

# Developments in the International and Euro Area Economy

## Overview

The global economic outlook has shown signs of improvement in recent months, with global growth turning positive in the second quarter following a steep fall in output over the previous two quarters. The Asian economies in particular have delivered strong performances in recent months, with China and India leading the way, while advanced economies are showing signs of stabilisation. Monetary and fiscal policy have clearly played a role in supporting this improved performance. However, uncertainty surrounding the outlook remains high, and any recovery is expected to be gradual and will vary across regions. Financial systems remain fragile and there may be further negative feedback between the financial sector and the real economy.

Economic activity contracted sharply in the final quarter of 2008 and in the first quarter of this year, as the intensification of the financial crisis had a severely negative impact on confidence and access to credit. Households and businesses alike significantly cut back on spending and production, while global trade contracted sharply. Prompt intervention by governments and central banks around the world helped to reduce uncertainty, and confidence has been recovering slowly. Growth is currently being supported by expansionary monetary and fiscal policies that are assisting private demand, leading to a rebound in manufacturing activity and some rebuilding of inventories.

Policy actions have been key to softening the impact of the crisis on the world economy. Central banks in most advanced economies dramatically reduced interest rates to all time

lows, with other measures being put in place in some countries to ensure market rates remain low over longer horizons. Unconventional measures have also been introduced to inject liquidity into the financial system and to maintain the supply of credit. Government intervention has also been marked, providing the banking system with guarantees and capital injections as well as substantial fiscal stimulus packages. However, this high level of intervention is unsustainable in the long-run and attention has already turned to appropriate exit strategies to be implemented when the time is right. It is generally agreed that macroeconomic policies should remain supportive while the recovery is still tentative, and governments should stand ready to further boost efforts if downside risks to growth materialise. However, steps must also be taken to limit rising public debt and to avoid long-run fiscal problems.

**Table 1: Changes in Key Economic Variables in Selected Economies**

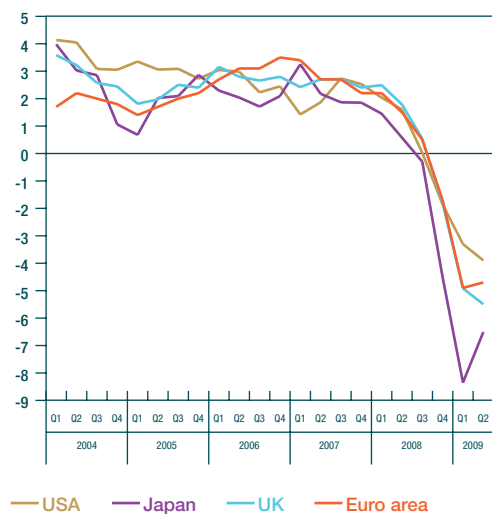
	Real GDP Growth %			Inflation %		
	2008	2009 <sup>f</sup>	2010 <sup>f</sup>	2008	2009 <sup>f</sup>	2010 <sup>f</sup>
<b>US</b>	0.4	-2.7	1.5	3.8	-0.4	1.7
<b>Japan</b>	-0.7	-5.4	1.7	1.4	-1.1	-0.8
<b>Euro area</b>	0.7	-4.2	0.3	3.3	0.3	0.8

<sup>f</sup> Forecast

Source: IMF, WEO, October 2009.

Chart 1: GDP Growth

% Year-on-Year



— USA — Japan — UK — Euro area

Source: Reuters EcoWin

Looking ahead, it appears that global output will continue to expand slowly over the near term. Global growth is unlikely to return to its pre-crisis levels for a number of years, however, as the financial crisis has had a negative impact on potential output. Ongoing corporate restructuring as well as a still high numbers of bankruptcies will hinder investment, and consumer demand will be dampened by a desire to rebuild private savings in some major economies. Even in the shorter term, downside risks to the global outlook remain, with a stalling recovery the most pressing concern in the short-run.

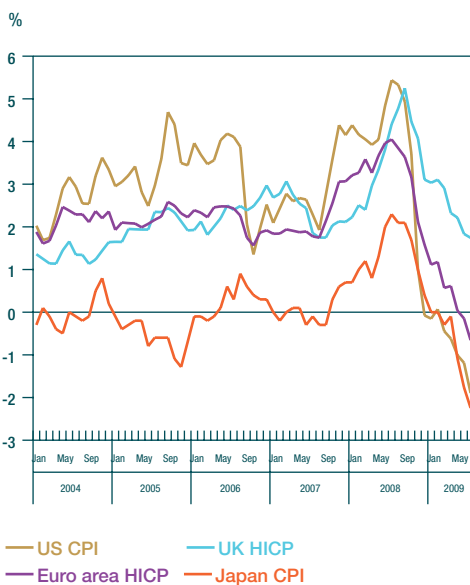
Global inflation rates have been declining since the second half of last year and may now be close to a trough, driven by developments in commodity prices over the past eighteen months. Oil prices, as well as a number of other commodity prices, have picked up in recent months, with oil prices in euro terms more than doubling since the beginning of this year. However, underlying inflationary pressures are also weak and inflation is expected to remain subdued for quite some time, as the world economy remains fragile and output gaps expand. Commodity prices may also remain volatile as the fledgling recovery takes hold to varying degrees across countries.

## Section 1: Euro Area

### Economic Growth

The euro area economy contracted marginally in the second quarter of the year when real GDP fell by a weaker than expected 0.1 per cent. This followed a decline in real output of over 4 per cent in the preceding two quarters, an unprecedented contraction in recent history. As Table 2 outlines, the improvement reflected both the positive impact of macroeconomic stimulus policies on private demand and a recovering external environment. Household consumption increased for the first time in over a year as car scrappage schemes boosted auto sales significantly and consumer confidence improved from record lows. Fixed investment and exports declined at a much weaker pace, meanwhile, as the global economy returned to positive growth and the decline in order books stabilised. Euro area firms also continued to run down stock levels aggressively, a development that should support activity levels in the second half of the year. In current prices, inventories fell by over €11 billion in the second quarter, the sharpest fall on record.

Chart 2: Inflation in the Major Economies

— US CPI — UK HICP  
— Euro area HICP — Japan CPI

Source: Reuters EcoWin

**Table 2: GDP and expenditure components: percentage change over the previous quarter**

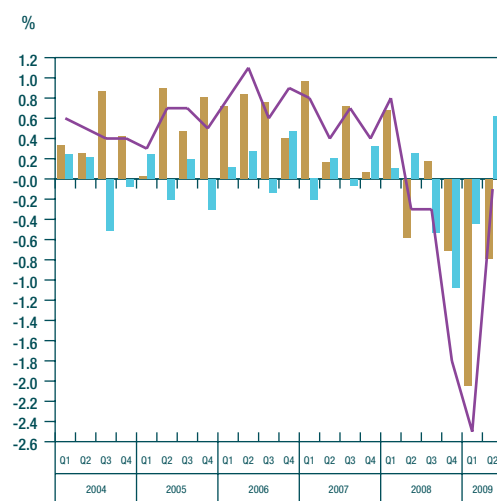
	2008		2009	
	Q3	Q4	Q1	Q2
<b>Personal Consumption</b>	0.0	-0.5	-0.5	0.2
<b>Government Consumption</b>	0.5	0.6	0.7	0.4
<b>Fixed Investment</b>	-1.4	-3.4	-5.3	-1.3
<b>Exports</b>	-0.9	-7.2	-8.8	-1.1
<b>Imports</b>	0.3	-4.7	-7.8	-2.8
<b>GDP</b>	<b>-0.3</b>	<b>-1.8</b>	<b>-2.5</b>	<b>-0.1</b>

Source: Eurostat.

Reflecting the stronger than expected second quarter performance, coupled with a further strengthening of the latest economic data, the euro area outlook has improved somewhat. It now appears that the region's economy has broadly stabilised and may expand modestly in the second half of the year. Survey indicators of confidence and activity have continued to increase from the record lows reached in the first quarter, while there has also been an improvement in hard data on exports and order books. Taking a medium term view, however, it still appears that the pace of economic recovery will be very gradual. This reflects both domestic and external factors. On the domestic

side, given that it is a lagging indicator, the region's unemployment rate is expected to continue to increase throughout next year. Furthermore, significant excess capacity has developed — which it will take some time to work through — and the process of balance sheet adjustment will be ongoing for both firms and households. Accordingly, once the temporary boost from the policy stimulus has waned, it appears that private consumption and fixed investment expenditure will remain subdued for some time. On the external side, the global outlook has also improved in recent months, and global GDP and trade growth are expected to strengthen in 2010. Nevertheless, the increase in both indicators is expected to be modest, well below the rates seen in recent years.

**Chart 3: Contributions to Real GDP Growth, 2004-2008**

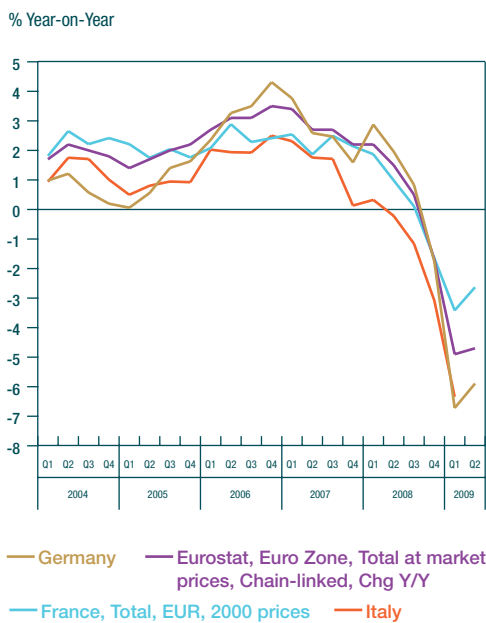


— Domestic Demand — External Trade  
— Eurostat, Eurozone, Expenditure Approach, Gross Domestic Product, Total Market Prices

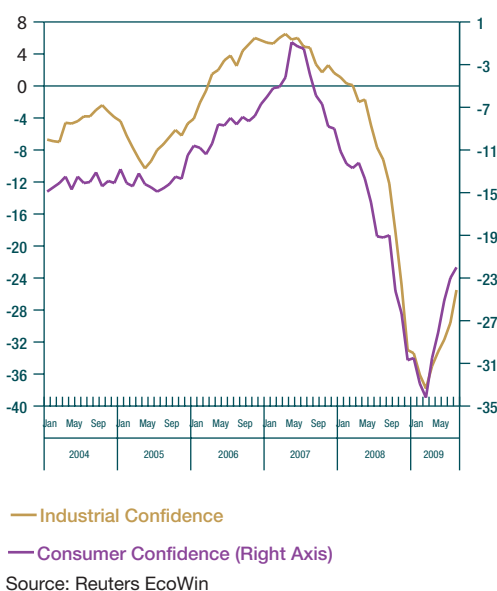
Source: Reuters EcoWin

These developments are reflected in the latest ECB staff projections, which have been revised upwards but remain consistent with a gradual recovery. The projections anticipate that euro area real GDP will contract by between -4.4 and -3.8 per cent this year, with growth of between -0.5 and +0.9 per cent expected in 2010. These figures are broadly in line with those produced by other international organisations. The risks to this economic outlook, meanwhile, would appear to be broadly balanced. There may be stronger than expected positive effects from the extensive macroeconomic stimulus underway but, on the other hand, there remains the potential for the financial turmoil to have a stronger than expected impact on the real economy over the forecast horizon.

**Chart 4: Euro Area GDP Growth**



**Chart 5: Euro Area Confidence Indicators**



**Inflation — Recent Developments**

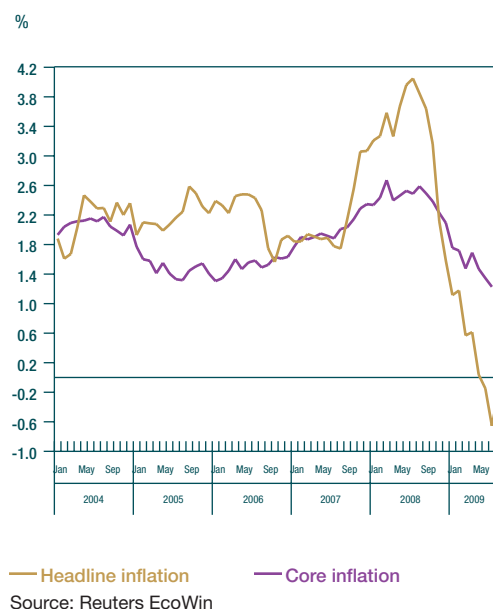
Headline HICP inflation declined to -0.7 per cent in July, driven largely by base effects in commodity prices, which are much lower this year than last year, despite some recovery. These base effects will unwind from August, however, as commodity prices declined sharply

in the later part of last year and the preliminary estimate of inflation for August is -0.2 per cent. Beneath the volatility in the headline rate, underlying inflation has been declining significantly, with inflation excluding energy and food falling to 1.2 per cent in July from 1.9 per cent last December. This is evident in most goods and services prices, indicating a general effect from economic weakness on pricing decisions. Survey evidence points to ongoing weakness, with selling-price expectations close to record lows in both manufacturing and services.

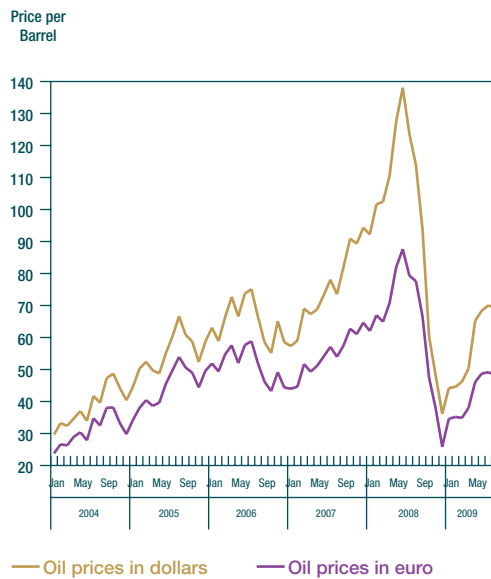
The headline producer price inflation rate dropped to -8.5 per cent in the year to July and the rate excluding energy declined to -3.5 per cent. Commodity price increases earlier in the year have fed through to a stabilisation in intermediate goods prices, which had been declining sharply. Final goods prices are following a similar pattern and were broadly flat in June and July. Import prices are still declining, however, indicating intensifying competition, as well as the strength of the euro.

The pace of increase in earnings has decelerated significantly this year, driven

**Chart 6: Euro Area Inflation Indicators**



**Chart 7: Oil Prices — Brent Crude**



Source: Reuters EcoWin

initially by a decline in hours worked. This is shown in the first quarter, when negotiated wages only declined to 3.2 per cent from 3.6 per cent in the previous quarter but compensation per employee growth declined from 2.8 to 1.8 per cent. Negotiated wages take longer to adjust but the early indications for the second quarter suggest that this process is well underway.

### Oil and Other Commodity Prices

Oil prices have increased significantly in recent months, as expectations of future demand for oil were revised upwards with improving global economic prospects. Oil prices have been on a broad upward trend since dipping to almost \$30 per barrel in December though they seem to have stabilised around \$70 per barrel since late July. Spare capacity is currently much higher than for many years, but weak global investment raises concerns as to supplies in the medium to longer term.

Food commodity prices are dominated by largely positive trends in global food production. Meat and dairy prices remain weak while cereals and oils/fats prices are unwinding from increases earlier in the year. Sugar prices have strengthened further in recent weeks,

however, and rice prices have only declined slightly, due to unfavourable weather in Asia. Metal prices have generally stabilised in recent weeks following strong price increases earlier in the year, driven, as with oil, largely by improving global economic prospects.

### Inflation — Outlook

Headline inflation is expected to increase to around 1 per cent by the end of the year, as base effects in commodity prices unwind, and to broadly stabilise thereafter. Eurosystem staff projections are for inflation rates to average between 0.2 and 0.6 per cent this year and between 0.8 and 1.6 per cent next year. These projections incorporate a substantial dampening impact from weak economic growth. Risks to these projections are balanced, related mainly to the outlook for economic activity and future commodity prices. There is heightened uncertainty over future changes to indirect taxes and administered prices, with fiscal positions playing a significant role in ameliorating the crisis but deteriorating significantly at the same time.

### Emerging EU Member States

Economic growth in the eight emerging EU Member States declined sharply in the second half of 2008 and again in the first quarter of 2009, and is expected to remain weak over the remainder of the year. A modest and slow recovery is expected over the course of 2010, although output growth is still forecast to be negative in the Baltic States and Bulgaria. The collapse in global trade at the end of last year was the main driving force behind the economic slowdown and any recovery will be closely linked to an improvement in the economic health of trade partners and a return to strong export growth. Current account positions in the Central and Eastern European countries have improved markedly in the past eighteen-months and are now well below the double-digit deficits seen in recent years. Financing conditions remain tight as confidence hovers near record lows, especially among international investors, and, as a consequence, investment is likely to remain subdued for some time. Inflation has declined notably in most emerging EU countries as

**Table 3: Contributions to percent change in real annualised US GDP**

	2008		2009	
	Q3	Q4	Q1	Q2
<b>Personal Consumption</b>	-2.5	-2.2	0.4	-0.7
<b>Government Consumption</b>	1.0	0.2	-0.5	1.3
<b>Fixed Investment</b>	-1.3	-3.3	-6.6	-1.8
<b>Inventories</b>	0.3	-0.6	-2.4	-1.4
<b>Exports</b>	-0.5	-2.7	-4.0	-0.5
<b>Imports</b>	0.4	3.1	6.6	2.1
<b>GDP</b>	<b>-2.7</b>	<b>-5.4</b>	<b>-6.4</b>	<b>-1.0</b>

Source: Bureau of Economic Analysis

economic activity slows and commodity prices fall. However, inflation projections diverge considerably reflecting differences in the economic outlook for the eight countries.

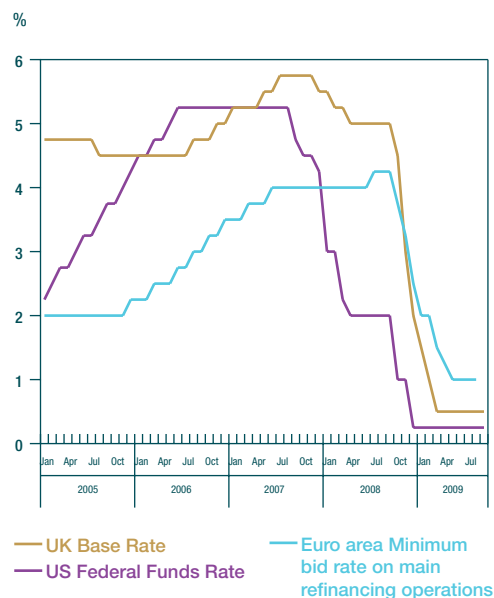
## Section 2: External Environment

### US Economy

The US economy contracted once again in the second quarter of the year, albeit at a weaker pace than in the preceding quarters. Real GDP fell by 1.0 per cent on an annualised basis. This followed very sharp declines of 6.4 and 5.4 per cent in the first and fourth quarters, respectively, and represents the first time that the US economy has experienced four successive quarters of declining GDP in over sixty years. As Table 3 outlines, personal

consumption subtracted from the growth rate — as increasing unemployment outweighed the positive impact of the American Recovery and Reinvestment Act (ARRA) on real income growth — but this was counterbalanced by a strong increase in government consumption. Investment spending continued to contract reflecting declines in both fixed capital spending and inventories. Stock levels have fallen significantly over the past year, a factor that should provide support to economic activity in the coming quarters. Net exports made a positive contribution to the growth rate once again; while this continued to be driven by falling imports, the pace of the export decline slowed significantly from previous quarters as the external environment improved.

Turning to more recent developments, the latest economic data have been more favourable, and it now appears that the US economy returned to positive growth in the third quarter. In their recent interim assessment, the OECD forecast annualised increases of 1.6 and 2.4 per cent in the third and fourth quarters, respectively. A range of factors is expected to boost the growth rate in the second half of the year. Most notably, there was a significant impact on auto sales in the third quarter from the ‘cash for clunkers’ scheme, which, in turn, is supporting auto production. There has also been further evidence that the housing market is stabilising, while, as noted above, inventories are now at a very low level. Even if housing starts and inventories remained at their current low levels they would, at the least, no longer be subtracting from growth. Looking further ahead, a gradual rather than a more rapid recovery remains the most likely outcome. The labour

**Chart 8: Key Policy Interest Rates**

Source: Reuters EcoWin

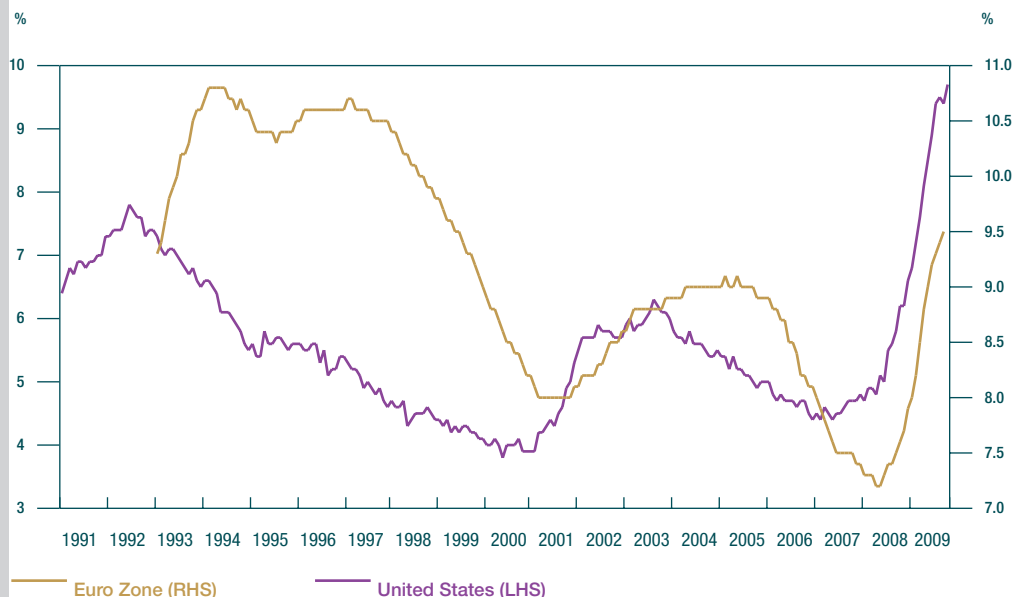
**Box 1: The current labour market downturn — some distinctive features**

The economic downturn has already had a significant negative impact on global labour market developments. The number of people employed in the euro area was over 2½ million lower in the second quarter of 2009 when compared to its recent peak, and this negative trend has continued into the second half of the year; the region’s unemployment rate was 9.5 per cent in July (see Chart 1). The unemployment rate has also picked up sharply in the United States, to 9.7 per cent, a rapid increase from the same month of the previous year, which reflects the loss of around 6 million jobs since the US recession began. Looking ahead, further deterioration in labour markets is expected even though there are indications that the global downturn has stabilised. Unemployment is a lagging indicator and as such it typically continues to weaken even after economic recovery has begun. This is one of the factors that suggest that the pace of the global recovery will be very gradual. In June, the OECD forecast that euro area unemployment will average 12 per cent next year, while the US rate is expected to average 10.1 per cent.

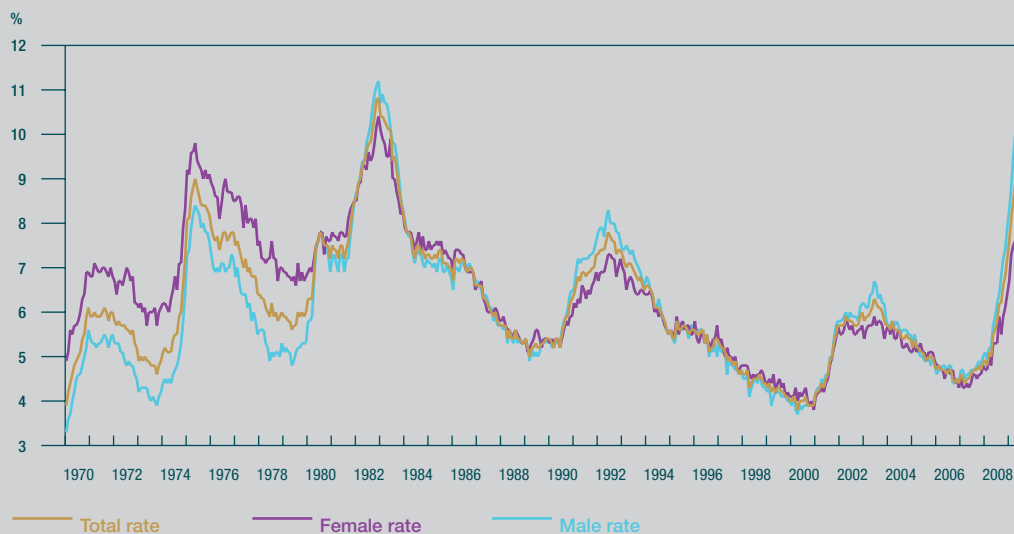
An interesting development in the recent downturn is that the burden of the labour market adjustment has been felt more by male workers than their female counterparts. In the US economy, for example, the male and female unemployment rates were almost identical at the start of the recession (see Chart 2). Since then the number of males out of work has increased by 135 per cent, and resulted in a male unemployment rate of 10.9 per cent, more than double the January 2007 rate. Female unemployment, by comparison, has increased

by 85 per cent over this period, and as a result the female unemployment rate was 8.2 per cent in August. New workers entering and exiting the labour market cannot explain the divergence; there was actually a greater increase in female labour market participation over this period. Rather, it would appear to reflect the industries that have been worst affected by the downturn. Of the nearly 6 million workers that have lost their jobs since January 2007, two-thirds of the job losses

**Chart 1: Unemployment Rate Total, SA**



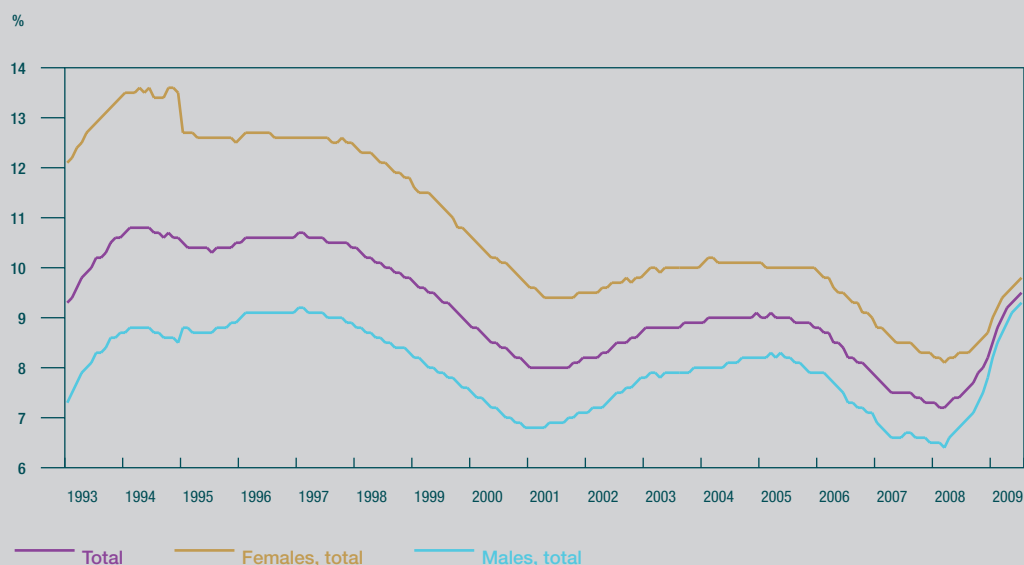
**Chart 2: United States Unemployment Rate**



have occurred in goods producing industries (including construction) — which typically employ more male workers — with the remaining third occurring in service producing industries. Such a development is not typical in times of economic stress. The current divergence between male and female rates is significantly higher than has occurred in any

period of rising unemployment over the past 60 years. For example, as Chart 2 illustrates, in the recession of the early 1980s — the last time the US unemployment rate increased so sharply — the male unemployment rate was 1.2 per cent higher than the female rate at its peak. In August of this year, the gap was more than twice as large at 2.7 per cent.

**Chart 3: Euro Zone Unemployment Rate**

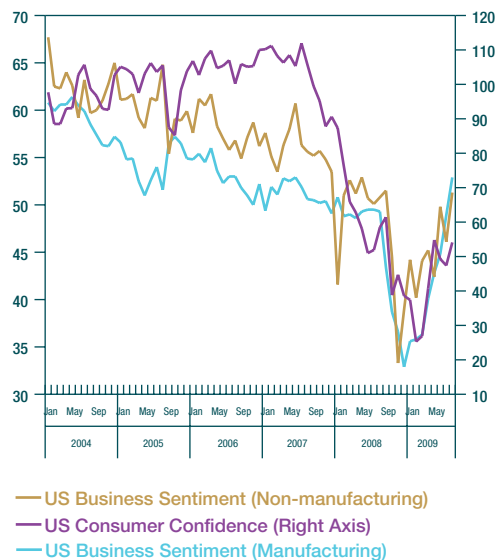


A similar trend has been observable in the euro area labour market. The male unemployment rate in the region has been lower than the female rate since the early 1990s; after narrowing gradually between the years 1995 and 2002, the gap between the two rates broadly stabilised for several years at around 2 per cent (see Chart 3). Since the start of 2008, however, the divergence between male and female unemployment rates has fallen sharply and the gap is now at its lowest ever level, just 0.5 per cent. As in the case of the US economy, it appears that this can be primarily explained by sectoral developments. Three-quarters of job losses in the past year have occurred in the construction and manufacturing

sectors, with a more modest decline occurring in the services sector.

Given that the outlook is for a gradual strengthening in economic activity and global trade, and with unemployment forecast to increase further, it will take some time before many of the jobs that have been lost during the downturn are recovered. Furthermore, in some sectors of the goods producing industries — most notably the construction sector — permanent downsizing of the work force may be required. This suggests that a redeployment of workers to other sectors may be required in the coming years, with much of the burden of this adjustment falling on male workers.

Chart 9: US Confidence Indicators



Source: Reuters EcoWin

market is expected to continue to deteriorate in the coming quarters and, coupled with the negative wealth effects experienced over recent years, is likely to weigh on consumer spending. Substantial excess capacity is also forecast well into the medium term, which may limit a strong investment recovery. Even taking account of ARRA, the Congressional Budget Office does not expect the negative output gap to be closed for a significant time, reflecting the magnitude of the downturn. In its latest projections, the IMF has forecast an annual

GDP contraction of close to 2½ per cent this year followed by growth of around 1½ per cent in 2010.

The Federal Reserve's Federal Open Market Committee (FOMC) kept interest rates unchanged at their meeting in August, maintaining a target range of 0.0 to 0.25 per cent. The Committee noted that 'economic activity is levelling out' but added that 'substantial resource slack is likely to dampen cost pressures, and inflation will remain subdued for some time'. The annual change in the headline consumer price index was -2.1 per cent in July, while the annual change in the Federal Reserve's preferred gauge of inflation — the core PCE deflator — continued to moderate, falling to 1.4 per cent. Against this backdrop, the FOMC concluded that 'economic conditions are likely to warrant exceptionally low levels of the federal funds rate for an extended period'.

### UK Economy

Following an exceptionally sharp contraction of 2.4 per cent in the first quarter of this year, the pace of decline in output moderated in the second quarter, with real GDP falling by 0.7 per cent. During the quarter, household expenditure remained in negative territory, although the rate of contraction did moderate somewhat, while business investment once again subtracted from output. The latest survey data suggest that economic activity will continue to improve in the coming months, with

output growth expected to turn positive before the end of the year. Business surveys have been generally stronger recently, industrial production, while still very weak, is showing signs of improving, and housing market activity has continued to recover modestly in recent months. Private consumption, however, is likely to remain subdued in the coming months given the tight credit conditions, lower financial wealth and the fall in employment. Overall, the IMF estimates a contraction of around 4½ per cent in GDP this year before picking up to close to 1 per cent growth in 2010.

There has been a further moderation in inflationary pressures in recent months. Since early 2009, annual CPI inflation has fallen from 3.2 per cent, to stand at 1.6 per cent in August of this year, with the largest downward pressures coming from lower food and gas and electricity prices. With substantial risks of undershooting the 2 per cent target rate in the medium term and a very difficult economic environment, the Bank of England has taken exceptional measures, cutting the main policy rate to 0.5 per cent, and increasing the programme of asset purchases to £175 billion in total.

### Japanese Economy

Following a severe contraction in economic activity in the final quarter of 2008 and first quarter of this year, there are signs of real GDP stabilising. The second quarter of 2009 saw the Japanese economy return to growth, with output expanding 0.6 per cent from the previous quarter, the first rise in economic activity in five quarters. The expansion in output reflected positive growth in exports, private consumption and government investment, with the latter two largely driven by the fiscal stimulus, while private residential and non-residential investment once again contracted. Growth is forecast to continue in the third quarter as the stimulus policies boost consumer spending and public investment, although early signs suggest that output could be somewhat weaker than in the previous quarter. As government support tapers off, the pace of growth is likely to slow by the end of the year. Overall, the IMF projects that output

will contract by close to 5½ per cent this year, before growing by around 1¾ per cent in 2010.

Since the beginning of this year, inflation has eased considerably, with the core consumer price index declining by a record 2.2 per cent from a year earlier in July. This marked the fifth consecutive month of decline, and inflation is not expected to move back into positive territory for some time yet. Producer prices have also fallen substantially in recent months, contracting by a record 8.5 per cent in July. Having lowered its target rate to 0.1 per cent at the end of last year, the Bank of Japan left its main policy rate unchanged in the first eight months of this year. The Bank of Japan has also extended the period for which a number of their non-standard policy measures, such as the purchase of corporate bonds and commercial paper, will remain in effect.

### Emerging Asia

Economic activity began to recover in most countries in emerging Asia in the second quarter of 2009, reflecting favourable fiscal packages and some revival in regional trade in Asia, while favourable developments in real estate and equity markets has supported private consumption and investment in some countries. Output in China has strengthened particularly, rebounding to a robust 7.9 per cent year-on-year in the second quarter, from 6.1 per cent in the previous three months. This reflects the sizeable monetary and fiscal stimuli, which are supporting investment growth and private consumption, while external demand, on the other hand, remains relatively weak. In India, meanwhile, economic activity has also improved, with annual GDP expanding by 6.1 per cent in the second quarter of 2009, compared with 5.8 per cent in the first three months of the year. In the global context, these growth figures for the second quarter mark strong performances, with the IMF pointing to around 8½ per cent growth in China and close to 5½ per cent growth in India this year. Meanwhile, inflationary pressures have continued to ease over the past number of months for the area as a whole, with inflation turning negative in a number of Asian countries.