The economic background

The world economy

Overview

It would be tempting to say that all is rosy in the world economy with relatively strong growth and stable inflation. However inflation is rising across the globe but the impact of the rise in oil prices on wage inflation is weaker than expected. The effect is slightly more pronounced however in the US where unemployment is relatively low compared to Europe which has higher unemployment. This suggests that monetary policy will be more likely to be tightened in the US than elsewhere. It is probable that deflation in Japan will end this year and China and Asia are set to perform strongly despite rising oil prices. These economies have experienced strong export growth but increasingly the balance is shifting as domestic demand is driving these economies forward. There are also significant movements in economic policy that will effectively deal with the current imbalances facing the world economy. World growth in the third quarter of 2005 was just over 1 per cent with growth in North America at a similar level while Euro Area growth strengthened to 0.7 per cent. Growth in Japan eased slightly but forward looking indicators remain positive especially investment intentions. China and East Asia remained an area of strong growth in the latter part of 2005. Oil exporting countries have also experienced relatively strong growth because of high oil prices. The growth of world trade slowed in the first half of 2005. NIESR estimates that world trade grew by 6.5 per cent in 2005.

Outlook

The outlook for the US has deteriorated slightly with growth slowing from the strong growth of the previous two years. Japan will expand at a slightly stronger rate while growth in China is expected to remain relatively strong. The Euro Area is also expected to pick up but only very modestly over the next two years. The extent of the pick-up depends on whether Germany increases VAT and if the ECB raises the base rate further. Both these are likely to subdue growth slightly. Overall world growth is forecast to expand by 4.5 per cent in 2006 and in 2007. The slowing of US growth is compensated for by the uplift in Japanese growth and this is why the forecast is similar to that of 2005Q3.

Growth in the US is forecast to be 2.9 per cent this year (down significantly from the forecast of 3.8 per cent in 2005Q3) and be 2.8 per cent in 2007. The US forecasts are back in line with those of 2005Q2. Two factors influencing the slowing in the US economy are: a slowing of the housing market and a decline in exports. Japan is forecast to grow by 2.3 per cent in both 2006 and 2007 and this is a significant upgrade of our forecast from of 2005Q3. The Euro Area is forecast to increase by 1.9 per cent and 2.2 per cent compared to growth of 1.4 per cent in 2005.

Table 1 Forecasts of the main world economy indicators

	% Growth in real GDP				Unemployment rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	3.6	2.9	2.8	2.7	5.1	5.1	5.2	5.3
Japan	2.4	2.3	2.3	2.1	4.4	4.0	4.2	4.0
Euro zone	1.4	1.9	2.0	2.2	8.5	8.4	8.3	8.1
Germany	1.1	1.6	1.8	2.0	9.4	9.0	8.6	8.6
France	1.6	1.9	1.8	1.9	9.5	9.4	9.0	8.8
OECD	2.7	2.8	2.7	2.6	6.5	6.3	6.0	5.9
	Inflation rate (%)				Short term interest rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	2.9	3.3	3.2	3.0	3.5	4.6	4.8	4.8
Japan	-0.7	0.5	0.7	0.6	0.0	0.1	0.5	1.0
Euro zone	1.9	2.3	2.0	1.9	2.2	2.8	3.4	3.6
Germany	1.3	2.1	1.7	1.5	n/a	n/a	n/a	n/a
France	1.2	1.8	1.8	1.8	n/a	n/a	n/a	n/a
OECD	2.1	2.5	2.4	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, 195, January 2006.

Our forecasts for the Euro Area are the most consistent of them all, although two to four years on there is more uncertainty in the Euro Area than elsewhere, primarily because of the expectation of relatively low growth. 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 2004 to 2006 for the US, Japan, the Euro Area and the UK. For those countries where growth in domestic demand drops significantly then the outcome for GDP growth is also poorer. However in the US and Japan investment growth has declined sharply between 2004 and 2005 while government spending has also fallen. In the US export growth is forecast to fall steadily while in Japan this is forecast to rise again in 2006. We can also compare the growing US deficit over 2004 to 2005 with the surplus position of Japan when we examine the current account (as a percentage of GDP). It can be seen that as domestic demand does not increase fast enough in the Euro Area or in the UK, then the CA position worsens and indeed the Euro Area shifts from a surplus position to a deficit position. Export growth outpaces import growth but the volume of imports is still larger than that of exports. In general the effective exchange rate weakens as the CA position deteriorates. Table 2 therefore provides a clear indication of the likely future drivers of change and main trends over the period 2004 to 2006, highlighting the improvement in the Japanese position and the change in the US.
United States

Preliminary US GDP growth for 2005Q4 crashed with growth of only 0.3 per cent or 1.1 per cent on annualised basis. This compares with US GDP growth in the third quarter of 2005 of 1.1 per cent (4.1 per cent at the annualised rate) compared to 3.3 per cent in the second quarter. The third quarter estimate was revised up from the preliminary estimate. Annual growth for 2005 is estimated to be 3.5 per cent compared to 4.2 per cent for 2004.

In 2005Q4 consumption grew by 0.3 per cent (1.1 per cent on an annual basis) and gross private investment grew by 2.9 per cent (12.2 per cent on an annual basis). Government spending declined by 0.6 per cent (-2.4 per cent) while exports grew by 0.6 per cent (2.4 per cent) and imports increased by 2.2 per cent or 9.1 per cent on an annual basis. Personal consumption grew by 1.0 per cent, private fixed investment by 2.1 per cent and government spending by 0.8 per cent in 2005Q3.

These were the main drivers of growth in the third quarter. Net trade made a small negative contribution (-0.1 percentage points) to GDP due to growth of 0.6 per cent in exports but similar growth of imports. Inventories reduced GDP by 0.1 percentage points. The rapid consumption growth seen in 2005 led to improving employment conditions (although there were some job losses in 2005).

The US current account has narrowed slightly to $195.8 billion in 2005Q3 (6.2 per cent of GDP) from $197.8 billion in the second quarter (6.4 per cent of GDP). The US trade deficit is now costing $1 trillion dollars because the trade deficit widened to $725.8 billion i9n 2005 compared to

Table 1 Forecasts of the main world economy indicators

$617.6 billion in 2004. In December the trade deficit was $65.7 billion compared to $64.7 billion in November. It is expected that the trade deficit will exceed $800 billion in 2006. Higher oil prices and a relatively strong dollar (if interest rates continue to rise) will worsen the trade deficit.

Annual CPI slowed slightly in late 2005 and headline inflation of 3.5 per cent was observed in November. Excluding food and energy it was 2.1 per cent the same as the rate in October. The Federal Open Market Committee (FOMC) raised interest rates by 25 basis points to 4.25 per cent in December 2005. Since June 2004 there has been a cumulative rise of 325 basis points. Alan Greenspan has finally, after 18 years, relinquished the chairmanship of the FOMC and his replacement is Ben Bernanke. It is clear that there will be further tightening of monetary policy (perhaps a further 50 points in 2006) in the US. Higher interest rates may further slow the US housing market and could lead to a slowing of growth because there are high levels of indebtedness in US households and a negative saving rate.

The US dollar is 15 per cent below its 2002 peak and is leading to a long-term realignment of exchange rates. The US is not showing strong wage growth but second round effects will be important in determining the future path of inflation as they are estimated to be stronger in the US than elsewhere in the world. Recent exchange rate movements have negated about 10 per cent of the oil price rise across the world economy but not in the US where the weaker dollar has compounded the problem. The Chinese currency is allowed to rise by 1.2 per cent per year but actually increases in value by ~5 per cent per year. The US dollar is therefore over-valued compared to the Chinese currency and significantly so.

Industrial production appears to have recovered and there is a modernisation of manufacturing taking place. This is due to a relative decline in oil prices and hurricane effects. Thus business investment has been important in the third quarter. Manufacturing activity appears robust after its recent and temporary slowdown.

Non-farm payrolls increased in January 2006 by 193,000 as employment stood at 134,160,000. The strongest job gains were in services, providing 135,000 jobs with construction contributing 46,000 jobs while manufacturing only created 7,000 jobs. Unemployment was 4.7 per cent (7.0 million persons unemployed) compared to 4.9 per cent in December (7.4 million persons). In 2005 unemployment ranged from 4.9 per cent to 5.1 per cent.

The outlook for the US economy has not changed much and remains good. The outlook has deteriorated slightly over the next two years. The forecast for GDP growth in 2006 is 2.9 and 2.8 per cent in 2007. Inflationary pressures are relatively muted but obvious. Inflation is forecast to be 3.3 per cent this year with the Federal Funds rate at 4.6 per cent in 2006, although this could be slightly higher.

Monetary policy is appropriate at this time but further tightening will be seen in 2006 and 2007. The current account is expected to improve marginally although perhaps at the expense of growth.

Europe

Euro Area GDP growth was 0.6 per cent in 2005Q3 compared to 0.4 per cent in the second quarter and 0.3 per cent in the first quarter. There are clear signs of a strengthening of activity. This latest estimate of growth is the same as the flash estimate. There was stronger domestic demand growth with investment growth of 1.6 per cent and government consumption increasing by 0.7 per cent. The contribution of investment is at its highest since 2000Q1. Consumption growth was 0.3 per cent in 2005Q3 compared to 0.4 per cent in the previous quarter. What was encouraging about the growth of consumption was that it was geographically broadly based and is expected to rise further as disposable income increases. GDP growth has also been broadly based across sectors. The strong growth in investment was driven by strong corporate profits, corporate restructuring (efficiency gains) and favourable financing conditions. Net trade contributed 0.3 percentage points to GDP but inventories made a negative contribution of 0.3 percentage points. Both net exports and investment have now been making a substantial contribution to Euro Area GDP since 2003Q3. It is likely that global demand will continue to support exports from the EU. Although the changes in growth and the components of demand are encouraging, growth itself remains disappointing. The outlook for the Euro Area is more promising than it was previously with low base rates, stronger corporate profits and positive survey evidence for the next six months. It is reasonable to believe that Euro Area growth is now on a stronger basis than it previously was. It is likely that Euro Area activity will continue at this pace into the first half of 2006, or indeed be at a slightly higher level. It is also plausible that the Euro Area may return to trend growth (~2 per cent) in the near future (see Table 1 for the forecasts of growth). The downside risks to the Euro Area are fiscal consolidation in 2007, the loss of competitiveness (particularly Italy and Spain), global imbalances and to a lesser extent continued high oil prices.

In Germany GDP grew by 0.6 per cent in the third quarter of 2005 compared to 0.2 per cent in the previous quarter. Consumption declined by 0.2 per cent in 2005Q3 but investment increased by 2.2 per cent and government spending grew by 0.4 per cent. Net trade contributed 0.3 percentage points to GDP but inventories made a negative contribution of 0.1 percentage points. Overall German growth is relatively weak. The German ifo index fell back to 97.8 in November 2005 from 98.8 in October but reached its highest value in five years in December. Germany still has high unemployment and this puts pressure on taxation with high social security spending. The public sector deficit is now 4 per cent of GDP with government debt which was 50 per cent of GDP in 1994 and is now at 68 per cent in

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		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
Consumption	3.9	3.5	2.6	1.9	2.0	1.6	1.4	1.4	1.8	1.8	2.0	2.2
Investment	10.3	7.4	5.5	2.0	-1.1	2.3	2.2	2.3	2.5	3.3	3.9	4.1
Government	2.1	1.7	1.8	2.0	1.8	1.0	0.9	1.5	2.4	1.0	2.3	2.6
Domestic Demand	4.7	3.6	3.1	1.5	2.4	2.1	1.8	1.6	2.0	1.7	2.4	2.6
Exports	8.4	6.9	4.7	13.9	6.1	7.6	5.9	4.1	4.7	4.5	4.7	6.0
Imports	10.7	5.9	5.0	8.5	6.9	7.0	6.1	4.7	5.1	2.3	2.9	3.3
GDP	4.2	3.6	2.9	2.3	2.4	2.3	1.8	1.4	1.9	1.7	2.3	2.7
Unemployment	5.5	5.1	5.1	4.7	4.4	4.0	8.8	8.5	8.4	4.8	4.8	5.0
CA (% GDP)	-5.7	-6.2	-5.6	3.8	3.2	1.9	0.6	-0.4	-1.2	-2.0	-2.2	-2.6
Effective Ex. Rate	94.1	91.8	92.1	85.2	79.2	74.1	124.6	121.6	117.6	99.8	97.7	96.0

Notes: US investment is housing investment, others are private investment. Forecasts are those of the National Institute for Economic and Social Research; see NIER (2006) January, 195.

2005. The 3 per cent rule has now been broken in Germany every year since 2001 and fiscal consolidation is due to take place in Germany in 2007.

French GDP grew by 0.7 per cent in 2005Q3 compared to 0.1 per cent in 2005Q2. Consumption grew by 0.7 per cent, investment by 0.9 per cent and government spending by 1.2 per cent. Net trade contributed 0.2 percentage points to GDP but inventories detracted 0.4 percentage points from it. In France the strong consumption growth and business investment are the most important drivers of growth. Employment growth tends to be mostly in temporary and low paid jobs. Unemployment declined significantly from 10.2 per cent in May 2005 to 9.6 per cent in November 2005.

Survey evidence shows that the Euro Area is more likely to have strengthening economic activity in 2006. Industrial confidence increased by 0.2 percentage points in December; the manufacturing index of the PMI rose in December for the fourth consecutive month (reaching its highest level since August 2004); the EC services confidence indicator declined in December but is close to its highest value of 2005; the business services index of the PMI services survey increased in December 2005 and the employment and outstanding business indicators also rose in December. Industrial production decreased by 0.8 per cent in October 2005 (3 month moving average) and the strongest growth was in intermediate goods. Retail sales volumes decreased by 0.1 per cent in November following an increase of 0.2 per cent in October. Retail sales and new car registrations made an important contribution to growth in the third quarter. Consumer and industrial confidence suggests that fourth quarter growth will be slightly ahead of trend. Overall this is a positive sign for both the fourth quarter and the beginning of 2006. The improvement in confidence that started in may 2005 has been maintained.

Annual HCIP inflation was 2.2 per cent in December compared to 2.3 per cent in November. The decline was mainly due to a loosening of oil prices although some food prices also fell. It is expected that over the short-term this will get higher but in the medium-term it is expected to be close to target as monetary policy is tightened. What is encouraging is that wage growth is moderate (2.1 per cent in the second and third quarters) and indeed slightly below trend. This suggests that oil price increases are not feeding directly into wage bargains. There could of course be further problems ahead especially if higher oil prices are sustained over a longer period or what impacts come from second round effects of bargaining. It is unlikely however that these problems will pose a serious threat to the inflation outlook and in the medium-term inflation is expected to be close to target and stability will be achieved. This is reinforced when considering inflation excluding energy and food which rose by 1.5 per cent in November, largely unchanged and reflecting underlying stability in Euro Area inflation. Although energy prices growth declined in October and November, on an annual basis it was still growing by 10 per cent in November. Producer price inflation was broadly stable in November at 4.2 per cent. There has only been a limited transmission of energy costs to other sectors. Survey evidence suggests that there is still pressure on input prices (manufacturing and services) but this is not being passed onto selling prices. This is due to strong competition and a lack of consumer demand.

The ECB increased the base rate in December 2005 by 25 basis points to 2.25 per cent. Longer term rates also rose slightly, pricing further increases in the key rates by the ECB this year. It is forecast that interest rates will rise to 2.3 per cent this year although other commentators believe they will rise as high as 2.5 to 2.7 per cent in 2006.

The Euro Area current account was €42.6 billion in October 2004 (over 12 months but now is a deficit of €8.7 billion in October 2005. In January 2005 it dropped to €1.9 billion, followed by €1.8 billion in April 2005 and went negative in July 2005 at €-0.8 billion. This is because there has been a rapid rise in the value of Euro Area imports while export volumes increased strongly but the value of exports did not match that of imports. The Euro has been relatively stable in December 2005 and appreciated slightly against the US dollar, sterling and the Chinese renminbi but fell against the Yen in January.

The Euro Area labour market improved as it did in the first half of 2005. The Euro Are unemployment rate was 8.3 per cent in November and remains unchanged. However, the number of unemployed increased for the first time since March 2005. This is probably due to circumstances in Germany because if Germany is excluded the Euro Area unemployed declines. Employment is driven again by services and in particular finance and business services although the public sector remains important. Employment growth in the economy as a whole for the Euro Area was 0.3 per cent but it was 0.4 per cent in services and 0.6 per cent in finance and business services. The largest fall in employment was in agriculture which decline by 0.7 per cent. The employment index of the PMI survey was at its highest value for 4 years in December 2005.Some of the improvements in the labour market are due to changes arising out of the Lisbon agenda but some are due to methodological changes. It is because of this that the data should be interpreted with caution as some changes in large countries are non-negligible. Overall however it is likely that there has been a real improvement in the Euro Area labour market.

The outlook for the Euro Area is now more promising than previous commentaries. The forecast of the Euro Area GDP growth is 1.9 per cent this year and 2 per cent next year. Inflation is expected to remain relatively subdued with further monetary tightening in 2006. Unemployment will remain at relatively high rates although decline slowly over the medium-term. The main risks are global imbalances, fiscal consolidation in 2007, a loss of competitiveness and sustained higher oil prices.

Japan

GDP grew by 0.2 per cent in the third quarter of 2005 following a revision to the national accounts revising growth down from the original estimate of 0.4 per cent. The revision took into account lower contributions from public spending and inventories. The rapid expansion of the first half of 2005 has eased in the second half. Investment is still strong (due to de-stocking in the first half of the year when export growth was strong). Domestic demand is strengthening and GDP is forecast to grow by 2.3 per cent in both 2006 and 2007.

The Bank of Japan maintains its zero interest rate policy but rates are expected to rise towards the end of this year. Price deflation is abating. CPI (excluding fresh food) grew by 0.1 per cent for the first time in two years. Headline inflation declined again (-0.8 per cent on an annual basis). CPI is expected to pick up again as deflationary pressures decrease over 2006. The Bank of Japan is maintaining its target of current account balance of 30-35 trillion yen. The yen has weakened over recent months but appreciated against the Euro in January.

The December 2005 Tankan survey demonstrated an improvement in business conditions which is broadly based across sectors. An increasing number of large manufacturers report improving business conditions which is strongly encouraging for future growth. However recent stock exchange conditions may impact on business confidence reducing consumption and investment, therefore growth might be marginally lower than expected.

Non-Japan Asia grew robustly at the end of 2005 with export growth rising again except in China. Asian GDP growth in the third quarter is above trend and the fourth quarter expectation is for similar growth. Domestic demand has expanded again in most Asian countries despite higher oil prices. Inflationary pressures in November were moderate. China revised up 2004 GDP in December 2005 by CNY 2.3 trillion, an increase of 16.8 per cent. Most of this is due to improvements in measuring the service sector as it estimated to be 50 per cent larger than previously expected. China is increasingly being driven by domestic demand rather than exports. Indeed export growth is decelerating (both in November and December) falling to below 20 per cent for the first time in 2 years. November retail sales increased by 12 per cent while housing investment grew by 29 per cent on an annual basis. The Chinese trade surplus is estimated to be $102 billion. Annual CPI was 1.3 per cent in November. The outlook for non-Japan Asia and China remains very good.

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