The economic background

The world economy

Overview

World economy growth remains relatively strong as we having been forecasting for some time, albeit from time-to-time there has been a slight moderation in growth. The third quarter moderation does not appear to have impacted on fourth quarter growth; certainly not in the major economies of the world. There is robust growth in the US, China, India and in the emerging Asian economies. Inflation in most countries has moderated in late 2006 as energy prices have declined significantly since September 2006. Inflation remained relatively high in early 2007 however, as the effects from falling energy prices diminished. Survey evidence across the world suggests that there will be relatively strong growth in 2007.

The decline in oil prices was a welcome relief to the world economy. The unusually mild winter; high stocks in the US and signs that OPEC output will not be restricted (particularly the statement from the Saudi Arabia) in the near future guaranteeing oil supply will meet demand led to the weakening of the price from September 2006.

The fall in oil prices has levelled off with OPEC cutting production to 1.2 million barrels a day in November 2006. Prices have continued to fall since then primarily due to the mild winter, high US stocks and a plentiful supply. Given the February price of $59.89 and if there are no further geopolitical events or adverse shocks to supply then the forecast for the oil price (Texas West) is $47.90 in June 2007. The OPEC restriction may make the $45 mark a more optimistic figure. Prices are likely to be $45-$51 in the medium-term.

Exchange rates are of little concern just now with the main risks to the world economy coming from a further sustained rise in oil prices, geopolitical concerns in the oil producing regions, imbalances in the world economy, overheating in India and China and the prospect of a sharp slowdown in the US housing market leading to a significant decrease in asset prices and growth. Any of these events would have a significant negative effect on world GDP growth and trade.

Outlook

The world economy is forecast to grow by 5.3 per cent in 2006 and by 5.0 per cent in 2007. This is largely driven by growth in China, India and the US as well as most other main OECD economies and some emerging economies. US real GDP is forecast to grow by 3.2 per cent in 2006 and by 2.9 per cent in 2007 and slowing to 2.5 per cent in 2008. Japanese performance is expected to be good with forecast growth rising from 2.1 per cent in 2006 to 2.4 per cent in

	Growth in real GDP (%)				Unemployment rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	3.5	3.2	2.9	2.5	5.1	4.6	4.6	5.0
Japan	1.9	2.1	2.4	2.5	4.1	3.8	3.9	4.1
Euro zone	1.5	2.7	2.2	2.1	8.6	7.9	7.4	7.3
Germany	1.1	2.5	1.7	1.8	9.5	8.4	7.8	7.4
France	1.2	2.1	2.2	2.0	9.7	9.1	8.9	8.2
OECD	2.7	3.2	2.8	2.6	6.6	6.0	5.8	5.7

	Inflation rate (%)				Short term interest rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	2.1	2.2	1.9	2.2	3.5	5.2	5.3	4.8
Japan	-0.8	-0.2	0.5	0.9	0.0	0.2	0.7	1.1
Euro zone	2.0	2.1	2.1	2.1	2.2	3.1	4.0	4.3
Germany	1.3	1.4	2.5	2.4	n/a	n/a	n/a	n/a
France	1.8	1.4	1.4	1.5	n/a	n/a	n/a	n/a
OECD	2.1	2.2	1.9	2.2	n/a	n/a	n/a	n/a

Note: Inflation rate is measured by consumer prices.
Sources: OECD Latest Release, www.oecd.org, the National Institute Economic Review, **199,** January 2007.

Table 2: Change in components of demand and main macroeconomic indicators for the US, Japan, the euro area and the UK, 2005-2007

	The US			Japan			Euro Area			The UK		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Consumption	3.5	3.2	2.8	1.6	0.7	0.9	1.4	1.7	1.8	1.4	1.9	2.6
Investment	6.8	7.9	7.2	7.8	9.6	8.3	2.9	4.5	3.6	3.4	5.9	5.9
Government	0.9	1.6	1.9	1.7	0.3	1.5	1.3	2.3	2.1	3.1	2.1	2.4
Domestic Demand	3.3	3.4	2.7	2.2	1.6	1.7	1.8	2.4	2.2	1.9	2.8	3.1
Exports	6.8	9.1	6.7	6.9	10.1	8.8	4.6	8.5	5.0	7.9	10.7	-0.7
Imports	6.1	6.1	4.2	5.8	4.9	5.1	5.6	8.3	5.2	7.0	10.8	0.8
GDP	3.2	3.4	2.9	1.9	2.1	2.4	1.5	2.7	2.2	1.9	2.5	2.6
Unemployment	5.1	4.6	4.6	4.4	4.1	3.8	8.6	7.9	7.4	4.9	5.5	5.7
CA (% GDP)	-6.4	-6.5	-6.1	3.7	3.9	4.6	-0.1	-0.4	-0.9	-2.4	-2.9	-3.1
Effective Ex. Rate	91.9	90.9	89.8	79.2	72.1	68.3	122.3	121.5	123.3	98.6	99.1	102.2

Notes: US and Japanese investment is business investment, others are private investment. Effective Exchange Rate = 100 in the year 2000. Forecasts are those of the National Institute for Economic and Social Research; see National Institute Economic Review, **199,** January 2007.

2007 but both lower than previously forecast. The Euro Area is forecast to have performed more strongly than expected at 2.7 per cent in 2006 (compared to a forecast of 2.1 per cent in the last quarter) but growth is likely to slow to 2.2 per cent in 2007. German growth is forecast to be only 1.7 per cent in 2007 and 1.8 per cent in 2008 after strong growth of 2.5 per cent in 2006. The French forecasts are relatively unchanged. Chinese growth is expected to remain close to 10 per cent in both 2007 and 2008.

Growth is driven by investment and exports in the first half of 2007 as it was in the latter part of 2006. Undoubtedly higher oil prices have impacted on growth on some areas of the world economy. In the Euro Area productivity remains poor and Japan also has productivity issues related to hours worked that will restrict growth slightly in the next two years. The issue is probably more serious for the Euro Area. Table 1 presents the forecasts of main economic indicators for the period 2005 to 2008.

Table 2 illustrates the components of demand and main macroeconomic indicators for the period 2005 to 2007 for the US, Japan, the Euro Area and the UK. There is a slight slowing in US growth, down to 2.9 per cent in 2007 while Japan is forecast to perform slightly better for both 2006 and 2007. Euro Area growth has also strengthened significantly in 2006 but is forecast to slow somewhat in 2007. Domestic demand in the US is expected to hold up relatively strongly given the increased income from employment growth supporting consumption so the 2007 forecast may be on the pessimistic side. Compared to these data is forecast to perform robustly. In particular, the effective exchange rates are forecast to remain relatively stable. The size of the US CA deficit remains a concern even at 6.1 per cent of GDP in 2007.

United States

In the US real GDP (chained 2000 measure) grew by 3.4 per cent on an annualised basis in 2006. Quarterly growth for 2006Q4 was 0.9 per cent compared to 0.5 per cent in the third quarter and to 0.4 per cent in the fourth quarter of 2005. Annual growth has slowed slightly over the 2004-06 period but growth in the US is still relatively strong. While there has been a marked slowdown in the US housing market the evidence suggests that this has only had a modest effect on consumption. Strong employment growth is more likely to have supported consumption and thus aided overall growth. Another factor aiding consumption has been higher borrowing.

Fourth quarter growth in the US remained strong despite the significant slowing in the housing market. Personal consumption grew by 0.4 per cent in October 2006 and by 0.7 per cent in the third quarter. In 2006Q4 consumption growth was 4.4 per cent on an annualised basis compared to 2.8 per cent in the third quarter. The former was supported by stronger income growth whereas the latter was driven by falling fuel prices. Housing investment had slowed considerably but business investment remains strong. US GFCF increased by 7.2 per cent in 2005; by 5.4 per cent in 2006 and is forecast to be 3.9 per cent in 2007. Non-residential investment grew by 8.6 per cent; 8.4 per cent and 6.5 per cent respectively. The corresponding growth rates for residential investment are 7.1 per cent; 2.3 per cent and -0.3 per cent. Housing investment has declined to a level 8.1 per cent less than a year earlier. Despite this slowdown US housing investment to GDP ratio was 5.6 per cent for 2006 compared to 6.3 per cent at the end of 2005. This compares with historic values of 4 to 4.5 per cent. In 2006Q4 non-fixed residential investment declined by 0.4 per cent compared to a decline of 10.0 per cent in the third quarter. US government spending grew by 4.5 per cent in 2006Q4 compared to 1.3 per cent in 2006Q3. US exports increased by 10.0 per cent in the fourth quarter of 2006 compared to growth of 6.8 per cent in the previous quarter. There was also a downturn in imports to the US in the fourth quarter thus boosting the contribution of net trade to overall growth. In the fourth quarter consumption, exports and government spending were the main drivers of GDP growth in the US while residential investment had a negative effect.

In 2006 average employment growth was 187,000 jobs per month. Since the low of August 2003 the US has seen non-farm employment grow by 7.4 million jobs. The main jobs gains came in construction, transport, professional and business services, health and education as well as leisure and government. Professional and business services have accounted for nearly 25 per cent of all non-farm employment in 2006. Manufacturing employment continued its downward trend (for the seventh consecutive month). The main manufacturing job losses were in car manufacture and electronics. Over the past three years the trend in hours worked has been upward. Average earnings for the past 12 months grew by 4 per cent in December 2006 and remain non-inflationary. The personal saving ratio was close to -1 per cent in November 2006 while households continued to borrow significant amounts.

Trade in the latter part of 2006 slowed slightly and this is expected to impact on the reduced growth forecast for 2007 (see Table 1). This was primarily due to the slowing of import growth to about 0.5 per cent for October and November 2006. While exports may have grown by 9 per cent in 2006 compared to import growth of 6 per cent the net trade position will probably have little effect on GDP. The CA deficit requires much higher growth in export volumes in order to offset this imbalance. The current account deficit is forecast to improve from 6.5 per cent of GDP to closer to 6 per cent in 2007. In the third quarter the CA deficit widened from $217.1bn to $225.6bn.
Annual CPI (U) was 2.5 per cent higher in December 2006 than it was in December 2005 (the corresponding figure for the period December 2004 to 2005 was 3.4 per cent). In the month of December inflation increased by 0.4 per cent on the previous month. It was unchanged in November and showed significant declines in August and September.

Petrol based energy increased by 7.7 per cent in December while the energy index rose by 1.2 per cent. In contrast, the food index was unchanged. The seasonally adjusted annual rate of inflation was 4.3 per cent in 2006Q1; 5.1 per cent in 2006Q2; 0.8 per cent in 2006Q3 and 0.2 per cent in 2006Q4. Clearly, the impact of high energy prices was felt most significantly in the first half of the year, when energy costs increased by 22 per cent and by 2.9 per cent on an annualised basis for 2006. The increase of 2.9 per cent compares with 17.1 per cent in 2005 and 16.6 per cent in 2004. The index excluding food and energy was relatively similar over the period 2004 to 2006.

At its December meeting the Federal Reserve Open Market Committee kept the federal funds rate unchanged at 5.25 per cent. Rates may rise further yet however and are likely to peak at 5.5 or 5.75 per cent later this year.

Non-farm employment grew by 111,000 jobs to 137,300,000 in January 2007. This compares with 206,000 and 137,147,000 respectively in December 2006. In the third quarter of 2006 non-farm employment averaged 136,442,000 rising to 136,944,000 in the fourth quarter. For 2006 average job growth has been 187,000. Since the low of August 2003 employment has increased by 7.4 million. Unemployment increased marginally to 4.6 per cent in January from 4.5 per cent in December 2006. The employment-population rate (63.3 per cent) and the participation rate (66.3 per cent) were relatively unchanged at the end of the year.

Despite the slowing in the housing market the outlook for the US remains good with consumption, investment and government spending continuing to drive growth. Employment growth has also been significant and has supported consumption through higher incomes. Inflation has moderated significantly but the Federal Reserve may still raise rates this year. The main downside risks to the US economy remain the CA deficit; the effects of the housing market slowdown to impact on the rest of the economy and the potential of sustained higher oil prices.

Europe

In the Euro Area real GDP grew by 0.5 per cent in the third quarter of 2006 following strong growth in the first half of the year. GDP growth is forecast to be 2.7 per cent for 2006. This is the strongest growth the Euro Area has seen since 2000. Real GDP growth is expected to pick up slightly in 2007 as domestic demand strengthens in the Euro Area. Forecast growth is down slightly from the last quarter (3.1 per cent for 2007) mainly due to the global economic developments but also hampered by slower than expected growth in Germany. French GDP is forecast to grow by 2.2 per cent in 2007 after growing by 2 per cent in 2006. We should also note that Slovenia joined the Euro Area on 1st January 2007 but the impact of this on Euro Area GDP is negligible as Slovenia's GDP is only 0.35 per cent of Euro Area GDP. Real GDP growth exceeded 3 per cent per annum in Ireland, Finland, Greece, Spain, Austria and Belgium.

The impact of the increase in German VAT is expected to constrain consumption growth to about 1.8 per cent this year although it is forecast to pick-up in 2008 perhaps above 2 per cent. Euro Area consumption grew by 0.7 per cent in 2006Q3 compared to 0.3 per cent in the previous quarter. On an annual basis consumption has grown by 1.8 per cent in the Euro Area for each of the last three quarters. The contribution to GDP change by consumption is relatively steady around a level of 1.0 percentage points. Government spending growth for the year was 2.0 per cent in 2006Q2 and has risen marginally to 2.1 per cent in the third quarter after quarterly growth of 0.6 per cent in the latest quarter. It contributed 0.4 percentage points to the GDP change in 2006Q3, unchanged from the previous quarter. Annual investment growth has slowed to 4.6 per cent in 2006Q3 compared to growth of 5.4 per cent in the second quarter. This is because investment grew on a quarterly basis by 2.3 per cent in 2006Q2 but only by 0.6 per cent in 2006Q3. The contribution to GDP change has declined from 1.1 percentage points in 2006Q2 to 0.9 percentage points in the third quarter. Overall, domestic demand has strengthened and growth remains strong at 2.8 per cent on an annual basis in the third quarter. Euro Area exports grew by 7.5 per cent in the third quarter compared to 8.3 in the second quarter. Import growth was unchanged at 8.0 per cent for the same period therefore net trade made a negative impact on GDP change in the Euro Area.

Consumption continues to be supported by improvements in the labour market and growing consumer confidence. Some survey data for the fourth quarter remains robust while other data show a slight decline. In particular, survey data for the industrial sector remains high despite a slight decrease in recent months. It is expected that industrial growth in the fourth quarter will be positive and relatively robust. Industrial production spending on durables increased by 5.1 per cent in the third quarter compared to only 3.8 per cent in the second quarter. Spending towards the end of the year has picked up slightly compared to the low growth of 1.5 per cent seen in September. It should be noted however, that the growth in industrial production has not matched the levels seen in 1999 or in 2000. This may be explained by a lack of investment in capital equipment thus production is constrained. It may also be that labour shortages have contributed to this. While activity might not have matched the levels seen in 1999 or the year 2000 it is clear that since mid 2005 there has been a significant strengthening of industrial activity in the Euro Area. The European PMI was virtually unchanged in December although the fourth quarter level was slightly below the third quarter level. Industrial confidence was unchanged in January remaining at a very high level with order books, stocks, finished goods, consumer and capital goods sectors all recording high levels of confidence.

German GDP increased by 2.6 per cent in 2006, the strongest growth seen in six years. Government spending and investment were strong drivers of growth in Germany. Real exports also contributed 0.7 percentage points to real GDP change. Consumption growth is expected to decline by 0.2 per cent this year due to the rise in German VAT. Investment and government spending are forecast to grow by 1.7 per cent and by 2.6 per cent respectively. In Germany in 2007 and in 2008, export volumes are forecast to outstrip import growth thus net trade is forecast to make a net contribution to GDP growth in each of these years. Annual real GDP growth averaged only 0.6 per cent in the period 2001 to 2005 but is forecast to rebound to just over 2 per cent per annum 2006 to 2008. Unemployment is forecast to fall from 8.4 per cent in 2006 to 7.8 per cent in 2007. Real wages have declined over the recent years in Germany but now there are real profits and wage growth as well as increased capacity utilisation. Both business and housing investment have recovered (although housing investment may decline slightly in the fourth quarter again). All of this favours increased economic expansion in the future. German inflation averaged 1.7 per cent in 2006. The German government are also likely to bring their general government deficit down to about 2.5 per cent of GDP due to the increase in VAT. The outlook for Germany remains good with GDP growth of 1.7 per cent forecast in 2007 and slightly higher in the following year.

French GDP increased by 2.1 per cent in 2006 after fourth quarter growth of 0.9 per cent. Average quarterly growth in 2006 was 0.6 per cent. French real GDP is forecast to grow by 2.2 per cent in 2007 and by 2.0 per cent in 2008. GDP growth stalled in the third quarter because there was a significant decline in exports volumes coupled to de-stocking in the economy. Investment also declined from an average of 4.0 per cent (for 2004 to 2005) to 2.6 per cent in 2006. Business investment however, picked-up in 2006 while net trade had a negative impact on GDP. The slowdown in Germany in 2007 is expected to constrain French growth due to their strong trading links. Capacity utilisation also increased in France (similar to Germany) although survey data is not as positive about France as it is about Germany. French profit share and mark-up have declined significantly while the impact of higher unit labour costs has also had an effect. Employment growth in 2006 was 0.7 per cent but this is expected to slow to 0.3 per cent in 2008 (this is the same as the 2002 to 2005 average rate). There have been some significant productivity gains and in the future firms will probably try to restore profitability margins. With growing employment it is expected that France could raise its participation rate (one of the lowest in Europe, a full 8.8 per cent lower than Germany). It is unlikely however that it will grow beyond 70 per cent before 2013. French GDP growth will probably be stronger than German growth in 2007 but this is simply due to the effects of the VAT increase. If 2006 and 2007 are taken together then average GDP growth is likely to be 2.1 per cent in both countries. French inflation remained below 1.5 per cent in 2006.

HCIP inflation in the Euro Area was 2.2 per cent in 2006 and had been 1.9 per cent in December 2006 unchanged from that in November. When energy prices are excluded inflation was 1.9 per cent in 2006. Indeed, in June 2006 HCIP was 2.5 per cent and the fall in energy prices saw HCIP decline to 1.9 per cent by the end of the year. Conversely, inflation excluding energy increased over the period from 1.5 per cent per annum to 1.9 per cent. Inflation is expected to rise in 2006Q1 perhaps up to 2.4 per cent but a large part of that will be due to the increase in VAT in Germany. Energy prices will also play an important part in the path of inflation in 2007. There is little evidence however that HCIP in 2007 will be markedly different from that in 2007. The main forecast for Euro Area inflation is 2.1 per cent for both 2007 and 2008. The ECB raised the interest rate by 25 basis points to 2.5 per cent in December 2006 but left it unchanged at its January meeting.

In the Euro Area labour markets continued to improve especially with regard to employment growth (0.4 per cent in 2006Q3) with services and construction having the strongest employment gains while manufacturing employment declined by 0.1 per cent. Unemployment fell to its lowest value in over ten years in November 2006. Unemployment was 7.6 per cent in November with number of people in unemployment declining by 100,000. Previously it had fallen by 45,000 and by 100,000 in the previous months. Unemployment in the Euro Area has fallen in every month except August although the decline was fastest in the Jan-Apr 2006 period.

The forecasts for the Euro Area are for real GDP to grow by 2.2 per cent and 2.1 per cent for 2007 and 2008 respectively. German growth is forecast to be somewhat lower at 1.7 per cent and 1.8 per cent in 2007 and 2008. French growth for the same years is forecast to be 2.2 per cent and 2.0 per cent respectively. The ECB reports that the outlook for the Euro Area remains positive with the downside risks being a renewed resurgence in oil prices, continuing imbalances in the global economic and risks in global trade. However, it should be noted that market volatility might increase, especially if the slowdown in the US housing market is exacerbated and spills over into asset markets. Clearly, this has the potential to have a global implication that could lead to a deepening of the slowing of GDP growth.

Japan

Japanese GDP growth for 2006 was 2.1 per cent compared to 1.9 per cent in 2005. The main drivers of growth were robust business investment and strong demand for its exports. Third quarter growth slackened somewhat but export growth of 2.5 per cent offset this setback. In the third quarter therefore GDP grew at an annual rate of 1.7 per cent. GDP growth is forecast to be 2.4 per cent in 2007 and 2.5 per cent in 2008. Consumption growth in 2006 was 0.7 per cent and is forecast to grow by 0.9 per cent in 2007. Business investment is forecast to grow at 8.3 per cent in 2007 following growth of 9.6 in 2006. Housing investment however, only grew by 0.4 per cent in 2006 and is forecast to slow to 0.1 per cent in 2007. Government spending grew by 0.3 per cent in 2006 and is forecast to grow by 1.5 per cent in 2007. Exports grew by 10.1 per cent in 2006 and are forecast to grow by 8.8 per cent in 2007 and by 7.7 per cent in 2008. Import growth for 2006 was 4.9 per cent and is forecast to be 5.1 and 6.4 per cent respectively. Net trade is therefore expected to contribute significantly to Japanese GDP growth in the coming years. The Japanese current account continues to be a significant surplus at 3.9 per cent of GDP in 2006 and forecast to rise to 4.6 per cent of GDP in 2007.

Japanese deflation was 0.2 per cent in 2006, the smallest contraction seen in recent years. Inflation is forecast to be 0.5 and 0.9 per cent for 2007 and 2008 respectively. Both October and November data suggest future positive increases in inflation. Japanese wages are rising slightly and this will translate into higher unit labour costs. The pick-up in expected inflation rates correlates well with the increasing propensity of consumers to buy more durable goods and this in turn suggests consumption overall will increase in the coming years. This in turn will lead the Bank of Japan to raise interest rates over the year (0.7 per cent in 2007 and 1.1 per cent in 2008).

Employment in Japan is also rising on an upward trend with Japanese unemployment falling to 4.1 per cent in 2006 compared to 5.3 per cent in 2003. Unemployment is forecast to fall to 3.8 per cent in 2007. Labour supply in Japan is getting tighter according to the latest Tankan survey data. Bonuses and strong corporate earnings are expected to be significant this year and next. The Japanese government deficit is considerable given that it spent significantly in order to get the economy back on track. The draft budget signals an intention to get this down below 5 per cent of GDP. The forecast for 2006 is –4.6 per cent and –4.3 per cent by 2007.

China continues to grow rapidly at 10.6 per cent for 2006 and is a major force in the world economy. Private consumption is forecast to become more important in China. Inflation remains relatively benign and there are little threats to the Chinese economy. China has a current account surplus close to 8 per cent of GDP for 2006 and this is mainly driven by its strong growth in exports. House prices have risen on average by nearly 50 per cent.
Foreign exchange transactions are also being liberalised in China allowing citizens to engage in transactions up to the value of $50,000. This is designed to offset capital inflows into China. The outlook for China is that it will continue to grow at around 10 per cent per annum over the next two years.

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