



omies were faring better saw significantly higher inflation rates.

*HICP inflation rate distorted for 11 months of 2013*

Average annual consumer price inflation in the euro area was 1.4% in 2013. The annual HICP inflation rates in the first 11 months of the year were distorted upwards by an average of 0.1 percentage point owing to special statistical effects in Germany (for more, see the margin heading "Special statistical factors in the HICP" on page 63). These statistical effects were gone with the December rate.

The subdued upward price trend continued at the beginning of 2014. According to the Eurostat flash estimate, annual HICP inflation fell slightly from 0.8% in December to 0.7% in January, due largely to favourable energy price developments. HICP excluding energy, by contrast, held steady at 1.0%. In the light of the favourable outlook for the euro-area real economy, deflation risks should be regarded as being low.

*Subdued upward price trend continued at the beginning of the year*