

■ Global and European setting

■ World economic activity

*World economy
still treading
water in
summer*

The global economic slowdown, which had begun in 2011 and was interrupted in the first quarter of 2012 only by a brief revival, continued in the third quarter. It remains regionally broad based. Although the focal point of the current economic weakness is still the crisis in the euro area, aggregate growth also remained subdued in the major emerging economies, including China, during the summer months. The slow growth in this group of countries compared to earlier expansion rates can be attributed only in part to specific causes in the euro area; rather, it is connected to internal factors to a considerable extent (see the box on pages 11 to 14). The Japanese economy, which after a powerful start to the year lost a considerable amount of steam in the spring, even contracted sharply in the third quarter. In this highly unfavourable environment, the United States once again proved to be a bulwark for the world economy, with continuing moderate growth in gross domestic product (GDP). The UK economy has managed to come out of recession, even though its latest growth spurt is probably largely the result of one-off effects. On the whole, seasonally adjusted real GDP in the United States, Japan, the United Kingdom and the euro area has gone up only slightly compared with the previous period, according to calculations based on initial preliminary data, and was a mere $\frac{3}{4}\%$ up on the year.

Global GDP growth, too, is likely to have persisted throughout the summer, though still throttled. One indication of this is that, in July-August, seasonally adjusted global industrial output rose by $\frac{1}{2}\%$ compared with the spring quarter. At the same time, however, the volume of real world trade fell by $\frac{1}{2}\%$. All in all, for several quarters now, global growth does not appear to have been keeping pace with potential output any longer; utilisation is therefore likely to have already fallen distinctly.

For the last quarter of 2012 and the first quarter of 2013, the global economy is expected to improve only slightly. Growth is likely to be bolstered mainly by considerably looser monetary policy, which the emerging economies have now also adopted. In line with a gradual improvement of the global cyclical outlook, the Purchasing Managers' Index (PMI) for the manufacturing industry went up markedly again in September and October, distinctly approaching the expansion threshold. Moreover, the oil markets do not appear to be imposing any additional burdens, at least. However, a cyclical upturn in the world economy is dependent on the swift achievement of clarity in the United States with regard to the country's future path of consolidation.

Given the stubbornness of the global economic slowdown and the unclear nature of the signs of recovery, in October the International Monetary Fund (IMF) once again revised downwards its global growth forecast for 2012 and 2013, by $\frac{1}{4}$ percentage point to $3\frac{1}{4}\%$ and $3\frac{1}{2}\%$ respectively compared with its last forecast of early July; the first preliminary estimate for 2012 in the spring of last year had still been $+4\frac{1}{2}\%$. According to the new forecast by the IMF, the advanced economies' real GDP will rise in 2013 by $1\frac{1}{2}\%$, only a slight improvement on this year ($+1\frac{1}{4}\%$). This is predicated on the expectation that US GDP will continue to grow by just over 2% whereas the euro area, after a nearly $\frac{1}{2}\%$ decline, will see GDP grow by only $\frac{1}{4}\%$ and the Japanese growth rate will shrink by nearly one-half to $1\frac{1}{4}\%$. The forecast states that the emerging economies' growth in 2013, at $5\frac{1}{2}\%$, will likewise not be much stronger than in the current year. The forecast for global trade growth was also revised downwards by more than one-half percentage point for each year to $3\frac{1}{4}\%$ this year and $4\frac{1}{2}\%$ next year. The price forecast for the industrial countries was virtually confirmed, at 2% and $1\frac{1}{2}\%$ respectively.

*Probably only
slight improve-
ment in 2012
Q4-2013 Q1
period*

*IMF autumn
forecast ad-
justed down-
wards further*

Impact of weak euro-area demand on the global economy

The macroeconomic problems in the euro area are usually seen as the major driving force behind the current lull in the global economy in general and the economic slowdown in the emerging market economies (EMEs) in particular. Weak demand from the euro area is said to be having a dampening effect on output elsewhere, especially via the direct foreign trade channel. In actual fact, one aspect or reflection of the necessary adjustment processes in the European peripheral countries is the reduction of their domestic demand from past levels which, owing to unsustainable macroeconomic developments, were excessive.¹ A contraction in domestic demand also results in a decline in imports. On the one hand, this cushions the fall in domestic GDP as imports represent an outflow of income. At the same time, however, the negative growth momentum spills over to the foreign trading partners in the form of dwindling exports. An important part of these adjustments occurs in intra-euro-area trade without directly affecting non-euro-area countries. The German export sector, in particular, has already suffered markedly, however.² In the remainder of this box, we will investigate the quantitative importance of weak export demand in the euro area for the global economy and economic activity in the EMEs.

The analysis is based on the IMF's Direction of Trade Statistics (DOTS). These statistics can be used to trace the nominal trade flows of goods (on a US dollar basis) between the individual countries and regions. Given that the figures are quoted in nominal terms, fluctuations in the data should be interpreted with caution as they may also reflect shifts in prices and exchange rates. A comparison with nominal GDP in

US dollar terms, however, which can be found in the IMF's current World Economic Outlook (WEO) database, makes the size of the relevant trade flows clear. According to data from the DOTS database, the euro area imported US\$2,340 billion worth of goods from non-euro-area countries last year (calculated on the basis of the exports from these countries), which is equivalent to around 18% of euro-area GDP. In the period from January to June 2012 – more recent DOTS data were not available as this report went to press – the value of imports decreased by 4% on the previous year. This decline is still likely to have made an implied contribution to nominal GDP growth in the euro area of $\frac{3}{4}$ percentage point over the year as a whole. A further factor to be considered is that the economic momentum stems not so much from the contribution of nominal imports to growth itself but rather from its development over time. Given that the growth contribution of nominal imports has gone from being strongly negative to being slightly positive, nominal imports of goods are likely to soften the economic downturn in the euro area perceptibly.

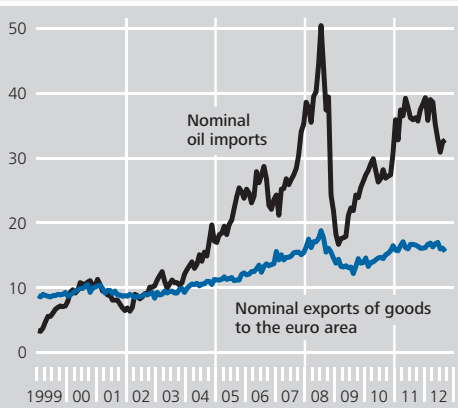
Conversely, the lower income outflows from the euro area mean lower income inflows to the rest of the world. Nevertheless, a shift in the trade flows is occurring as the economic output of non-euro-area countries is several times greater than that of the euro area. For example, nominal exports of goods to the euro area accounted for just 4% of GDP of the rest of the world in 2011,

¹ See Deutsche Bundesbank, On the problems of macroeconomic imbalances in the euro area, Monthly Report, July 2010, pp 17-38.

² See Deutsche Bundesbank, The pronounced rise and fall in Germany's current account surplus vis-à-vis its euro-area partner countries between 1999 and 2011, Monthly Report, March 2012, pp 18-20.

Factors weighing on the US economy

US\$ billion, seasonally adjusted, monthly



Source: Global Insight.
 Deutsche Bundesbank

and thus their muted decline this year had virtually no effect on the nominal growth in activity in the supplier countries. It should be noted, however, that the importance of goods exports to the euro area is likely to vary quite a bit among individual exporting countries and regions. In the case of EMEs and developing countries, their share of GDP, at 5%, is significantly higher than in the advanced economies outside the euro area (3½%). Nevertheless, the metric for the industrial countries is being depressed by the USA, whose goods exports to the euro area account for no more than 1¼% of GDP.³ Moreover, given that US exports have remained relatively stable in 2012, too, their contribution to the nominal income growth of the US economy is virtually zero. Against this backdrop, the often-cited claim that weak demand in the euro area is weighing heavily on the US economy, at least via the direct foreign trade channel, does not appear to hold water. By contrast, according to national data, the value of oil imports for the US economy is twice as significant as that of goods exports to the euro area. Moreover, given that the value of imports is subject to the sharp fluctuations in the price of crude oil, it is more likely to be a driving force behind a sudden change of

economic pace than exports, which are comparatively steady.⁴

Exports of goods from emerging and developing economies to the euro area are not particularly significant, accounting for just 5% of nominal GDP. However, given that these goods exports made positive contributions to growth of around 1 percentage point in the preceding years, the removal of this stimulus would, in and of itself, give rise to a marked slowdown in economic activity. Compared with the IMF estimate of a deceleration of over 10 percentage points this year in nominal GDP growth in emerging and developing economies, the effect is small, however, which means that, taken in isolation, it does not provide an adequate explanation.⁵ Nevertheless, the heterogeneity within the group of countries should also be borne in mind in this context. The weak euro-area demand is likely to have primarily hit central and east European countries, whose exports of goods to the euro area accounted for 15% of GDP last year. On the other hand, the external trade links between the euro area and the major emerging market economies (Brazil, India and China) play only a minor role: in Brazil and India, the share of GDP accounted for by goods exports to the euro area stood at 1¾% and 2¼% respectively in 2011 and was thus far below the average of the entire emerging and developing world

³ Excluding the USA, nominal exports of goods to the euro area by the other advanced economies accounted for 5¼% of GDP in 2011.

⁴ See Deutsche Bundesbank, The price of crude oil and its impact on economic activity in the industrial countries, Monthly Report, June 2012, pp 27-49.

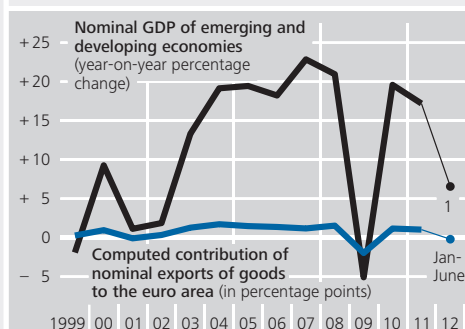
⁵ Nominal GDP growth in the emerging and developing world (in US dollar terms) is largely determined on the basis of price and exchange rate fluctuations. The only relevant factor here is the computed nominal contribution to growth made by exports of goods to the euro area, compared with exports to non-euro-area countries, imports and domestic demand. Owing to the low weight of nominal exports of goods to the euro area, their contribution to growth must also be comparatively limited.

put together. Even for China, itself a comparatively open economy, these exports made up just 3¾% of GDP. The current lull in economic growth in Brazil and India is particularly pronounced: according to the recent IMF forecasts, real GDP growth this year is expected to be 6 percentage points lower in Brazil and 5¼ percentage points lower in India than in 2010, a year of very dynamic growth. The average annual rate in the period from 2004 to 2007 will also be undershot by 3¼ and 4¼ percentage points respectively. As for China, the deceleration compared with 2010 is expected to be somewhat more moderate (2½ percentage points), although of a similar magnitude (4¼ percentage points) when compared with the trend rate in the previous period of expansion. Given the sizes of the economies involved, economic slowdowns of this magnitude are likely to be due less to the limited dampening impulses from trade with the euro area than to specific domestic factors.

Furthermore, the current thinking has implied that the cause of the downturn in exports to the euro area lies in Europe alone. However, the export slump is probably also due, at least in part, to a global economic slowdown. This is supported by the fact that the DOTS data also indicate a marked downturn in nominal goods exports by emerging markets to other advanced economies as well as in exports within their own group of countries. Generally speaking, developments in the growth rates of nominal goods exports to various regions are largely synchronous. The same findings are also obtained if data on the total exports of goods are considered in real terms on the basis of the region of origin, as they are estimated in the statistics of the Dutch Centraal Planbureau (CPB).⁶ Thus, it is not just the growth in the overall exports of goods in emerging and developing economies

Importance of exports of goods to the euro area for emerging and developing economies

Annual averages, US dollar basis



Source: IMF and Bundesbank calculations. **1** IMF forecast (WEO October 2012).
 Deutsche Bundesbank

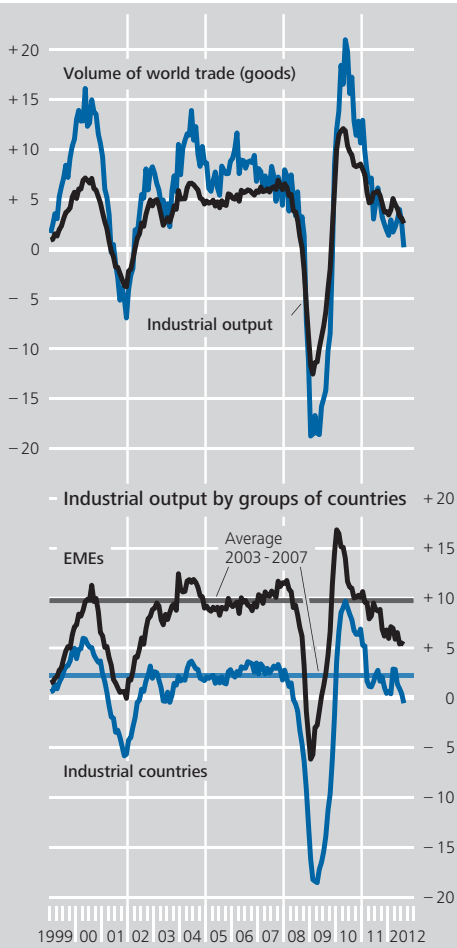
(measured in terms of volume) that has recently ground to a virtual halt, but also the growth in exports of industrial countries in general and of the euro area in particular.

In actual fact, the underlying trend in world trade does not seem to be overly dependent on the fortunes of individual regions. Rather, it moves in line – albeit with somewhat stronger cyclical fluctuations – with the ups and downs in the global industrial sector, where tradable goods are produced. The current slowdown in the international goods trade therefore reflects the downturn in the global manufacturing industry, where the economic cycles are generally much more pronounced and frequent than in the economy as a whole. Owing to the international foreign trade interlinkages, it is hardly surprising that industrial activity in emerging markets and advanced economies also develops largely in sync. What is striking, however, is that the current slowdown in the catching-up economies is more pronounced. Despite the fact that output growth in industrial countries stagnated

⁶ It should be noted that the CPB's definition of the groups of countries is not entirely consistent with the IMF's definitions.

Volume of world trade and global industrial output

Monthly, year-on-year percentage change



Source: Centraal Planbureau (CPB).
 Deutsche Bundesbank

to stabilising the euro-area economy as a whole. Trade with the euro area plays only a minor role for the rest of the world, however, which means that the global economy is unlikely to have been significantly affected by developments in the euro area. The slowdown in growth in the international flows of goods is closely related to a pronounced slump in the global manufacturing sector and not so much to the specific problems in the euro area. Admittedly, it is possible that these problems did not spill over to non-euro-area countries solely via direct foreign trade, but also via other channels. In this case, though, positive repercussions would also have to be taken into account, such as those caused by capital inflows to “safe havens” outside the euro area. Finally, with regard to the economic significance of uncertainty, which has frequently been emphasised recently, it should be stressed that this is by no means stemming from European sources alone. The dispute regarding fiscal policy in the USA and Japan, along with the geopolitical conflicts in the Middle and Far East, are also giving rise to considerable uncertainty for the world economy at present.

completely of late, whereas it rose by 5¼% in August in the emerging markets compared with the same month last year, the gap between the current rate and the average rates in the previous period of expansion – 2¾% annually and 9¾% in the period from 2003 to 2007 – is now significantly greater in the case of the emerging market economies. A more pertinent question would be to what extent this slowdown could also reflect a deceleration of trend growth in these countries.

All in all, the contraction in goods imports is likely to have made a distinct contribution

Diverging commodity prices

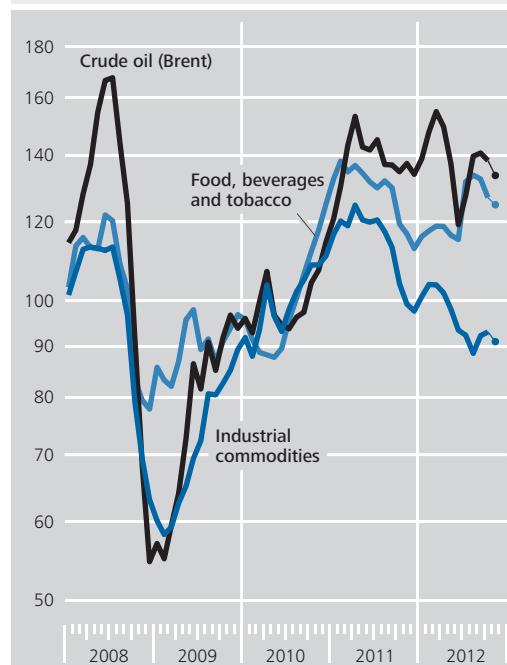
In the summer months, the international commodity markets went along diverging paths. Given the global economic slump, average industrial raw materials prices for the quarter were much cheaper than in the spring. By contrast, the prices for food, beverages and tobacco rose sharply due to a considerable deterioration in the crop prospects owing, not least, to a severe drought in the United States. In contrast to this, the average spot price for a barrel of Brent crude oil was nearly unchanged from the preceding three-month period. However, the quarterly view obscures a sudden reversal at the start of summer of the calming on the oil market which had been becoming apparent during the spring months. In particular, the entry into force of the EU embargo against Iran pushed the geopolitical conflicts in the Middle East more under the spotlight. In addition, global demand for oil continued to increase despite concerns about the economy. The considerable markdowns at which oil futures are currently still being traded could be an indicator of the current scarcity of oil. As this report went to press, Brent was trading at US\$108¼ per barrel, still considerably higher than in June.

Higher fuel prices causing renewed acceleration of consumer prices

Higher oil prices were passed through to consumer prices in the industrial countries with a slight time-lag. In August and September, consumer prices, after elimination of seasonal influences, rose month-on-month, in some cases very strongly. In conjunction with the preceding period of calm, however, average consumer prices for the third quarter were up only slightly from a quarter earlier. Owing to unfavourable developments a year earlier, year-on-year consumer price inflation even fell slightly to 1.8%. Excluding energy and food, consumer prices were up by 1.5% from their level of summer 2011.

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

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



Sources: Thomson Reuters and HWWI. • Average of 1 to 9 November or 1 to 14 November 2012 (crude oil).
 Deutsche Bundesbank

Selected emerging market economies

In China, year-on-year growth of real GDP slackened in the third quarter of 2012 to just under 7½%. The decline in year-on-year rates – for the seventh consecutive quarter – was only slight, however. According to the official seasonally adjusted figures, the statistical quality of which, however, is difficult to assess, quarter-on-quarter GDP growth has even accelerated slightly to +2¼%. A major factor in the year-on-year slowdown is that, in the third quarter, exports lost considerable momentum; their nominal and US dollar-denominated growth rate fell from 10½% to 4½%. Nonetheless, there are signs that the upswing in China has revived in the past few months. Since the spring, the Chinese authorities have taken a series of monetary and fiscal policy measures to stimulate domestic demand forces; these measures might now be showing initial positive ef-

Moderate growth in China continues in summer, but once again positive signals at last report

fects. In September and October, exports were also signalling a distinct recovery, the sustainability of which, however, is not yet clear. As there were no major fluctuations in food prices, which are generally volatile, consumer prices were calm during the reporting period; headline inflation hovered around the 2% mark.

India's economy growing at slower pace

Real year-on-year GDP growth in India slowed down distinctly once again in the second quarter, up to which national accounts data are available, from 5½% to 4%. Although the latest data could well understate the actual growth rate,¹ there is no denying that the Indian economy is currently in the doldrums. The data on industrial output do not indicate any distinct acceleration of growth in the third quarter, either. After a relatively long period without any meaningful gains made with regard to reform, in the past few months the Indian government has once again undertaken major efforts to strengthen the supply-side forces of growth. The federal government is planning to open retail trade to foreign direct investment alongside air transport. However, it remains to be seen what is actually implemented at state level. In addition, the government-controlled price for diesel fuel was raised markedly in order to reduce the large government budget deficit. However, this measure is likely to have contributed to keeping consumer price inflation high in October as well (+9.8%).

Brazilian economic recovery not broad based

Following anaemic growth in the preceding quarters, the Brazilian economy appears to have picked up a higher pace again in the summer. One sign is that industrial output, after trending downwards since mid-2011, went up by a seasonally adjusted 1% on the quarter. This recovery, however, was, above all, supported by motor vehicle manufacturing, which benefited from government fiscal incentives to purchase cars. From mid-2011 to October 2012, the Brazilian central bank cut its policy rate by a total of 525 basis points to 7.25%, marking an all-time low; this could have also had a positive impact. Whether or not this is consistent with stability remains to be seen.

Lastly, consumer price inflation has surged in the past few months. The inflation rate stood at 5.4% in October, as against 4.9% in June.

The Russian economy continued to lose steam in the last few months. According to initial information from the Russian federal statistics service, year-on-year real GDP growth in the third quarter slowed to 3% after previously having stood at 4%. Although the manufacturing industry was able to maintain its modest growth rate, construction activity and also agricultural output fell considerably short of their previous year's levels. In addition, a significant surge in inflation has been weighing on the short-term economic outlook, causing the Russian central bank to increase its policy rate in September. In October, consumer price inflation stood at 6.5%, and thus outside the Russian central bank's target corridor of 5% to 6% at the end of the year.

Further slow-down in economic growth in Russia

USA

In summer, the US economy remained on its path of moderate expansion. Quarter-on-quarter growth of overall output, at ½% after seasonal adjustment, was even distinctly stronger than in the spring, despite the fact that growth had been hampered slightly by accelerated inventory depletion in agriculture owing to the severe drought. Households proved to be a particular bulwark for the economy; their real consumer spending continued to climb considerably despite higher fuel prices. Although average year-on-year headline inflation, as measured by the Consumer Price Index, fell to +1.7% for the quarter, or +2.0% excluding energy and food, the index was up by 0.6% from the previous three-month period after adjustment for seasonal variations, however. On balance, households were able to post only a moderate rise in real disposable incomes, which

Household demand robust, ...

¹ Real gross value added, the measure of aggregate output preferred by the Indian Ministry of Statistics and the Reserve Bank of India, rose by 5½% year-on-year in the second quarter, as against +5¼% a quarter previously.

meant that they had to find ways of funding their increased spending, such as scaling back their saving. Housing construction represents a glimmer of hope for the economy. However, it is starting from such a low level that even the recent strong increase in activity provided only a modest contribution to aggregate growth.

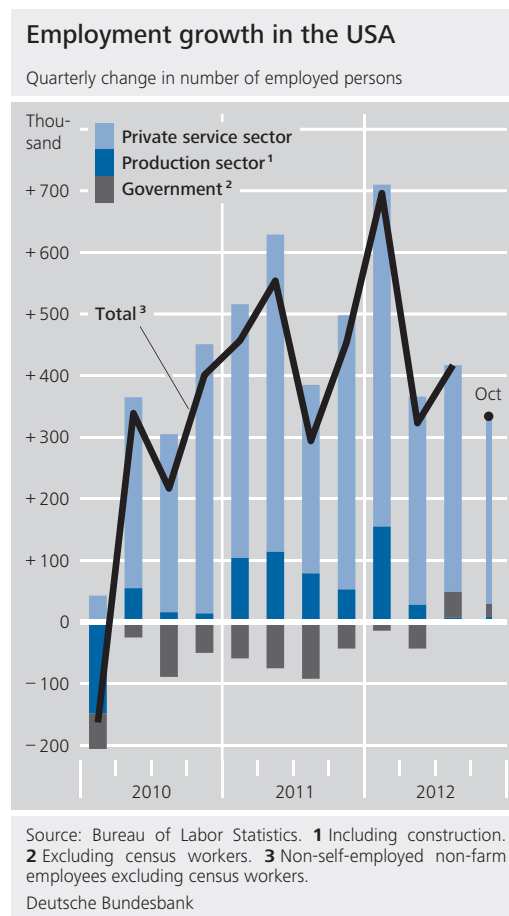
... but corporate investment sputtering

Whereas consumer demand generally grew healthily, corporate gross fixed capital formation began to sputter. Firms' reluctance to invest could be, at least in part, a reflection of uncertainty about the course of US fiscal policy. In this context, the substantial increase in real defence spending in the third quarter may be classified as only a temporary blip. The fact that the global weakness in manufacturing impacted on the US economy in the summer months, however, probably outweighed the effects of the fiscal outlook. The decline in real exports in the national accounts is consistent with this picture. Industrial output stagnated at the same time, and new orders of non-aircraft civilian capital goods slumped sharply in terms of value. These dampening factors also had an effect on the labour market. Although in the first quarter the production sector (including construction) had created, on balance, as many as 155,000 new jobs compared with the previous period, job creation in this sector ground to a virtual halt in summer. All in all, net creation of new non-farm jobs was higher than in spring but still considerably lower than at the start of the year. All the same, the jobless rate slid from 8.3% in July to 7.9% in October.

Japan

Renewed cyclical set-back

In Japan, the cyclical recovery encountered a renewed set-back in the third quarter. After adjustment for seasonal influences, aggregate economic output contracted by 1% compared with the spring. Strongly retarding forces in foreign trade were the main reason for this development; in the summer period, a total of 5% fewer goods and services were exported, in terms of volume, than a quarter earlier. Falling



euro-area demand played only a relatively minor role in this context. China is a much more significant recipient of Japanese exports, which, however, in nominal terms, were latterly contracting at similar rates. The boycott by Chinese consumers over the island dispute between the two nations has not yet had any impact on the figures. The situation was exacerbated by the robustness of Japanese imports, to which anticipatory effects in the run-up to an increase in the tax on imports of crude oil and other fuels are likely to have contributed. Lastly, domestic demand also weakened, not least because real household consumption expenditure flagged in connection with the expiry of government incentives for purchasing cars. However, at 4.2% in September, the unemployment rate was even marginally lower than just three months earlier. At the same time, year-on-year consumer price inflation, on average over the third quarter, slid back into negative territory (-0.4%); core inflation, however, barely budged (-0.6%).



in July-August, a set-back in the current quarter cannot be ruled out. Nonetheless, activity in the services sector in September, according to current estimates by the UK Office for National Statistics, surpassed its level of April 2012, prior to the deviations from the usual calendar, by 1½%. The decline in the number of recipients of unemployment benefits over the summer months is consistent with the strong third-quarter growth. At 7.8% in August, the national unemployment rate fell to its lowest level since April 2011. At the same time, the price climate calmed down again, at least on an annual basis. The Harmonised Index of Consumer Prices (HICP), at 2.4% in the third quarter, showed the lowest rate of year-on-year inflation since autumn 2009 and thus continued converging to the core inflation rate (+2.2%), which excludes energy and unprocessed food.

United Kingdom

Revival of macroeconomic recovery process

In contrast to developments in Japan, in the summer the UK economy was able to overcome the recessionary tendencies of the three preceding quarters. Real GDP was up by a seasonally adjusted 1% on the quarter, its strongest growth in five years, and thus returning to its level of the comparable period of 2011. Construction output, which was hit particularly hard by the government's efforts at fiscal consolidation but is still only a small segment of the economy, continued to be clearly on the decline; services, broad based across their individual segments, saw activity rise by 1¼%, and manufacturing output was likewise stepped up substantially. However, various one-off factors contributed to the good result, particularly the return to the usual number of working days following an additional holiday in the spring. In addition, according to official data, sales of admission tickets for the Olympic and Paralympic Games boosted real GDP growth in the third quarter, to which these transactions are assigned merely for accounting purposes, by one-quarter percentage point.² These events could also have affected economic output through other channels, although the significance of the effects is difficult to quantify. Owing to the importance of the one-off factors

New EU member states

In the entire group of new EU member states (EU-7),³ economic output, after rising in the second quarter by ¼% on the period in seasonally adjusted terms, is likely to have expanded only sluggishly once again. The result for the region as a whole, however, still masks heterogeneity among the various countries. Whereas the cyclical recovery continued to make good progress in Lithuania and Latvia, the recession persisted in Hungary and the Czech Republic (each -¼%). In Poland, for which no national accounts figures are available as yet, economic growth seems to have been only moderate throughout the reporting period, according to the indicators. In the summer, seasonally adjusted industrial output failed to surpass its depressed level of a quarter earlier; in addition to

Moderate expansion of economic output in new EU member states

² Revenue from the sale of TV rights and sponsors' payments for advertising rights flow to the International Olympic Committee (IOC). Payments from UK firms were posted as imports of services, which, in and of themselves, reduce UK GDP. Out of this revenue, the IOC pays a contribution to the national host; however, this is a transfer and, unlike the proceeds from ticket sales, does not increase UK GDP.
³ This group comprises the non-euro-area countries that joined the EU in 2004 and 2007.

this, construction once again weakened significantly. For the EU-7 group, consumer price inflation accelerated by 0.4 percentage points to 3.9% in the third quarter. It ranged from 1.9% in Latvia to 6.0% in Hungary, where an increase in turnover tax from 25% to 27% came into effect at the beginning of the year.

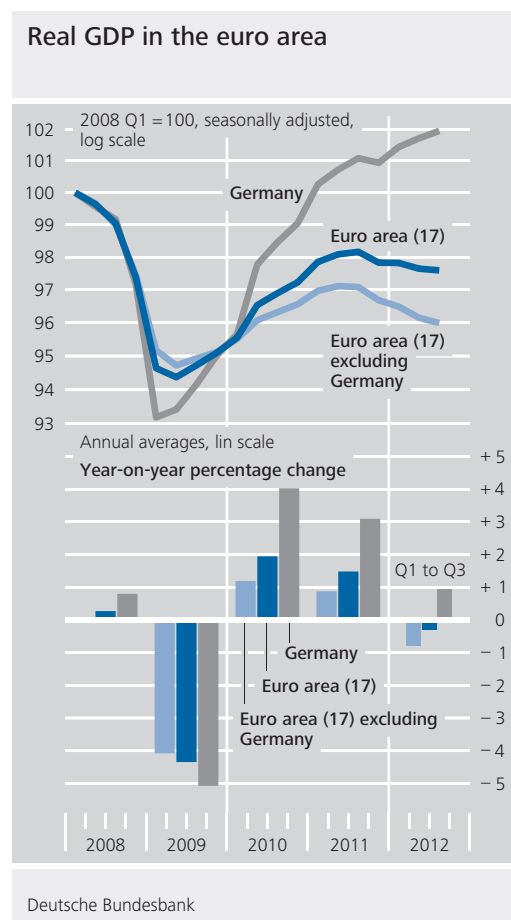
Macroeconomic trends in the euro area

Sustained economic slowdown in the euro area ...

The euro-area economic slowdown which followed a brief phase of recovery in autumn 2011 continued in the third quarter. Seasonally adjusted aggregate output fell slightly below the depressed level of the preceding period, in which it had fallen by ¼%, and thus stood ½% below its level of a year earlier. The continued gloom in the economy was caused mainly by contracting domestic demand in the southern peripheral countries; this was connected with the consolidation of public sector budgets, unfavourable corporate financing conditions and the general crisis-related uncertainty among consumers and investors. Added to this was the loss in purchasing power, which, given continued high US dollar prices in the crude oil markets, were due mainly to a general increase in import prices caused by the euro's depreciation over the past year. This also weighed on the economies of the euro-area countries that are not at the centre of the crisis. Moreover, negative confidence effects radiated to these economies from the peripheral countries as well.

... and growth still extremely divergent

On the whole, however, it may be stated that the pace of the economic downswing has decelerated, sometimes considerably, in the southern crisis countries, whereas the moderate growth continued in some of the northern countries. Of the 13 member states for which data on GDP growth for the third quarter are available, Estonia leads the pack with a seasonally adjusted rate of 1¾%, followed by Slovakia (+½%) and then Finland, France and Germany (each +¼%). Aggregate economic production



stagnated in Belgium and pretty much treaded water in Austria, too. Countries recording declines were Italy and Spain (each -¼%), Cyprus (-½%), Portugal (-¾%) and the Netherlands (-1%). For Greece, currently no official seasonally adjusted quarterly data are available; its output was down by 7¼% on the year. Excluding Germany, euro-area real GDP was down in the third quarter after seasonal adjustment by ¼% on the period; all in all, this caused the growth gap between Germany and the rest of the euro area, which has developed since the beginning of the global financial and economic crisis, to open up even further. The continued parlous state of the peripheral countries' economies, however, should not be permitted to obscure the fact that considerable progress has been made in reducing those countries' external imbalances and that a large percentage of these reductions may be regarded as long-term (see the box on pages 20 to 25).

The reduction of current account deficits in the euro-area peripheral countries

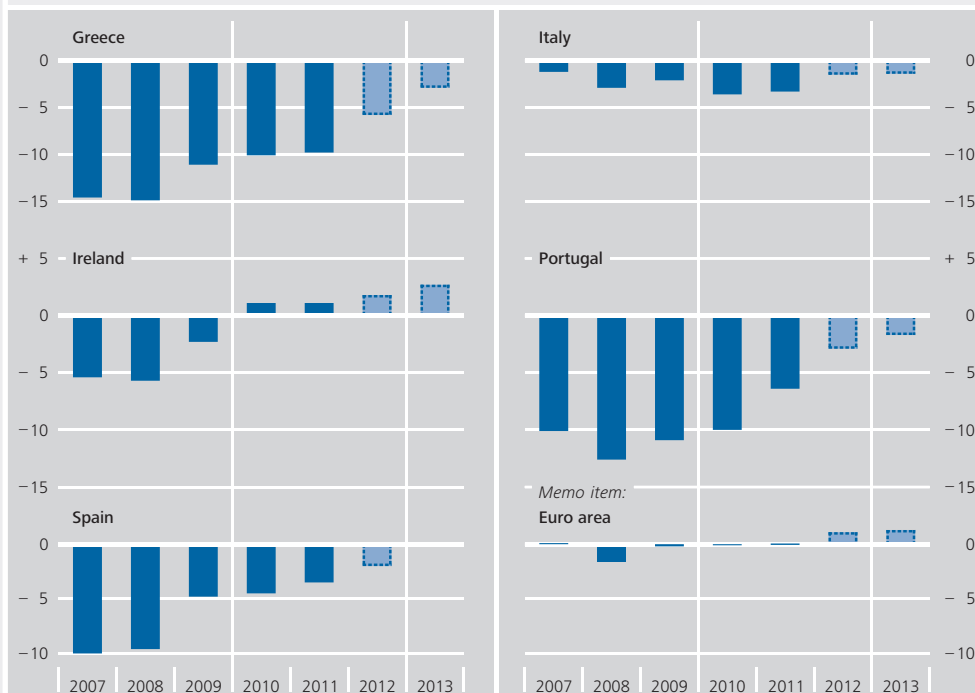
In the years preceding the global financial and economic crisis, a combination of partly excessive growth in demand, relatively sharp inflation and a significant deterioration in price competitiveness led to the accumulation of high current account deficits in a number of member states located on the geographical periphery of the euro area. This was ultimately due to unsustainable domestic economic developments, which varied in form from country to country.¹ Owing in part to the related steep increase in net external liabilities, these deficits are one of the main causes of the current euro-area crisis. The necessary correction of the unsound macroeconomic developments therefore also involves reducing the external imbalances.

This adjustment process is now underway and has made good progress, especially over the last two years. The peripheral countries have narrowed their current account deficits distinctly since the outbreak of the global financial and economic crisis. Ireland's negative balance, which amounted to 5¾% of GDP in 2008, had already moved back into positive territory by 2010. According to the IMF's latest forecast, Portugal and Spain, whose current account shortfalls peaked at 12½% and 10% in 2007-2008, will record only comparatively small deficits for 2012, and further improve-

¹ Deutsche Bundesbank, On the problems of macroeconomic imbalances in the euro area, Monthly Report, July 2010, pp 17-38.

Current account balances

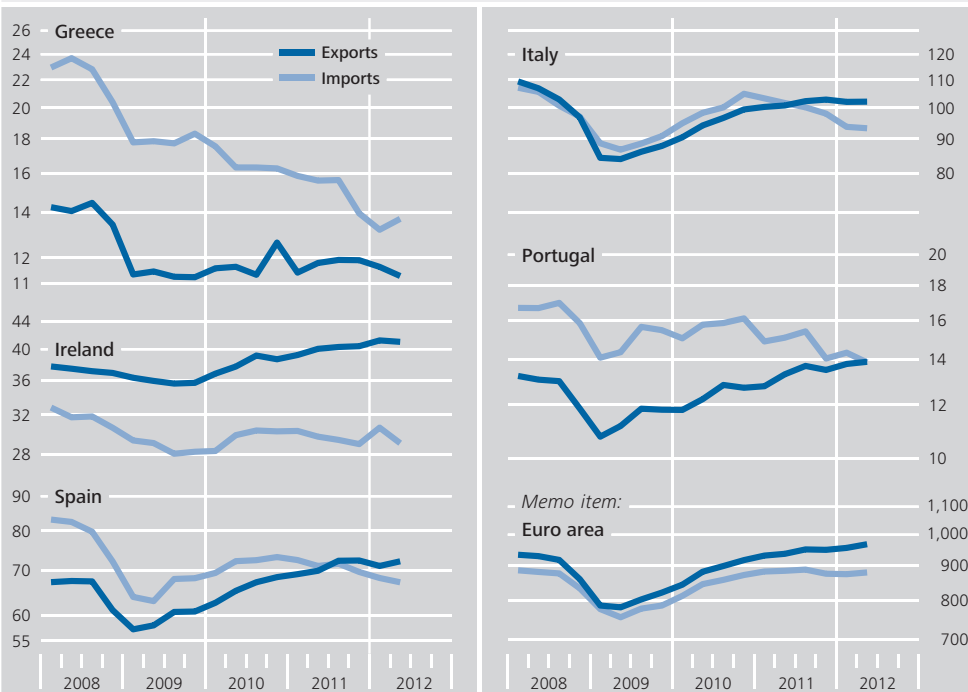
as % of GDP



Source: IMF. 2012 and 2013 forecast figures from the World Economic Outlook, October 2012.
 Deutsche Bundesbank

Real exports and imports*

€ billion, seasonally adjusted, log scale



* As defined in the national accounts. Chain-linked volumes, reference year 2005.

Deutsche Bundesbank

ments are expected for 2013. Although Greece's 2012 deficit, which is expected to be 5¾% of GDP, is quite large, this is nearly 10 percentage points lower than in 2008. The sharp decrease in nominal GDP in recent years, and hence in the ratio's denominator, must also be taken into account. Italy's external deficit, which was a less serious problem from the outset, is likely to have fallen by 2 percentage points from its last high in 2010 to 1½% in 2012.

In most of these states, the reduction of the current account imbalance is chiefly due to an improved net balance of exported goods and services, although a significant contribution has also been made in Greece's case by lower interest payments stemming from the haircut in spring 2012, which are recorded as a sub-balance in the income account. At the same time, not only have the current account deficits in peripheral countries become smaller but also the surpluses

in other euro-area countries, including Germany, whose positive current account balance vis-a-vis its euro-area partner countries has fallen to less than half its pre-crisis level (and in trade in goods and services to one-sixth).

These developments, although positive in themselves, also raise the issue of to what extent the changes are cyclical (and therefore temporary) or represent sustainable adjustments to the economies' demand and supply structure, and thus imply a correction of the underlying internal imbalances and are likely to persist in the longer term. The sharp contraction in domestic demand in the peripheral countries was accompanied by a fall in imports. In spring 2012, real domestic demand was down on the pre-crisis level in the second quarter of 2008 by 25¾% in Greece, 21¾% in Ireland, 14¼% in Portugal, 12¾% in Spain and 8½% in Italy. At the same time, real imports of

goods and services showed decreases ranging from 8½% in Ireland to 42% in Greece. Fears have therefore been expressed that a future cyclical recovery in the peripheral countries could cause imports to rise sharply and current account deficits to increase rapidly once more.² In this case, the adjustment achieved thus far would only be short-lived. These fears are supported by relatively high figures for the aggregate output gap, which is calculated using international institutions' estimates of potential output. For example, in its current Autumn Economic Forecast, the European Commission reports aggregate capacity underutilisation figures for 2012 that range from 1½% of GDP in Ireland, 3½% in Italy, 4½% in Portugal and 4¾% in Spain to 13% in Greece. However, the actual amount of spare capacity available is likely to be considerably smaller at present.³ Furthermore, a number of structural adjustments have been initiated that are intended to lead to a further improvement of the current account and prevent new imbalances from building up too quickly, which are discussed in greater detail below.

On the one hand, structural improvements occur if the supply side is permanently strengthened by increasing the economy's price and non-price competitiveness. Enterprises are then able to consolidate their position on the domestic market by squeezing out foreign competitors and on the foreign market by increasing their market share. On the other hand, positive structural change can take the form of a permanent decline in unsustainable drivers of domestic demand (such as excessive borrowing). However, it is not enough to reduce domestic demand by the amount by which it exceeded GDP in the boom phase – which corresponds to the negative balance of goods and services – because in such a cyclical setting, aggregate output is

usually significantly higher than potential output. Domestic demand therefore needs to be reduced to the level of potential output. However, given the mostly negative income sub-accounts in the peripheral countries' current account, this will not on its own achieve a fully balanced current account and so stop the build-up of net external liabilities. If these states wish to reduce their accumulated external liabilities, they must generate distinct current account surpluses over a prolonged period. This implies that domestic demand must be clearly below GDP and that a permanent export surplus must be generated.

That a major part of the fall in domestic demand in the peripheral countries in recent years is permanent is supported by the fact that reforms of the statutory pension system and of unemployment benefits have been initiated in several states owing to the urgent need to consolidate public finances, resulting in a reduction in government transfers. In addition, taxes on income and wealth as well as indirect taxes have been

² See Eurokrise dämpft Konjunktur (Joint Economic Forecast, Autumn 2012, Euro Crisis Curbs Economic Activity – Risks to Stability Remain High), October 2012, p 17.

³ Based on current estimation procedures, potential output is often overstated following a cyclical boom entailing severe sectoral distortions because incorrect market signals previously encouraged the creation of production capacities that cannot be used profitably in a normal economic setting. The misallocation of resources is revealed particularly clearly once a housing bubble bursts, as has occurred in Ireland and Spain in recent years, in the form of a large stock of unsold housing which is also unmarketable in the long term and a sharp rise in the number of bankrupt construction companies. However, excessive borrowing by households and governments for pure consumption purposes can also lead to similar misallocations. Experience has shown that after a credit boom has dried up, a significant part of the new capital stock created in the most overheated sectors becomes obsolete, while structural unemployment increases owing, among other factors, to limited intersectoral labour mobility coupled with falling demand. In practice, however, it is somewhat difficult to reliably identify the volume of capital stock that has become obsolete for individual countries, not least because the detailed data required are not available.

raised, which will also compress households' purchasing power in the long term. Households' real disposable income in the crisis countries has concurrently been reduced since the credit bubbles burst as the result of income losses caused by higher structural unemployment, in individual cases even by a decrease in nominal wages accompanied by fairly high levels of inflation. This is likely to continue in the medium to long term, at least in some cases. Public consumption and investment expenditures have likewise been reduced. Credit-financed housing bubbles, which have occurred in some countries, or excessive government borrowing are unlikely to recur on the scale seen in the past, not least thanks to stricter supervisory rules for the banking sector and the new EU macroeconomic imbalance surveillance procedure.

Robust export performances in some peripheral countries also support the diagnosis that the observed current account adjustment is partly structural (see chart on page 24). In spring 2012, real exports of goods and services exceeded their peak levels reached prior to the global financial and economic crisis by 9½% in Ireland, 7% in Spain and 6¼% in Portugal. In these three countries, exports grew only slightly more slowly than in Germany (+10%), which has an above-average export record among industrial nations. By contrast, exports were 4½% lower than pre-crisis levels in Italy, and 19¾% lower in Greece, where public unrest and strikes temporarily inflicted heavy damage on the tourist industry and where domestic banks were reluctant to provide enterprises with export finance.

The strong lift in exports in the three countries mentioned above is all the more remarkable given that the global economic environment has ceased to provide strong stimuli, particularly in 2012. On the one

hand, there is reason to believe that many firms in the three states have stepped up their export efforts in the face of weak domestic demand in order to stabilise or increase their capacity utilisation. On the other hand, exporters' price competitiveness has improved slightly following the euro's depreciation. However, because the euro-area partner countries' share of exports of the peripheral states remains large, their relative price development in relation to these countries is at least as important. The assessment as to whether and to what extent a lasting adjustment has already taken place depends on which of the relevant indicators is used as the gauge. While price competitiveness indicators based on consumer prices and GDP deflators do not point to a substantial improvement,⁴ the indicator based on unit labour costs shows a more favourable picture.

Although indicators based on consumer prices and GDP deflators generally provide a fairly reliable picture of changes in price competitiveness, they are of limited informative value in the specific case of the peripheral countries. The main reason for this is that numerous increases in indirect taxes and administrative prices introduced for fiscal consolidation purposes have been driving up consumer prices and the deflator of domestic demand for quite some time, whereas export prices have hardly been affected.⁵ It is therefore more appropriate to use the competitiveness indicator based on unit labour costs in this specific situation

⁴ However, if only those HICP components that are under the strongest international pressure are observed, ie the prices of industrial goods excluding energy, Ireland, Spain, Portugal and, recently, also Greece display significantly weaker price dynamics than the euro area as a whole.

⁵ It is not always possible to compare export deflators, which could also be used to calculate price competitiveness, across euro-area states, because in some countries they are based on export price indices and in others, such as Italy, on unit values.

Unit labour costs in the economy as a whole

Nominal, year-on-year percentage change



Deutsche Bundesbank

even if, unlike the GDP deflator, it disregards important aspects such as changes in enterprises' profit margins, which have a major indirect impact on companies' export potential.

In the peripheral countries (except Ireland), the year-on-year changes in the GDP deflators have remained stable or have increased slightly on average over the last two-and-a-half years, while unit labour costs have decreased in all the countries, in part considerably. This is further supported by the fact that labour shares have also fallen across the board. All in all, the price competitiveness indicator based on unit labour costs confirms that the first steps towards creating more competitive cost structures have been taken. Since the first quarter of 2008, it shows improvements of 17½% in Ireland, 11½% in Spain, 10½% in Greece and 8¼% in Portugal. However, no appreciable change is evident for Italy. Italy is conse-

quently also clearly further below the long-run average of the indicator for the period 1999-2011 than the other peripheral countries.

In three out of the four peripheral countries in which unit labour costs have fallen in recent years, a decrease in compensation per employee has played at least a contributory role. In Portugal, the compensation level in the first half of 2012 was almost 3% lower than the peak level in the first half of 2010 in seasonally adjusted terms. In Ireland, although another slight increase was observed in the first half of 2012, the level of compensation was still 4½% lower than in the second half of 2008. The greatest adjustment occurred in Greece, where *per capita* employee compensation in the first half of 2012 was as much as a tenth lower

than in the first half of 2009.⁶ In Spain, compensation per employee has continued to rise until recently, albeit at a considerably slower pace than in the boom years. There, marked wage moderation, in combination with much stronger productivity growth, has helped to bring about the aforementioned significant contraction in unit labour costs. Distinct increases in productivity were also observed in Portugal and Ireland, although similar developments did not take place in Greece until 2012.⁷

On the one hand, the increased productivity gains in Ireland, Portugal and Spain owe something to a rise in the number of unprofitable companies being squeezed out of the market across all sectors during the crisis, as often happens in such an economic setting. On the other hand, the majority of job cuts have taken place in sectors in which the recruitment of workers with comparatively low labour productivity had previously been worthwhile owing to cyclical exaggerations. This being so, the contraction of these economic sectors in recent years and the accompanying productivity gains are *per se* a necessary and economically meaningful correction. Hence it is not fair to present this redundancy-related productivity improvement as a sort of second-class contribution to the reduction in unit labour costs, which has periodically happened in the public debate.⁸

All in all, a number of factors indicate that the reduction in the current account deficits of the euro-area crisis countries is not predominantly of a cyclical nature, but instead is based strongly on lasting changes. However, even though international institutions predict that most of these countries will reach a balanced or positive current account in the near future, they must continue to systematically pursue structural reforms. Above all, wage moderation needs

to be continued over a prolonged period. This lowers the employment threshold, ie the rate of macroeconomic growth at which the number of employees or the total hours worked begin to increase. Without a lowering of the employment threshold it is likely to be extremely difficult to reduce the generally high level of structural unemployment. Furthermore, continued wage moderation generally also has a positive impact on firms' profit margins, which helps to restore their sometimes severely impaired ability to innovate and invest. In some peripheral countries, over the past decade, the manufacturing sector, in particular, has suffered a considerable decline owing to excessive wage growth not supported by corresponding productivity gains. It will be almost impossible to establish the requisite sustainable economic model without creating new, more competitive capacities in both industry and the service sectors.

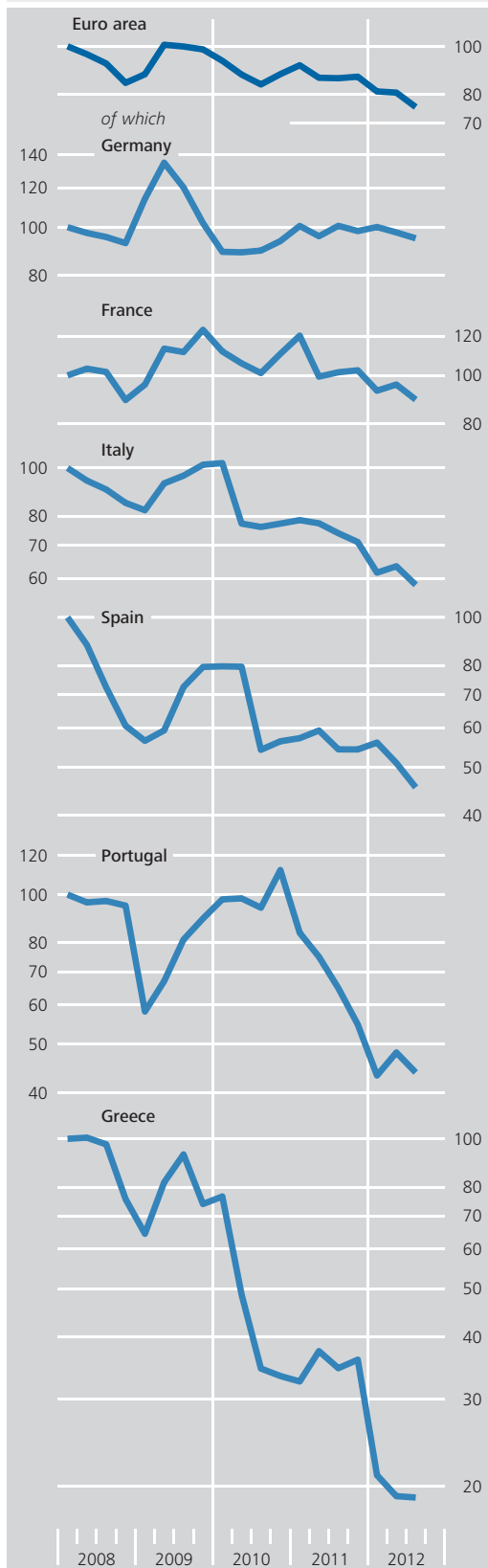
⁶ Because there are no seasonally adjusted data on compensation per employee for Greece, comparisons can only be made based on values for the first half of the previous years.

⁷ In Italy, however, the unfavourable productivity trend that had prevailed for some time continued after the global recession.

⁸ Euro-Sorgenländer erholen sich langsam. Frankfurter Allgemeine Zeitung, 17 September 2012, p 13.

New passenger car registrations in the euro area

2008 Q1 = 100, seasonally adjusted, quarterly, log scale



Source: ECB.
 Deutsche Bundesbank

Current survey-based leading indicators do not appear to be pointing to any thoroughgoing improvement in the fourth quarter of 2012 and first quarter of 2013. The Purchasing Managers' Index (PMI) for manufacturing fell once again in October after having risen slightly in each of the two previous months and remains considerably below the expansion threshold. Consistent with this picture, industrial confidence once again took a substantial hit in October and has become even further removed from its long-term average. The assessment of order books has become especially gloomy. The PMI for services had stabilised at quite a low level as this report went to press. A renewed slight decline in GDP growth is expected for the last quarter of the year. Average GDP growth for 2012 as a whole will probably settle somewhere between -¼% and -½%.

No end to recession in sight

Looking at the individual sectors, the production sector held up relatively well in the summer quarter. Industrial output (excluding construction) in the third quarter was ¼% up on the spring after eliminating seasonal influences, yet down by 2¼% on the year. The pick-up in seasonally adjusted output of capital goods (+1½%) and consumer durables (+1%) was particularly significant. The production of non-durables stagnated, whereas the manufacture of intermediate goods and energy contracted by ½% and 1¼% respectively. Industrial capacity underutilisation intensified in the July to October period, according to surveys. Construction output stabilised, at least temporarily, following mid-year. It was up by a seasonally adjusted ¼% in July-August yet down by 6% on the year.

Production sector held up relatively well in summer

On the demand side, positive impulses from household consumption have been minimal at best. Although real retail sales (excluding cars) in the euro area rose by ½% between the second and third quarters, over the same period new car registrations fell by a seasonally adjusted 6½%, though these data also include commercial vehicle registrations. The demand for new cars, which has been trending down-

Weak domestic demand; exports up once again

wards since the government stimulus programmes for the car industry expired, was even 12½% below its cyclical low in the period spanning the fourth quarter of 2008 and the first quarter of 2009. For 2012 as a whole, the number of car registrations could reach its lowest level since 1993. The main reason for this drastic drop is that demand for cars has collapsed in the euro-area crisis countries. The downward slide in gross fixed capital formation, which has been ongoing since the second quarter of 2011, may have slowed down somewhat in the summer. A sign of this is that capital goods production has been pointing upwards, in conjunction with a slight increase in construction output in the July-August period. Exports are likely to have once again promoted growth in the third quarter; nominal exports of goods to non-euro-area countries are up by ¾%, after seasonal adjustment, from the quite good second-quarter result. Simultaneously, however, imports rose by a very substantial 2¾%; considerable increases in the price of imported goods may have also played a part here.

*Labour market
downturn
continuing at
slower pace*

The downturn in the euro-area labour market was not as strong in summer as in the preceding quarters. Between June and September, the number of unemployed persons rose by around 360,000 after seasonal adjustment, and thus considerably more moderately than in the spring (+660,000). On the year, it picked up by 2.3 million to 18.2 million. The standardised unemployment rate rose to 11.6% in seasonally adjusted terms. After mid-year, the number of unemployed persons trended upwards in most euro-area countries, with the situation being exacerbated particularly in Spain, France and Cyprus. In the second quarter of 2012, the number of employed persons in the euro area hovered near its level of the winter months. It

would be premature, however, to interpret from this figure and from the weaker rise in unemployment in the summer that the labour market is about to stabilise anytime soon. If anything, because employment usually lags behind output developments, up until and into the year 2013 the labour market situation is more likely to deteriorate than to improve.

In the third quarter of 2012, euro-area consumer prices were up by 0.5% on the quarter after seasonal adjustment. This represents a continuation of the relatively more moderate price trend compared with the period spanning the fourth quarter of 2011 and first quarter of 2012. Once again, it was energy and unprocessed food prices which developed particularly unfavourably. At 0.5% after seasonal adjustment, the prices of services rose at a pace similar in strength to the previous quarter, whereas rises in the prices of processed food and other goods (excluding energy and food) weakened distinctly. As in the spring, annual HICP inflation stood at 2.5% on average for the third quarter and for October. The constant price trend has been making itself apparent in most euro-area countries, too. On average over the July to October four-month span, annual inflation in Germany remained unchanged at 2.1% and declined only slightly in France to 2.2%. In Italy, however, it fell from a high level of 3.6% in the second quarter to 3.4% in the third quarter and then to 2.8% in October, especially because past fiscal measures no longer affect the index directly. The increase in inflation in Spain from 1.9% in the second quarter to 2.8% in the third quarter and 3.5% in October is linked to tax hikes. By contrast, inflation in Greece has continued to decelerate; at 0.8% (October: 0.9%), it was well below the euro-area average.

*Steady rise in
consumer prices*