Global and European setting

World economic activity

Global upswing still intact

In the last quarter of 2005, the global economy continued to grow briskly, although the pace probably dropped off a bit from the third quarter. Slower growth in the industrial countries was the key factor, with slumping growth in the United States having had a particularly pronounced impact. Overall economic output in the euro area likewise grew more slowly than in the third quarter. The slowdown in the USA and the euro area, particularly in the light of the strong growth that preceded it, was not offset by increased manufacturing activity in Japan. In the major industrial countries and economic regions, total Q4 real gross domestic product (GDP), according to as-yet provisional information, was up by a seasonally adjusted ½% from the previous quarter, in which it had risen by ¾%. It was up by 2¾% on the year. GDP growth for all of 2005 amounted to 2½%, compared with 3% a year earlier.

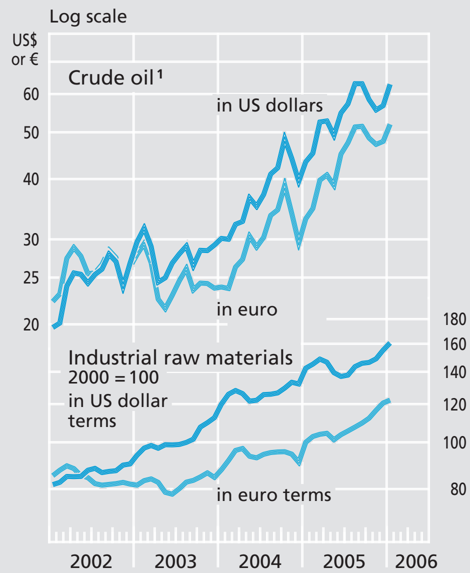
Weaker inflationary pressure in Q4 …

Price movements in industrial countries, after having been affected in the summer months by soaring prices for petroleum products, calmed down somewhat when the energy markets eased in the fourth quarter of 2005. Industrial countries saw consumer price inflation fall from 3.0% in September to 2.4% in December. Core inflation (excluding energy and food) inched up slightly over the same period, from 1.4% to 1.6%. This reflects a slight strengthening of the indirect effects of higher Q3 energy prices on products with a relatively large energy component. The movement of overall inflation and core inflation in opposite directions reduced the gap between the two, which had at times been much wider; in December it was the same as in mid-year. For the industrial countries – excluding Japan, which had seen slight deflation throught the period under review – the two rates stood at 2.7% and 1.8% respectively in December.

... especially owing to falling crude oil prices

The trend decline in crude oil prices is the main reason for the receding price pressure in the industrial countries during the fourth quarter. The price of a barrel of Brent fell from its early September record high of US$67½,[1] which was the result of hurricane damage, to US$57½ in December, despite high interim volatility. The price of Brent crude oil averaged US$55 for all of 2005, compared to US$38 and US$28½ respectively in the two preceding years. However, prices have gone back up, in some cases distinctly, since the beginning of 2006 – not least on account of renewed geopolitical tensions in the Middle East. Since the beginning of February, however, the price trend has pointed downwards, coming to US$59 by mid-month. This translated to a year-on-year rise of just over 30%. Over the past half-year, the euro price for a barrel of Brent crude moved largely in lockstep with dollar prices owing to the relative stability of the exchange rate. Due to the euro's depreciation against the US dollar in the first half of 2005, the oil price, at €50, stood around 45% higher in mid-February than a year earlier. The sharp price increases in oil markets in January and the forward quotations for crude oil have shown once again that prices may be expected to remain very high and volatile due to the continuing rise in the demand for crude oil, largely exhausted production capacities and recurring political tensions.

World market prices for crude oil and industrial raw materials



Sources: Thomson Financial, HWWA Commodity Price Index. — **1** Price for one barrel of Brent crude oil.

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Prices of industrial raw materials continuing to rise

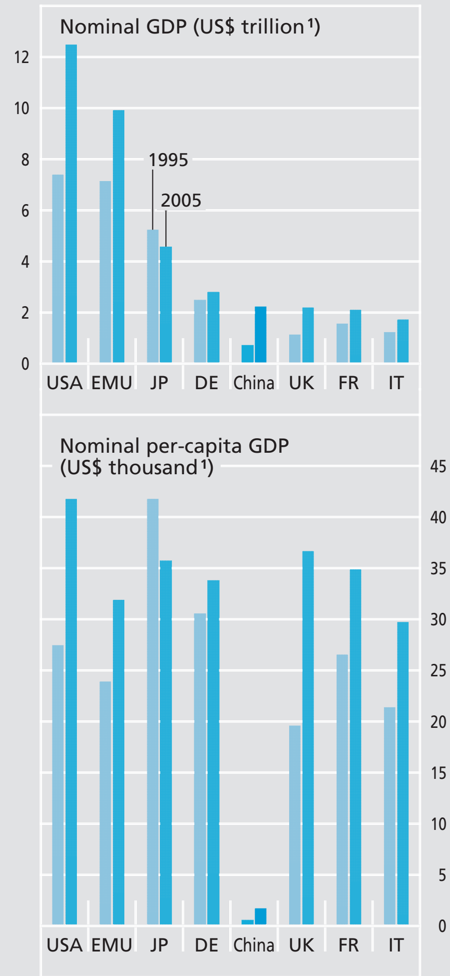
Dollar prices for industrial raw materials have gone up perceptibly since temporarily bottoming out in June 2005. In January they rose by 13% from their already high level of a year earlier. In euro terms, prices were up by nearly one-quarter in the first half of 2005 owing to the euro's depreciation against the US dollar. Prices for iron ores and scrap metal rose particularly sharply, by 38% in US dollar terms on average for the year.

South and east Asian emerging market economies

The sharp increases in crude oil prices in the past year have left evidence of a slowdown in

1 In real terms, ie after accounting for consumer price movements in industrial nations, this figure did not quite reach the peak set by oil prices at the end of 1979.

China's position
in the world economy



1 Converted at annual average exchange rates.

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some south and east Asian emerging market economies and have, in some cases, also caused inflation to increase distinctly. However, this may hardly be said of the Chinese economy, which continues to run full speed ahead and has been a key pillar of global growth throughout the period under review. In 2005 Q4, total output was up by 10%. Real GDP likewise rose by an average of one-tenth on the year – as in the two preceding years. At the same time, consumer price inflation remained moderate, averaging 1.8% on the year.

China's position in the global economy

Following the most recent recalculation of GDP by China's statistical office, which led to a 17% upward revision at constant prices for 2004, the country's weight in the world economy has grown even further. On the basis of the new GDP information, in 2005 China overtook the UK to become the world's fourth-largest economy. Its nominal GDP, denominated in US dollars, has tripled since 1995. At its present rapid rate of growth, China will probably pass Germany by 2007 and become the third-largest economy behind Japan.[2] In terms of purchasing power parities, a measure designed to take account of differences in price levels relative to the industrial nations by directly comparing the prices of selected tradable and non-tradable goods, China has already been in second place behind the United States for some time, according to IMF statistics. China's surge in the international GDP table, however, is tempered considerably by looking at the large population across which the GDP result is spread. As a rough indicator of wealth, per capita income is far superior to absolute GDP levels anyway. It serves to show that China ultimately still lags far behind the industrial nations (see adjacent chart). Per-capita income in China in 2005 was only 4% of the comparable figure for the United States and 5% of the relevant figure for Germany. In the

2 Japan is a special case in this regard because overall and per-capita nominal GDP fell between 1995 and 2005. Deflationary developments in Japan, which at that time caused the GDP deflator to fall by one-tenth, were the main reason.

mid-1990s, the gap was even larger. The highly uneven distribution of income in China also needs to be taken into consideration.

Latin America

The Latin American countries were on a growth track throughout the reporting period; however, in some major countries growth slowed down distinctly in 2005. The ongoing positive stimuli from exports of crude oil and raw materials were held in check by a variety of different factors depending on the country involved. Growth in Brazil was curbed at times by high interest rates and political uncertainty. The Brazilian central bank has since cut its key lending rate several times following a distinct easing of price pressures; it now stands at 17¼%. Overall output growth in Mexico suffered in the first half of 2005 from weak export growth and, in autumn, from the effects of hurricane damage, especially to the tourist infrastructure. In both countries, however, economic activity seemed poised to regain speed at the end of the period under review.

Russia and the Commonwealth of Independent States

Russian industry is under rather strong real revaluation pressure as a result of the raw materials boom. The diminishing price competitiveness of Russian industrial goods is amplifying the Russian economy's dependence – which was already high to begin with – on exports of crude oil, natural gas and industrial raw materials. According to estimates by Russia's economic ministry, real GDP grew by 6½% in 2005 compared with 7½% in 2004. Inflation, at 12¾%, remained very high. Most other oil-producing members of the Commonwealth of Independent States (CIS) are even more heavily dependent on oil. A balanced sectoral development has, for the most part, not gotten off the ground yet. Average real incomes in the CIS are, in many cases, currently still below 1989 levels. Extensive market economy reforms are urgently needed in order to sustainably enhance prosperity in these countries.

USA

According to as-yet provisional information, total output in the United States in the last quarter of the year was up by only ¼% on the quarter after adjustment for seasonal and working-day variations. This was the lowest growth since end-2002. Year-on-year real GDP growth was 3% and averaged 3½% on an annual basis. The sluggish Q4 growth is attributable to a number of special factors and should therefore not be interpreted as ushering in a lasting economic slowdown in the United States.[3] In addition, the available leading indicators are pointing to a continuation of the strong upswing in 2006. For one thing, real private consumption grew relatively weakly in 2005 Q4, at a seasonally adjusted ¼%, owing to a drop-off in car sales following a third quarter in which special offers had driven sales up. The saving ratio, which had fallen to -1¾% in the preceding quarter, went up to -½%; even so, the average for the year, at -½%, represented a new low. For another, government consumption fell owing

3 The degree to which total output for the fourth quarter was dented by the hurricane damage in the late summer is difficult to assess. However, there are many signs that rapid reconstruction in the oil industry considerably offset the production shortfall and that, in fact, Q4 output may have equalled its September 2005 level. This would mean that the region's quarterly GDP growth was diminished only slightly, if at all. The reduced production therefore had a relatively negligible impact on the US economy as a whole because less than 1% of US GDP is generated in the affected region.

to a perceptible decline in defence spending, which is usually quite volatile. In addition, commercial investment growth, at ¾%, failed to meet expectations. In view of muted export growth and a sharp increase in imports, foreign trade reduced real GDP growth by one-quarter percentage point in absolute terms. The rise in imports, however, coincided with a turnaround towards inventory growth, which made a contribution to growth of one-quarter percentage point of GDP.

Owing to the easing of energy markets in the fourth quarter, consumer price inflation receded quite rapidly and distinctly, from 4.7% in September to 3.4% in December. However, due to a renewed surge of oil prices at the beginning of the year, the inflation rate is not likely to continue its fall for the time being. Core inflation picked up slightly, from 2.0% in September to 2.2% in December. By contrast, the personal consumption expenditure (PCE) deflator excluding energy and food, the US Federal Reserve's preferred instrument for analysing prices, was no higher in December (1.9%) than in mid-2005. At the beginning of the year, however, hourly non-farm wages rose somewhat more sharply, which means that domestically generated price pressures could rise.

Japan

In the fourth quarter of 2005, economic growth in Japan rebounded following a distinct slump in the third quarter. Real GDP was up by a seasonally adjusted 1½% on the quarter and 4¼% on the year. Total economic output grew by 2¾% on average for 2005. In the fourth quarter of the previous year, growth was driven mainly by private domestic demand, which was up by a seasonally adjusted 1% on the quarter. Private consumption rose by ¾%, contributing ½ percentage point of GDP to growth. The improvement in the labour market did much to increase households' propensity to buy. In addition, nominal wages have continued to rise, and year-end bonuses paid by companies were much higher than a year earlier. Private gross fixed capital formation likewise rose visibly. Real exports grew by a seasonally adjusted 3%. With imports down by 1¼%, foreign trade made a contribution to growth of one-half percentage point. In the last quarter, consumer prices again fell a bit more sharply on the year, by 0.5%, due mainly to falling food prices. If this group of goods is excluded, prices remained virtually unchanged.

United Kingdom

In the last quarter of 2005, real GDP in the United Kingdom, according to initial estimates and after adjustment for seasonal and working-day variations, was up by just over ½% on the period, following just under ½% a period earlier. Overall output was up by 1¾% on average for the year, representing the weakest increase since 1992. Sectoral trends remained uneven in 2005 Q4, too. The production of services rose sharply in the final quarter, at just under 1% in seasonally adjusted terms, whereas output in the production sector (excluding construction) fell by ½%. Since 2000, the services sector has grown by 16%, yet the production sector has shrunk by 5½%. Available information on demand aggregates is only sketchy thus far. What is known is that seasonally adjusted real retail sales rose rather sharply in the fourth quarter (+1½%) after having gone up only slightly in the preceding quarters. Property prices, having virtually stagnated in the second quarter, resumed their rise in the second half of the year. Consumer price inflation – measured in terms of the Consumer Price Index (CPI) – went down from 2.5% in September to 1.9% in December as a result of the easing in the energy markets. During that period, core inflation fell by 0.2 percentage point to 1.4%.

New EU member states

The new EU member states maintained their impressive growth in the fourth quarter of 2005. In the October-December period, industrial production grew by a seasonally adjusted 3¼% compared to the third quarter and by 9% on the year. Growth for 2005 as a whole, at 5¼%, remained well below year-on-year growth; this was attributable mainly to the slowdown in growth in the second half of 2004. The sharp rise in production also spurred employment growth, leading to a more pronounced decline in unemployment. The standardised unemployment rate, at a seasonally adjusted 13.0% in December, was around one percentage point less than at the end of 2004. Prices in the new member states calmed distinctly over the course of the fourth quarter. Year-on-year consumer price inflation fell from its last high in October by ½ percentage point to 2.0% in December. The inflation rate averaged 2.5% for 2005, with considerable differences between individual countries.

Macroeconomic trends in the euro area

GDP growth in 2005 Q4

According to initial Eurostat estimates, seasonally adjusted growth in the euro area in the fourth quarter failed to reach third-quarter levels; real GDP was up by ¼% on the period, compared with just over ½% in the third quarter. GDP growth was up by 1¼% on the year. The annual average growth rate likewise stood at 1¼%. Momentum seems to have picked up at the beginning of the year, though. According to the European Commission's short-term forecast, overall output growth will lie in the range of 0.4% to 0.8% for the first quarter of 2006. In addition, the Consensus Forecast predictions for the euro area for 2006 have been adjusted upwards since December, by an average of one-quarter percentage point to just under 2%.

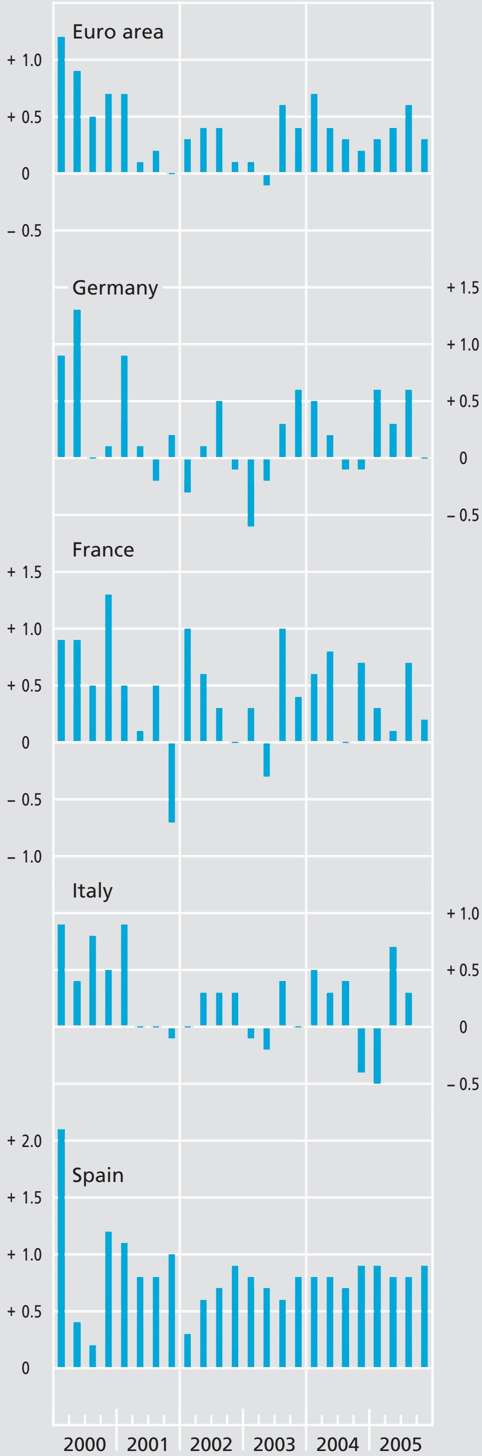
Industrial activity

Seen from the output side, the slower growth in the last quarter of the year was due in part to weaker growth in industrial production, which in the October-December period averaged a seasonally adjusted ½% on the quarter following 1% growth in the third quarter. However, in the fourth quarter of 2005 and the beginning of 2006 the underlying trend in industrial activity was clearly growing, a finding which is backed up by a host of indicators. As a case in point, industrial capacity utilisation saw a noticeable rise between October and January; at the end of the reporting period, it was nearly as high as a year earlier.

New orders seem to be indicating a similar trend; in the October-November period they were up by a seasonally adjusted 3% from an already high third-quarter level. Orders were up in terms of value by 6¾% on the year; however, this result was influenced by large orders, especially for transport equipment.

Growth trends in the euro area

Seasonally adjusted, quarterly percentage change



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Export business appears to have been particularly brisk: according to the quarterly EU survey for October-January, export expectations soared. This is consistent with a continuous improvement in industry confidence in the past few months, which in January reached its highest level since the end of 2004.

Mixed demand developments

On the demand side, households' reluctance to buy seems to have curbed GDP growth in the fourth quarter. After seasonal adjustment, real retail sales were virtually unchanged from third-quarter figures. (Information on the expenditure components of real GDP for the fourth quarter of 2005 is not yet available.) In the meantime, however, private consumption, which has been the Achilles heel of the euro-area economy for some time, is showing increasing signs of a recovery of sorts. For example, consumer confidence in December-January was much higher than in the previous months, though still slightly below its long-term average. Unlike households' purchases, (nominal) exports to non-euro-area countries picked up sharply in October-November, rising by 1¼% on the third quarter and by 9¼% on the year. However, imports rose even more strongly, by a seasonally adjusted 2¾% on the period and 14½% on the year, causing a visible reduction in the trade surplus.

Labour market

The number of unemployed persons in the euro area continued to fall in the fourth quarter of 2005. According to provisional Eurostat figures, the average number of persons without work in the fourth quarter stood at a seasonally adjusted 12.20 million. This represents a reduction by 5% on the year. The standardised unemployment rate fell to 8.3%, having been 8.8% a year earlier. Labour market developments were particularly favourable in Spain, France and Italy. In some smaller economies (Austria and the Netherlands, for instance), however, underemployment increased somewhat. At present, the standardised figures for Germany are virtually impossible to interpret in economic terms on account of the breaks in the seasonal patterns. Euro-area labour costs were up by 2¼% in the third quarter, the last quarter up to which statistics are available, compared with 2½% in the second.

Consumer prices in 2005 Q4 ...

Consumer price inflation slowed down to a seasonally adjusted ½% in the final quarter of 2005. This translates to an annualised rate of 2%. Because of stronger inflation in the preceding periods, the year-on-year rate remained unchanged at 2.3%. The much weaker period-on-period increase in energy prices of 0.4%, following 4.5% and 5.6% in the second and third quarters respectively, were key in curbing inflation. Unprocessed food prices, by contrast, picked up again slightly after falling somewhat in the third quarter.

Excluding energy and unprocessed food, quarter-on-quarter inflation rose to ½%. Although core inflation stood only at 1.5% on the year, it was still somewhat higher than in the second and third quarters of 2005. Whereas services price inflation tailed off slightly, the prices of industrial goods excluding energy went back up more sharply for the first time in a relatively long period of time.

Euro-area consumer prices

Annual percentage change

Item	2005 Q1	Q2	Q3	Q4
HICP, total	2.0	2.0	2.3	2.3
of which				
Energy	7.6	8.8	12.7	11.1
Unprocessed food	0.5	0.8	0.8	1.4
HICP excluding energy and unprocessed food	1.7	1.5	1.4	1.5
of which				
Industrial goods	0.3	0.3	0.1	0.4
Services	2.4	2.3	2.2	2.1
Processed food	2.4	1.6	1.8	2.2

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The prices for processed food, too, rose more sharply than earlier.

... and on average for 2005

For 2005 as a whole, euro-area consumer prices rose by an average of 2.2% – as in 2004. The relatively high rate of inflation was influenced mainly by the sharp rise in oil prices in international markets, which caused energy prices to soar by 10% on the year. Price trends in 2004, by contrast, were shaped in large part by administered price increases. Energy accounted for only slightly less than 9% of the HICP basket but two-fifths of the past year's inflation. Excluding energy and unprocessed food, inflation stood only at 1.5%. Owing to the non-stop rise in energy prices, however, the core rate seems, if anything, to be understating the current underlying trend in consumer prices.

Initial estimate for January 2006

In January 2006, for which results for individual euro-area countries are already available, inflation has picked up slightly according to Eurostat estimates. The annual HICP inflation rate, at 2.4%, was two-tenths of a percentage point up on the month.