The economic background

The world economy

Overview

Growth in the world economy remains robust with both China and India experiencing fast growth. The US continues to have strong growth despite a slight weakening in the last quarter of 2005. Consumption and investment are much more important in Japan now, driving growth forward. Exports are also contributing significantly to Japanese growth. The Euro Area grew below trend in 2005 but is forecast to have stronger performance in both 2006 and 2007. However, the main impetus to growth is external to the OECD. World growth is forecast to be 4.8 per cent per annum for the four years ending in 2007 compared to average growth of 3.4 per cent per annum for 1975 to 2003. Oil prices are expected to be close to $60 but the decreased dependency on oil of the advanced economies has meant that it has had little impact on inflation.

China’s current account surplus has risen by 4 per cent and their contribution to the goods market means that the world interest rate has been effectively reduced by about 0.5 percentage points. This has constrained global inflation and squeezed nominal interest rates. Confidence in world markets is rising despite several setbacks in financial markets and business confidence now suggests that even in Germany a broad based recovery is taking place.

The main risks to the world economy continue to come from current account imbalances and house prices although a sharp correction to oil or commodity prices would have a significant impact on growth and inflation. The surplus in Germany, Japan and China are forecast to grow to 4.5, 5.5 and 6 per cent of GDP respectively whereas the deficit in the US and Spain are forecast to be 7.5 and 10.0 per cent respectively. While some of these data are alarming there are no signs of policy makers allowing a sharp unfolding of these imbalances. Should current account problems worsen then the weaker economies (in terms of growth) are more likely to suffer the most from output loss.

Outlook

Growth in the US is forecast to be 3.3 per cent this year and be 2.9 per cent in 2007. There is significant uplift to the 2006 forecast but only a marginal increase for 2007 compared to our previous forecast. Exports are expected to have a neutral effect on growth but the housing market slowdown will contribute more significantly to GDP growth slowing in 2007. Japanese growth is forecast to be 2.9 per cent and 2.3 per cent in 2006 and 2007 respectively. This is a significant improvement on previous economic performance. Although the Euro Area has been slow to sustain recovery it appears that growth will strengthen over

2006 and 2007. 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. Investment is forecast to rise in the Euro Area and in the UK over 2006 and 2007 but the housing slowdown in the US could be quite pronounced looking at the US data over the same time period. Government spending is forecast to peak in 2006 in most developed economies except Japan where it peaks in 2007. The US deficit is forecast to decline slightly over 2005 to 2007 which will be encouraging for the rest of the world economy, although this depends on how policy achieves this. Table 2 highlights the likely future drivers of change and main trends over the period 2005 to 2007, specifically the decline in the US housing sector; relatively strong and balanced growth across the major economies of the world and signs of an improving situation in both the Japanese and Euro Area economies.

United States

GDP grew by 4.8 per cent on an annualised basis in 2006Q1 (or 1.2 per cent on the preceding quarter) compared to 1.7 per cent (0.4 per cent) in 2005Q4. The 2006Q1 estimate was revised up slightly. Clearly US growth remains relatively strong. It looks likely that GDP growth will return to its trend rate of growth.

Consumption growth in 2006Q1 was 5.2 per cent compared to only 0.9 per cent in 2005Q4. Gross investment increased by 8.3 per cent in 2006 compared to 16.1 per cent in the previous quarter. Residential investment grew by 13.4 per cent while non-residential investment increased by 11.3 per cent. The increase in government spending was 10.5 per cent compared to a contraction of 2.6 per cent in the previous quarter. Exports rose by 14.7 per cent in the latest quarter compared to 5.1 per cent in 2005Q4. Overall exports are expected to have a neutral effect on US GDP this year. Imports grew by 12.8 per cent in 2006Q1 compared to 12.1 per cent in the previous quarter.

Investment and consumption are expected to remain significant drivers of growth in the US however we expect a significant slowdown in housing investment. There is also likely to be a slight slowing of both business and government investment towards the end of the forecast horizon. Services grew by 4.1 per cent in the latest quarter with the slowing in real estate adversely affecting the sector, consequently services prices only rose by 2.6 per cent. Manufacturing increased by 4.0 per cent in 2006Q1 and prices increased for the first time since 1995. Industrial production declined by 0.1 per cent in May but had increased by 0.8 per cent in April. Capacity utilisation was 81.9 in April but declined slightly to 81.7 in May. Manufacturing productivity grew by 3.8 per cent over the quarter and by 4.0 per cent over the year. In the business sector productivity increased by 3.9 per cent in 2006Q1 compared to 2.5 per cent in 2005Q4.

The US current account deficit: improved by $14.4 billion to $208.7 billion in 2006Q4 (6.4 per cent of GDP) from $223.1 billion in the fourth quarter of 2005 (7.0 per cent of GDP). The surplus on services declined from $17.7 billion to $17.2 billion however in the first quarter of 2006. Of course a sharp correction to oil prices that was sustained could adversely affect the US current account position.

Annual CPI grew by 4.2 per cent in the twelve months to May 2005 and increased by 0.5 per cent over the quarter. Core inflation (excluding food and energy) increased by 2.4 per cent on an annual basis. Producer prices increased by 0.2 per cent in May compared to an increase of 0.9 per cent in April. The lower inflation in the early part of the year is unlikely to remain the pattern over 2006 and we expect inflation to gather pace because of the high capacity utilisation in the US and because oil price increases are more likely to feed into wages than say in the Euro Area.

The Federal Open Market Committee (FOMC) raised interest rates by 25 basis points to 5.00 per cent in May 2006. Given the significant risen in core inflation it is very likely that the FOMC at its meeting at the end of June will raise rates again by another 25 basis points to 5.25 per cent. Ben Bernake (the Chairman of the Federal Reserve) has been criticised as not being willing to cut rates in order to avoid a significant slowing of the housing market and of growth in general. The saving rate remains a problem in the US as it is –0.5 per cent of disposable income.

Non-farm payrolls increased by 75,000 in May 2006 and employment rose by 2.4 million over the year. Employment has increased from 134,161,000 in 2005Q4 to 134,722,000 in 2006Q1. In the three months prior to April 2006 US full time employment was rising but this has declined in May while par-time employment has increased. Services employment grew the most significantly while manufacturing and construction remained relatively static. Unemployment stood at 5.1 per cent in May 2005 (or 7,629,000 persons unemployed) and has declined to 4.7 per cent (7,123,000 persons unemployed) in April 2006 and then to 4.6 per cent in May 2006 (7,015,000 persons unemployed). The increased income from employment is a key driver to sustained growth in consumption.

The outlook for the US economy remains promising with relatively strong growth. Most forecasters have increased their forecasts for the US certainly for 2006 and 2007. The forecast for US growth is 3.3 per cent in 2006 and 2.9 per cent in 2007 and like other forecasters this is above our forecasts for the previous quarter. Inflation is forecast to be slightly lower at 3.0 per cent for 2006 and 3.3 per cent in 2007. The Federal Funds rate is expected to be between 5 and 5.25 per cent for 2006 and 5.25 in 2007. The current account remains a concern of policymakers.

Table 1: Forecasts of the main world economy indicators

	Growth in real GDP (%)				Unemployment rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	3.5	3.3	2.9	2.8	5.1	4.8	4.7	5.0
Japan	2.7	2.9	2.3	2.2	4.4	4.1	3.7	3.5
Euro zone	1.4	2.1	2.0	2.1	8.6	8.2	8.0	7.9
Germany	1.1	2.0	1.6	1.8	9.5	8.9	8.6	8.6
France	1.4	1.9	2.1	2.1	9.5	9.1	8.9	8.8
OECD	2.8	3.1	2.9	2.7	6.5	6.3	6.0	5.9

	Inflation rate (%)				Short term interest rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	2.8	3.0	3.3	2.7	3.5	5.0	5.2	5.2
Japan	-0.8	-0.2	-0.1	0.4	0.0	0.2	1.1	1.7
Euro zone	2.0	2.2	2.2	2.0	2.2	2.9	3.8	4.3
Germany	1.3	1.9	2.4	1.8	n/a	n/a	n/a	n/a
France	1.2	1.5	1.7	1.8	n/a	n/a	n/a	n/a
OECD	2.1	2.4	2.5	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*, **196**, April 2006.

Europe

Euro Area GDP increased by 1.4 per cent in 2005. Growth weakened significantly in 2005Q4 to 0.3 per cent but rose by 0.6 per cent in 2006Q1, giving growth of 2.0 per cent on the same period last year. One of the problems of the Euro Area is the weakness of domestic demand, particularly consumption and investment. Consumption grew by 1.4 per cent last year but is forecast to increase by 1.8 per cent this year. The quarterly growth estimate for consumption initially indicated a contraction of 0.2 per cent but this has been revised up to growth of 0.1 per cent for 2006Q1. Investment grew by 1.1 per cent last year and is forecast to grow by 3.4 per cent this year and 3.5 per cent in the following year. The estimate for investment in 2006Q1 was growth of 0.8 per cent but this has been revised down to 0.3 per cent. Export growth has been revised upwards and net trade has contributed 0.2 percentage points to Euro Area GDP. The forecast for Euro Area growth for 2006 and 2007 are 2.1 and 2.0 per cent respectively. This should be compared to EU25 growth forecasts of 2.3 for both years. The downside risks to the Euro Area continue to be global imbalances and any sharp correction to oil prices or the housing market.

Table 3 indicates the strength of growth in some of the leading East European economies. Clearly the New Member States (NMS) are forecast to expand rapidly but convergence of growth within the NMS will begin in 2007. Thereafter there will be a slow period of harmonisation with the rest of the EU. The outlook for Europe therefore is improving (see Table 1 for the forecasts of growth) and recovery seems to be broadly based across sectors. The NMS are still expected to grow more quickly than the Euro Area but consolidation is expected in the future. Their growth is supported by strong exports to the Euro Area and by the absorption of EU funds. A danger for the EU NMS is that as their growth is broad based, and migrants leave their economies then consumption increases leading to an increase in investment (primarily from EU funds); then their will be a significant increase in domestic demand but this could lead to a current account deficit.

German GDP grew by 0.4 per cent in the first quarter of 2006 compared to in the last quarter of 2005. For 2005 as a whole GDP growth was 1.1 per cent. The forecast is for GDP to grow by 2.0 per cent in 2006 (having a significant temporary boost from the World Cup) but to slow to 1.6 per cent in 2007. Germany is set to have a substantial VAT increase (close to a 3 per cent increase in total indirect taxes) which should raise €24.4 billion. Employee insurance taxes will be cut by €1.5 billion and unemployment insurance will be decreased by €14.5 billion. There will be an increase of €3.0 billion in the contribution to public pensions and of €2.0 billion in public healthcare insurance. Overall the package should improve the budget balance by 0.4 per cent of GDP in 2007. The leading indicator for Germany increased by 0.4 per cent in 2006Q1 and by 1.4 per cent over the year.

Table 2 Change in Components of Demand and Main Macroeconomic Indicators for the US, Japan, the Euro Area and the UK, 2004-2006

	The US			Japan			Euro Area			The UK		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Consumption	3.5	3.2	3.0	2.2	2.4	1.4	1.4	1.8	1.8	1.7	2.2	1.9
Investment	7.1	3.6	1.0	-0.7	2.0	0.0	1.1	3.4	3.5	3.2	3.4	3.5
Government	1.5	2.1	1.3	1.8	1.8	2.2	1.4	2.1	1.5	2.9	2.5	2.3
Domestic Demand	3.6	3.4	2.9	2.6	2.3	2.0	1.4	2.2	2.1	1.9	2.5	2.3
Exports	6.9	5.3	4.8	6.9	8.6	6.0	3.9	6.1	4.9	5.6	6.1	4.7
Imports	6.3	5.2	4.4	6.2	5.3	4.6	4.7	6.4	5.2	5.3	5.9	3.1
GDP	3.5	3.3	2.9	2.7	2.9	2.3	1.4	2.1	2.0	1.8	2.5	2.8
Unemployment	5.1	4.8	4.7	4.4	4.1	3.7	8.6	8.2	8.0	4.8	5.2	5.3
CA (% GDP)	-6.4	-6.2	-6.0	3.6	2.5	2.6	-0.3	-1.0	-0.9	-2.6	-2.7	-3.0
Effective Ex. Rate	91.7	92.2	92.5	79.2	71.5	71.0	119.0	119.4	119.4	95.0	94.4	94.2

Notes: US investment is housing 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 NIER (2006) April, **196**.

German consumption grew by 0.2 per cent in 2005 but investment increased by 1.5 per cent in 2005. The forecast for consumption and investment in 2006 is 0.6 and 2.9 per cent respectively. One of the main problems in the German economy are structural factors where depressed consumption growth has led to a moderation of wage growth and this has led to an increase in competitiveness with respect to Eastern European states. This moderation of consumption and gain of competitiveness is however at the expense of gains in real wages thus impacting on German growth. To a lesser extent this is also observed in Italy.

Table 3, Growth in the New Member States, 2005-2007

	2005	2006	2007
Czech Republic	6.0	4.8	4.4
Slovenia	6.0	5.9	4.8
Lithuania	7.5	6.4	6.1
Latvia	10.2	7.6	6.9
Estonia	7.8	7.9	5.5

Notes: Forecasts are those of the National Institute for Economic and Social Research, see NIER (2006) April, **196**.

French GDP grew by 0.5 per cent in 2006Q1 and by 1.4 per cent in 2005. The leading indicator in France grew by 0.2 per cent in the first quarter of 2006 and by 3.4 per cent over the year. French GDP is forecast to increase by 1.9 per cent this year and by 2.1 per cent in 2007. French consumption increased by 0.5 per cent in 2005Q4 while household consumption of manufactured goods increased by 0.5 per cent in January 2006 and by 1.5 per cent in February. The indicators suggest that French consumption will rise by 2.5 per cent in 2006 compared to 2.1 per cent in 2005. Further the French economy is not being assisted by tax breaks but investment is strong. French investment grew by 3.5 per cent in 2005 and is forecast to increase by 2.8 and 3.1 per cent respectively in 2006 and 2007. Business investment is strong (growing at more than 10 per cent in 2004 and 2005) but government spending remains relatively muted. Exports are expected to make a positive contribution to GDP in 2006 despite a significant increase in imports in the last quarter of 2005. Most French exports go to the Euro Area and they have little penetration to fast growing regions of the world whereas Germany has considerable penetration to these countries. French exports are also less competitive than German exports. French employment growth has been significant, particularly in services growing at 0.9 per cent over the year compared to total employment growth of 0.4 per cent. Unemployment is forecast to decline slowly.

The European PMI survey and the ifo index indicate that there will be strong growth in European manufacturing and investment while the recession in construction will come to an end. Increased profits are leading to higher household demand and residential construction orders are up. Essentially the upturn is cyclical and fundamental. The German ifo index reached a 15 year high in April 2006 and there are signs of robust growth this year. The recovery is underpinned by employment growth and a slight pick up in wages.

Annual HCIP inflation was 2.2 per cent in 2005 in the Euro Area and is forecast to be 2.2 per cent in 2006 and the same in 2007. HCIP inflation was 2.4 per cent in April, up from 2.2 per cent in March. The price of services may have contributed significantly to this. Moreover, a contribution from oil may also have declined to this as up to February the growth of energy prices was 0.5 per cent but this has moderated. Producer prices slowed to 5.1 per cent in March from 5.4 per cent in the previous month. Again this was driven by a deceleration in energy prices. The ECB increased the base rate in March 2006 by 25 basis points to 2.5 per cent. It is forecast that interest rates will rise to 2.75-3.0 per cent this year.

The outlook for the Euro Area is now much more promising than previous expectations. The forecast of the Euro Area GDP growth is 2.1 per cent this year and 2.0 per cent next year. Inflation is forecast to be 2.2 per cent in 2006 and interest rates are expected to be tightened by a further 25 basis points to combat any rising inflation. Unemployment will only decline at a relatively slow rate over 2006 to 2008. The main risks are global imbalances, the fiscal consolidation in 2007, a sharp correction to the housing market and sustained higher oil prices.

Japan

Japanese GDP grew by 2.7 per cent in 2005 and by 0.5 per cent in 2006Q1 or by 3.0 per cent over the year (2005Q1 up to 2006Q1). Consumption grew by 2.2 per cent over 2005 and is forecast to grow by 2.4 per cent in 2006. Business investment increased by 7.9 per cent in 2005 and is forecast to grow at 4.5 per cent in 2006. Government spending rose by 1.8 per cent last year and is forecast to be the same this year. Exports grew by 6.9 per cent in 2005. Exports are mainly to the US and Asia. The forecasts for export growth differ according to source: the National Institute indicates Japanese exports will grow by 8.6 per cent whereas OECD estimates 12.3 per cent for 2006. Import growth was 6.2 per cent in 2005 but forecasts range from 4.9 to 5.3 for 2006. Exports, business investment, rising labour incomes and personal consumption will be the main drivers of growth in 2006.

The short-term interest rate in Japan is maintained at 0.0 per cent although the tone of the Bank's statement has differed with the Bank now referring to 'economic expansion' as opposed to the previous 'economic recovery'. The output gap is close to zero and is forecast to turn positive in 2006. The official inflation rate is 0 to 2 per cent and the lower end of this range needs to be increased. The April CPI increased by 0.3 per cent and over twelve months rose by 0.4 per cent. There have been several consecutive increases in inflation (excluding fresh food) but this is more limited when core inflation (excluding fresh food and energy) is taken into account. However with robust recovery, increasing employment, rising inflation and a closing output gap it seems definite that the Bank will move sooner rather than later to increase rates.

The Tankan survey continues to demonstrate rising confidence and Japan's main leading indicator increased by 0.7 per cent in April on a quarterly basis and by 2.7 per cent over the year. The Tankan survey showed particularly strong growth in 2006Q1 and Japanese manufacturing reported significantly buoyant results. The dampening effect on the survey reflected the sensitivity of the energy and commodity based industries. Unemployment was 4.4 per cent in 2005 and is forecast to be 4.1 per cent this year and 3.7 per cent in 2007. Overall the future for the Japanese economy is very promising.

Growth in China was 9.9 per cent in 2005 and it is forecast to be 9.7 per cent in 2006 and 9.5 per cent in 2007. Exports, investment and strong corporate profits are underpinning the expansion in the Chinese economy. Inflation was 3.8 per cent in 2005 and is forecast to be 3.4 per cent this year. The surplus (as a percentage of GDP) is forecast to decline slightly to 5.9 per cent compared to 6.3 per cent in 2005. India also exhibits very strong growth, 8.5 per cent in 2005 and forecast growth of 7.5 per cent in 2006 and 7.1 per cent in 2007. Inflation is forecast to peak at 4.8 per cent in 2006 before slowing to 4.3 per cent in 2007.

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16th June 2006