

## Global and European setting

### World economic activity

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In the autumn of 2004, the global economy remained on the somewhat flatter growth track on which it had embarked in the summer. The fact that crude oil prices, which had reached a new all-time high at the end of October, receded noticeably in the ensuing period (at the end of December, the price of North Sea Brent was a quarter down on the price two months earlier) is likely to have played a key role in stabilising the pace of expansion. Since then, prices have again shown a slight rising trend, however; in mid-February, the price of crude oil (US\$45) was just under 50% up on the year compared with 70% in October 2004. The way in which the oil price increases have been dealt with reaffirms that the upswing is very robust and therefore able to absorb such disruptions quite well. Bearing this in mind, the need to support driving forces by means of an expansionary economic policy also appears to be increasingly unnecessary or associated with greater risks. The Fed therefore continued on its course of gradually tightening monetary policy in the fourth quarter with two further interest rate increases totalling ½ percentage point in November and December and the decision at the beginning of February for a further rise of 25 basis points to 2.5%.

*Stable global  
economy*

All in all, 2004 was a very successful year for the world economy. According to IMF estimates, at 5%, output growth was the highest it had been since the mid-1970s. It was also well above the long-term average of 3½%. Moreover, unemployment fell somewhat. However, the global imbalances increased

*2004:  
impressive  
growth  
performance,  
but with flaws*

further. This was reflected in exchange rate movements towards the end of 2004. The euro, which appreciated sharply against the US dollar, thus had to bear further adjustment burdens (following the upward surges in 2002 and 2003). Although, if viewed in isolation, the resulting deterioration in the price competitiveness of the export sector dampened growth in the euro area, it was offset by better sales prospects on the part of producers in the dollar area.

*Outlook and risks for 2005*

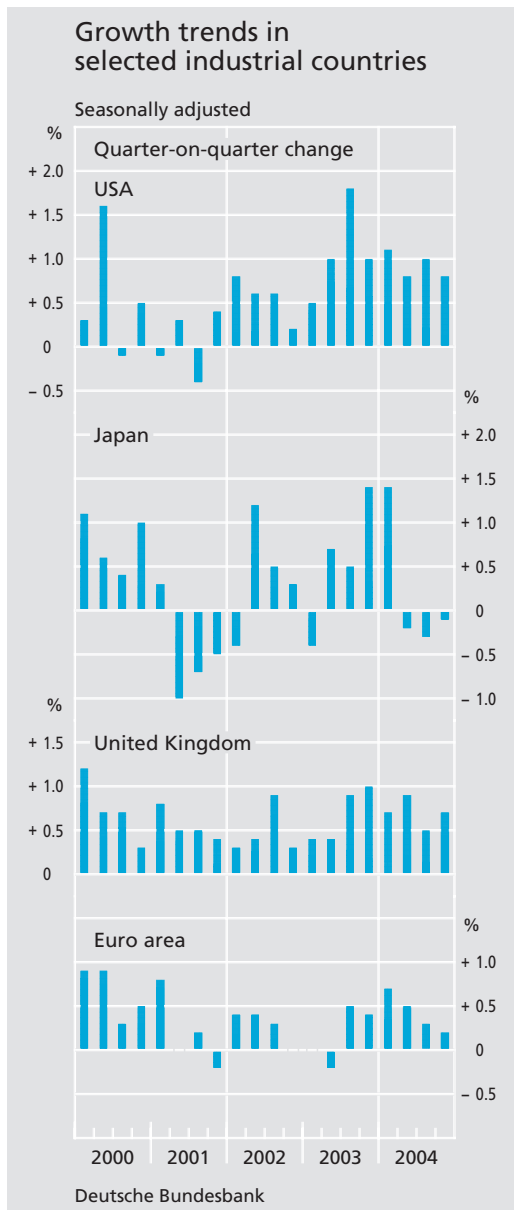
The outlook for the global economy with regard to above-average growth remains favourable for 2005; this was suggested not least by the altogether good start to the new year. The cyclical normalisation which occurred in the course of 2004 means that the conditions for sustained growth have tended to improve even further. However, the risk of potential setbacks is still considerable. For one thing, the oil markets are likely to remain volatile and prone to disruptions owing to the limited spare capacity in crude oil production worldwide and continuing geopolitical tensions in the Middle East. The major external imbalances are a further significant potential risk factor.

In 2004, the US current account deficit reached a new high of an estimated 5¾% of gross domestic product (GDP). Furthermore, it is being financed less and less through private investment and increasingly through foreign currency purchases by central banks in emerging market economies. The East Asian central banks, which are thereby trying to prevent their currencies from appreciating, have a particular role in this. It is not yet cer-

tain how long these central banks will continue to pursue their policy of supporting the dollar in view of the dollar holdings which they have accumulated up to now. A sharp reduction in or the discontinuance of the exchange rate-motivated purchases of US dollars would probably lead to a substantial depreciation of the US currency and, at the same time, to an interest rate rise on the international capital markets, which are currently exhibiting historically low rates of return.

From a regional point of view, global economic activity in the fourth quarter was characterised by a somewhat slower but still fairly strong rise in output in the USA and continued dynamic growth in the new EU member states. In the autumn, the UK economy again expanded somewhat more strongly than before. By contrast, euro-area growth continued to weaken. In Japan, overall economic output fell slightly in the autumn for the third time in succession. Overall output in the major industrial countries and regions (the USA, Japan, the United Kingdom and the euro area), which reflects the weaker economic developments in the euro area and Japan more precisely than the global picture, exceeded the third-quarter level by “only” just under ½% after seasonal adjustment in the October-December period. Growth in the second half of the year as a whole, at 1%, was markedly weaker than in the first half of the year (+1¾%). The rise in consumer prices in the industrial countries accelerated to 2.5% – from 2.1% in the third quarter – above all as a result of the sharp increase in energy prices in the autumn. The average rise

*Global upswing with distinct regional differences*



for 2004 was 2.0%. Excluding Japan, which in the autumn again reported slight price increases following a long period of falling prices, consumer prices in the fourth quarter were 2.8% up on the year compared with an increase of 1.7% in the first quarter of 2004.

The Commonwealth of Independent States (CIS) and the majority of Latin American economies benefited from the high prices on

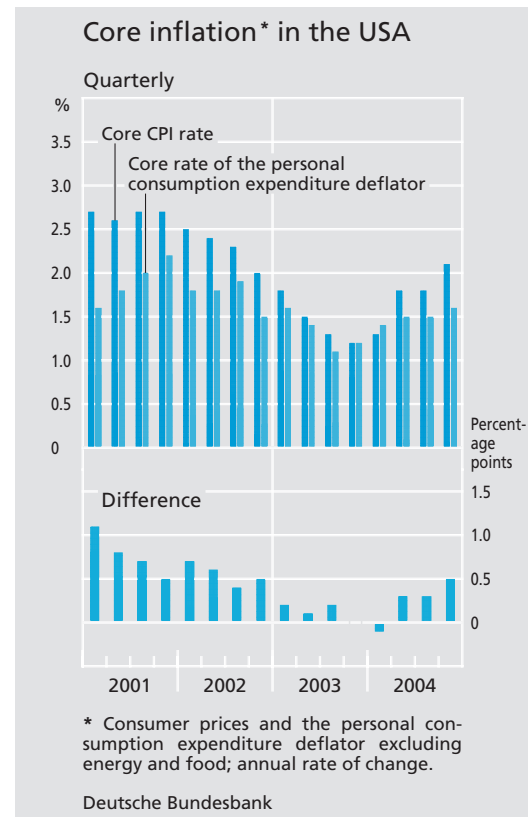
the commodity markets up to the end of the period under review. Furthermore, the improvements in the underlying economic conditions of the past few years now increasingly appear to be bearing fruit in several Latin American countries. The list is headed by Brazil which, in 2004, posted a sizeable current account surplus and was able to attract extensive net foreign direct investment. Growth in East Asia continued to be buoyed by the economic boom in China. According to estimates from China's statistical office, overall output rose by 9½% in the fourth quarter of 2004 compared with the level at the end of 2003; this increase also corresponds to the annual average growth rate. The tsunami caused an enormous loss of human lives and major damage to property in the countries bordering the Indian Ocean. However, there is much evidence to suggest that the high level of growth in the countries concerned will not be permanently dampened. Coastal fishing and the tourist industry are of rather minor economic significance (apart from in the Maldives and Sri Lanka). In addition, it will probably be possible to quickly rectify the worst damage caused, for example, to the infrastructure, thanks to extensive international aid.

Initial calculations show that fourth-quarter aggregate output in the USA was up by ¾% on the quarter after adjustment for seasonal and working-day variations. Year on year, it rose by 3¾%. On average over the past year, GDP growth amounted to 4½%; this was the highest rate of expansion since 1999. According to IMF estimates, with potential output growth at 3¾%, the output gap was consid-

USA

erably reduced in 2004, although it has not yet been completely eliminated. The strongest fourth-quarter expansionary stimuli again came from private consumption, which rose by just over 1% in seasonally adjusted terms. Owing to a marked increase in disposable income on account of exceptionally large dividend payments in December, the saving ratio rose quarter-on-quarter from ½% to 1¼%. Commercial investment also continued to rise substantially. By contrast, real expenditure on new residential buildings hardly grew any further. After adjustment for price and seasonal variations, exports fell by 1%.<sup>1</sup> With the continuing strong expansion of imports (+2¼%), the deficit in the real foreign balance reached a new high, amounting to 5¾% of GDP.

All in all, 2005 got off to a good start for the US economy. According to a survey conducted by the Conference Board, consumer sentiment improved further in January owing to an improved situation assessment; however, expectations were no longer quite as optimistic as in December. The intake of orders for durable goods increased by a seasonally adjusted 1¼% in the autumn and was thus 7½% up on the year. According to the most recent reports from the Federal Reserve's districts, private consumption and corporate investment continued to expand at the turn of 2004-05. The moderate level of employment growth also carried over into January; the number of employed people outside the agricultural sector was 1½% up on the year. The unemployment rate fell to 5.2% after seasonal adjustment.



The economic picture in the USA is being clouded by stronger inflationary pressures, however. In the fourth quarter of 2004, consumer prices were 3.3% higher than one year earlier, compared with 1.8% in the first three months of the year and 2.7% on an annual average. Excluding energy and food, the rate of price increase rose from 1.4% in the first quarter to 2.1% in the fourth quarter. However, this contrasts to a certain extent with the core rate of the personal consumption expenditure deflator, which is taken into particular account in the Fed's price analyses; at 1.6%, it was significantly lower in the fourth quarter and, moreover, only marginally higher

<sup>1</sup> According to the Bureau of Economic Analysis, which is responsible for the US national accounts, an upward adjustment of the export figures is becoming apparent. If viewed in isolation, this is also likely to lead to a slight upward revision of GDP growth data.

than at the beginning of the year. The increasing divergence between the two core rates is attributable, amongst other things, to the fact that the national accounts-based deflator, in accordance with the consumption concept applied in the US national accounts – and in contrast to the expenditure concept of the consumer price statistics –, also includes the government-funded health care services (Medicare and Medicaid), the price pressures on which diminished noticeably in the course of 2004.

*Japan*

Real GDP in Japan declined slightly again in the autumn of 2004, denoting a fall of ½% since the last peak at the beginning of 2004. It was up by only just over ½% on the year in the fourth quarter. Average growth for the year was 2½% owing to the strong growth overhang from 2003 and the rapid rate of expansion at the start of 2004. Measured in terms of the IMF and OECD autumn forecasts of 4.4% and 4.0% respectively, the annual result was certainly disappointing. Apart from the economic downturn which has persisted since the spring, it must also be borne in mind that strongly revised national accounts figures were published in early December 2004 showing, for example, growth rates for 2003 and the first three quarters of 2004 which, respectively, were 1 and 1½ percentage points lower. These corrections were recorded – so to speak – as a counterentry in the GDP deflator, meaning that a lower level of macroeconomic deflation is shown after revision, which seems plausible on the whole. The available economic indicators suggest an upturn in production at the beginning of 2005. On an average of the fourth quarter,

consumer prices were 0.5% up on the year. This was the first quarterly rise in consumer prices since the end of 1998. The main reasons for this were the surge in energy prices and the sharp rise in the price of seasonal food products owing to the extensive crop damage caused by typhoons in the late summer of 2004.

According to initial estimates, in the fourth quarter, the UK economy expanded by ¾% after adjustment for seasonal and working-day variations, ie somewhat more strongly than in the summer (+½%). The figure was 2¾% up on the end of 2003 compared with an increase of 3% for 2004 as a whole. The most important mainstay of growth in the autumn was once again the services sector; as in the summer already, the real value added of this sector rose by a seasonally adjusted 1%. In addition, construction output increased significantly. Although the value added in the production sector (excluding construction) declined again at the end of 2004, at ½%, the fall was no longer as pronounced as in the preceding period. This contributed materially to the slight rise in GDP growth in comparison with the summer months. All in all, however, the UK economy slowed down noticeably after mid-year. The distinct slowdown in price movements on the property markets was particularly noteworthy. According to the Halifax House Price Index, fourth-quarter seasonally adjusted house prices were barely higher than in the preceding period. However, the year-on-year increase was still 15%. Consumer prices, affected by the sharp increase in energy prices, picked up distinctly on an average of

*United  
Kingdom*

the October-January period. The year-on-year rise in the Harmonised Index of Consumer Prices (HICP) remained fairly moderate at 1.5%, however. According to the Retail Price Index excluding Mortgage Interest Payments – which is methodologically different from the HICP – prices went up by 2.2%.

*New EU  
member states*

The new EU member states were among the fastest growing economies in the world in 2004. The expansionary process in this region was driven by both burgeoning foreign trade and strong domestic demand. Although economic activity initially lost momentum after mid-year – like in most industrial countries –, aggregate industrial production was up by a seasonally adjusted 1¼% in the fourth quarter – following a decline in the preceding period. The year-on-year rise was 5¾%. Industrial production rose by an average of 9½% over the past year. The altogether robust expansionary process is also helping to improve the situation on the labour market. After adjustment for seasonal variations, the standardised unemployment rate in this group of countries fell by ½ percentage point to 13.8% between January and December 2004. The rate of consumer price increase, which had accelerated significantly in the second and third quarters, was more moderate again in the autumn. Fourth-quarter prices were 4.4% up on the year compared with 4.9% in the July-September period. The annual average rate of price increase was 4.0% compared with only 1.9% in 2003. This increased upward pressure on prices was attributable primarily to the development of economic activity, the sharp rise in food and energy prices and increases in indir-

ect taxes in connection with EU accession on 1 May 2004.

### Macroeconomic trends in the euro area

The pace of economic growth in the euro area, which had already eased noticeably in the summer, slowed down even further in the fourth quarter. According to the Flash Estimate, real GDP grew by a seasonally adjusted ¼% on the preceding period. Year-on-year growth was 1½%. At 1¾%, the average growth rate for the whole of 2004 fell somewhat short of the potential rate, however. Although more detailed information on the individual expenditure components is not yet available, data from the balance of payments statistics concerning nominal foreign trade with non-EEA countries in October and November suggest that exports picked up again in the autumn. The same is true for imports, which means that the contribution of real net exports to growth was probably limited. Fourth-quarter real retail sales stagnated at the same low level as in the previous quarter. According to the European Commission's indicator-based short-run forecast, in seasonally adjusted terms, economic growth in the first two quarters of 2005 may range between 0.2% and 0.6%.

*Low GDP  
growth in the  
fourth quarter*

The modest expansion in overall output in the fourth quarter, if viewed from the value-added side, is largely attributable to the decline in industrial production, which amounted to ½% in seasonally adjusted terms. The previous year's level was therefore exceeded by only ¾%. The production of durable con-

*Weak industrial  
activity in  
the autumn*

sumer goods, capital goods and energy was particularly weak. Non-durable consumer goods production also showed a downward trend, albeit a less pronounced one. The manufacture of intermediate goods stagnated. The fact that capacity utilisation in the manufacturing sector, after adjustment for seasonal variations, was no higher in January 2005 than it had been in October 2004 is in keeping with these developments.

*Mixed signals for the beginning of 2005*

The leading economic indicators available to date still present a mixed picture with regard to industrial production in the first few months of 2005. The intake of orders in the order-based manufacturing industry was exceptionally buoyant in October and November. Major orders for the aviation industry were a key factor in this development, however. The Purchasing Managers' Index continued its upward trend in January. By contrast, industrial confidence deteriorated again to a level only a little above its long-term average. At the start of the year, the indicator of consumer sentiment held firm at its low level of the preceding months.

*Labour market at a turning point*

According to preliminary data released by Eurostat, unemployment in the euro area appears to have reached its lower cyclical turning point. In the fourth quarter of 2004, the seasonally adjusted number of unemployed did not rise further in comparison with the preceding quarter. Moreover, the figure was barely higher than in the same period of 2003. The standardised unemployment rate stood at 8.9% in December. Labour market developments within the euro area were very uneven in 2004. While, for example, the level

of underemployment increased even further in Germany and the Netherlands, it fell – in some cases quite sharply – in several other countries. In Spain – traditionally the country with the biggest labour market problem in the euro area – the unemployment rate was 10.4% at the end of 2004 and thus only slightly higher than the rate in Germany (10.0%).

Euro-area consumer prices in the October-December period were up by a seasonally adjusted 0.5% on the preceding quarter. The rise in prices was therefore just as strong as in the summer months. This was due to the further hike in the cost of energy. Although energy prices already peaked in October and then fell again, on an average of the quarter, energy was 1.8% more expensive than in the preceding three months. Excluding the particularly volatile components of energy and unprocessed food, consumer prices rose by a seasonally adjusted 0.4%. This corresponds to an annualised rate of 1.6%. In the autumn, the year-on-year rise in the overall HICP increased from 2.2% to 2.3%; core inflation fell from 2.1% to 2.0%, however. At the start of 2005, the upward pressure on prices in the euro area weakened, above all as a result of baseline effects.

*Price developments marked by higher energy prices*

## Exchange rates

There was a fairly distinct shift in sentiment on the international foreign exchange markets at the turn of 2004-05. The euro appreciated noticeably in the autumn of 2004 and reached new all-time highs against the US

*Shift in sentiment on the foreign exchange markets at the turn of the year*

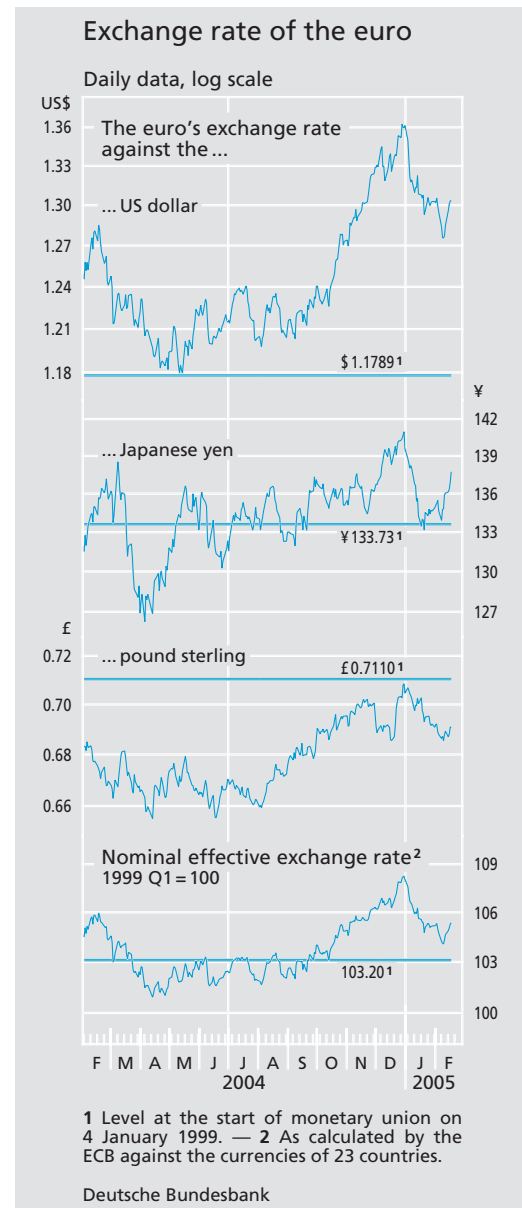


dollar and the yen at the end of December; the trend started to reverse at the beginning of 2005, however. The single currency has shown a tendency to depreciate as a result.

*Development of the euro's exchange rate against the US dollar, ...*

Market participants' concerns about the USA's external imbalance were initially the driving force behind the developments in the euro-US dollar exchange rate. The euro consequently made significant gains against the US dollar. The single currency continued to appreciate into December, boosted by the belief that several central banks could switch their foreign currency reserves – hitherto held predominantly in US dollars – to euro. At the end of December, the euro reached a new record high against the US dollar of more than US\$1.36. As a result of the Christmas and New Year public holidays, however, only small volumes were traded in the foreign exchange markets, which meant that comparatively minor orders not necessarily aligned with fundamental data may have caused this movement. This assessment is supported by the fact that the euro depreciated again immediately after the start of the year.

The Fed's decisions in December and February to raise the federal funds rate by a further 25 basis points in each case were generally expected and thus of no direct relevance to the exchange rate. The money market interest rates in the USA rose steadily following the Fed's transition to a policy of gradual increases in the key interest rate in the summer of 2004; they are now higher than the short-term interest rates in the euro area. The yield advantage enjoyed by US government bonds over similar euro-area instruments also tend-



ed to increase in the winter months. The USA's interest rate spread over other countries – viewed in isolation – is making US investments more attractive and thus facilitating the financing of the US current account deficit. However, this interest rate advantage may not necessarily be reflected immediately in exchange rate developments as a large number of different factors have an effect on



the exchange rate. It undoubtedly gave the US dollar a certain degree of support though.

Speculations on the foreign exchange market that the Federal Reserve might increase the speed at which it tightens its monetary policy probably also contributed to the euro's depreciation since the beginning of the year. This impression was reinforced by positive economic data from the USA. Against this backdrop, even reports about a new record deficit in the US balance of trade in November 2004 were able to suspend the euro's fall only temporarily. As this report went to press, the euro was trading at US\$1.30, almost 4½% below its level at the end of 2004.

*... against the yen ...*

The euro initially also tended to appreciate against the yen. This development was accompanied by negative economic data from Japan. Reports that the Japanese trade surplus had declined in November apparently also put downward pressure on the yen. Towards the end of 2004, the single currency reached a new record level of ¥141. However, at the beginning of 2005, the euro also started to depreciate noticeably against the Japanese currency. In this respect, the euro-yen exchange rate essentially appears to have mirrored the movements in the euro-US dollar exchange rate. The supposition of market participants that the Japanese monetary authorities might intervene in the foreign exchange market in favour of the US dollar may have been of relevance here. As this report

went to press, the euro was again trading at a somewhat higher level of ¥138, but was still around 1½% below its value at the turn of 2004-05.

The exchange rate of the euro against the pound sterling fluctuated without a clear trend between £0.68 and £0.71 in the reporting period. The short-term exchange rate movements in both directions were, as a rule, due to market participants' rapidly changing assessments of the Bank of England's interest rate policy. In the autumn, reports about a slowdown in the UK economy and deflated expectations of interest rate increases still contributed to the euro's virtually continuous appreciation against the pound sterling. The general weakening of the euro since the turn of 2004-05 has caused the single currency to lose around 2% of its value against the pound sterling. As this report went to press, the euro was trading at £0.69.

*... and against the pound sterling*

The effective nominal exchange rate of the euro showed similar movements to those of the bilateral exchange rates of the euro against the US dollar and the yen. For example, on average, the euro appreciated noticeably against the currencies of 23 important euro-area trading partners up to the end of 2004 and reached new all-time highs. Since then, the single currency has lost 2½% of its value in trade-weighted terms. It was thus 2% higher than its level at the start of monetary union.

*Effective exchange rate of the euro*