The economic background

The world economy

Overview

The recovery in the world economy remains strong despite some soft data over the summer. There have been weak figures on US employment and confidence but recent indicators and the statement from the Federal Reserve point to relatively strong growth in the medium-term. Unlike some commentators we have not been too pessimistic about global growth. There has been a slight slowing of the Chinese economy but US GDP growth for 2004Q2 has been revised up from 2.8 per cent to 3.3 per cent. There are clear signs of global inflationary pressures due to higher oil prices and to capacity constraints (with the latter probably being the more important in the medium-term while oil prices have a more dramatic current effect). Japanese growth has been stronger than expected and we still expect strong growth for the Asian economies despite a slowdown in import demand in the Far East. World trade is forecast to grow at 8.9 per cent this year and 10.1 per cent next year. Global GDP growth is forecast to grow at 4.2 per cent compared to 3.9 per cent in 2003. It is also expected to be above 4 per cent until beyond 2006. The Federal Reserve has now increased interest rates three times to 1.75 per cent. The ECB have kept rates at 2 per cent and the Bank of Japan are expected to maintain their zero rate policy until 2005. The downside risks to the world economy are the same as reported in the last QEC, namely: fear of terrorist attacks in the West; higher oil prices; the imbalances between the main economies and exchange rate fundamentals.

Outlook

In 2004 US GDP growth is forecast to be 4.3 per cent (unchanged from the previous forecast) and to be 3.3 per cent in 2005 (up from 3.1 per cent in the last quarter). The forecasts for world economic macro-variables are presented in Table 1. In Japan growth is forecast to be 3.4 per cent this year and by 2.5 per cent in 2005. While there has been a slowing in China GDP is forecast to increase by 7.3 per cent (down from 8.3 per cent in the previous quarter). The Euro Area remains sluggish with growth of 1.8 per cent forecast this year rising to 2.3 per cent in 2005. Unemployment is perhaps slightly higher (particularly in the Euro Area) than we would like just now but it should fall slightly over the next two years in most developed economies. As inflationary pressures build up we expect the monetary authorities to respond to this with a gradual tightening of policy. The expectation is still for low and stable inflation. The US presidential election result will tell us more about the possible policies the US will adopt over tax, the US deficit and foreign policy.

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United States

Real GDP was revised up for 2004Q2 from an annual rate of 2.8 per cent to 3.3 per cent (the first quarter data was also revised up). Quarterly growth was 0.7 per cent. Growth of this order still suggests that annual growth of 4.3 per cent is achievable. Furthermore many of the early indicators are optimistic about third quarter performance with slightly stronger GDP growth expected, although probably not as strong as the first quarter performance. The slowdown in 2004Q2 compared to the first quarter is probably due to a slowdown in personal consumption expenditure. This was mainly because of the effect of oil prices on real personal disposable income. It may be however that a slight slowing in housing wealth and net financial wealth contributed to this. Investment was a strong driver of growth in the second quarter. Survey evidence suggests that in August consumer confidence weakened compared to July and the Beige Book data also indicates that consumption may have eased slightly compared to July. Net exports made a negative contribution because of strong import growth. The current account widened to 5.7 per cent of GDP in the second quarter and is surely now a cause for concern for US policymakers. Oil prices have undoubtedly contributed to this. The trade deficit increased to $55.8 billion in June – up 19.2 per cent from $46.8 billion in May.

Consumption growth in 2004Q2 was 0.4 per cent, weaker than the 0.9 per cent in the first quarter. Private fixed investment growth was revised up to 3.1 per cent (from 2.7 per cent). Government spending grew by 0.6 per cent in the second quarter and was similar to the growth in the first quarter. The net contribution of trade was –0.3 per cent due to a surge in imports. US industrial production grew by 0.4 per cent in July. The ISM non-manufacturing index fell from 64.8 in July to 58.2 in August. The manufacturing index fell from 62.0 in July to 59.0 in August.

The US labour market has been 'disappointing' in many commentators' views but there have been increases in non-farm payrolls. Some believe that the number of jobs created is not sufficient to sustain growth at the pace seen in the first quarter of the year. It could be however that the US has had a strong increase in technical progress (see BARRELL and HOLLAND, (2004), NIER, 188, pp13-15) therefore productivity growth is higher. If, as the authors discuss, this is a temporary phenomenon then they expect employment growth to move more in line with output growth by the end of the year. Unemployment would probably fall to about 5.3 per cent by 2006 if this is true. Non-farm payrolls increased by 144,000 in August and by 96,000 in September (compared to 73,000 in July) while unemployment fell to 5.4 per cent in September. In the second quarter of 2004 productivity grew by 2.5 per cent.

The US has adjusted quite quickly to higher energy costs. There have been oil supply problems in Iraq; Nigeria; Saudi Arabia; Venezuela; Norway and Russia. There was also a

Table 1: Forecasts of the main world economy indicators

	% Growth in real GDP				Unemployment rate (%)			
	2003	2004	2005	2006	2003	2004	2005	2006
US	3.1	4.3	3.3	2.8	6.0	5.6	5.5	5.3
Japan	2.5	3.4	2.5	2.3	5.3	4.9	4.6	4.3
Euro zone	0.5	1.8	2.3	2.4	8.9	8.9	8.8	8.4
Germany	-0.1	1.4	1.7	2.2	9.6	9.5	9.1	8.5
France	0.5	2.3	2.5	2.4	9.4	9.7	9.5	9.0
OECD	2.2	3.4	3.0	2.9	7.1	7.0	6.8	6.5

	Inflation rate (%)				Short term interest rate (%)			
	2003	2004	2005	2006	2003	2004	2005	2006
US	1.8	2.4	2.5	2.4	1.2	1.5	2.9	4.0
Japan	-1.4	-0.4	0.4	0.6	0.0	0.0	0.3	0.5
Euro zone	2.0	1.9	1.8	1.7	2.3	2.2	2.6	3.2
Germany	1.0	1.5	1.1	1.2	n/a	n/a	n/a	n/a
France	1.8	2.0	1.9	1.5	n/a	n/a	n/a	n/a
OECD	1.7	2.1	2.2	2.3	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, 189, July 2004.

drop of US gas demand of 4.5 per cent in 2003. In 2003 the US accounted for 30 per cent of the increase in oil demand and this is estimated to be 20 per cent this year. This compares with China at 38 per cent in 2003 and an estimate of 30 per cent in 2004. This also contributed to the second quarter mini-slowdown. Retail sales, petrol sales and employment opportunities have all slowed slightly due to energy cost factors. It is likely that US markets have now built into their expectations an oil price of around $35in the medium-run.

The Federal Reserve increased interest rates by 25 basis points in June, August and September taking US rate to 1.75 per cent. Further increases are likely taking the interest rate to around 2 per cent by the end of the year. Annual growth in core CPI (excluding food and energy) was 1.7 per cent in August. By the end of 2004 it is estimated that this will be around 2 per cent.

As before, we believe the US will be one of the main drivers of the world economy. The current account deficit remains a concern but inflation is expected to be low and stable given the stance of the monetary authorities. We expect confidence, growth and employment to strengthen in the latter part of the year. The outlook for the US economy is good.

Europe

GDP growth was 0.5 per cent for 2004Q2, which was a relatively good performance compared to the other main economies. Growth in 2004Q1 was 0.6 per cent. This is the strongest growth seen in the Euro Area for some time. Forward looking indicators suggest that third quarter growth will be stronger. More importantly these data suggests that domestic demand will strengthen. Euro Area forecast growth for 2004 is only 1.8 per cent. We do not expect stronger growth until 2005 when growth is forecast to be 2.3 per cent. Germany in particular, is holding back Euro Area growth and unemployment remains quite high in both France and Germany relative to the UK. EA HICP inflation was 2.3 per cent in August and the impact of oil prices means it is unlikely to be below 2 per cent this year. The ECB have kept interest rates at 2 per cent but this was widely expected. Higher oil prices will hit the Euro Area slighter harder than the UK and is expected to contribute 0.4 percentage points to inflation next year. Most Euro Area countries are projected to miss their fiscal budgetary targets. Some countries have intervened in labour markets to increase flexibility but unemployment as a whole remains a problem.

While Euro Area GDP grew by 0.5 per cent (flash estimate) there are no data on components of change yet. The data we have however, suggests that exports and strong external demand remain important. Import growth is also estimated to be quite strong therefore the net contribution to GDP could be weaker than we think. Domestic demand is thought to have strengthened while investment may be flat or slightly negative. Industrial production increased by 0.8 per cent in 2004Q2 but new orders remain quite volatile. Third quarter survey data suggests new orders have strengthened. Confidence has been growing in the Euro Area despite a decline in the August PMI manufacturing index. The PMI remains above 50 however. Household spending declined slightly in the second quarter indicating the possibility of slower consumption growth. Retail sales also declined in 2004Q2.

Euro Area unemployment was 9.0 per cent in July (17.9 per cent for those aged <25 years and 7.9 per cent for those aged >25 years). There was a slight increase in the number of unemployed in July but the rate remained constant. Unemployment is forecast to be highest in: Finland, France, Germany, Greece and Spain in 2004 and in 2005. Employment is unchanged in the first half of the year. It is estimated that employment declined in the manufacturing sector but increased in services. The expectation is for manufacturing employment to pick up in 2005. Labour productivity in the Euro Area is thought to have increased significantly in the second quarter.

Japan

At the beginning of the year Japan's growth was the strongest of the G7 nations with 1.7 per cent in 2003Q4 and 1.5 per cent in 2004Q1. It only grew by 0.4 per cent in the second quarter though (first estimate). In 2004Q2 consumption grew by 0.6 per cent, government spending by 0.4 per cent while investment was flat. Net trade contributed 0.3 percentage points to GDP while domestic demand contributed 0.1 percentage point. Industrial production showed no change in July after declining by 1.3 per cent in June. Household spending grew by 2.9 per cent in July, significantly down from the 17.9 per cent recorded in June. Exports grew by 3.5 per cent in the second quarter.

Clearly external demand is still driving Japanese growth. Export growth was seen in Asian, US and European markets. The slowing in Japanese investment may be because of the fiscal consolidation and is likely to be temporary. We expect private investment to increase as machinery orders and corporate profits remain strong. Deflationary pressures decreased in July with CPI growth declining by 0.1 per cent (year-on-year). Corporate goods prices increased by 1.6 per cent in July however, the GDP deflator was -2.6 per cent in the second quarter suggesting more substantial deflationary pressures over the year. We still expect deflation to end in 2005. If growth remains above potential then this will put upward pressure on prices. Employment has only improved slightly but unemployment is declining steadily.

The forecast is for growth of 3.4 per cent in 2004 and 2.5 per cent in 2005 (see Table 1). The main downside risks for Japan are a further or prolonged rise in oil prices, a significant slowdown in the US or China and there are still some structural problems in the economy. The latter is slightly less important because the Government and the Bank of Japan have made some headway on some of these issues.

In China the prospect of a hard landing has diminished significantly as growth slowed slightly. Investment growth of nearly 50 per cent in 2004Q1 saw the Chinese Government take measures to constrain investment in the overheating sectors (aluminium, cement, construction and steel) and they have also introduced land controls. While macro-management of the Chinese economy remains difficult the forecast is for growth of 7.3 per cent for this year.

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