ECONOMIC AND MONETARY DEVELOPMENTS

1 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

The recovery in the global economy is continuing, although its momentum has been moderating somewhat. The short-term global outlook is clouded by the waning support from the inventory cycle and from the fiscal stimuli. This is supported by the latest survey-based data, which also point to a slowdown in the pace of the global recovery. Global price pressures have remained fairly subdued on account of prevailing spare capacity, particularly in advanced economies, while inflationary pressures have been somewhat more pronounced in emerging economies.

1.1 DEVELOPMENTS IN THE WORLD ECONOMY

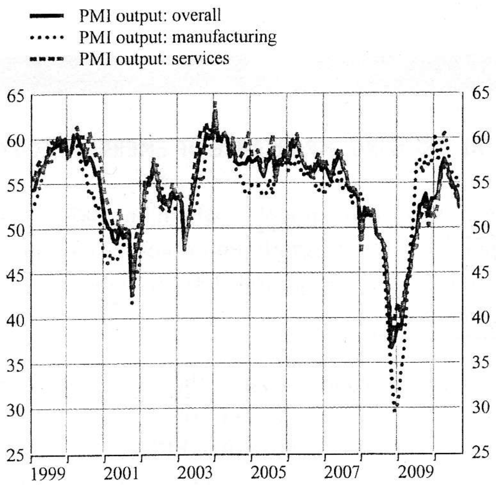
The recovery in the global economy is continuing, although its momentum has been moderating somewhat. The short-term global outlook is clouded by the waning support from the inventory cycle and from the fiscal stimuli. Across regions, the pace of the recovery remains somewhat uneven. In the major advanced economies, growth has remained moderate, as consumers and businesses in these countries repair their balance sheets in an environment of weak credit and labour markets as well as subdued consumer confidence. Growth has also slowed recently in emerging economies – particularly in Asia, which had been leading the global recovery – thereby diminishing the risk of overheating in some countries. Box 1 reviews the growing importance of emerging market economies.

The latest survey-based evidence substantiates the view that the global economic recovery has lost some momentum in recent months. The global Purchasing Managers' Index (PMI) for all-industry output stood at 52.6 in September, down from 53.9 in August, signalling that the global economy has continued to expand, albeit at a slower pace (see Chart 1). The momentum in both the manufacturing and the services sector continued to slow. The PMI for global employment was broadly unchanged at 50.4, suggesting generally very modest employment growth globally. This is broadly in line with the slow decline in the unemployment rate in OECD countries, which remained at the fairly high level of 8.5% in July (see Chart 2).

Global price pressures have remained fairly subdued on account of prevailing spare capacity, particularly in advanced economies. While the

Chart 1 Global PMI output

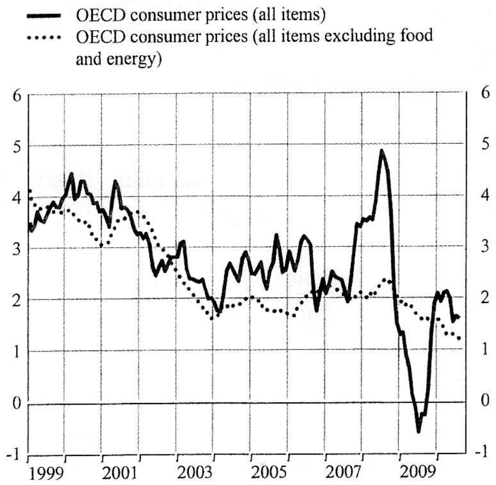
(diffusion index; seasonally adjusted; monthly data)



Source: Markit.

Chart 2 International price developments

(monthly data; annual percentage changes)



Source: OECD.

PMI input price index increased to 57.6 in September, from 56.8 in August, signalling a rise in average input costs, it remains below the levels recorded prior to the global financial crisis. According to the latest available data, in the OECD countries, annual inflation declined moderately in recent months, from a peak of just over 2% in the first quarter of 2010, on average, to 1.5% in June, before edging up again to 1.6% in July and August. Excluding food and energy, annual consumer price inflation has gradually declined and stood at 1.2% in August, unchanged from the previous month. In dynamic emerging market regions, by contrast, inflationary pressures have been somewhat more pronounced. In some countries, such as Brazil and India, capacity constraints have already exerted upward pressure on prices, while in China, overheating pressures have been diminishing somewhat. Finally, the rise in food prices over recent months has had a more pronounced impact on inflation developments in emerging markets, given that food has a greater weight in the consumption baskets.

Box 1

THE GROWING IMPORTANCE OF EMERGING ECONOMIES

Emerging economies[1] – which in 2009 accounted for 82% of the world's population – are playing an increasingly important role for the global economy and for the euro area in particular. Indeed, over the period 2004-09 emerging economies accounted for 63% of the increase in global output.

In terms of economic size, their share in global output has increased from less than 20% in the early 1990s to more than 30% at present, measured at market exchange rates. If the concept of purchasing power parity (PPP) is used – that is, taking account of differences in the cost of living – the share of emerging economies in world GDP is already 45%, almost 10 percentage points higher than in the early 1990s (Chart A). According to the IMF's World Economic Outlook, this share will surpass 50% in 2013.

GDP

Regarding individual economies, China and India – accounting for around 20% and 18% respectively of the world's population, compared with about 5% each for the euro area and the United States – have now entered the circle of the largest economies in the world. In terms of market exchange rates, China is now the third largest economy behind the United States and the euro area, based on 2010 World Economic Outlook projections. China's GDP level is already 91% of euro area GDP in PPP terms – though only 43% at market exchange rates. In PPP terms, India is among the top five economies, with GDP amounting to more than one-third of that of the euro area. Using either method, the subsequent positions are dominated by the emerging world, including Brazil, Russia and Mexico (the exceptions being the United Kingdom and Canada) (Chart B).

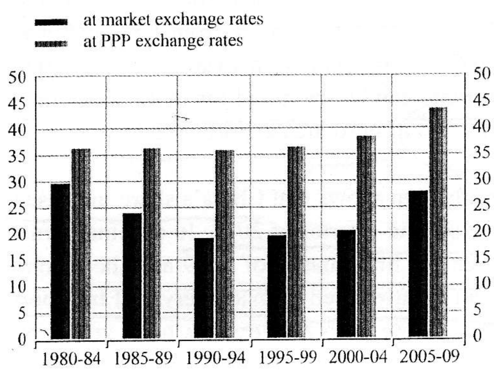
1990-2010

Emerging economies are very open to international trade, which is reflected in their growing share in world trade. On the export side, the emerging economies' share has increased from around 19% of world exports in the early 1990s to close to 35% recently. On the import side, the share has increased from 20% to 30% over the same period.

1 This box adopts the definition of emerging market economies given by the IMF.

Chart A Emerging economies' share in world GDP

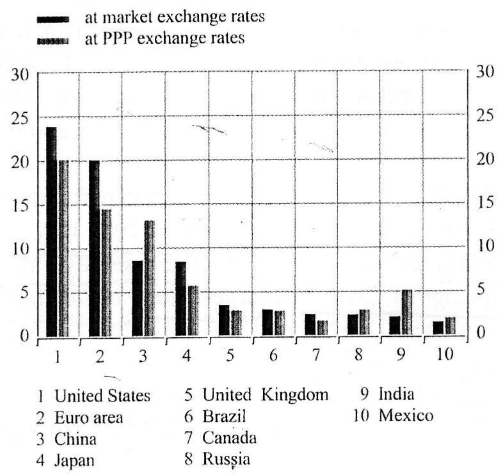
(percentages)



Source: IMF World Economic Outlook.

Chart B GDP of selected economies in 2010 relative to world GDP

(percentages)



Source: IMF World Economic Outlook.

Emerging economies have also made some significant progress in terms of financial development. In particular, the share of the major emerging economies' stock markets in world capitalisation increased from 7% in 1990 to 32% in 2009. This has been associated with considerable net private portfolio inflows both prior to the global financial crisis and – following a phase of temporary capital flow retrenchment, especially in the last quarter of 2008 and the first quarter of 2009 – during the subsequent recovery.

Regarding economic links with advanced economies, the recent global crisis has confirmed that developments in emerging economies continue to depend significantly on advanced economies. Indeed, even though the shock stemmed from the advanced world, the median emerging economy suffered about as large a decline in output as the median advanced economy.[2]

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Taking a historical perspective, however, it becomes clear that emerging economies have been less affected in the recent crisis than in the past, and have indeed even led the global recovery. Emerging Asia – especially its largest economies – has evidenced a large degree of resilience to the global economic downturn. In China real GDP growth declined only slightly, from 9.6% in 2008 to 9.1% in 2009. This is mainly because the Chinese authorities reacted promptly with a RMB 4 trillion (12% of GDP) stimulus package combined with a strongly expansionary monetary policy, which boosted infrastructural investment and contributed to the resilience of private consumption. Another important factor was that the domestic value-added content of Chinese exports is relatively low owing to a large share of processing trade. As a result, falling exports implied almost equally falling imports of intermediate goods and, thus, only a limited negative impact of net exports on GDP growth. Finally, owing to the still binding restrictions on inward and outward portfolio investments, banks' balance sheets were not severely impacted by the global financial turmoil. From the second quarter of 2009 onwards, private capital inflows regained pace, as did foreign exchange reserves, which totalled USD 2.4 trillion in June 2010.

China!!

2 See "How Did Emerging Markets cope in the Crisis?", IMF, 2010.

Turning to the importance of emerging economies for the euro area, it should be highlighted that the share of euro area exports (excluding intra-euro area trade) to Asia increased from 19% in 2000 to 22% in 2009, whereas exports to the United States decreased from 17% to 12% in the same period. The share of China in total euro area exports increased from 2% in 2000 to 5.3% in 2009. Exports to Russia more than doubled during the same period, from 1.8% to 3.9%, thereby exceeding exports to Japan, although Russia's share had been even higher in 2008 (5.0%), before the collapse in world trade. A similar trend can be identified for India, albeit on a much smaller scale, with this country accounting for 1.7% of euro area exports in 2009.

Defiat !!

A further breakdown of euro area exports using quarterly data shows that China's share increased from 3.8% in the first quarter of 2007 to 6.2% in the second quarter of 2010. In nominal terms euro area exports to China increased by 54% between the first quarter of 2009 and the second quarter of 2010. The largest share of this increase can be attributed to machinery and transport equipment – especially road vehicles. More generally, while euro area exports have grown by 21.8% since their trough in the second quarter of 2009, more than a quarter of this increase can be attributed to exports to emerging Asia, almost 10% to exports to Latin America, and a further 6% to exports to the Commonwealth of Independent States, including Russia.

Looking ahead, the importance of emerging economies for both global and euro area developments is likely to increase further over time. This is suggested by all available long-term projections based on demographic trends and models of capital accumulation and production.

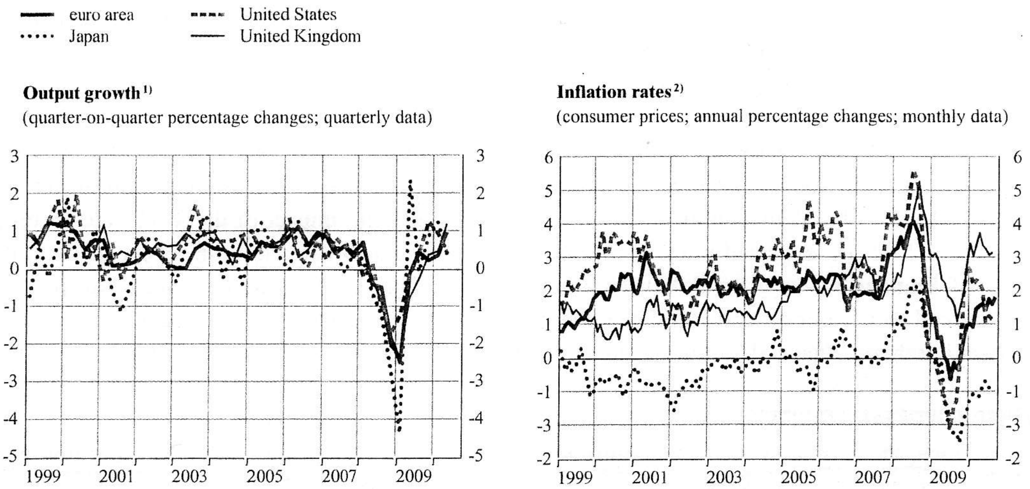
UNITED STATES

In the United States, the pace of recovery in economic activity moderated in the second quarter of 2010, after having rebounded strongly in the previous two quarters. According to the third estimate by the Bureau of Economic Analysis, annualised quarter-on-quarter real GDP growth was 1.7% (see Chart 3). GDP growth was supported by business investment and government spending. Meanwhile, growth was dampened by a large negative contribution from net exports, owing to a sharp acceleration in imports relative to that in exports. Recent data releases point to modest GDP growth in the third quarter. Industrial production rose at a slower pace in August than earlier this year, as the momentum from inventory accumulation waned. Looking ahead, survey-based indicators suggest a further weakening in the manufacturing sector. In the context of low consumer confidence and weak labour market conditions, personal consumption expenditure growth is expected to remain subdued.

As regards price developments, annual CPI inflation declined to 1.1% in August 2010, from 1.2% in July. The energy index rose by 3.8% year on year in August and, as in July, was the primary driver of headline inflation. Excluding food and energy, the annual rate of inflation remained at 0.9% in August, the lowest rate since 1966, reflecting the substantial slack in US product and labour markets.

On 21 September the US Federal Open Market Committee (FOMC) decided to keep the target for the policy rate unchanged within a range of 0% to 0.25% and continued to anticipate that economic conditions were likely to warrant exceptionally low levels of the federal funds rate for an extended period. The FOMC also said that inflation was at levels somewhat below those it judges to be most consistent, over the longer run, with its mandate and that it was prepared to provide additional accommodation if needed to support the economic recovery and return inflation, over time, to levels consistent with its mandate.

Chart 3 Main developments in major industrialised economies



Sources: National data, BIS, Eurostat and ECB calculations.
1) Eurostat data are used for the euro area and the United Kingdom; national data are used for the United States and Japan. GDP figures have been seasonally adjusted.
2) HICP for the euro area and the United Kingdom; CPI for the United States and Japan.

JAPAN

In Japan, the economy continued to expand in the second quarter, albeit at a slower rate than in the first quarter of 2010. According to the second preliminary data release by Japan's Cabinet Office, real GDP expanded by 0.4% quarter on quarter in the second quarter. Growth was still largely driven by exports, although the pace of increase has started to moderate. On the domestic side, the main contribution came from non-residential investment, while private consumption was flat, reflecting the waning effect of the policy stimulus measures. Recent data releases point to a further moderation of activity. In particular, industrial output fell in August, reflecting the slowdown in export growth given the appreciation of the yen and a slowdown in global demand. The September Tankan survey revealed that, while firms' assessment of current conditions has improved somewhat, their outlook has deteriorated.

Overall consumer price inflation remained negative in August (at -0.9% year on year), owing to the significant slack in the economy. CPI inflation excluding fresh food declined by 1.0%, while annual CPI inflation excluding fresh food and energy declined by 1.5%.

On 15 September the Japanese authorities intervened in the foreign exchange market for the first time since March 2004 in order to curb the appreciation of the yen. On 5 October the Bank of Japan decided to lower its target for the uncollateralised overnight rate to between 0.0% and 0.1%, from the previous level of 0.1%. At the same time, the Bank of Japan announced that it would examine the establishment, as a temporary measure, of a programme on its balance sheet to purchase various financial assets.

UNITED KINGDOM

In the United Kingdom, the economic recovery has continued. Real GDP increased by 1.2% quarter on quarter in the second quarter of 2010, after expanding by 0.4% in the first quarter. Growth was mainly driven by a rebound in private consumption and a continued accumulation of inventories in the second quarter, while the contribution of net trade was nil. House prices continued their upward trend in year-on-year terms, although month on month they have declined in recent months. Looking ahead, inventory adjustments, the monetary stimulus, external demand and the past depreciation of the pound sterling should support economic activity. However, growth in domestic demand is expected to remain restrained by tight credit conditions, household balance sheet adjustment and substantial fiscal tightening.

Annual CPI inflation increased markedly at the beginning of 2010, peaking at 3.7% in April, but has moderated somewhat in recent months, standing at 3.1% in August. Looking ahead, the lagged effects of the depreciation of the pound sterling and the impact of the VAT rate increase in January 2011 are expected to exert upward pressure on consumer prices. In recent quarters the Bank of England's Monetary Policy Committee has maintained the official Bank Rate paid on commercial bank reserves at 0.5%. The Committee has also continued to vote to maintain the stock of asset purchases financed by the issuance of central bank reserves at GBP 200 billion.

OTHER EUROPEAN COUNTRIES

On balance, the economic situation continued to improve in the second quarter in other non-euro area EU countries, while inflationary developments were mixed. Real GDP increased by 1.7% and 1.9% quarter on quarter in the second quarter of 2010 in Denmark and Sweden respectively, suggesting that the recovery has gained pace in both countries. In Denmark, HICP inflation has been stable in recent months, hovering around 2%, while it has followed a decreasing trend in Sweden. In August 2010 annual HICP inflation stood at 2.3% in Denmark and 1.1% in Sweden.

Overall, the largest central and eastern European EU countries continue to recover, although economic growth has been volatile in recent quarters. The recovery continues to be supported by external demand and inventory accumulation. Domestic demand has remained fairly subdued owing to weak labour and credit market conditions as well as fiscal restraint in some countries. Recent confidence indicators and industrial production and trade data point to the continuation of an external demand-driven recovery in all countries, with the exception of Romania. In August 2010 inflation stood at 1.5% in the Czech Republic and 1.9% in Poland. In Hungary, inflation declined markedly to 3.6% in August 2010, in line with the base effect related to last year's tax hike. In Romania, inflation hovered slightly above 4% in the months prior to July, before increasing to 7.6% in August following the recent VAT hike.

East

EMERGING ASIA

In emerging Asia economic activity remains buoyant, albeit moderating slightly. The latest available data for industrial production and export indicators exhibit marginally lower growth rates compared with the second quarter, whereas domestic private demand is increasingly contributing to economic growth in a number of countries. Inflationary pressures have been somewhat more pronounced owing to the favourable economic conditions, but also as a result of rebounding commodity prices.

In China, overall economic activity remained strong in the summer months, despite the gradual withdrawal of fiscal stimuli. Annual year-on-year growth rates of both investment and industrial production picked up in August. Retail sales have also risen, led by vehicle sales. August data indicate a further shift in the composition of investment, away from public stimulus-related infrastructure investment and towards private sector investment. Measures to tighten activity in the property sector adopted in April had only a limited negative impact on actual construction growth and were complemented by additional fine-tuning measures in late September. Despite a continued deceleration, export growth remained strong at 34% in year-on-year terms in August, and the monthly trade surplus was close to pre-crisis levels for the fourth consecutive month. In the first eight months of 2010 the cumulated trade surplus was USD 104.5 billion, which is 15.4% below that of the same period last year. CPI inflation increased to 3.5% year on year in August (from 3.3% in July), led by an increase in food prices.

LATIN AMERICA

Economic activity in Latin America continued to advance at a rapid pace in the second quarter. However, recent high-frequency indicators point towards a moderation in growth. At the same time, inflationary pressures have remained broadly stable. In Brazil, real GDP grew at an annual rate of 8.7% in the second quarter of 2010, slightly below the 9.0% growth rate recorded in the first quarter. Industrial production in July, meanwhile, stood 8.7% higher than a year earlier, down from 11.1% in June. In August consumer price inflation stood at 4.4% on an annual basis, broadly unchanged from the previous month. Argentina also recorded strong levels of economic activity during the second quarter, with real GDP expanding by 9.2% on an annual basis. At the same time, consumer price inflation continued to record double-digit rates on an annual basis, reaching 11.1% in August, broadly unchanged compared with July. Finally, in Mexico, industrial production grew by 6.1% in July, after having increased by 8.3% in June. Consumer price inflation was broadly unchanged in August as compared with July, standing at an annual rate of 3.7%.

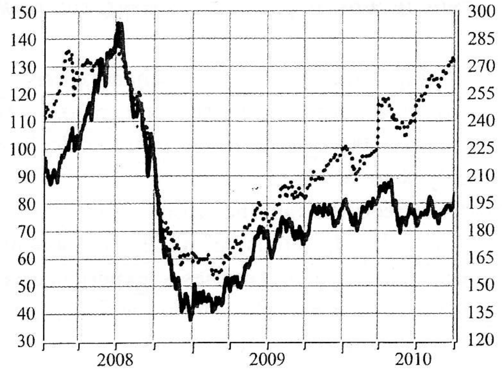
1.2 COMMODITY MARKETS

Oil prices recovered during September and early October. Brent crude oil prices stood at USD 83.9 per barrel on 6 October, which is 5.8% higher than at the beginning of the year (see Chart 4). Looking ahead, market participants expect higher oil prices in the medium term, with futures contracts for December 2012 trading at around USD 90 per barrel.

Oil

Looking at fundamentals, oil demand is growing robustly in non-OECD countries and recovering steadily in OECD countries, in particular in the United States. According to the International Energy Agency, global oil demand is expected to rise by 1.5% in 2011. On the supply side, oil production capacity remains ample, partially owing to increases in non-OPEC output. While high levels of inventories have dampened the demand-side pressures on oil prices in recent months, some signs of an inventory drawdown have started to materialise, which may hint at tighter market conditions in the future.

Chart 4 Main developments in commodity prices



Sources: Bloomberg and HWWI.

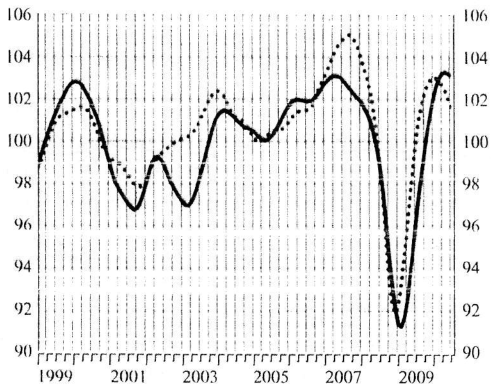
The prices of non-energy commodities increased significantly in September. Food prices continued to increase strongly, driven in particular by maize and sugar. Price increases were due to a combination of robust demand, a reduced supply owing to adverse weather conditions and low inventories. Cotton has also reached record prices, mainly owing to a strong recovery in demand and tight supply. Metal prices have also increased, driven in particular by aluminium, tin and nickel. In aggregate terms, the price index for non-energy commodities (denominated in US dollars) was 20.8% higher at the end of September than at the beginning of the year.

1.3 OUTLOOK FOR THE EXTERNAL ENVIRONMENT

Looking ahead, the latest survey and indicator-based information suggests that the recovery in the global economy is continuing, although the momentum has been moderating somewhat. In July the OECD composite leading indicator decreased slightly to 103.1, albeit remaining above its long-term average (see Chart 5). This development suggests that the global recovery may have passed its peak in the first half of this year. Some further moderation of the global economic expansion in the near future is also suggested by the lower inflow of new orders, as indicated by PMI data for September. The overall new orders index declined to 52.6 in September, from 55.2 on average in the second quarter. New business growth slowed mainly in the manufacturing sector, while the slowdown of growth in new orders in the services sector was less pronounced. In fact, the services sector new orders index picked up slightly in September, as compared with August. Box 2 briefly presents trends in world trade following the financial crisis.

Chart 5 OECD composite leading indicators

(monthly data; amplitude-adjusted)



Source: OECD.
Note: The emerging market indicator is a weighted average of the composite leading indicators for Brazil, Russia and China.

In an environment of uncertainty, the risks to global activity are slightly tilted to the downside. On the upside, trade may continue to grow faster than expected. On the downside, concerns remain relating to the emergence of renewed tensions in financial markets, renewed increases in oil and other commodity prices, and protectionist pressures, as well as the possibility of a disorderly correction of global imbalances.

Box 2

TRENDS IN WORLD TRADE FOLLOWING THE FINANCIAL CRISIS

A striking feature of the recent financial crisis was the collapse in world trade, which was highly synchronised across countries and regions.[1] Between the third quarter of 2008 and the second quarter of 2009 global trade volumes declined by approximately 15% and, thus, much more steeply than world GDP, which fell by around 2% over the same period (see Chart A). This partly reflects the fact that global trade is more cyclical than global economic activity, because the more "trade-intensive" GDP components – such as private investment, durable goods consumption and inventories – experience larger swings than non-traded goods and services over the business cycle. The increased presence of global supply chains in recent years may have further amplified this effect.

1 For more details, see the article entitled "Recent developments in global and euro area trade", *Monthly Bulletin*, ECB, August 2010.

Following this severe downturn, world trade recorded a vigorous rebound which started in the second half of 2009 and continued well into the first half of 2010 (see Chart A). By the second quarter of 2010 global trade had recovered by more than 14% from its trough, although it still remained somewhat below the level recorded in the third quarter of 2008 before the intensification of the financial crisis. NB

The pace of the recovery in global trade seems to have moderated in the second and third quarters of this year. Monthly data from the Centraal Planbureau (the Netherlands Bureau for Economic Policy Analysis) – which provides timely data on global trade in goods – suggest that the momentum of growth in global trade in goods has slowed, declining from 5.4% in the first quarter of 2010 to 2.8% in July (on a three-month-on-three-month basis). Recent survey-based data point to a further slowdown in growth in the third quarter. The new export orders component of the global Purchasing Managers' Index (PMI), which is strongly correlated with developments in global trade, has declined steadily over the past few months. In September it stood at 52.1, significantly below the peak of 58.5 recorded in April (see Chart B). At the same time, it remained above the expansion/contraction threshold of 50, suggesting that global trade is continuing to expand, although at a more subdued rate than in the first half of the year.

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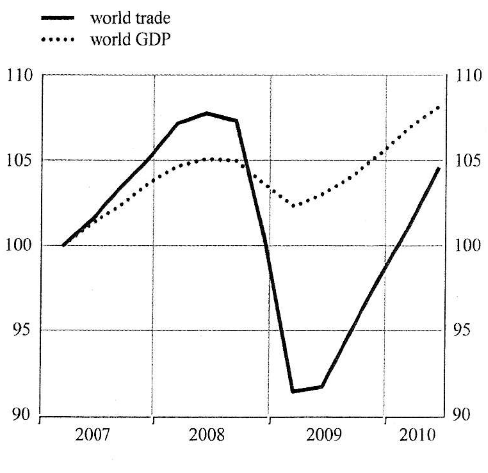
The recent trends in and near-term prospects for global trade are affected by the unwinding of several transitory factors. During the financial crisis, fiscal stimulus measures – most prominently car scrappage schemes – supported global trade. As these measures are being phased out and governments are embarking on a process of fiscal consolidation, the previously supportive effects on trade are unwinding. Moreover, inventory dynamics magnified both the downturn and the subsequent upturn in global trade. More recently, however, inventories have been approaching levels in line with historical averages, which implies that restocking is likely to have a less

Chart A World trade in goods and services and world GDP

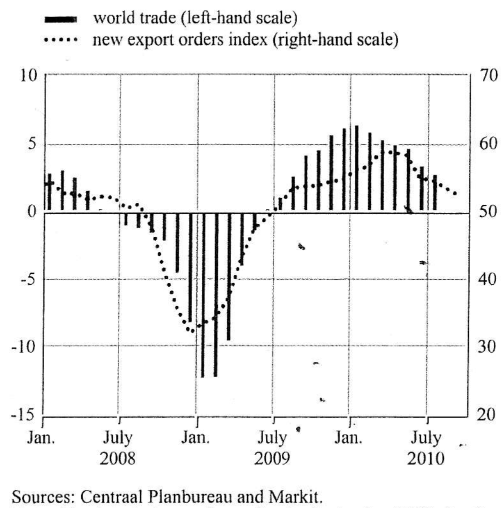
(index: Q1 2007 = 100; quarterly data)



Source: ECB.
Note: The latest observation refers to the second quarter of 2010.

Chart B World trade in goods and the new export orders component of the global PMI

(three-month-on-three-month percentage changes; diffusion index)



Sources: Centraal Planbureau and Markit.
Note: The latest observation refers to September 2010 for the export orders component of the Purchasing Managers' Index (PMI) and July 2010 for world trade.

pronounced effect on global trade in the near term. Finally, the strong rebound in global trade may also reflect a technical correction following the extremely sharp fall during the crisis.

Looking ahead, trade levels are likely to remain below their pre-crisis trajectory for some time to come. First, trade-intensive sectors are credit-sensitive. As lending standards are unlikely to return to pre-crisis standards in the near future, persistent repercussions on the level of trade cannot be ruled out. Second, in several advanced economies, demand for non-tradable goods has increased somewhat relative to demand for durable goods, as consumers repair their balance sheets and thereby tend to reduce their expenditure on durable goods more than their spending on services.[2] This is also likely to have a negative impact on global trade. In the longer term world trade growth can be expected to continue to outpace growth in economic activity, as emerging economies continue to integrate rapidly into the world economy.

Overall, the vigorous recovery in global trade in recent quarters was partly a technical correction and is waning now, as suggested by recent survey data releases. Meanwhile, there is little evidence that global trade integration has been hindered by the financial crisis. While tight credit standards and balance sheet restructuring are likely to dampen trade growth for some time to come, in the longer term world trade prospects will largely depend on the outlook for global economic activity and the ongoing globalisation process.

2 See also Chapter 4 entitled "Do financial crises have lasting effects on trade?", *World Economic Outlook*, IMF, October 2010.