The economic background

The world economy

Overview

One of the most important developments at the end of 2004 was the depreciation of the effective exchange rate of the dollar by 4.5 per cent on the previous quarter and the rise of the Euro effective exchange rate by 7.2 per cent. The world economy is still adjusting to this and growth has slowed slightly in the main economies. The main reduction in growth sadly will fall on the Euro Area. The main effect in the US will be slightly higher inflation.

GDP growth in the US was 4.4 per cent in 2004 with inflation of 2.2 per cent. Euro Area growth was only 1.8 per cent in 2004 while Japanese growth was 2.9 per cent. The slowing of growth in the Euro Area was due to the appreciation in the Euro but also because of the poor performance of the German economy where urgent labour market reforms are needed to improve the situation. The impact of rising oil prices was also more significant in the Euro Area. The slowing of growth in the US, China and other important economies across the world comes at a time when these economies approach full capacity and need not be taken as an indication of a serious downturn in performance in the future. Interest rates have been on a general upward trend through 2004 but this may not continue because of fears of exacerbating the slowdown. Rates seem to be at sustainable levels at the moment. While inflation remains relatively low across the world economy, inflationary pressures are building. This is concerning given we are running into the winter with thoughts turning to US winter oil reserves and an oil price of $60 a barrel.

Outlook

We are forecasting that US growth will be 3.5 per cent in 2005 and 3.0 per cent in 2006. Japanese performance is forecast to be 1.2 per cent and 1.4 per cent respectively. The Euro Area shows no signs of major improvement in 2005 with forecast growth of 1.8 per cent, close to the 2004 outturn, but growth is forecast to be 2.2 per cent in 2007. While Germany is forecast to have improved growth it is expected to continue to lag behind the rest of the Euro Area and is considerably below OECD forecast growth. The outlook is also good for Latin American economies, the former Soviet republics and in OPEC countries. China remains an engine of growth in Asia. World trade is forecast to slow to 8 per cent in 2005 (from 9 per cent in 2004). The current oil price is concerning as it was viewed as a spike but there are no immediate signs of a downward movement (4th July 2005 Brent Crude - $57.94 per barrel).

Table 1: Forecasts of the main world economy indicators

	% Growth in real GDP				Unemployment rate (%)			
	2004	2005	2006	2007	2004	2005	2006	2007
US	4.4	3.5	3.0	2.8	5.5	5.2	4.9	5.0
Japan	2.9	1.2	1.4	1.6	4.7	4.6	4.4	4.3
Euro zone	1.8	1.8	2.2	2.4	8.8	8.7	8.7	8.6
Germany	1.2	1.6	1.9	2.0	9.8	9.6	9.3	9.0
France	2.0	2.1	2.4	2.3	9.6	9.6	9.5	9.3
OECD	3.1	2.8	2.6	2.6	6.9	6.8	6.6	6.5
	Inflation rate (%)				**Short term interest rate (%)**			
	2004	2005	2006	2007	2004	2005	2006	2007
US	2.2	3.0	3.2	3.0	1.6	2.7	3.2	4.0
Japan	-0.6	0.1	0.5	0.9	0.0	0.1	0.4	0.8
Euro zone	1.9	1.8	1.6	1.7	2.1	2.4	3.2	3.5
Germany	1.7	1.5	1.1	1.0	n/a	n/a	n/a	n/a
France	1.7	1.9	1.9	2.0	n/a	n/a	n/a	n/a
OECD	2.0	2.3	2.5	2.4	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, **191,** January 2005.

United States

US real GDP growth grew by 0.9 per cent in the first quarter of 2005 (revised up from 0.8 per cent) following growth of 0.9 per cent in 2004Q4. In the first quarter of 2004 real GDP growth was 1.1 per cent and 2003Q4 growth was also 1.1 per cent. The indications here are clearly we expect a lower rate of growth for 2005 compared to that in 2004. Consumption in the US was 0.9 per cent in 2005Q1 compared to 1.0 per cent in 2004Q4 and also against 1.0 per cent in 2004Q1. We believe US consumption will remain relatively strong throughout 2005. Investment in the US fell sharply from 2.5 per cent in 2004Q4 to 1.2 per cent in the first quarter of 2005 as fiscal incentive were withdrawn at the end of 2004. Growth in government spending decreased significantly from the middle of 2004 and in 2005Q1 growth in government spending was only 0.1 per cent compared to 0.6 per cent in 2004Q1. Net trade continues to make a negative contribution to GDP however with -0.4 percentage points in 2005Q1 compared to -0.3 percentage points in 2004Q4.

This growth and strong domestic demand is supporting employment gains in the US. The most significant problem facing the US is that the strong growth has been achieved at the expense of a widening current account deficit (6.3 per cent of GDP in 2004Q4) and these imbalances do pose a risk to the rest of the world.

US inflation remains in check with both CPI and 'core' inflation easing slightly in April. This year CPI increased by 0.4 per cent in February, by 0.6 per cent in March, by 0.5 per cent in April but fell by 0.1 per cent in May. This was mainly due to energy costs. Inflation is now running at an annual rate of 3.7 per cent with core inflation at an annual rate of 2.4 per cent.

Industrial production increased by 0.4 per cent in May after a decline of 0.3 per cent in April. The increase in May was double the expectation of most analysts. Manufacturing drove the increase in industrial production with growth of 0.6 per cent due to the reversal of the decline in car production.

The US continues to enjoy a good outlook with good growth prospects ahead. Inflationary pressures remain in check and interest rates remain supportive of policy. The widening current account deficit remains a considerable threat to the rest of the world economy and the US government must address these sometime.

Europe

Growth remains a problem for Europe with an increase of only 1.7 per cent in 2004. The outlook is for growth of 1.8 per cent in 2005 and 2.2 per cent in 2006. This is largely because the Euro Area is still dependent on external conditions. Net trade exerted a negative influence on GDP in 2004Q4 despite holding up GDP in the second and third quarters of 2004. The contribution of consumption, government spending and investment to GDP remains poor. The ECB have left rates at 2 per cent given their poor growth outturn. High unemployment across the Euro Area but especially in Germany and France is also a problem. Undoubtedly urgent labour market reforms are needed to give these large economies the stimulus they require to achieve higher growth.

GDP grew by 0.5 per cent in 2005Q1 and this is closer to trend than was expected compared to growth of 0.2 per cent in 2004Q4. Euro Area domestic demand was flat in the first quarter thus the increase in GDP was due to external trade. This sadly is probably due to weaker imports rather than an increase in exports. Investment fell by 0.7 per cent in the first quarter. Clearly oil prices have had a significant impact on the Euro Area economy.

As was widely expected the ECB held rates at 2 per cent at its meeting on 2nd June. The expectation is that inflation remains contained in the medium-term.

Unemployment remains high in Europe and is unlikely to fall significantly at all. The standardised unemployment rate for the Euro Area was 8.8 per cent in 2004. The forecast is for this to decline slowly to 8.7 per cent in 2006 and remain at that rate in 2007. German unemployment was 9.8 per cent in 2004 while French unemployment was 9.6 per cent. Serious labour market reforms are required to improve this situation and the political fallout of this is seen in both France and Germany.

Japan

Japan grew by 2.9 per cent in 2004 and by 1.3 per cent in 2005Q1. The latter is much stronger than was expected. Growth in 2004Q4 was flat. Domestic demand was strong in the first quarter, especially consumption and non-residential investment. We must be careful here as this strong first quarter growth may to some extent compensate for the poor performance in the last quarter of 2004. CPI growth was zero in April but producer prices increased by 1.8 per cent. Elsewhere however in Asia there are signs of growth slowing and this is in keeping with expectations across the world. China grew by 9.5 per cent in 2005Q1.

Recovery remains fragile in Japan and it requires a boost from external demand to boost growth. The Yen has appreciated considerably (particularly against the dollar) and this has slowed export growth. The other threat to growth is the aggressive fiscal stance taken by the authorities who are determined to reduce the fiscal deficit of 7.3 per cent. Consumers expect a tax increase in the first quarter of 2006 (actually a decline in tax refunds). The Japanese have moved to chain base their national accounts and this has meant that GDP has been revised downwards slightly.

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5th July 2005