

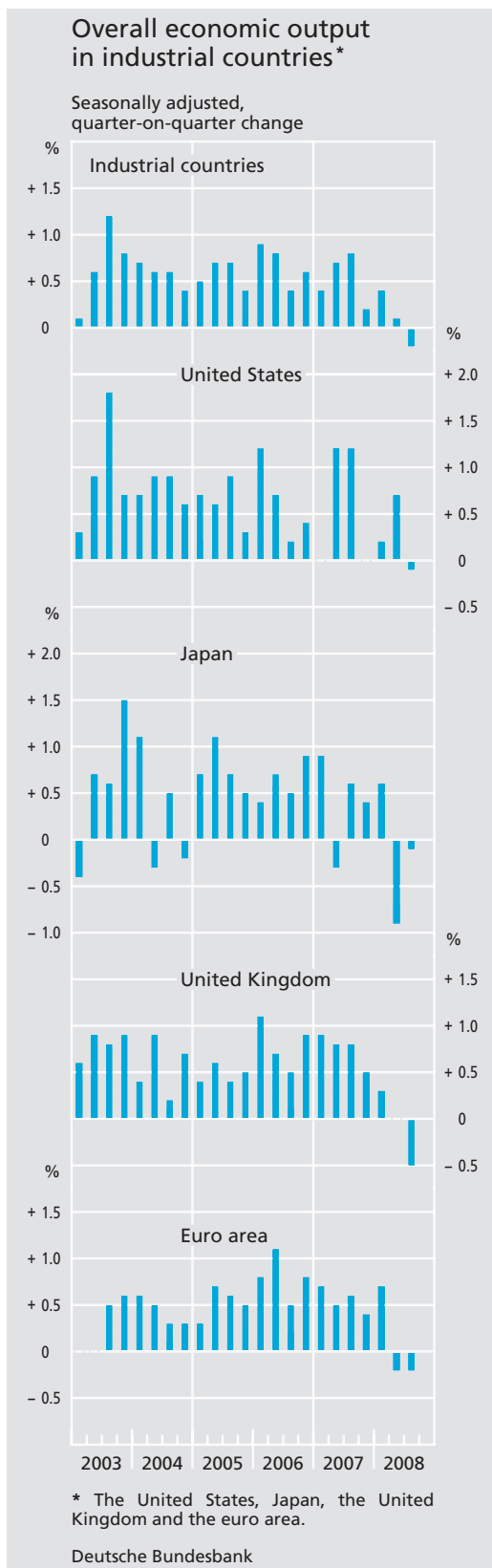
Global and European setting

World economic activity

The crisis of confidence in the financial markets has intensified even further since mid-September. The heart of the crisis was again in the United States, where the upheaval had begun last year following the collapse of the sub-prime mortgage market. Consequently, the outlook for the world economy has continued to deteriorate significantly; as 2008 draws to a close, it is worse than it has been in a long time. Of the various transmission channels via which the disruptions to the financial system are passed on to the real economy, the tightening of financing conditions for enterprises and households and negative wealth effects seem to be the most significant. Expectations in the private sector have now also deteriorated sharply.

World economy in the throes of the financial crisis

The negative effects on the goods and income cycle, which are not expected to become fully apparent until next year, are still mainly being felt in the industrial countries, some of which are now on the brink of a recession. The fact that price pressure on the commodity markets – and consequently also at the consumer level – has eased considerably in the past few months provided some relief. This has made it easier for central banks, above all in the industrial countries, to cut interest rates significantly and further broaden their use of liquidity policy instruments. Extensive government measures for recapitalising the ailing banking system have now been taken and coordinating agreements have been made at the euro-area and international levels.



In recent months, emerging market economies, including some central and eastern European countries, have been more severely affected by the events unfolding on the financial markets. Stock market prices have fallen dramatically, interest rate premiums – even for government bonds – have risen significantly and the currencies of many emerging market economies faced downward pressure owing to capital outflows. In addition, the looming marked deceleration of exports from the emerging market economies to industrial countries and, in many cases, the substantial cyclically induced adjustment in the prices of crude oil and other commodities are increasingly having a negative impact.

As early as the summer – before the most recent intensification of the financial crisis – the slackening effects on the global economy had gained the upper hand. These were caused, first, by earlier financial sector malfunctions and the severe pressure to adjust in real estate markets in the USA and some European countries. Second, global inflation, which had initially continued to accelerate from mid-year onwards, dampened global growth in two ways: through the loss of consumers' purchasing power and concerns about a sustained fall in future real income. Against this backdrop, some central banks, particularly in the emerging market economies, raised interest rates in order to counteract the considerable increase in price pressures and unfavourable inflation expectations. However, real interest rates remained relatively low – in some cases, they were even negative.

Significant slackening effects in Q3 ...

... with significant dampening effects in the industrial countries ...

In the industrial countries, economic activity slowed quite substantially in the third quarter. Real gross domestic product (GDP) declined somewhat in the United States following a sharp rise – driven by the extensive stimulus package and foreign trade – in the spring. In Japan, economic activity remained on a downward course. The British economy contracted for the first time since the early 1990s. Growth in the euro area was likewise down on the depressed level of the preceding quarter. In the third quarter, real GDP in the industrial countries overall fell to ¼% below its level in the second quarter, in which it had grown somewhat. However, it was up by only ½% on the level of the third quarter of 2007.

... and a more subdued momentum in the EMEs

Together with the – in some cases – considerable inflation-related real income losses, the negative trend in the developed economies also further dampened the pace of growth in the emerging market economies (EMEs). However, year-on-year growth in overall output is still likely to have been rather high. In most emerging market economies in south and east Asia, industrial activity in particular became noticeably more subdued from mid-year onwards. This is especially true of India, Taiwan, Hong Kong and Singapore. In the case of China, the scaling back or suspension of production by many industrial firms near sporting venues – above all, in and around Beijing – during the Olympic Games in order to improve the air quality was also significant. Year-on-year GDP growth fell by 1 percentage point to 9% compared with the second quarter. Private consumption was a major mainstay of economic growth and was boosted by the decline in inflation (4.0% in Octo-

ber, compared with 7.1% in June). For the current quarter, there are indications of a further slowdown owing primarily to the weaker trend in export demand.

In Latin America, the economic picture became less uniform in the summer months. Seasonally adjusted industrial output in Brazil grew again perceptibly (+2¾%) from its level of the second quarter and was up by 6¾% on the year. By contrast, the economic situation in Mexico deteriorated further from mid-year onwards. This can be explained largely by reduced exports of goods to the United States and the downward trend in workers' remittances, which has been evident for some time. In addition, unlike in other emerging market economies, consumer price inflation has not fallen in recent months; at 5.8%, the rate in October was even higher than in the June-July period. In many Latin American countries, the retarding effects are likely to continue to gain strength in the fourth quarter owing mainly to a significant reduction in receipts from commodity exports and the further tightening of lending conditions.

Around mid-year, the economies of the Commonwealth of Independent States (CIS) were still growing at a rapid pace. Subsequently, however, the negative effects of the financial crisis on the real economy became increasingly apparent, primarily in Russia and Ukraine, the two countries that were hit hardest. In Russia, the year-on-year rise in car sales has now slowed considerably owing to more difficult loan financing and a loss of consumer confidence. Furthermore, persistently high in-

flation (14.2% in October) continued to place a strain on households' real income. Economic activity in the Caucasus was additionally impaired by the Georgian conflict and the resulting blockade of ports on the Black Sea. For the current quarter, there are increasing signs that economic growth in the CIS will weaken again perceptibly in the wake of the financial crisis and falling revenue from exports of energy sources and other commodities.

*Revised IMF
autumn
forecast*

In November, the International Monetary Fund (IMF) again significantly lowered its global growth projection; compared with the beginning of October, the projection for 2008 was down 0.2 percentage point to 3.7% and that for 2009 was down 0.8 percentage point to 2.2%. The forecast for the advanced economies was down by around the same amount to 1.4% for 2008 and -0.3% for 2009. In its updated autumn forecast, the IMF expects GDP to fall by 0.7% in the USA and by 0.5% in the euro area. For the United Kingdom, a decline of as much as 1.3% is predicted. In the case of Japan, the IMF now estimates that overall economic output will decrease by 0.2%. Of the G7 states, only Canada is expected to experience marginal growth (+0.3%).

The forecast for the emerging market economies and the developing countries was lowered by 0.3 percentage point to 6.6% for 2008 and by 1 percentage point to 5.1% for 2009. This reflects below-average corrections for the south and east Asian emerging market economies and Latin America, while the projections for the African countries and the

Commonwealth of Independent States were reduced comparatively sharply. The IMF predicts that, at 3.5%, growth in Russia in 2009 will be 2 percentage points lower than previously forecast. In the central and east European countries – most of which are members of the European Union – the pace of growth is expected to slow from 5.7% in 2007 to 4.2% this year and 2.5% in the next. The forecast for world trade growth in 2009 was lowered dramatically by 2 percentage points to 2.1%. Consumer price inflation in the advanced economies as well as in the bloc of emerging market economies and developing countries is expected to weaken by well over 2 percentage points in 2009 to 1.4% and 7.1%, respectively. The IMF forecasts a preponderance of downside risks, the most significant of which will originate in the financial markets.

The global improvement in the outlook for prices is intrinsically linked to the decline in commodity prices, which began around mid-year and has continued throughout the reporting period. Following the peak in July (US\$146½), the price of Brent crude oil fell by almost two-thirds to US\$53¾ in mid-November. In euro terms, the decrease was somewhat smaller (-54%) owing to depreciation. The decline in crude oil prices was not steady and was interrupted in mid-September, mainly because considerable hurricane damage temporarily impaired oil production in the Gulf of Mexico. From the beginning of October, when fears of a recession increased significantly, oil prices again began to decline more dramatically; OPEC's decision at the end of October to cut production quotas failed to

*Falling
commodity
prices ...*

bring the decline to a halt. The fall in prices for industrial raw materials also gained pace from the beginning of October; they were just over one-third lower in mid-November than in July. Prices for food, drinks and tobacco traded on the world markets went down by a similar amount during this period.

... impacting favourably on consumer prices

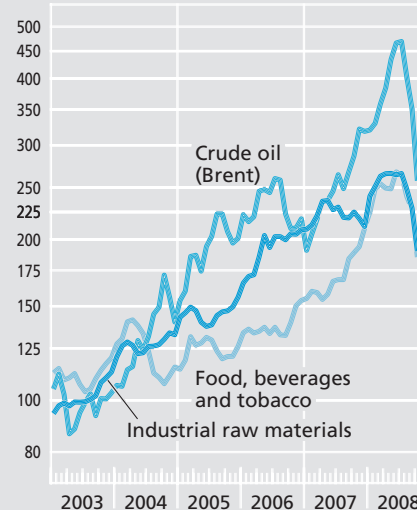
Owing to the decline in prices for crude oil and other commodities, price pressures have eased perceptibly over the past few months; seasonally adjusted consumer prices have fallen again moderately following a sharp rise in the May-July period. The annual rate of inflation in the industrial countries decreased from 4.6% in July to 4.3% in September. A further decline seems likely for October and November. However, core inflation (excluding energy and food), at 2.3% in September compared with 2.4% in August, barely budged.

United States

Shortly after mid-year, it became apparent that the stimulus package launched by the US government in the spring had not succeeded in bringing lasting stability to the US economy. According to the initial estimate, real GDP in the third quarter fell marginally after seasonal adjustment compared with the second quarter, in which it had grown robustly. It rose by just $\frac{3}{4}\%$ on the year. The weak outcome was mainly attributable to the fact that real private consumption contracted for the first time since 1991. This was due, first, to the fact that the available nominal income was 1% below the second-quarter level, which had been boosted considerably by tax refunds. The sustained fall in employment also played a role in this respect. From June to

World market prices for crude oil and industrial raw materials as well as food, beverages and tobacco

US dollar basis, 2000 = 100, log scale



Sources: Thomson Financial Datastream and HWWI. — As at ● = 14 November 2008; 17 November 2008 (crude oil).

Deutsche Bundesbank

October, the number of (non-farm) jobs declined by around 720,000 ($\frac{1}{2}\%$) after seasonal adjustment. The unemployment rate increased by 1 percentage point to 6.5%. Furthermore, households faced further losses in purchasing power from mid-year onwards as a result of the sharp rise in energy and food prices. Although the household saving ratio, which had increased considerably to 2.7% in the second quarter owing to tax refunds granted as part of the US government's stimulus package, decreased again significantly as expected, it remained, at 1.3%, considerably higher than in the final quarter of 2007 and the first quarter of 2008.

In addition, residential construction investment, which declined by a seasonally adjusted $5\frac{1}{4}\%$, had a detrimental effect on overall

economic output. It was more than 40% lower than the peak at the end of 2005. Commercial spending on new plant and equipment and buildings was cut by ¼%. By contrast, a sharp increase in real government expenditure and a deceleration in the depletion of inventories helped to boost domestic demand. The decline in domestic demand coincided with a further reduction of imports. However, exports remained on an upward curve in the third quarter; foreign trade thus contributed ¼ percentage point to growth overall.

In the third quarter, the annual rate of inflation increased by just under 1 percentage point to 5.3%. It reached a cyclical peak of 5.6% in July and declined over the following months to 4.9% in September owing to falling crude oil prices. Excluding energy and food, inflation stood at 2.5% as this report went to press. The core Personal Consumption Expenditure deflator, the US Federal Reserve's preferred measure of inflation in its price analyses, decreased to 2.4%.

Japan

The Japanese economy contracted again – albeit marginally – in the third quarter after seasonal adjustment following a considerable decline in the second quarter (-1%). Real GDP was likewise down somewhat on the year. The weak outcome was primarily attributable to a sustained reduction in corporate investment of a seasonally adjusted 1¾% compared with the second quarter. Somewhat more buoyant private consumption, a significant increase in housing construction and higher government investment expenditure sustained domestic demand at the level of

the previous quarter. In price-adjusted terms, foreign trade had a marked negative impact of ¼% of GDP. Although exports still grew by ¾% in price-adjusted terms, this was offset by a sharp increase of 2% in real imports, which is hardly consistent with the picture of stagnating domestic activity. Seasonally adjusted consumer prices declined slightly in August and September in the wake of falling crude oil prices. The former were up 2.1% on the year at the end of the reporting period, compared with 2.3% in July. Excluding energy and food, the prices were only 0.2% higher than in September 2007.

In the summer, overall output in the United Kingdom fell quarter-on-quarter (by ½%) for the first time since spring 1992. In year-on-year terms, there was an increase of only ¼%. The decline in GDP was caused by negative developments in all major sectors of the economy. Manufacturing output (excluding construction) decreased by 1%, construction contracted by ¾% and real value added in the services sector fell by ½%, although an even larger decline in private services segments was offset by a slight increase in the public sector. The most noteworthy development is that, on the demand side, private consumption – which has been the main driving force behind growth in recent years – no longer had a positive effect. On a third-quarter average, real retail sales stagnated at the level of the second quarter. The low propensity to purchase is probably connected, among other things, with the sharp increase in unemployment over the past few months. In addition, consumer price pressure continued unabated until September; at 5.2%,

*United
Kingdom*

the annual rate of inflation even marked a new high this year. This can be explained largely by sharp rises in gas and electricity prices. In October, however, the rate of inflation fell back down to 4.5% owing to the significant decline in crude oil prices. Since mid-year, seasonally adjusted house prices have decreased by no less than 6¾% and were 15% lower than a year earlier as this report went to press.

*New EU
member states*

The new EU member states continued to lose economic momentum in the third quarter. Industry was affected particularly severely, with a reduction of 2¾% in output. Year-on-year growth was only 1¼%. Latvia (-7½%) and Estonia (-4%) are at the bottom end of the ranking, while Poland and Slovakia still experienced relatively strong growth (2½% and 2¾%, respectively). Industrial activity in the new EU member states was dampened by a decline in export growth. In addition, the inflation-related losses in purchasing power increased from mid-year onwards. Inflation peaked at 7.1% in July and subsequently fell to 5.9% in October. Despite the cyclical downturn, however, the unemployment rate decreased again marginally to 6.3% on average over the July-September three-month period. In recent weeks, some new EU countries have increasingly been sucked into the undertow created by the international financial crisis. Those countries with very high structural current account deficits, low foreign reserves and a requirement for large inflows of funds from abroad in the short term have proven particularly vulnerable in this respect.

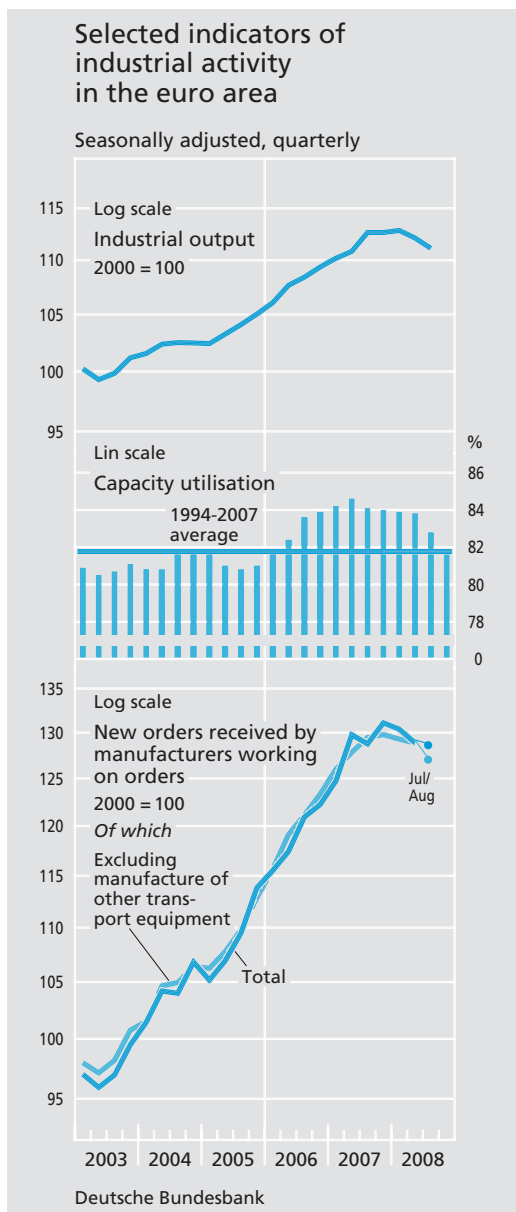
Macroeconomic trends in the euro area

In the third quarter, real GDP in the euro area was a seasonally adjusted ¼% lower than in the second quarter, in which it had already declined owing, in part, to special factors. In the summer months, year-on-year growth was only ¾%. The negative developments in the euro area were caused by considerable reductions in output in Germany, Italy and, to a lesser extent, Spain, while France and most of the smaller countries that have already published initial GDP estimates still managed to record minimal growth. The frontrunners were Cyprus and Greece with a rise in overall output of a seasonally adjusted ½%.

*Further output
reductions
in Q3*

The decline in GDP in the euro area is – as with the reduction in the second quarter, which is partly due to technical issues – largely attributable to the downward trend in manufacturing. Industrial output in the third quarter was down 1% on the quarter and 1½% on the year after seasonal adjustment. Only energy production continued to grow, while the output of intermediate goods and the manufacture of capital goods and consumer goods contracted significantly. The decline in industrial output coincided with a reduction of 1¼ percentage points in capacity utilisation from July to October, meaning that the latter fell below its long-term average for the first time since the beginning of 2006. In October, the Purchasing Managers' Index for industry in the euro area even dropped to its lowest level since the start of the series in 1997. The negative development in new orders is also consistent with the gloomier economic picture. Their value in the July-

*Marked decline
in industrial
activity*



August period was ¼% lower than in the second quarter. Excluding the manufacture of other transport equipment, where orders received are strongly influenced by large orders, they decreased by as much as 1½%. Industrial confidence also deteriorated sharply. The indicator is now as low as it was at the end of 2001, but is still clearly above the historic low of 1993.

The decline in construction output by a seasonally adjusted ¼% in the July-August period from its second-quarter levels indicates that construction investment in the third quarter – no data are yet available for the expenditure aggregates – contracted. Investment in new plant and equipment may have fared somewhat better. On the demand side, households' low propensity to purchase also contributed to the decline in real GDP. Seasonally adjusted real retail sales (excluding motor vehicles) barely exceeded the depressed level of the preceding period and were down 1½% on the year. Expenditure on new cars likewise decreased further; in the July-October period, new registrations in the euro area were down 10½% on the year. The year-on-year decline was particularly strong in Spain (-35%) and Italy (-15%). Consumer confidence in the euro area deteriorated again noticeably in October. By contrast, exports to non-euro-area countries, which were 1½% in nominal terms above the second-quarter average in the July-August period, made a positive contribution. However, this was accompanied by significantly stronger growth (+4¾%) in import values. Although import price rises may still have been a significant factor in mid-2008, the volume is also likely to have grown markedly.

Demand indicators mainly pointing downwards

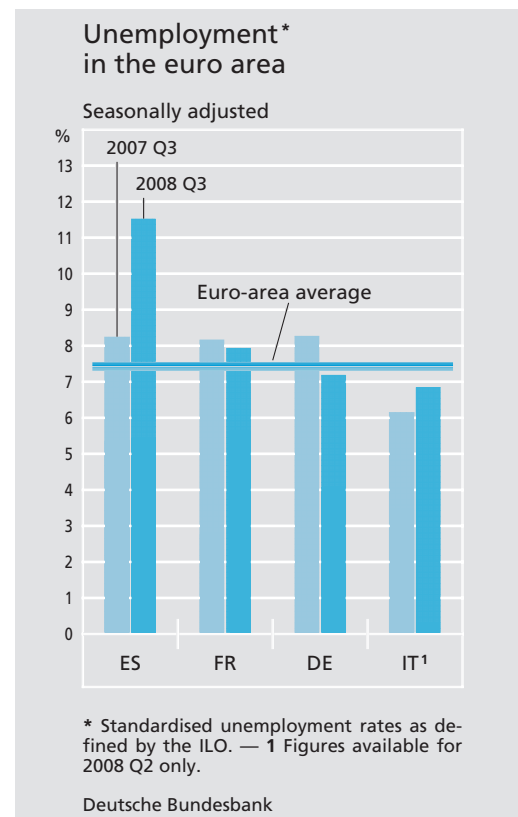
The slowdown in employment growth which began in mid-2007 continued in the first half of 2008 (further information is not yet available). In the second quarter, the number of employed persons was up by only 0.2% on the quarter, with year-on-year growth contracting to 1.2%. The seasonally adjusted unemployment rate increased to 7.5% in the

Labour market showing signs of weakness

third quarter owing to the weakened economic performance; at the beginning of the year, it still stood at 7.2%. This was mainly attributable to the sharp rise in underemployment in Spain, where the corresponding rate rose by more than 2 percentage points to 11.5%. In Ireland, too, the labour market situation deteriorated significantly. By contrast, other countries, including Germany, the Netherlands and Austria, saw marginal declines. According to initial estimates, which are often revised upwards, seasonally adjusted hourly labour costs increased by 0.6% in the second quarter and were up by 2.7% on the year. At 3.1%, the rise in the first half of 2008 was considerably sharper than it was previously.

Price pressure easing

Consumer price inflation in the euro area eased again in the third quarter of 2008. On a quarterly average, prices were up by a seasonally adjusted 0.7% on the second quarter, when they had risen by 1.1%. The increase in year-on-year inflation from 3.6% in the second quarter to 3.8% in the third is also connected with base effects resulting from moderate price developments in the same period last year. The improvement in the overall picture was overwhelmingly driven by the stabilisation of the international oil markets, which led energy prices to go down by more



than 2% over the summer months. Among the other categories of goods, by contrast, there was no relief on average. Excluding energy, consumer prices in the third quarter rose by a seasonally adjusted 0.6% and thus somewhat more robustly than in the second quarter. Since the beginning of 2008, year-on-year growth has remained unchanged at 2.6%. In October, consumer prices fell by a seasonally adjusted 0.1%, with the annual rate of inflation declining to 3.2%.