Global and European setting

World economic activity

Global economy likely to have grown at somewhat slower pace at start of year

Global economic growth probably tailed off somewhat in the first three months of the year, but the deceleration varied considerably from one country to the next. Having increased robustly in the previous quarters, real gross domestic product (GDP) in the euro area has climbed at a moderate rate of late. The United Kingdom saw its macroeconomic upswing more or less peter out. In Japan, economic output even contracted slightly, while momentum faded just a little in the United States. The Chinese economy continued to see what was, by international standards, a strong and steady rate of expansion. In most of the other emerging economies, economic activity is also likely to have remained rather favourable.

Industrial activity faltering in some countries

One-off factors probably contributed in part to the slowdown in growth experienced in some advanced economies. Moreover, momentum appears to have waned in particular in the industrial sector, which was a key driving force in the preceding quarters. Manufacturing output in the euro area in the first quarter declined compared with the preceding quarter, and even fell sharply in Japan. This weakness should, however, be viewed against the backdrop of the very steep rise since mid-2016. In the six quarters leading up to the end of 2017, euro area manufacturing output had increased by more than 6%, whilst in Japan, it had climbed by almost 8%. In the USA, output increased by only 2½% in the same period. On an average of the first four months of this year, however, it rose by just over half a percentage point on the fourth quarter of 2017.

Sentiment indicators stabilised following decline

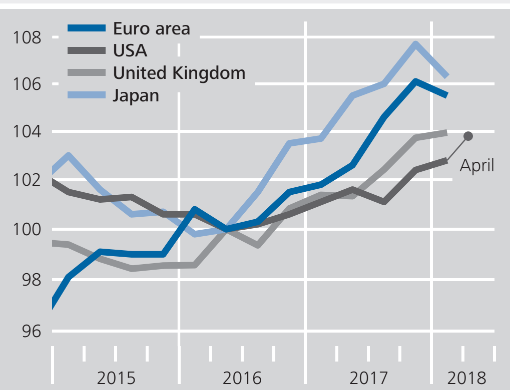
The Bundesbank leading indicator for the global economy also points to a certain slowdown in worldwide industrial activity. According to the data currently available, it has declined since January and is now falling slightly short of its long-term average.[1] This is probably due not least to a deterioration in the upbeat sentiment still in evidence at enterprises and amongst investors at the global level. Geopolitical tensions and trade disputes, in particular, presumably dented confidence during the winter months. In April, however, the aggregate purchasing managers' index for global economic activity levelled off. Global consumer sentiment remains buoyant. Optimism also prevailed among the staff of the International Monetary Fund (IMF), who confirmed their January projections of brisk global economic growth this year and next year in their spring forecast.

Trade disputes and risk of escalation

That said, there are downside risks for the world economy, not least in connection with the United States' trade policy. Citing national security considerations, the US government imposed new tariffs on steel and aluminium imports in March in order to protect domestic industries. Imports from some countries and economic areas (including the EU) were at least temporarily exempted. In addition, trade policy

Manufacturing output in selected industrial countries

2016 Q2 = 100, seasonally and calendar-adjusted, log scale



Sources: Eurostat, national statistics, Haver Analytics and Bundesbank calculations.

Deutsche Bundesbank

1 As a result of the underlying smoothing procedure, the indicator is subject to revision at the current end. The values should therefore be interpreted with caution.

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

Monthly averages, log scale

Sources: Bloomberg Finance LP and HWWI. • Latest figures: average of 1 to 11 May 2018, or 1 to 17 May 2018 for crude oil.
Deutsche Bundesbank

measures against China were announced in retaliation for the violation of intellectual property rights. In turn, China threatened to apply punitive tariffs to imports from the United States. This conflict thrust the global risk of increased protectionism or even a trade war into the public eye. Macroeconomic model simulations indicate that the introduction of tariffs could dampen economic activity and amplify price pressures.[2] In particular, an economy with protectionist policies is ultimately at risk of causing damage to itself. The member states of the World Trade Organization (WTO) have committed to following an agreed multilateral framework to settle the dispute. The risk of further escalation could be averted if all parties concerned were to comply with this framework and hold back on unilateral measures. Both the United States and China have submitted complaints to the WTO.

Crude oil prices at highest level since 2014

The new US import duties initially depressed steel and aluminium prices on the international markets. On account of the United States imposing targeted sanctions on a Russian manufacturer, however, the price of aluminium surged in the first half of April, though it stood considerably below its peak again towards the end of the month. Overall, the prices of non-energy commodities in April (denominated in US dollars) barely differed from their January level. By contrast, the price of crude oil has been increasing sharply since mid-March. This was probably mainly due to heightened geopolitical tensions in the Middle East. Adopted at the beginning of May, US sanctions against Iran could result in marked shortages in the global oil supply given continued OPEC production restrictions and declining production in Venezuela. As this report went to press, the spot price for a barrel of Brent crude oil was US$79 – its highest level since the fourth quarter of 2014. Forward quotations did not keep up with the latest increase, meaning that the discounts for futures increased considerably.

Consumer price inflation stabilised

The impact of the increase in oil prices is likely to pass through to the consumer level in industrial countries. The inflation rate for a corresponding aggregate of countries had already risen to 2.0% in March, which was its highest level since February 2017 and 0.2 percentage point more than at the end of the preceding year. The core inflation rate, for the calculation of which energy and food were excluded from the basket of consumer goods, increased by a similar margin. At 1.6% in March, it was still somewhat lower than the headline rate.

2 See Deutsche Bundesbank, The danger posed to the global economy by protectionist tendencies, Monthly Report, July 2017, pp 77-91.

Selected emerging market economies

Sustained high growth in China

China's real GDP increased by 6.8% on the year in the first quarter of 2018, according to the official estimate. The pace of growth in the two preceding quarters was thus maintained; industrial activity even increased slightly. The renewed sharp rise in Chinese exports is likely to have played a role here. In addition, private consumption demand proved to be a mainstay of economic activity. Surveys suggest that households' sentiment was very upbeat throughout the reporting period. Consumer price inflation did increase slightly, but remained moderate at 2.1% on an average of the winter months. On the housing market, on the other hand, the downturn persisted; selling prices were even lower than they had been a year previously in a number of major cities.

Strong upward trend in India

At 7.2%, India's year-on-year growth rate in the final quarter of 2017 was at its highest since the summer of 2016. In the first quarter of 2018, for which no GDP estimate has been published as of yet, economic activity probably increased strongly once again, according to the available indicators. Overall, economic activity has rebounded in the wake of sweeping reforms, including the introduction of a single Goods & Services Tax (GST) across the country. However, the tax reform could also have spurred on inflation. Despite a rather low increase in food prices, the annual consumer price index (CPI) climbed by 4.6% on an average of the first quarter of the year, just as in the final quarter of 2017.

Recovery in Brazil remains tentative

In Brazil, economic output at end-2017 remained at the level of the previous quarter in seasonally adjusted terms. While gross fixed capital formation continued to recover distinctly, the expansion of private consumption almost came to a standstill. The indicators available for the first quarter suggest that economic activity has been persistently weak. Thus, industrial production stagnated, and the labour market situation also remained difficult. The unemployment rate recently went back over 13%. Weak wage growth continued to dampen consumer price inflation. Annual CPI inflation rose by +2.8% on an average of the January to March period. Against this background, the central bank continued its monetary policy easing, lowering the policy rate by 25 basis points on two occasions since the beginning of the year.

Moderate growth in Russia

According to a preliminary estimate by the Russian Federal State Statistics Service, real GDP in Russia was 1.3% higher in the first quarter of 2018 than in the same period of the previous year. The economy thus continued to expand at a slightly faster pace than at the end of 2017. This was due, amongst other things, to a recovery in industrial output, which increased by 1.6% on the year in the first quarter of 2018 following an unexpected decline in the fourth quarter of 2017.[3] On the whole, in spite of the upward trend in the price of oil, which was beneficial to Russia, cyclical momentum remained very subdued. On average over the first quarter, CPI inflation declined to a rate of 2.3%. In both February and March, therefore, the Russian central bank cut its policy rate by 25 basis points. Following the devaluation of the rouble in April, which was the result of new US sanctions, it refrained from any further interest rate moves.

USA

Growth has eased off slightly

The US economy was not quite able to sustain the momentum of the past few quarters into the beginning of 2018. According to an initial estimate, real GDP in the first quarter rose by 0.6% on the previous period, following adjustment for seasonal effects. From spring until autumn 2017, growth rates fluctuated between +0.7% and +0.8%. Gross fixed capital formation recently experienced renewed strong

3 The weakness at the end of 2017 may predominantly have been due to a decline in armaments production, which is not identified separately in the statistics.

growth, and a greater build-up of inventories and foreign trade supported the macroeconomic upswing slightly. However, private consumption growth slowed down sharply as households had increasingly exhausted their scope for expenditure. Yet against the background of tax relief, which came into force in January, as well as further improvements on the labour market, conditions remain favourable for private consumption. In April, the unemployment rate fell to its lowest level since December 2000. In addition, some indicators are pointing to an advancing consolidation of wage growth.[4] Consumer price inflation has also increased in line with rising domestic cost pressures in the last few months. The CPI inflation rate climbed to 2.5% in April, while core inflation increased to 2.1%. In this setting, the US Federal Reserve maintained its stance of a gradual normalisation of monetary policy and raised its policy rate by 25 basis points.

Japan

Upward macroeconomic trend interrupted

The recovery of the Japanese economy did not continue into the beginning of the year. A provisional estimate shows that real GDP declined by 0.2% on the final quarter of 2017 after adjustment for seasonal factors. This was the first decline on the quarter after a two-year period of expansion. Once again, housing investment, in particular, fell sharply. The other components of domestic demand were weak. At the same time, the upward momentum of foreign trade flows slowed. However, as exports grew slightly more than imports, real GDP received another slight positive stimulus. Although the unemployment rate sank to a cyclical low of 2.5% in the first quarter, domestic inflationary pressures remained weak. The annual core rate of CPI inflation (excluding energy and food) came in at +0.3% in March, while the headline rate stood at +1.1%. The Japanese central bank kept its monetary policy on an expansionary track.

United Kingdom

Only limited macroeconomic growth

After adjustment for seasonal variations, real first quarter GDP in the United Kingdom was up by just 0.1% on the previous quarter according to a provisional estimate; the economy had grown moderately in the second half of 2017. A significant drop in output in the construction sector, to which adverse weather conditions may have contributed, was a considerable factor behind this slowdown. The rebound in the services sector was held back by a decline in the gross value added of consumer-related sectors. This is consistent with the marked fall in real retail turnover, which some have likewise associated with inclement weather. While output in the production sector experienced considerable growth, this was primarily due to a rise in energy production as a result of the cold weather, and to the significant recovery in oil and gas production.[5] The unemployment rate in the first quarter nevertheless did fall to its lowest level since the winter of 1975. While nominal wage growth remained moderate, inflation as measured by the Harmonised Index of Consumer Prices (HICP) dropped further in March, to 2.5%. The Bank of England maintained its monetary policy stance in light of the recent sluggishness in the overall economy.

New EU member states

Robust growth with moderate inflation

In the new EU member states (EU-6),[6] the economic upswing continued in the first quarter of 2018. Real GDP rose significantly, or even sharply, compared to the previous quarter in most countries in the region. Despite a certain deterioration in some sentiment indicators, industrial activity remained robust. Looking at the

4 Thus the annual rate of the Employment Cost Index for employees in the private sector, which largely eliminates distorting composition effects, rose to +2.8% in the first quarter of 2018. Two years earlier, it had been one percentage point lower.
5 The breakdown of the Forties pipeline had strongly limited oil and gas production at the end of 2017.
6 This group comprises the non-euro area countries that have joined the EU since 2004, ie Poland, the Czech Republic, Hungary, Bulgaria, Romania and Croatia.

expenditure side of GDP, aggregate growth was probably given a boost particularly by private consumption. Households have long been benefiting from high wage increases without this having resulted in any major acceleration in consumer price inflation so far. HICP inflation even fell somewhat to +1.7% in the first quarter of 2018, which was mainly owing to declining inflationary pressures from food. Excluding energy and food, consumer price inflation remained at 0.9%.

Macroeconomic trends in the euro area

Slowdown in growth at the start of the year

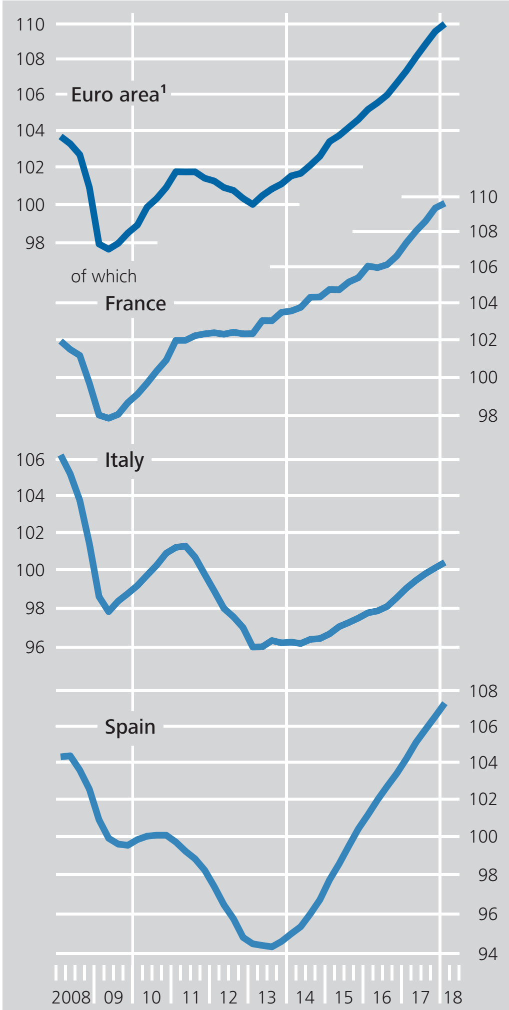
The euro area upswing continued at a more subdued pace at the beginning of 2018. Eurostat's flash estimate indicates that, after seasonal adjustment, real GDP growth contracted to 0.4% from 0.7% in the fourth quarter of 2017.[7] Compared with the previous year, the increase amounted to 2.5%, following 2.8% in the previous quarter. In terms of expenditure, this slowdown was likely caused by domestic and external economic factors. While private consumption is likely to have kept increasing at a subdued rate in winter, investment activity tailed off. Meanwhile, exports rose less strongly than in the previous quarter. In regional terms, economic growth in the euro area appeared to be somewhat less homogenous. Economic activity dropped in some member states, while underlying momentum remained dynamic elsewhere. Sentiment indicators suggest a rate of aggregate expansion for the second quarter similar to that at the start of 2018.

Subdued growth in private consumption

Private consumption is likely to have risen somewhat in the first quarter. Price and seasonally adjusted retail sales remained almost unchanged on the quarter, though the significant rise in new motor vehicle registrations has probably offset this. The fact that households have upped their saving may be a key factor behind the muted consumption growth that has persisted for a number of quarters. It is likely that the real income gains in the first quarter were also not entirely used to increase private consumption expenditure. Since the saving ratio had reached a historical low at the beginning of 2017 due to increased inflationary pressures, a certain correction appeared to be in the cards.[8]

Aggregate output in the euro area

Real GDP, 2010 = 100, seasonally adjusted, quarterly data, log scale



Source: Eurostat. **1** Affected by jump in Irish GDP since 2015 Q1.
Deutsche Bundesbank

Lower investment activity

Investment in machinery and equipment, which had still recorded respectable gains in the final quarter of 2017, has presumably lost steam re-

7 A growth rate of 0.6% was originally calculated for the fourth quarter of 2017, but this was revised to 0.7% in the wake of Ireland's GDP result (+3.2%).
8 See Deutsche Bundesbank, Energy prices and private consumption, Monthly Report, February 2017, pp 13-15.

Sentiment indicators for the euro area

Percentage balances, seasonally adjusted, monthly data

Source: European Commission.
Deutsche Bundesbank

cently, as the steep decline in the output of capital goods would suggest in any case. Meanwhile, the corresponding seasonally and price adjusted domestic turnover rose at a similar rate in January/February as in the autumn. There was also probably no major increase in construction investment following noticeable gains in the autumn. Construction decreased slightly in the winter months.

Weaker rise in exports

Exports in the first quarter of 2018 were also presumably unable to maintain the extremely high momentum of the final quarter. The slowdown in export growth was broad-based across the most important trading partners in the euro area. Income from goods exports to non-euro area countries barely changed, even in real terms. Spending on goods imported from outside the euro area was also less brisk at the start of the year. At the same time, import prices rose distinctly again, meaning that the imports of goods in the first quarter, once adjusted for prices, fell short of the level at the end of 2017. Trade between member states increased slightly.

Setback for industrial production

In line with the declining impetus coming from exports and investment, industry was unable to match the favourable growth of the preceding quarters. In the first quarter, seasonally adjusted industrial output in the euro area fell by 0.6% on the previous period. This drop was particularly pronounced for capital goods, and only consumer goods were able to record a slight increase.

Regional growth in the euro area somewhat more disparate again

Following the regionally broad-based, powerful upsurge in the fourth quarter of 2017, economic growth among the member states was somewhat more disparate again at the start of 2018. In France, real first quarter GDP was a seasonally adjusted 0.3% up from the previous quarter, in which it had climbed by 0.7%. This weaker growth was primarily caused by exports, which were virtually stagnating after a very sharp rise in autumn. Additionally, private consumption only grew slightly, while investment expanded markedly, albeit at a slower rate. The upswing in Italy continued in the first quarter without any change of pace, with economic output rising by 0.3%. Foreign trade figures for the first quarter indicate that the previously extremely buoyant export activity is slowing. Private consumption has probably gone up only slightly given the stagnant employment growth, and investment activity was also likely to have been relatively restrained. Spain experienced the strongest growth among the major member states, with an unchanged quarterly GDP growth rate of 0.7%. Economic growth was once again probably boosted primarily by its domestic economy. Although the upsurge in investment appears to have eased up somewhat, this has likely been offset by the rather steep rise in private consumption. Strong GDP growth could also be seen in the Netherlands, Austria and Finland.

Recovery in the labour market continuing

Despite the somewhat slower upturn in macroeconomic growth, the situation in the labour market continued to improve in the euro area.

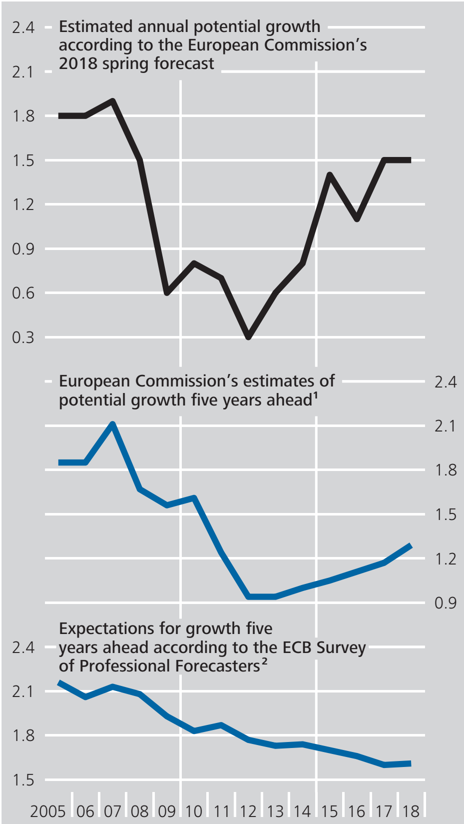
Longer-term growth prospects in the euro area

Economic growth in the euro area picked up distinctly last year, with real gross domestic product (GDP) expanding at a calendar-adjusted rate of 2.5% – a pace last seen more than ten years ago – after contracting in 2012 and 2013. Aggregate capacity utilisation will have increased appreciably in 2017.[1] However, potential output is a variable that is difficult to quantify in real time,[2] hence the lack of consensus over whether utilisation in the euro area as a whole has already returned to normal.[3]

There is also the question of whether the brisker macroeconomic dynamics observed in the past years can be put down entirely to more benign cyclical conditions, or whether they might also be masking a strengthening of growth potential. The latest estimates by the European Commission reveal that potential growth in the euro area soared from 0.3% in 2012 to 1.5% in 2017. Note, however, that 2012 marked a low point in the European Commission's data since their estimates of potential growth track cyclical fluctuations with a reduced amplitude. This is because some components of potential output are influenced not just by structural factors, but presumably by the economic cycle, too – a phenomenon that can be seen in total factor productivity (TFP), for example. The rise in estimated potential growth recorded in the last few years is thus likely, in part, to be a reflection of past cyclical weaknesses having been overcome.[4]

One way of fathoming the outlook for growth is to use estimates of the longer-term potential rate that are less dependent on cyclical developments. In its 2018 spring forecast, the European Commission puts potential growth in the euro area five years ahead at 1.3%, which, though slightly higher than in earlier reports, is weaker

Estimated potential growth and longer-term growth expectations in the euro area



Sources: European Commission, ECB and Bundesbank calculations. **1** According to the spring forecast in the year shown. The projections for the euro area for the years 2005, 2006 and 2008 were calculated on the basis of national forecasts (12 countries). **2** Annual averages of the quarterly rounds each year and average outcome of the Q1 and Q2 rounds in 2018.
Deutsche Bundesbank

1 Judging by the surveys of the European Commission, capacity utilisation in the manufacturing sector returned to its long-term average back in the first quarter of 2015 and has been approaching the peak of the series of late.
2 See Deutsche Bundesbank, On the reliability of international organisations' estimates of the output gap, Monthly Report, April 2014, pp 13-35.
3 See European Central Bank, Measures of slack in the euro area, Economic Bulletin, Issue 3/2018, pp 31-35.
4 The European Commission's estimates indicate that the contribution from capital accumulation has risen only marginally since 2012.

than the potential growth rate for 2018 and 2017. This expected contraction in potential growth over the next five years will be driven chiefly by adverse demographic developments, which will dampen the supply of labour. As regards other potential growth factors, the European Commission's projections include a renewed uptick in impetus from capital accumulation and a largely unchanged TFP growth rate going forward.

Similarly, surveys on the growth outlook for the euro area do not suggest that potential rates in the euro area will pick up noticeably over a longer-term horizon. The private sector expectations for real GDP growth over a five-year horizon[5] surveyed as part of the ECB Survey of Professional Forecasters (SPF) remained practically unchanged from the previous year's level at 1.6% in the first half of 2018. Unlike the European Commission's estimates, the projections from the SPF even declined slightly in the past few years.

Overall, both the European Commission's forecasts and the expectations surveyed as part of the SPF suggest that potential output in the euro area will follow a subdued path. Bearing this in mind, there is good reason to believe that, in the absence of structural reforms that boost potential growth, macroeconomic growth will lose traction again over the longer run.

5 The SPF expectations for real GDP growth five years ahead will probably mirror the longer-term expectations for potential growth because it can generally be assumed that these two variables will converge over the longer run. A special SPF questionnaire likewise reveals that most respondents, when asked where they see real GDP growth over the longer term, make judgement-based calls of the potential growth rate. See European Central Bank, Fifteen years of the ECB Survey of Professional Forecasters, Monthly Bulletin, January 2014, pp 55-67.

The number of unemployed people in the first quarter fell by just under 260,000 compared to the fourth quarter of 2017, after seasonal adjustment, and by around 1.5 million on the year. The standardised unemployment rate in March fell to 8.5%, after 8.6% in December and 9.4% one year earlier. The employment data show a sharp rise in employment for the final quarter of 2017, with a year-on-year increase of 2.4 million people, or 1.6%. Wage growth strengthened slightly, and given an increase in the average number of hours worked per employee, the year-on-year rise in gross hourly earnings accelerated slightly in the fourth quarter to 1.6%. Hourly employee compensation rose by 1.4% over the same period.

Consumer prices up noticeably again in first quarter

Consumer prices in the euro area rose in the first quarter of 2018 by a seasonally adjusted 0.5% on the quarter, an even stronger increase than in the fourth quarter of 2017. As was already the case then, the fact that energy prices were raised on the back of higher crude oil prices was especially noticeable. Processed food, especially dairy and fat products, also became markedly more expensive, while prices for unprocessed food largely remained unchanged following the significant increase in the preceding period. Likewise, consumers did not have to spend much more on industrial goods (excluding energy) than in the autumn, though services prices rose noticeably by 0.5%, which was also linked to the early date of Easter. Despite the clear inflation viewed over the period, headline annual HICP inflation was somewhat lower than in the two previous quarters, at 1.3%, on a quarterly average. A key factor in this was that energy prices had increased steeply a year earlier and that the prices for unprocessed food had risen strongly owing to the especially poor weather conditions at the time.

Core inflation in Germany still above euro area rate

The average inflation rate excluding energy and food stood at 1.0% in the first quarter, slightly higher than the rate in the autumn of 2017.

Rates in the euro area ranged from 0.0% in Cyprus to 2.1% in Austria. Germany's core rate (1.3%) exceeded the euro area average by 0.3 percentage point, which is highly consistent with Germany's cyclical position.

Further slight rise in consumer prices in April

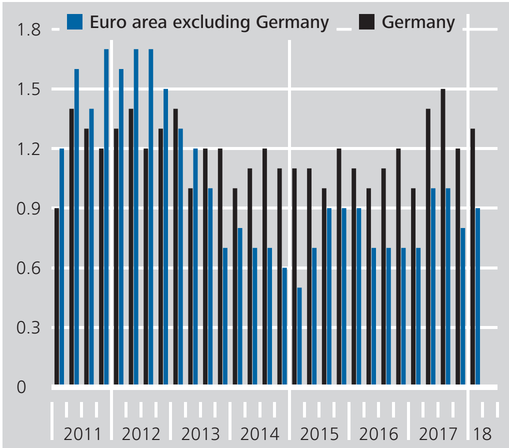
Consumer price inflation continued to rise slightly in April particularly on account of energy and food. This increase in consumer prices was down on the year, however, at 1.2%, primarily due to travel prices, which had increased much more sharply last year than this year owing to the later date of Easter. As a result, annual HICP inflation excluding energy and food fell markedly by 0.3 percentage point to 0.7%.

Moderate economic growth likely in the second quarter again

It is likely that the economic upturn in the euro area will continue in the second quarter at a similar pace to that recorded in winter. Sentiment among businesses and consumers is still good following a noticeable corrective movement. The domestic economy will probably continue to benefit from the labour market recovery and favourable financing terms, while exporters are expected to continue to share the benefits of the global economic upturn. Although the underlying expansionary forces remain intact, it is possible that aggregate growth will no longer reach the extremely high rates experienced last year. This is also suggested by the path of potential output for the euro area's economy, which is only sloping upwards moderately (see also the box on pages 17 and 18.).

HICP excluding energy and food

Year-on-year percentage change



Deutsche Bundesbank