Developments in the International and Euro Area Economy

Overview

The global economy recovered more strongly in the second half of last year than had been previously expected and there have been significant upward revisions to growth forecasts for this year. Financial market conditions and the performance of emerging Asian and Latin American economies, in particular, have improved markedly. Nevertheless, the outlook remains one of gradual, and possibly quite uneven, economic recovery. While there has been some improvement in fundamentals, recent growth also reflects more temporary factors and much of the substantial support from fiscal and non-conventional monetary policies is not sustainable in the medium term. Also, while the impetus from inventory accumulation and the recovery in trade volumes has been substantial, this could wane after volumes have normalised. Unusually severe rates of contraction were recorded in late 2007 and early 2008 when purchases of durable and investment goods in particular were essentially postponed. In addition, substantial headwinds still remain. In particular, high unemployment and, in many economies, the impact of weak balance sheets among banks, firms and households will continue to weigh on the global recovery. Recent trends in global trade are explored more fully in a box later in this article.

Regional economic differences can be explained to a large extent by variations in levels of domestic debt. Bank balance sheets are still quite impaired in a number of advanced and Eastern European economies as a result of loan losses while firm and household debt levels in some of these economies are high. Amid uncertainty surrounding future loan losses and future capital requirements, banks are concentrating on replenishing capital and reducing leverage, which may be limiting credit provision. Firms and households are also focusing on reducing debt levels. Labour market deterioration has also been particularly sharp in these economies. Banks in most emerging economies have been relatively unscathed by the financial crisis, while firm and household balance sheets are generally less leveraged. Nevertheless, emerging economies were most dependent on trade and, though benefiting from recovering trade volumes, have also seen sharp increases in unemployment. Significant differences in the scale and timing of fiscal stimulus measures also help to explain differences in economic growth across economies.

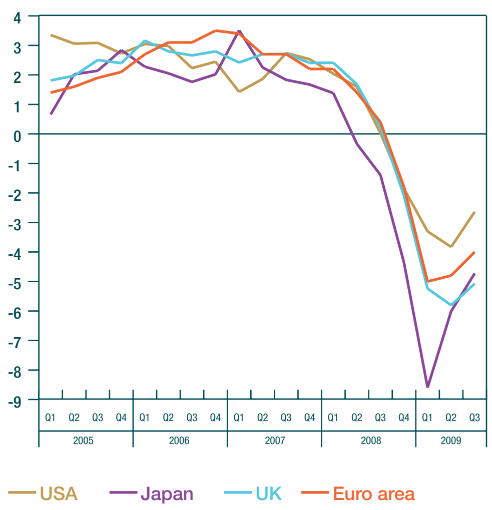
Looking ahead, the ongoing interaction between balance sheet adjustment in advanced economies and global policy stimulus is likely to result in a modest and uneven economic recovery and creates a high degree of uncertainty as to whether the recovery will be stronger or weaker than expected. In addition, fiscal consolidation measures have become a necessity in a number of advanced economies with weak fiscal balances and maturing debt. In many emerging economies, there is a renewed risk of asset price bubbles from a liquidity glut arising from investors taking advantage of cheap borrowing costs to invest in higher yielding assets. The withdrawal of fiscal stimulus and the removal of non-conventional monetary policy measures will need to be done carefully so as to chart a course between stoking inflation and risking a renewed downturn in growth. In this regard, the IMF has warned of the danger of a double dip recession if stimulus were to be withdrawn too early. Finally, notwithstanding significant progress to date, the potential for a disorderly unwinding of still significant global trade imbalances remains a concern.

Table 1: Changes in Key Economic Variables in Selected Economies

	Real GDP Growth %			Inflation %		
	2009[f]	2010[f]	2011[f]	2009[f]	2010[f]	2011[f]
US	–2.5	2.5	2.8	0.2	1.4	1.2
Japan	–5.3	1.8	2.0	–1.2	–0.9	–0.5
Euro area	–4.0	0.9	1.7	0.2	0.9	0.7

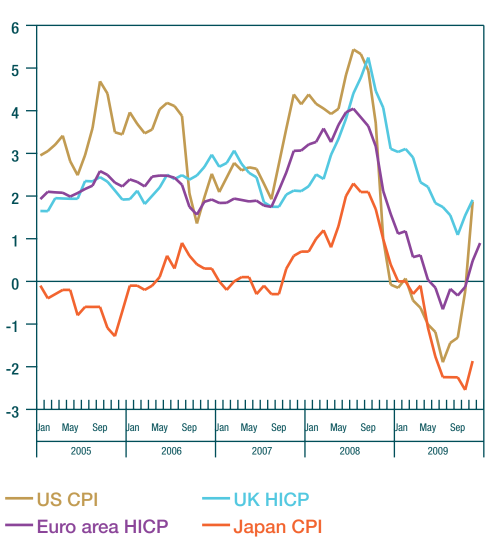
[f] Forecast
Source: OECD Economic Outlook, November 2009.

Chart 1: GDP Growth



Source: Reuters EcoWin

Chart 2: Inflation in the Major Economies



Source: Reuters EcoWin

Global inflation rates in many economies are recovering from troughs reflecting the impact of sharp declines in commodity prices in the second half of 2008 and their subsequent recovery. Underlying pressures are generally weak, however, amid substantial spare capacity in labour markets and low physical capital utilisation. Nevertheless, there are some significant differences between economies, which can be partly explained by exchange rate developments and variations in the weights of commodities in consumer price baskets. Looking ahead, a liquidity surplus in the global economy could, over time, transmit itself into higher consumer prices if measures are not taken to reduce it. This risk is most apparent in some emerging economies though the impact of excess capacity is likely to dominate developments in underlying inflation in most economies for some time yet.

Section 1: Euro Area

Economic Growth

Having broadly stagnated around mid-year, euro area economic activity expanded in the third quarter, increasing by 0.4 per cent. This represented the first quarter-on-quarter increase in real GDP since the first three months of 2008 and followed a very sharp decline in output around the turn of the year. Over the preceding five quarters, euro area real GDP contracted by close to 5 per cent, a somewhat larger decline than registered in the US economy of under 4 per cent from peak to trough. The third quarter growth rate was primarily driven by a recovery in exports coupled with a positive contribution from the inventories component (see Table 2). A strengthening of the global growth rate supported the former, as activity in advanced

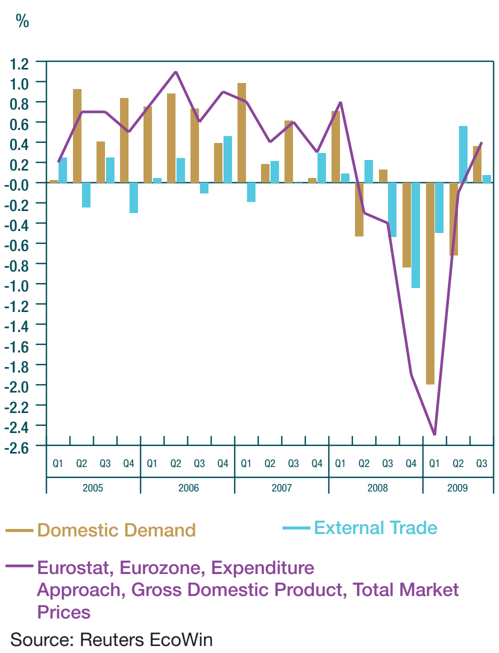
Table 2: Contributions of expenditure components to percent change in euro area GDP

	2008	2009		
	Q4	Q1	Q2	Q3
Personal Consumption	–0.3	–0.2	0.0	–0.1
Government Consumption	0.1	0.1	0.1	0.1
Fixed Investment	–0.9	–1.1	–0.3	–0.2
Inventories	0.2	–0.8	–0.6	0.5
Exports	–3.0	–3.4	–0.4	1.2
Imports	1.9	3.0	1.0	–1.1
GDP	**–1.9**	**–2.5**	**–0.1**	**0.4**

Source: Eurostat.

economies expanded and GDP growth in emerging economies accelerated. The latter reflected the decisions of euro area firms to start to rebuild stocks after a sharp fall in the preceding period. Domestic demand, on the other hand, remained extremely weak; personal consumption and fixed investment spending declined and were only partly counterbalanced by an increase in government expenditure. The underlying trend in private consumption is particularly weak when one considers that auto sales — boosted by car scrappage schemes — increased sharply in the second quarter, and continued to grow in the third quarter. Finally imports to the region picked up in the third quarter for the first time in six quarters.

Chart 3: Contributions to Real GDP Growth, 2005-2009

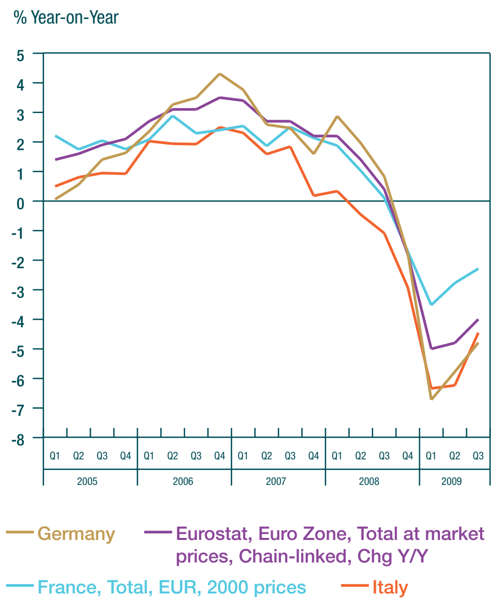


Source: Reuters EcoWin

Turning to more recent developments, the latest data suggests that the region continued to expand in the final months of last year and in early 2010. Key survey indicators of confidence and activity have continued to strengthen, and there has also been further growth in hard data on industrial production and order books. There is some uncertainty over the pace of this expansion, however, and the outlook remains one of moderate and somewhat uneven recovery. While the global outlook has improved, and suggests that a recovery in euro area exports will now occur at a quicker pace, world trade growth is still expected to be weaker than in the years prior to the downturn. Furthermore, a number of headwinds still exist and suggest that the recovery in domestic demand will occur only gradually. For example, the euro area labour market is not expected to begin to improve for some time, with the OECD forecasting an increase in the average unemployment rate in both 2010 and 2011. Significant excess capacity has developed in the manufacturing sector, which will temper investment demand, while further balance sheet adjustment is required in both the financial and non-financial sectors. The significant support provided to activity from macroeconomic policies will also begin to dissipate given the need for fiscal sustainability to be restored over the medium-term.

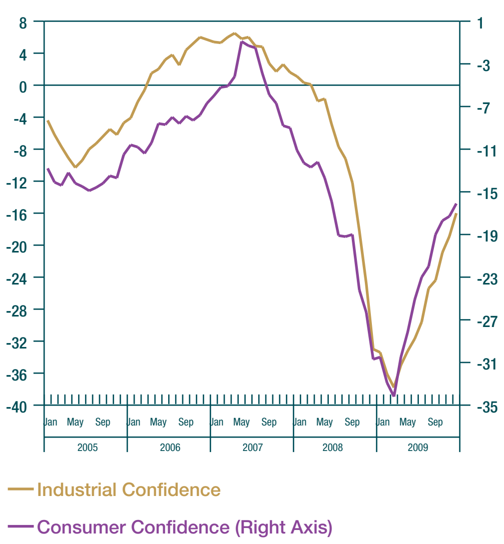
These developments are reflected in the latest projections by the ECB staff, which were revised upwards in December, but remain consistent with a gradual recovery. The projections anticipate that euro area real GDP

Chart 4: Euro Area GDP Growth



Source: Reuters EcoWin

Chart 5: Euro Area Confidence Indicators



Source: Reuters EcoWin

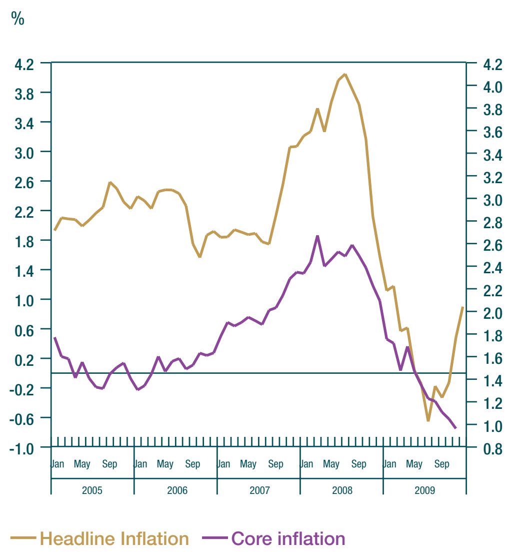
contracted by between 3.9 and 4.1 per cent last year, with growth of between 0.1 and 1.5 per cent expected in 2010 as a whole and between 0.2 and 2.2 per cent in 2011. These figures are broadly in line with those produced by other international organisations. There may be stronger than expected positive effects from the extensive macroeconomic stimulus underway but, on the other hand, there remains the potential for strains in the financial sector to have a stronger than expected impact on the real economy over the projection horizon.

Inflation — Recent Developments

Headline HICP inflation in the euro area rose to 0.9 per cent in December, according to a preliminary estimate from Eurostat, having increased sharply from a trough of -0.7 per cent last July. This largely reflects the pattern of base effects in energy and food prices, which declined sharply in the second half of last year from record highs, but have since recovered somewhat. Inflation excluding energy and food prices is showing some signs of stabilising in recent months, from a declining trend earlier last year. Nevertheless, non-energy goods prices appear to be reflecting some transmission of sharp declines in producer prices earlier in the year and euro appreciation. Selling-price expectations, as measured by the European Commission business survey, remain very weak among firms in both manufacturing and services.

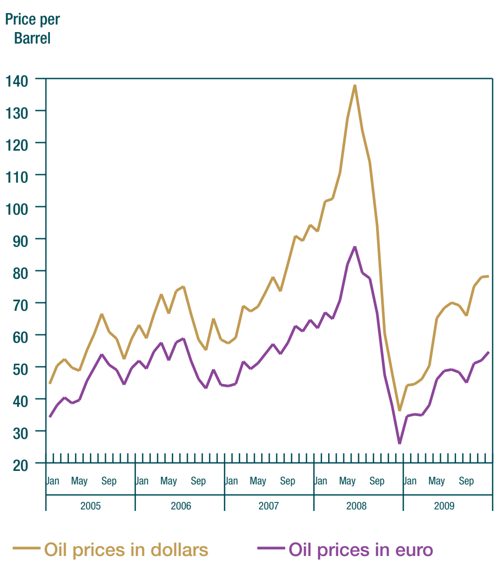
Underlying inflationary pressures remain muted. Producer prices declined by 4.4 per cent in the year to October (and by 3.1 per cent excluding energy), although monthly dynamics have stabilised in recent months. Import prices excluding energy prices have also stabilised somewhat, suggesting that previous euro appreciation is feeding into the recovery of profit margins. Labour cost growth moderated significantly over the course of 2009, with annual growth in compensation per

Chart 6: Euro Area Inflation Indicators



Source: Reuters EcoWin

Chart 7: Oil Prices — Brent Crude



Source: Reuters EcoWin

employee declining to 1.4 per cent in the third quarter from 2.9 per cent in the last quarter of 2008. Much of the adjustment in the first half of the year took place in hours worked rather than in hourly earnings but the burden of adjustment has since shifted to wage rates.

Oil and Other Commodity Prices

Oil prices increased sharply in early to mid October, from $68 to nearly $80 per barrel but subsequently gave up some of these gains in mid December before recovering strongly to $81 per barrel in early January. Oil prices benefited from increasing optimism regarding the global economic outlook and consequent increases in official forecasts for oil demand. This optimism waned somewhat in December, however, while oil stockpiles were accumulating at the relatively higher prices before renewed optimism and unusually cold weather in the Northern Hemisphere drove prices higher once again.

Food commodity prices increased over the final quarter, recovering from cyclical lows over the summer and with higher energy prices seeing some renewed interest in biofuels. Dairy prices have increased particularly sharply amid stronger global demand and evidence that low prices during the summer affected supply. Metals prices have either remained stable or increased, reflecting the general effect of higher optimism regarding global economic prospects and specific supply and stockpile issues in each case.

Inflation — Outlook

HICP inflation is expected to stabilise at, or just above 1 per cent, in the coming months amid much reduced base effects in energy and food prices. Eurosystem staff projections are for inflation to average between 0.9 and 1.7 per cent for the year 2010 as a whole and between 0.8 and 2.0 per cent in 2011. These are generally in line with forecasts from international institutions and the private sector. The expected gradual nature of economic recovery implies significant spare capacity over the medium-term, dampening cost pressures, pricing power and wage developments. Risks to the projections centre on the outlook for economic activity and commodity prices. There is also uncertainty over future changes to indirect taxes and administered prices, given the need for fiscal consolidation.

Section 2: External Environment

Emerging EU Member States

The economies of the eight emerging non-euro area EU member states have showed signs of economic recovery since around the middle of last year, though there are significant differences with some economies expanding once again but others merely contracting more moderately. These signs of recovery largely reflect the improved external environment, with the Czech Republic and Poland benefiting in particular due to currency depreciation. Many economies are, however, contending with large imbalances arising from overheating pressures before the crisis. Fixed exchange rate regimes in Bulgaria and the Baltic States has meant that the adjustment from large current account deficits has had to take place through contracting domestic demand, which, for the Baltic States, has been severe. Much of the trade adjustment has by now occurred but

Table 3: Contributions of expenditure components to percent change in US GDP

	2008	2009		
	Q4	Q1	Q2	Q3
Personal Consumption	–2.2	0.4	–0.6	2.0
Government Consumption	0.2	–0.5	1.3	0.6
Fixed Investment	–3.3	–6.6	–1.7	–0.2
Inventories	–0.6	–2.4	–1.4	0.7
Exports	–2.7	–4.0	–0.5	1.8
Imports	3.1	6.6	2.1	–2.6
GDP	**–5.4**	**–6.4**	**–0.7**	**2.2**

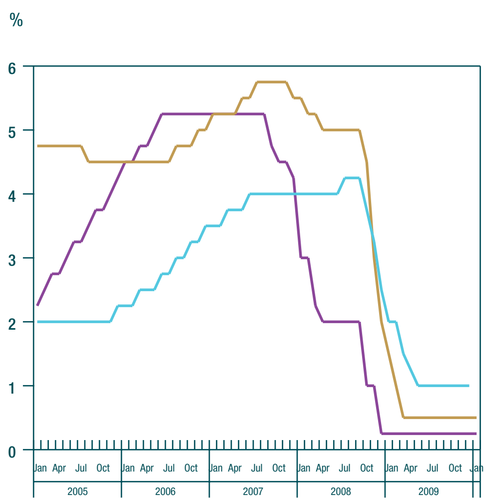
Source: Bureau of Economic Analysis

many economies are faced with impaired banks, large private sector debts and fiscal deficits that will weigh on their recovery. Inflationary pressures are generally muted due to the depth of the slowdown and a key challenge will be preventing deflation from taking hold where monetary policies are constrained. Overall, however, competitiveness has improved markedly, ensuring that the region is well positioned to take advantage of global economic recovery.

United States

US real GDP increased by 2.2 per cent in annualised terms in the third quarter, the first expansion in activity since the final months of 2007. According to the US administration, however, this primarily reflected the impact of macroeconomic stimulus policies. As Table 3 reveals, the third quarter expansion received

Chart 8: Key Policy Interest Rates



Source: Reuters EcoWin

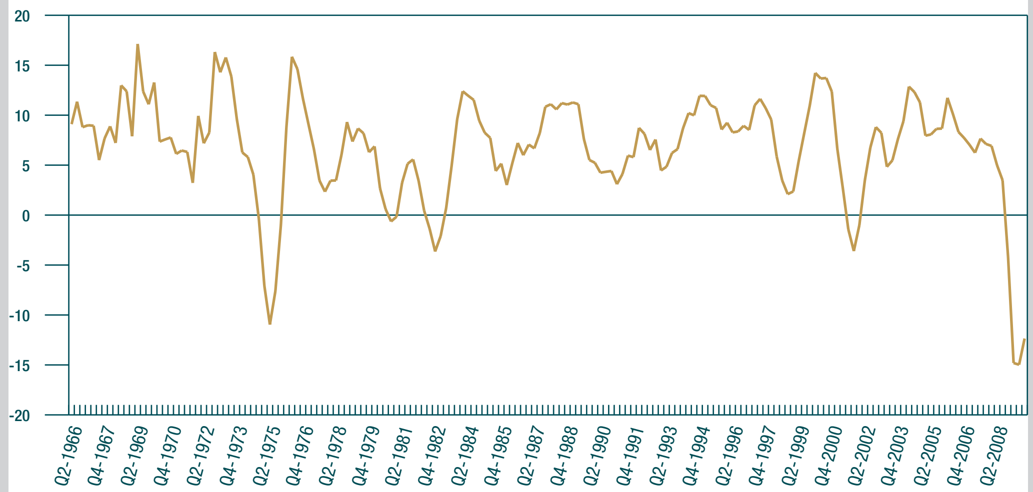
significant support from personal consumption expenditure. Despite a further pick up in the unemployment rate and a decline in real income growth during the quarter, consumer purchases of durable goods increased sharply, supported by the ‘cash for clunkers’ programme; new motor vehicle sales grew by an annualised 20 per cent from the preceding quarter. Government spending also made a positive contribution to the growth rate, while the broad stabilisation in fixed investment was notable not only as it followed a rapid decline in preceding quarters, but also because it was partly driven by an increase in residential investment, the first in 3½ years. Again, policy supports appear to have played a key role here, notably tax credits made available to first time buyers. Net exports also increased — against the backdrop of an acceleration in the global growth rate — although reflecting stronger import growth, the external sector as a whole subtracted from the growth rate. Finally, US companies reduced stock levels at a much slower pace during the quarter than earlier in the year and, as a result, inventories also made a positive contribution to the expansion.

The latest economic data has remained positive and suggests that the US growth rate may have accelerated in the final months of 2009. Consumer spending appears to have continued to increase, the labour market is weakening at a more modest pace, and there is evidence that the housing and inventory cycles have stabilised. Nevertheless, looking further ahead, while the latest growth forecasts have been revised up from those published at the time of the last Quarterly Bulletin, activity levels are still expected to increase at a weaker pace than in past recoveries. Following a contraction of 2.5 per cent last year, the OECD

Box 1: Global trade and the economic downturn[1]

One of the most striking features of the recent global downturn was the very sharp collapse in world trade that accompanied it. While external trade has historically experienced larger declines than overall output during downturns, the size of the recent contraction was exceptional. As Chart 1 outlines, world imports recorded their sharpest fall for at least 40 years; from peaking in Q1 2008 to reaching their cyclical trough in the second quarter of last year, world imports fell by 15.6 per cent. By comparison, they recorded a peak to trough decline of 11 per cent during the 1974-75 oil crises, and 3.6 per cent during the recessions that started in 1982 and 2001. As well as being sharp the collapse was sudden, occurring at a much steeper pace than at the start of the Great Depression, and highly synchronised. Both advanced and emerging economies were affected, while there was also a decline across almost every product category.

Chart 1: World Import Growth (Year-on-Year)



Source: OECD Quarterly Real Trade Data.

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Why was the decline in world trade so large in the final months of 2008 and the early months of 2009? This appears to have primarily reflected demand-side shocks, and, in particular, the nature of the demand shock that hit the global economy around this period. Growth of external trade was only modestly affected in the early months of the sub prime crisis, but that changed after the collapse of Lehman Brothers in September 2009. This led to a very sharp increase in uncertainty throughout the global economy. Sentiment levels declined sharply and consumers, firms and investors became extremely risk-averse, delaying purchases and investments that were considered 'postponeable' until they had a clearer idea of how the financial crisis would play out. Highly integrated international supply chains, coupled with better management practices related to information technology, amplified this development, ensuring that the demand shock was transmitted rapidly to the remainder of the global economy. Supply-side effects also appear to have played a role,

[1] This Box is based on a VoxEU.org Ebook, 'The Great Trade Collapse: Causes, Consequences and Prospects' edited by Richard Baldwin.

albeit to a lesser extent. In particular the lack of trade-credit availability may have been a contributing factor. The fact that the demand shock primarily impacted on ‘postponeable’ goods, meanwhile, provides an explanation for why the fall in world trade was so much larger than the fall in world GDP. These types of goods — consumer durables and investment goods — make up only a small proportion of world GDP, but a very large percentage of world trade.

The fact that the sudden drop in world trade appears to have been driven by economic agents delaying purchases and investments provides some encouragement going forward. It suggests that, as the uncertainty surrounding the economic outlook dissipates, and as it becomes clear that the worst-case scenarios will not occur, world trade should recover once again. There is already evidence of this; the success of car scrappage programmes in countries such as the US and Germany have highlighted a renewed willingness amongst consumers to purchase durable goods (albeit under favourable conditions), while world imports have started to increase once again, growing by 3.7 per cent in quarter-on-quarter terms in Q3 2009. Given the significant headwinds that remain in many advanced economies, however, it is still unclear whether a swift recovery in world trade can take place. Most countries experienced a trade rather than a financial crisis. The latter was primarily experienced by a number of advanced economies. Nevertheless, the necessity for balance sheet adjustment at both household and firm level in these advanced countries, coupled with the high level of excess capacity, suggests that it may take some time for a sustainable recovery in demand to take hold. The latest official projections continue to anticipate a gradual trade recovery in 2010 and 2011, underlining this point.

Chart 9: US Confidence Indicators

— US Business Sentiment (Non-manufacturing)
— US Business Sentiment (Manufacturing)
— US Consumer Confidence (Right Axis)
Source: Reuters EcoWin

anticipates that real GDP will increase by 2.5 per cent in 2010 and 2.8 per cent in 2011. This expectation of a subdued recovery reflects a number of factors. A full recovery in consumer spending, for example, is likely to be delayed by the weak labour market — the unemployment rate moved into double digits in the fourth quarter — and the necessity for households to continue to repair their balance sheets. Investment spending is also expected to be slow to return to pre crisis levels. With regard to business investment this reflects high debt levels and the very high level of spare capacity that exists, while despite the stabilising housing market, high vacancy rates and very low builder confidence points to limited growth ahead.

The Federal Reserve’s Federal Open Market Committee (FOMC) kept interest rates unchanged at their meetings in November and December, maintaining a target range of zero to 0.25 per cent. There are currently no indications that inflationary pressures are emerging in the economy. The annual change in the Federal Reserve’s preferred gauge of inflation — the core PCE deflator — was 1.4 per cent in October, and the FOMC noted that ‘inflation will remain subdued for some time’. The Committee did start the process of withdrawing some of its non-conventional measures at its December meeting, announcing that most of the Federal Reserve’s special liquidity facilities would expire on February 1, 2010. With regard to policy rates, however, the Committee continued to note that underlying economic conditions would 'warrant exceptionally low levels of the federal funds rate for an extended period'.

United Kingdom

Following a 0.2 per cent decline in real GDP in the third quarter of 2009 — the sixth consecutive quarter of contraction — economic activity is set to recover, supported by fiscal and monetary stimuli, a substantial depreciation of the pound sterling and improvements in overall global conditions. However, the pace of the recovery is expected to be slow and possibly uneven, reflecting strong headwinds from balance sheet adjustment, weak labour market conditions and, over the medium term, fiscal tightening. According to the OECD, real GDP is forecast to grow by just over 1 per cent in 2010, following a contraction of 4.7 per cent in 2009.

Examining the latest data, indicators of activity, while still at very weak levels are showing some signs of stabilising or improving, and housing market indicators have continued to improve modestly in recent months. Private consumption, on the other hand, is still very weak and several factors, including high unemployment and tight credit conditions, are likely to restrain spending for some time, and weigh on consumer confidence.

As regards prices, the headline rate of inflation has increased in recent months to reach 1.9 per cent in November, reflecting increasing price pressures from transport. In the near term, inflation is expected to pick up further, as a result of higher petrol price inflation, the reversal of last year's cut in VAT, and the past depreciation of sterling. However, in the medium term, inflation is likely to dip below its 2 per cent target, as spare capacity in the economy is expected to put downward pressure on prices.

Japan

Having been hit relatively hard by the economic crisis, there have been some signs of a gradual recovery in Japan. Following four quarters of contraction, Japan's economy recorded positive growth in the second and third quarters of 2009,with real GDP expanding 0.7 per cent and 0.3 per cent respectively, as various policy measures taken at home and abroad helped to support output. However, a self-sustaining recovery in domestic demand remains very weak, and as a consequence, the recovery is likely to be dependent on exports. Following a contraction of 5.3 per cent this year, output is forecast to expand by 1.8 per cent in 2010, according to the OECD.

While Japanese exports have been trending upwards since February, reflecting an improvement in the external environment, the December Tankan survey indicated that companies are still cutting costs to protect earnings that are under threat from the recent appreciation of the Japanese Yen, which reached 14-year highs. This, together with poor labour market conditions, is likely to weigh on domestic demand in the coming quarters. Indeed consumer confidence fell in November for the first time in 11 months as consumers become more cautious given the employment and income situation and also as the effect of stimulus measures on consumption begins to fade. Such conditions suggest that the economic activity will remain weak into the first half of 2010.

With respect to price developments, the Japanese government recently declared that the economy is in a "mild deflationary phase" for the first time in three years. Prices (excluding fresh food) declined by 1.7 per cent in the year to November, its tenth consecutive monthly decline, reflecting a decline in the price of oil products, while the substantial slack persisting in the economy as a whole is also putting downward pressure on prices.

Emerging Asia

Emerging Asia has been recovering strongly due to macroeconomic stimulus packages, some revival in regional trade in Asia and favourable developments in asset and real estate markets. Concerns, however, have been raised recently that the surge in investment capital in East Asia may fuel unsustainable asset price increases.

In China, the strength of economic activity picked up during the first nine months of 2009, to expand by 8.9 per cent year-on-year in the third quarter, and the latest data points to continued strong growth. Overall, in 2009, GDP growth is anticipated to exceed the government's target of 8 per cent. Based on OECD forecasts, output growth is then expected to reach 10 per cent in 2010, before easing slightly to just over 9 per cent in 2011, as the impact of the fiscal stimulus ends.

The large fiscal package as well as considerable monetary easing has boosted investment growth recently in China, while domestic consumption has remained robust, and there has been a strong recovery in the real estate sector. Furthermore, the strong increase in domestic demand stemming from stimulus measures has raised imports, while exports, on the other hand, have been rather weak. Concerns, however, are beginning to emerge that record lending may inflate asset prices to levels inconsistent with economic fundamentals, which may pose a real danger to inflation. Consumer prices have been picking up in recent months, and in November turned positive for the first time in ten months, as food prices picked up.

Meanwhile, the Indian economy is also improving on account of monetary and fiscal stimuli, with real GDP expanding 7.9 per cent in the third quarter. At the same time, inflation has recently turned positive once again, the result of a rapid acceleration in food price inflation.