Global and European setting

Global economic developments

Global activity remains subdued …

Global activity remained subdued in the second quarter. Private consumption, in particular, was slow to pick up on account of price inflation, which was easing but still strong in many places. At the same time, the tightening of monetary policy stances in many regions is likely to have been an increasing drag on the global economy. In the euro area, this backdrop meant that it was only thanks to irregular effects that the economy was able to register perceptible growth. The United Kingdom's economy barely made any forward progress. Economic activity in the United States, by contrast, remained in comparatively good shape. In Japan, upward movement in aggregate activity continued with greater intensity. In China, meanwhile, the recovery set in motion by the end of the zero-COVID policy quickly lost momentum.

… especially in industry

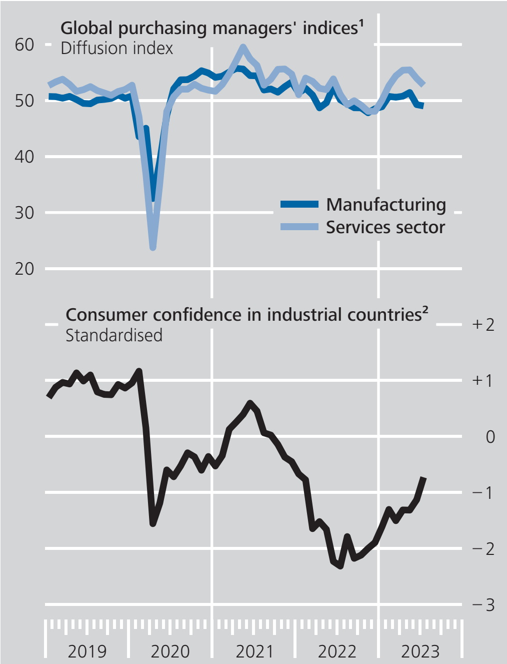
Around the world, industry in particular has been impacted by the frail economy right up to the present date. Industrial production worldwide and global trade have been lacklustre for more than a year now. Surveys amongst enterprises have so far shown no sign of any turnabout, either. Quite the opposite: purchasing managers' indices indicate that output and new orders were down again in July. This malaise now appears to have spilled over into the services sector, where growth had previously been fairly brisk.[1] A boost in private consumption could put wind in the global economy's sails. Consumer confidence has recently increased markedly in some major industrial countries, probably on the back of the continued robust labour markets and the prospect of a renewed upturn in real incomes.

Inflation rates on the decline worldwide

The past few months have seen consumer price inflation rates decline significantly around the world, even if they were still high in many places. By July, annual inflation in the group of

International sentiment indicators

Seasonally adjusted



Sources: S&P Global, national data, Haver Analytics and Bundesbank calculations. **1** Components for output (manufacturing) and business activity (services). **2** Australia, the EU, Japan, the United Kingdom and the United States. Weighted using private consumption expenditure for 2019 in US dollars.

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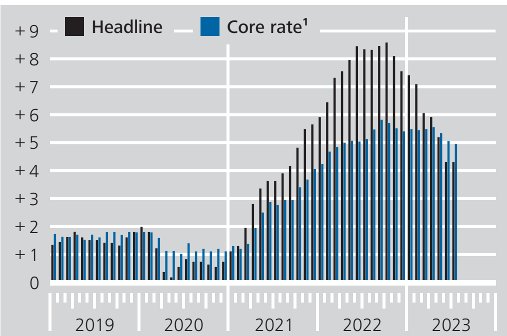
Consumer prices in industrial countries*

Year-on-year percentage change



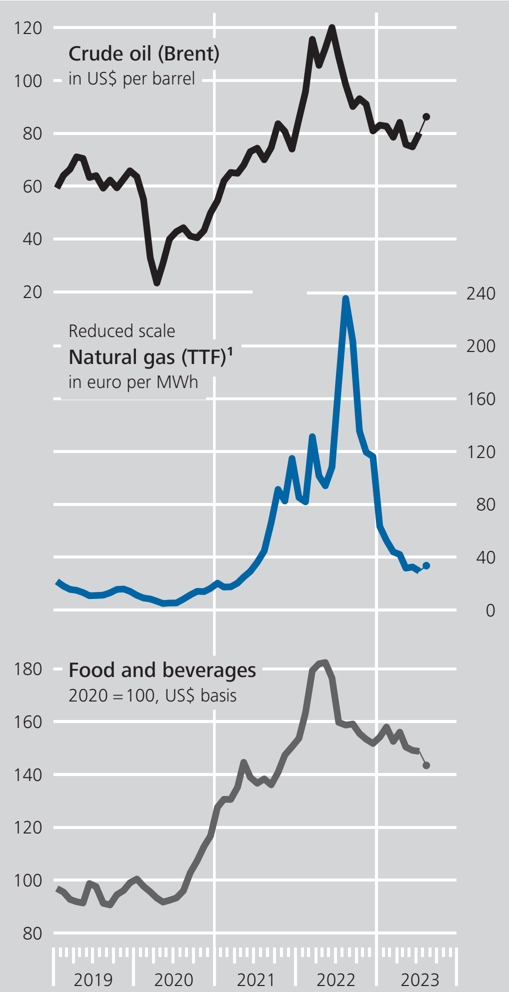
Sources: Bundesbank calculations based on national data. * EU, Canada, Japan, Norway, Switzerland, the United Kingdom and the United States. **1** Consumer prices excluding energy and food; additionally excluding alcoholic beverages and tobacco products for the EU, Norway, Switzerland and the United Kingdom.

Deutsche Bundesbank

1 The services sector has rarely been able to decouple itself from a weakness in the manufacturing sector for long, see Deutsche Bundesbank (2019).

Commodity prices

Monthly averages



Sources: Bloomberg Finance L.P., Haver Analytics, ICE and HWWI. • Latest figures: Average of 1 to 11 August 2023, or 1 to 17 August 2023 for crude oil and natural gas. **1** Price for the front-month futures contract.
Deutsche Bundesbank

advanced economies had dropped to 4.3%, just under 1.6 percentage points lower than three months earlier, largely on account of the significantly lower energy prices. Underlying inflation, however, also appears to have now passed its peak. Consumer prices excluding energy and food were 5.0% higher than in the previous year as this report went to press. However, further curbing of inflation could become more difficult. This is due, not least, to wage growth, which remains very vigorous in many places.

There were no signs of further relief from the commodity markets at the end of the period under review. In fact, crude oil prices have even picked up again markedly since the end of June. This was mainly due to new production cutbacks by OPEC and its partners. Against this background, it appears increasingly less likely that global oil output will meet demand in the second half of the year.[2] As this report went to press, the price of a barrel of Brent crude oil stood at US$86, just under 14% more than in May. The decline in gas prices also petered out in recent months. At €37/MWh, European gas (TTF) was noticeably more expensive than in May. Thanks to well-stocked storage facilities and subdued demand, however, chances are good that drastic price spikes – like those observed in the previous year – could be avoided in the coming heating season. The prices of most other commodities have seen only a minor decline of late. Concerns about the supply of some food products could become even more serious in future. Following Russia's termination of the Black Sea Grain Initiative, this is true of cereals, amongst other goods.[3]

Decline in commodity prices levels off

The decisive factor for the way the global economy develops going forward will be how quickly and sustainably consumer price inflation can be brought back into line with the stability objectives of the central banks. The International Monetary Fund (IMF) took a sceptical view in its regular economic outlook update for July.[4] Inflation targets are unlikely to be met in almost 90% of all economies in 2024, either. For the advanced economies, the corresponding inflation forecasts were actually revised slightly upwards again. The staff of the IMF largely maintained their subdued growth outlook for the global economy. At rates of 3.0% each, global GDP is likely to expand much more slowly this year and the next than was usual in the years before the pandemic. However, given

IMF not expecting quick return to price stability

2 For example, the International Energy Agency expects an undersupplied global oil market in the second half of 2023, see International Energy Agency (2023).
3 Global supply of rice could also decline significantly, as India, the world's most important rice exporter, has recently prohibited exports of various varieties of the crop in the face of rising prices.
4 See International Monetary Fund (2023).

the easing of the bank turmoil that occurred in March and April, the IMF estimates the risk profile to be less unfavourable.

China

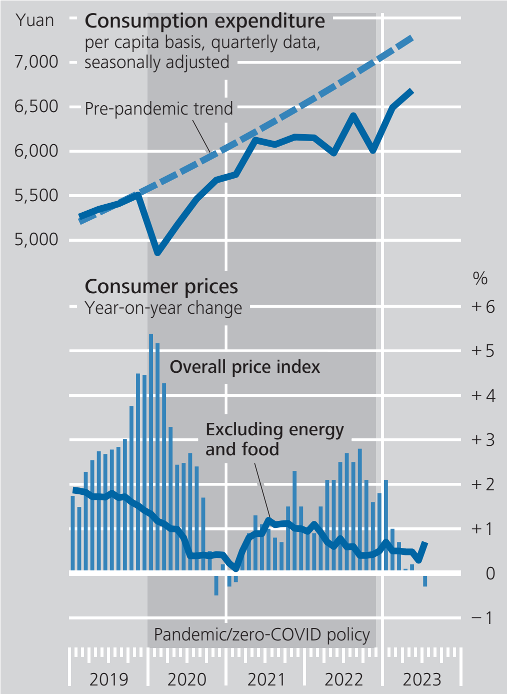
Recovery loses momentum

In China, the economic recovery that started after the end of the zero-COVID policy lost considerable momentum in the second quarter of 2023. According to the official estimate, real GDP grew by only 0.8% in seasonally adjusted terms compared with the first quarter, in which it had risen by 2.2%. Consumption, in particular, lost momentum. Exports also declined markedly, and the real estate market tended once more to sluggishness after having stabilised at the beginning of the year. All of this also dampened consumer price developments. In July, they were even 0.3% lower than in the previous year. Food and energy prices fell in particular. However, even excluding these goods, inflation was subdued at 0.8% at the end of the period under review. Given the broad economic slowdown, the Chinese government recently launched some support measures and the central bank eased its monetary policy slightly.

No significant growth acceleration expected in the short term

Nevertheless, growth in the Chinese economy is likely to remain anaemic for the time being. According to purchasing managers' surveys, sentiment in industry has been clouded, and households have also not had much optimism. The deteriorating labour market situation has contributed to this. Youth unemployment has continued to rise significantly in recent months, reaching just over one-fifth of the labour force under 25. All in all, there is much to suggest that the COVID-19 pandemic and, in particular, the containment measures taken in this context have left China with deeper economic scars than other countries.

Consumption and price developments in China



Source: National Bureau of Statistics of China and Bundesbank calculations.
Deutsche Bundesbank

Other selected emerging market economies

Buoyant growth in India likely continuing

India's economy appears to have remained on a buoyant growth trajectory in the second quarter. This is indicated by persistently favourable surveys among purchasing managers. In the services sector, the corresponding index actually rose in July to its highest level since 2010. However, the current monsoon season, which could be considerably weaker than usual due to the weather phenomenon El Niño, poses a risk for further macroeconomic developments. A weaker monsoon would worsen harvest prospects and with them the income situation of a large part of the rural population. Owing to weather-related harvest difficulties, some food prices have already risen significantly in recent weeks. As a result, consumer price inflation rose to 7.4% in July. The central bank left its policy rate unchanged at 6.5%.

Economic activity in Brazil lacking momentum

In Brazil, the underlying cyclical trend is likely to have remained rather weak in the second quarter of 2023. Real GDP, which had risen very steeply at the beginning of the year due to a record harvest, may in fact have contracted somewhat again. At any rate, domestic demand continued to provide only a small boost in the second quarter. Consumer price inflation nevertheless rose to 4.0% in July on the year. Transport costs, in particular, have risen recently after the government reintroduced the tax on fuel, which had been suspended last year. By contrast, the core rate excluding food and energy has fallen significantly in recent months. At the beginning of August, the central bank reduced the policy rate by 50 basis points to 13.25%.

Russia's economy probably still on path to recovery

In recent months, Russia's economy appears to have remained on the path to recovery it embarked on following the sharp slump at the start of the war in Ukraine. According to data from the country's national statistical office Rosstat, real GDP rose by 4.9% year on year in the second quarter of 2023. The recovery was driven in part by the significant expansion in public expenditure since the beginning of the war, in particular for the production of weapons. Moreover, the availability of foreign intermediate goods appears to have improved considerably. This was due, in particular, to the sharp increase in deliveries from China and other neighbours of Russia. As a result, its trade surplus fell considerably and downward pressure on the rouble intensified significantly. Against this backdrop, consumer price inflation rose to 4.3% in July. For this reason, the Bank of Russia has increased its policy rate since July in two steps by a total of 450 basis points to 12%.

United States

Robust economic activity

In the United States, the economy remained in good shape in the second quarter. According to preliminary estimates, real GDP grew by 0.6% in seasonally adjusted terms compared with the previous quarter. The robust domestic economy made up for weaknesses in foreign business. Households continued to expand their consumption after the considerable rise already seen at the start of the year. Government demand also continued to support economic growth. The impulse was even greater owing to gross fixed capital formation, which picked up substantially after a one-year drought. Further easing of supply constraints in the transport sector made itself felt here. Commercial construction benefited from a boom in the semiconductor sector, which was also sparked by political initiatives (see the box on pp. 15 f.). By contrast, the decline in private housing investment continued, albeit at a slower pace. Most of the adjustments to less favourable financing conditions appear to have already been made in this sector.

Monetary policy tightening is gradually having an impact

The tightening of monetary policy over the past one and a half years has had an increasing impact in other areas. Although labour market utilisation has remained high of late, job and wage growth have continued to decline slightly. Consumer price increases have also been less pronounced in recent months, with lower energy prices playing a key role. In July, the consumer price index (CPI) rose by 3.2% on the year. Price inflation also eased somewhat when excluding energy and food. However, the core rate was still 4.7% at the end of the period under review. In this context, the Federal Reserve System increased the target range for the federal funds rate by 25 basis points in July, making it 5.25% to 5.5%.

Japan

Significant GDP growth

Japan's economic growth picked up momentum in the second quarter. According to preliminary estimates, real GDP increased by 1.5% on the quarter after seasonal adjustment. However, this was largely due to high net exports. Following a steep decline in the previous quarter, exports of goods, including motor vehicles in particular, saw a distinct recovery. Ex-

The construction boom in the US semiconductor industry

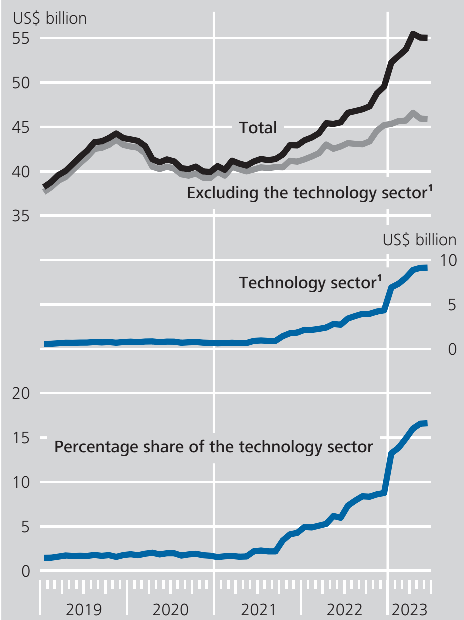
Governments around the world are currently competing to establish semiconductor production sites. This development has been triggered not least by the experiences of the past few years. The pandemic led to repeated shortages of semiconductor products on account of both supply disruptions and extremely vigorous demand. The automotive industry in particular suffered considerable production losses due to a lack of intermediate products. Furthermore, concerns about being too reliant on Asia have increased recently in western industrial countries amid rising geopolitical tensions. Almost three-quarters of the semiconductors produced worldwide come from China, Taiwan, Japan and South Korea.[1]

Against this backdrop, the US government is pushing ahead with initiatives to strengthen semiconductor production in the United States. Last year, the US government adopted the CHIPS and Science Act, which will provide subsidies of around US$280 billion up until 2031 to promote the semiconductor industry. The bulk of the expenditure is to be used for research purposes. US$39 billion is being fed directly into fostering the construction of semiconductor production sites. Added to this are around US$24 billion worth of tax credits for semiconductor investment.[2]

These incentives appear to be having significant effects. Numerous international technology companies have announced the opening of new sites and their intention to expand in the United States. The total volume of the ongoing and planned projects is estimated at almost US$220 billion.[3] This is more than five times the construction investment for the entire US technology sector in 2022.[4]

Despite complaints about long approval processes and a shortage of skilled workers, many investment projects have already been initiated in recent months. The US technology sector's expenditure on construction investment tripled last year. Its share in private non-residential construction investment jumped from less than 6% in the second quarter of 2022 to more than 16% most recently. The surge in investment in the technology sector also explains why non-residential construction investment

Non-residential construction investment in the United States



Sources: U.S. Census Bureau, Haver Analytics and Bundesbank calculations. 1 Production of computers, electronic and electrical products.
Deutsche Bundesbank

1 Data refer to the year 2020. See Congressional Research Service (2023a).
2 See Congressional Budget Office (2022) and The White House (2022).
3 See Semiconductor Industry Association (2023).
4 This includes not only the semiconductor industry but also, in particular, the software, consumer electronics and e-mobility sectors.

grew strongly overall on the year. In other non-residential construction, the situation remained tense in the face of ongoing problems, such as the high vacancy rates for office buildings and the challenges posed by tighter financing conditions.

Nevertheless, the direct impact of the construction boom in the technology sector on aggregate economic activity in the United States is likely to be rather modest given its small weight. Non-residential construction investment contributed just one-quarter of a percentage point overall to the real GDP growth of 2.6% in the last four quarters. The impact on the labour market is also likely to be barely visible.[5]

However, the US government could achieve at least some of its industrial policy goals. Downstream production should become more resilient through the promotion of the domestic semiconductor industry. Nevertheless, the pursuit of greater self-sufficiency means that the potential offered by the international division of labour remains untapped. It should also be noted that other regions, including the European Union (EU), are likewise promoting the establishment of semiconductor production sites. The aim is for one-fifth of all semiconductors to come from the EU by 2030; compared with 10% at present.[6] The danger of all of these initiatives is that the substantial use of public funds will create global overcapacity.

5 According to announcements in the industrial sector, the new manufacturing sites would create only 50,000 additional jobs in the United States. This would not even be in line with the trend in aggregate employment growth seen within one month. See Semiconductor Industry Association (2023).
6 By launching its initiative for a European Chips Act, the EU is pursuing similar objectives to those of the US government; see European Union (2022). For an overview of funding programmes in other countries, see Congressional Research Service (2023b).

ports of travel services also rose briskly again. By contrast, imports fell again significantly, reflecting subdued domestic activity. Private consumption declined and gross fixed capital formation increased only marginally. Nevertheless, the labour market remained robust. Unemployment dropped to 2.5% by June. In line with the above, wage growth recently picked up markedly. Recent wage agreements suggest that the coming months should continue to see considerable growth. Consumer price inflation also remained strong by Japanese standards. The year-on-year CPI rate barely changed towards the end of the period under review, standing at 3.3% in July. Against this backdrop, the Bank of Japan has maintained its expansionary stance as at the end of July, but has announced that it will be more flexible in future. The fluctuation band around ten-year government bond yields will be interpreted less rigidly.

United Kingdom

Economic activity still subdued

In the United Kingdom, economic activity improved only slightly in the second quarter. Seasonally and price-adjusted GDP rose by 0.2% on the quarter. The services sector in particular stayed subdued, although unusually sunny weather provided the leisure activity and hospitality sectors with good quarterly results. In the retail sector, real gross value added remained well below its pre-pandemic level. Construction output rose markedly in the favourable weather conditions. Manufacturing output actually increased robustly. By contrast, the labour market situation continued to deteriorate. The unemployment rate rose to 4.2% at the end of the period under review. However, this has not yet curbed high wage growth and has also contributed to the year-on-year rate of the Harmonised Index of Consumer Prices (HICP) remaining at 6.8% in July. In the face of persistently high inflation, the Bank of England continued to tighten its monetary policy stance, raising its key interest rate by a total of 75 basis points in July and August to 5.25%.

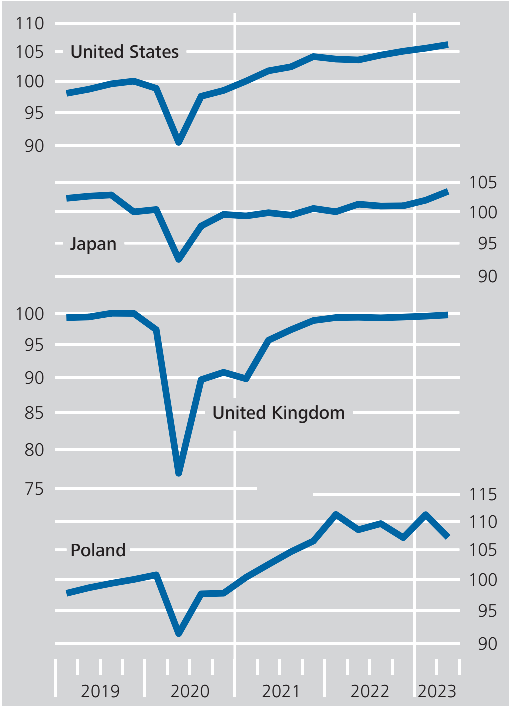
Poland

Marked decline in GDP

In Poland, economic output fell significantly by 3.7%, following a steep rise in the previous quarter. The underlying trend dynamics of the Polish economy have thus moved sideways since the start of the Russian invasion of Ukraine. Economic growth has also weakened in other countries in the region since the outbreak of the war (see the box on pp. 18 ff.). In Poland, inflation abated only little and remained exceptionally strong, weighing on purchasing power and dampening domestic demand. In price and seasonally adjusted terms, retail sales continued to decline substantially in the second quarter. Industrial output likewise fell significantly. By contrast, impetus was provided by investment. The labour market remained robust. The unemployment rate remained close to its historical low. Wages grew robustly by 12% on the year. Consumer price inflation decreased slightly to 10.8% in July. At 10.6%, the core rate was almost as high. The National Bank of Poland left its policy rate unchanged at 6.75%.

Real GDP in selected industrial countries

Q4 2019 = 100, seasonally and calendar adjusted, log scale



Sources: Bureau of Economic Analysis, Cabinet Office of Japan, Office for National Statistics, Statistics Poland and Bundesbank calculations.
Deutsche Bundesbank

Macroeconomic trends in the euro area

Slight rise in economic output

Following two quarters of stagnation, the underlying trend of economic output in the euro area improved slightly in the second quarter of 2023. According to the Eurostat flash estimate, real GDP rose surprisingly sharply by 0.3% on the quarter after seasonal adjustment. However, this included a comparatively large contribution from Ireland. Excluding Ireland, whose GDP is heavily influenced by the strategic activities of multinational enterprises,[5] growth amounted to just under 0.2%. The GDP figures for the two preceding quarters were revised slightly upwards as part of the regular revisions of the national accounts. Following these revisions, the figures are now indicative of a prolonged period of weakness, but not a recession. In this context, demand-side factors increasingly displaced supply-side factors as the most significant factors limiting production (see the box on pp. 22 and 23).

No further decline in private consumption

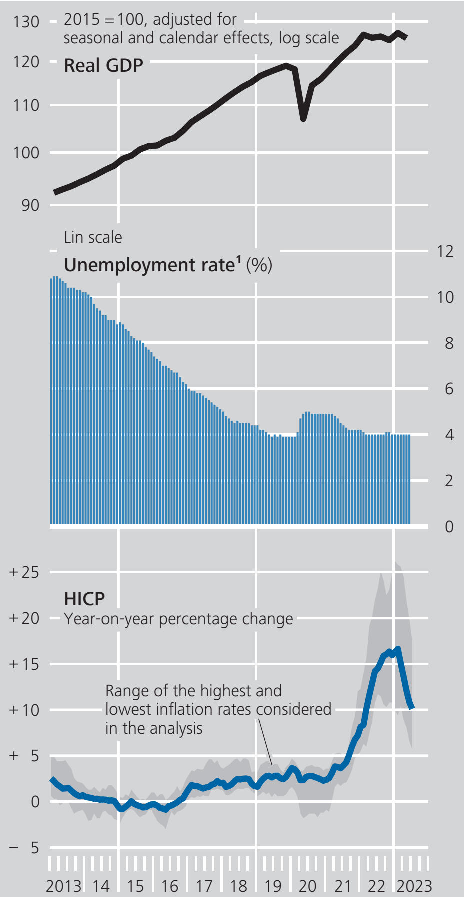
Private consumption in the euro area is likely to have stabilised in the second quarter, following two quarters of marked decline. Disposable income is also likely to have risen very considerably again and, in light of the gradual easing of inflation, purchasing power is also likely to have increased somewhat. In particular, expenditure for services, including transport and hospitality services, probably saw some growth as a result. By contrast, retail sales stagnated in real terms, and there was another drop in new car registrations. Despite steady improvement,

5 Ireland's GDP grew by 3.3% on the quarter. For more information on the issues surrounding Ireland's GDP, see Deutsche Bundesbank (2018).

The central and eastern European EU Member States between decelerating growth and persistent inflation

The severe economic shocks of recent years hit the central and eastern European EU Member States especially hard. This group of countries overcame the COVID-19 pandemic surprisingly quickly, and, at first, the brisk growth of the preceding years continued. The fallout from Russia's war of aggression against Ukraine placed central and eastern European economies under renewed pressure, however. Price inflation, in particular, heated up considerably.

Economic performance, unemployment and consumer prices in the central and eastern European EU Member States



Sources: Eurostat and Bundesbank calculations. **1** ILO definition, seasonally adjusted.
Deutsche Bundesbank

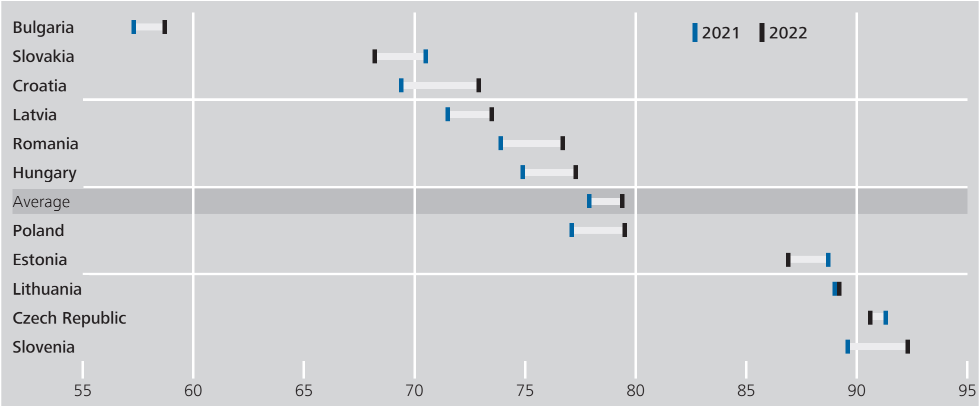
During this crisis, too, the central and eastern European EU Member States initially proved more resilient than anticipated, with the grouping still recording a 4.1% increase in real gross domestic product (GDP) in 2022. However, economic growth weakened significantly over the course of the year. In some countries – Estonia, Latvia and Lithuania, as well as the Czech Republic and Hungary – economic output declined markedly, at least for a time.

Success in securing the energy supply and the fact that the direct effects of diminished opportunities for sales in Russia and Ukraine turned out to be moderate were instrumental in keeping economic developments favourable overall last year. In addition, industrial output was buoyed by the easing of supply chain problems and by pent-up demand. Some countries also benefited heavily from the return of tourism following the end of the pandemic. As a result, the labour market situation remained favourable. At 4%, unemployment stayed close to its low, despite the influx of Ukrainian refugees fleeing the war. Employment continued to climb in most of the countries.

This drove a significant increase in inflation, however. Immediately after the outbreak of the war, the inflation rate as measured by the Harmonised Index of Consumer Prices, rose from about 8% in January 2022 to more than 10% in March. It continued its upward trajectory as the year progressed, reaching just over 16% in November. Overall, this group of countries experienced higher rates of inflation than the western and southern European countries. This was partly due to the above-average rise in food prices, a component accorded a higher

Per capita GDP in the central and eastern European EU countries

As a percentage of the average GDP per capita across the EU's 27 Member States, adjusted for purchasing power parity



Sources: Eurostat and Bundesbank calculations.
Deutsche Bundesbank

weighting in the basket of goods in the central and eastern European countries.

However, core inflation, too, was up in the central and eastern European EU Member States, hitting 11.5% by December 2022. Strong wage growth, which had already intensified markedly prior to the COVID-19 crisis, was a key driving factor. Wages in central and eastern Europe climbed by a good 12% in 2022, with the strongest growth being recorded in countries conducting their own, independent monetary policy. In Slovenia and Slovakia, in particular, growth was far more moderate. Despite the strong wage increases, all countries in the group saw a considerable slide in real wages. Levels of price inflation in the region have now eased somewhat in the intervening period. Headline inflation receded to 10.8% by mid-2023, while the core rate fell to 10.1%. There was another slight cooling of headline inflation in July, taking it to 10.1%.

Monetary policymakers responded to the rise in consumer price inflation by adopting a much tighter stance. The Czech central bank had already raised its policy rate to 7% by June 2022 and has since left it unchanged. Poland's central bank increased its policy rate to 6.75% by September 2022, while the Hungarian central bank even went to 13%. Most recently, January 2023 saw the Romanian central bank hike its policy rate to 7%.[1] In addition, the Czech and Polish central banks also sought to support or strengthen their currencies by means of foreign exchange interventions, with a view to dampening imported inflation. While the Czech koruna appreciated against the euro, Poland, Hungary and Romania all experienced a depreciation, which pushed inflation even higher for a time.

Over the course of last year, macroeconomic imbalances increased markedly in the central and eastern European EU Member States. Unit labour costs climbed more strongly, and price and cost competitiveness declined considerably. On top of that, current account deficits grew, not least because of the dramatic rise in prices for imported energy. The current account deficits of Hungary and Romania reached levels in excess of 8% of GDP. Government budget deficits, too, receded only slightly from the highs seen during the COVID-19 crisis. Hun-

1 Owing to the currency board arrangement in Bulgaria, the country's central bank does not set a policy rate.

gary and Romania again led the field, with government deficits amounting to more than 6% of GDP.

Despite the challenging economic environment, further progress towards convergence was made last year. Calculated at purchasing power parities, the gap between per capita GDP for the country group as a whole and the average for the EU narrowed to 20.6%. Five years ago that figure stood at almost 30%. Once the COVID-19 crisis came to an end, countries with substantial tourism sectors especially – such as Slovenia and Croatia – made the greatest progress towards convergence. With firms setting up new production sites on Polish and Hungarian soil,[2] those two countries also made significant inroads on their way to convergence. But not all countries made progress. Slovakia and the Czech Republic actually lost ground last year in light of the ongoing economic downturn.

In 2022, Slovenia was furthest ahead in terms of real convergence, followed by the Czech Republic, Lithuania and Estonia, all of which exceeded the average for the country group. Poland's convergence level, at almost 80% of the EU average, is now slightly above the group average. It is followed by Hungary and Romania and, at just under 75% of the EU average, Latvia and Croatia. Next comes Slovakia, at just under 70%. Bulgaria still had the furthest to go in terms of convergence, with less than 60% of the EU average.

The central and eastern European EU Member States are facing muted growth prospects this year. Private consumption is generally expected to be more buoyant in the second half of the year. However, with industrial activity looking set to remain rather weak in the euro area, foreign demand is likely to stay on the subdued side.

Bringing the high inflation rates back down is a key policy objective. Inflation will abate to some extent simply by dint of the reduced energy prices. However, given the sizeable real wage losses and that a considerable degree of tightness is still evident in the labour market, there is a risk that further disinflation will be curbed by strong wage growth. This is also likely to weigh on price competitiveness. Nevertheless, lower energy prices mean that external imbalances are expected to decline markedly this year.[3]

The region's longer-term growth outlook remains favourable, meanwhile. The reorientation of supply chains has already brought increased foreign investment to the region in more recent times. According to the OECD, for example, net inflows in Poland have risen significantly again since the COVID-19 crisis. It is a similar story for Slovakia. In the Czech Republic, net inflows were up at least slightly.[4] This trend is likely to continue. In addition, sizeable payments from the Next Generation EU programme are still on the horizon, for investment in digitalisation and climate action.[5] Population ageing remains the biggest challenge facing economic performance going forward. Migratory movements have also stepped up again following the end of the COVID-19 crisis. Ageing and migration mean that most countries in the group have seen a decline in their population.

2 For example, two Korean electronics groups each opened a production site for manufacturing lithium-ion batteries destined for electric vehicles, one choosing Hungary (Samsung 2021) and the other Poland (LG Chem 2022).
3 See, for example, European Commission (2023).
4 By contrast, net inflows in Hungary declined sharply; see OECD (2023).
5 Having said that, EU funds have yet to be disbursed to Poland and Hungary: checks as to whether the conditions are met are still pending on account of the ongoing conflicts around judicial independence, the rule of law and safeguards to prevent funds from the EU budget being allocated without due control.

consumer confidence remained subdued. It remains to be seen whether the saving ratio, which was well above its average for the pre-pandemic years during the first quarter, has also declined given the rising interest rates on investments.

Increase in investment

Gross fixed capital formation is likely to have expanded further in the second quarter, but at a considerably slower pace than at the start of the year.[6] Expenditure on machinery and equipment probably increased once again. In any case, capital goods producers' domestic sales rose significantly in price-adjusted terms in April and May. The prolonged upward trend in investment in information and communication technologies and intellectual property seems to have continued. Construction investment appears to have recorded only marginal growth, following robust expansion at the beginning of the year. Construction output fell compared with the previous quarter in April and May. The tightening of financing conditions is probably having a growing impact in this regard. The number of construction permits for residential buildings was in decline in the period up to April, and household demand for real estate loans continued to fall.

Goods trade with non-euro area countries down slightly in price-adjusted terms

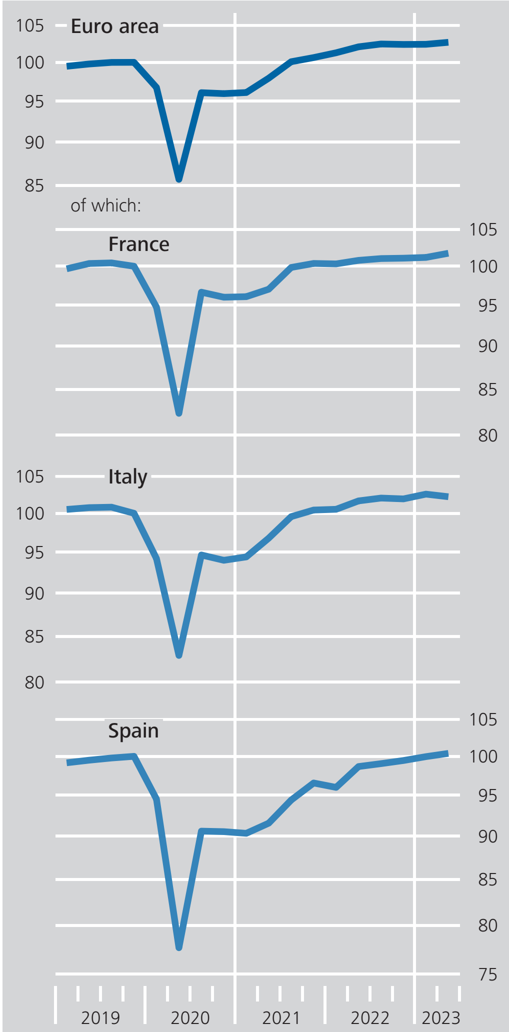
In light of the subdued global industrial activity, exports of goods from the euro area to non-euro area countries fell slightly in price-adjusted terms in the second quarter. Exports to China in particular saw sharp contraction, but exports to the United States were also lower than in the previous quarter. By contrast, exports to the United Kingdom rose again somewhat. Exports of services were considerably more spirited. In this context, international tourism in the southern euro area countries is likely to have played the most significant role. Imports of goods from non-euro area countries declined markedly in terms of value as import prices fell significantly.

Output down in the manufacturing sector

Industrial output continued to contract in the second quarter. Here, the slowdown was broadly based across segments. Production of intermediate goods continued to fall, and the decline in consumer goods production intensified once again. One exception was the production of motor vehicles, which increased again as supply chain problems continued to ease. In this segment, production has now caught up with pre-pandemic levels. Furthermore, the manufacture of capital goods saw distinct expansion. Capacity utilisation decreased markedly between April and July, most recently falling below its long-term average.

Aggregate output in the euro area

Real GDP, Q4 2019 = 100, seasonally and calendar adjusted, log scale



Sources: Eurostat and Bundesbank calculations.
Deutsche Bundesbank

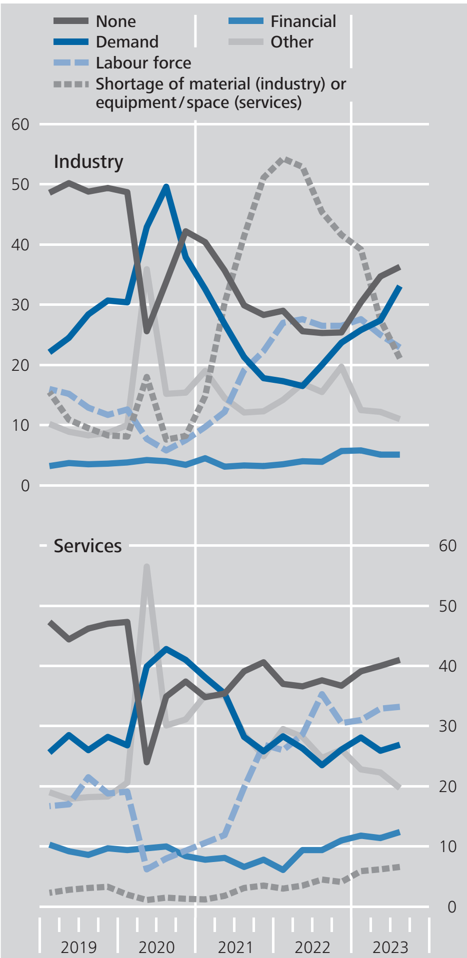
6 Excluding Ireland (for more information, see footnote 5).

Supply-side and demand-side factors limiting production in the euro area

Monthly surveys asking firms about their current situations and outlooks for the near future are indispensable sources of information for economic analysis. These surveys are published considerably earlier than the indicators encompassed by the official statistics and allow for initial appraisals of current developments and – depending on the questions posed – the reasons behind them, too.

Factors limiting production, as reported*

Percentage of surveyed firms



Sources: European Commission, business and consumer surveys. * Multiple answers possible.
Deutsche Bundesbank

The European Commission also publishes quarterly survey results on factors limiting production in the euro area, with the most recent round in July 2023.[1] The surveys draw a distinction between insufficient demand, shortages of labour, shortages of material (or equipment/space in the case of services), financial constraints, and other factors. Respondents are also able to answer that they did not experience any factors limiting their production.

The results of these surveys can be used to track the exceptional developments seen over the past three years. The COVID-19 pandemic and the measures taken to contain it in the spring of 2020 hampered production either directly ("Other" category), which was the case particularly in the services sector, or via drops in demand. In addition, complaints of materials shortages began to surface in industry, probably owing to pandemic-related production losses. These quickly died down, however, as did reports of insufficient demand. Other factors limiting production also receded in significance again, but remained elevated for a long time. This is likely to reflect the continued existence of pandemic-related restrictions at the time.

Subsequent developments were initially shaped by the steep rise in production constraints caused by shortages of materials in industry. Labour force shortages also became considerably more prominent in both industry and services. At the same time, barely any enterprises were complaining of

1 The data currently available extend back, in some cases, to 1985 (for industry) and 2003 (for services) and were calculated on the basis of national sources.

sales problems. Combined, all of this reflected the strong – and in some cases temporarily pent-up – demand, first for goods and later for services as well.

Shortages of materials then gradually became less significant in industry from the beginning of 2022, but remained elevated until recently, partly owing to the repercussions of Russia's ongoing war of aggression against Ukraine. In industry, complaints about demand picked up again from mid-2022 as a result of higher inflation and tighter monetary policy, mounting considerably in recent times, too. However, even at the current end, only one-third of firms reported insufficient demand – a proportion barely higher than the long-term average. In mid-2020, at the beginning of the COVID-19 pandemic, it was one-half of firms and, in 2009, at the height of the financial crisis, the figure was just over 60%. In the services sector, just under 30% of firms also cited demand as a factor limiting business, but this was less than the long-term average.

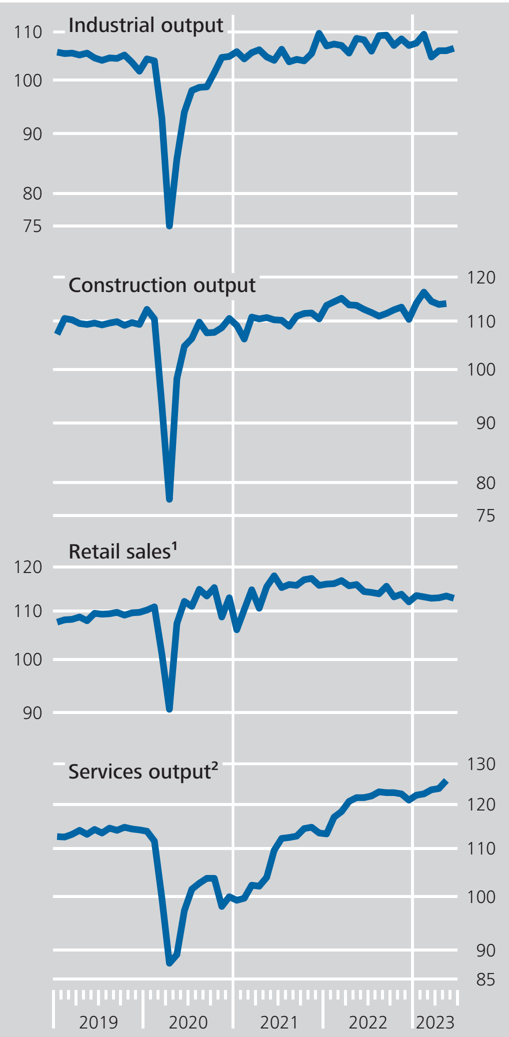
In industry, labour force shortages appear to have recently become somewhat less significant, but they remain an important factor weighing on production. This was true to an even greater extent in services. At the current end, no less than one-third of firms within the services sector complained of labour force shortages, compared with the long-term average of around 10%. This is likely to be, in part, an after-effect of the COVID-19 pandemic. During the pandemic, many skilled workers turned their backs on various branches of the services sector due to a lack of job opportunities.

Remarkably, financial factors did not play any notable role over the entire period under review. Even at the current end, their significance has climbed only slightly. So far, the tightening of monetary policy seems to be acting primarily as a curb on demand.

The overall picture for the moment, as painted by the European Commission's latest quarterly survey, reveals a services sector that is prosperous but constrained by shortages of labour, with industry suffering from insufficient demand in some areas. Looking at the euro area economy as a whole, demand-side limiting factors took on considerably more weight again, outstripping supply-side constraints. This should also have an impact on how prices develop. Shortages of labour remain a challenge, however.

Short-term indicators for the euro area

2015 = 100, seasonally adjusted, log scale



Sources: Eurostat and Bundesbank calculations. **1** Price-adjusted figures. **2** Excluding trade.
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Services activity distinctly more robust

The services sector is likely to have held up better than the manufacturing sector in the second quarter. Business activity rose in most segments. The hospitality sector in particular recorded significant gains. Brisk tourism is likely to have provided a boost primarily to the hotel sector. Activity in the transport and commercial services sectors was also up again.

Weak economic activity in most euro area countries

There continued to be major differences in macroeconomic dynamics among the member countries of the euro area. This was mainly attributable to differences in the significance of industry and tourism as well as developments in household purchasing power.

Strong growth in French economy, partly due to one-off effect

In France, preliminary estimates suggest that economic growth in the second quarter was 0.5% higher than in the previous quarter. The main driver was once again buoyant foreign trade. Alongside the continually vibrant tourism business, a key role was played by a one-off effect in goods exports arising from the delivery of a cruise ship. Domestic demand remained weak. Private consumption decreased considerably and investment increased only slightly. On the output side, it was mainly industry that saw expansion, recording another substantial rise. Service providers also expanded their business activities. By contrast, construction activity continued to decline.

Contraction in Italian GDP

In Italy, economic output did not quite maintain its elevated level from the first quarter. According to preliminary data, real GDP fell by 0.3% in the second quarter, after climbing by 0.6% in the first quarter. This was due chiefly to weak domestic demand. The tighter financing conditions and the rollback of the very large tax incentives that had been granted in previous years weighed on construction investment in particular. In addition, demand for industrial goods also weakened owing to the global economic situation. Against this backdrop, industrial output declined.

Further marked increase in GDP in Spain

The Spanish economy continued to grow in the second quarter, expanding by 0.4%. As a result, economic output exceeded its pre-pandemic level again for the first time. There was another considerable rise in investment. Private consumption saw distinct recovery following two quarters of decline. This is likely to have been driven by the comparatively good labour market situation and the recovery in households’ real disposable income as price pressures eased. By contrast, despite a strong tourism season, there was a marked fall in foreign trade, with exports dropping more sharply than imports. On the output side, considerable gains were recorded primarily in construction, but also in the services sector, while there was a distinct decline in manufacturing.

Marked differences among the smaller euro area countries, too

In Lithuania and Finland, real GDP increased significantly; these countries had previously been especially impacted by the effects of the war against Ukraine. There was moderate economic growth in Belgium, Slovenia and Slovakia, while the economy stagnated in Portugal. Economic activity declined in the Netherlands, Austria, Latvia, Estonia and Cyprus.

Labour market still well utilised, strong growth in wages

The labour market situation remained favourable in the second quarter. The unemployment rate even fell once again compared with the winter months, and employment continued to rise. However, employment growth flattened and labour shortages eased somewhat. Employment expectations for the next three months also declined for both industry and the services sector. Wage growth is likely to remain strong.

Price inflation somewhat weaker

Consumer price inflation weakened somewhat further in the second quarter, but remained fairly high despite the renewed steep decline in energy prices. HICP rose by just under 0.6% on the quarter in seasonally adjusted terms. Excluding energy and food, this figure stood at 1.1%.

Core inflation rate still high

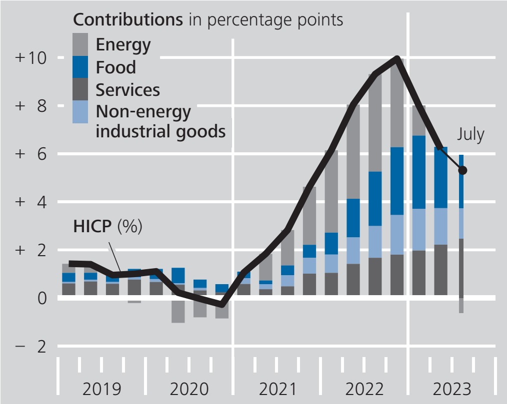
Year-on-year inflation fell significantly to 6.2%. Unlike in the previous quarter, energy no longer contributed to price inflation. Food prices rose somewhat less sharply than they had previously. At 5.5%, the core inflation rate excluding energy and food remained unchanged on the year. On the one hand, price inflation for services was much higher than it had been in the spring. This was chiefly attributable to considerably higher wages, alongside base effects arising from fiscal relief measures in 2022.[7] On the other hand, the high inflation for non-energy industrial goods diminished markedly. This held especially true for durable goods such as furniture and passenger cars, but also for non-durable goods, which had previously been subject to particularly high price inflation.

In July, consumer prices rose by 0.3% in seasonally adjusted terms compared with the previous month. Energy prices continued to fall substantially, and the rise in the prices of services was also somewhat less strong. However, the prices of unprocessed food and non-energy industrial goods increased to an exceptionally strong degree. At 5.3% in July, euro area annual inflation was only 0.2 percentage point lower than in the previous month. The core rate remained unchanged at 5.5%.

Only slight decline in inflation in July

Contributions to the euro area inflation rate (HICP)

Quarterly averages



Sources: Eurostat, ECB and Bundesbank calculations.
Deutsche Bundesbank

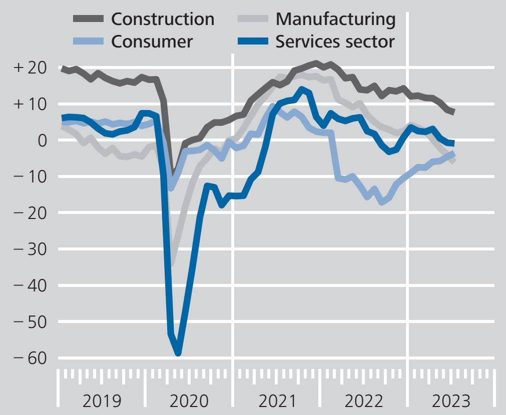
Underlying dynamics likely remain very subdued in current quarter

The pace of economic activity in the euro area is likely to remain subdued in the third quarter. While supply-side burdens, such as shortages of materials and labour, continue to ease, it is now weak demand that is likely to depress economic activity. The main reasons for this are inflation, which is easing only slowly, higher financing costs, and the subdued global economy. According to the business and consumer surveys conducted by the European Commission, the business climate has actually clouded again since April, following a brief period of recovery. The Purchasing Managers' Index for the whole economy also dropped back below the expansion threshold in June and continued to fall in July. In particular, the sub-index for manufacturing decreased further. The sentiment indicators

7 In particular, services in the passenger transport sector were significantly more expensive than they had been one year earlier, as the €9 ticket was available in Germany for a limited period of time from June 2022.

Sentiment indicators for the euro area*

Seasonally adjusted



Sources: European Commission and Bundesbank calculations. * Deviations from the respective average since 2000.
Deutsche Bundesbank

for the services sector likewise point to a marked slowdown, even though the situation in this sector still appears to be better than in industry. Despite rising financing costs, sentiment in the construction sector remained distinctly better. Thus far, it has mainly been new housing construction that has suffered, while public and commercial construction is likely to have continued to flourish. Against the backdrop of receding inflation and rising incomes, consumer confidence continued to improve up to the end of the period under review, but remained below its long-term average. While private consumption appears to be gaining traction, strong growth stimuli are probably not to be expected here for the time being either.

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