The economic background

The world economy

Overview

The world economy is now picking up with strong growth in the US and the Far East economies. Europe remains relatively weak and since the last quarter has worsened slightly. It is not expected to improve until next year with a return to trend growth forecast for 2005. The forecasts for world growth and trade have both improved since the last quarter. The outlook for the world economy remains good. The downside risks are the uncertainty over terrorist attacks in the west, the size of the US deficit, and the continued weakness in Europe.

Outlook

We still expect the world economy to recover through the second half of 2003 and into 2004. This growth is led by the US and strong growth in Asia (mainly in China). Japan has performed above expectations but there are still concerns over the strength of domestic demand in Japan. The Euro Area is a major concern in the short-run where economic prospects have worsened slightly. It is expected that recovery will be in place in the Euro Area by 2005. World trade is forecast to grow by 5.7 per cent in 2003 and by 8.8 per cent in 2004. Manufactures grew by 2.5 per cent after declining by 2.1 per cent in 2001. Non-OECD exports grew by 8.1 per cent while OECD imports grew by 2.7 per cent. The forecast for world economic growth has been revised up to 3.5 per cent. This is supported by the rapid recovery in the US and the rebound in Japan. Equity prices have recovered in most markets.

United States

Real GDP growth for the second quarter of 2003 was revised up to 0.8 per cent and growth in the third quarter was well above trend at 1.7 per cent. This compares to 0.4 per cent in the first quarter of 2003. We forecast that for 2003 growth will be 2.7 per cent, with growth of 3.5 per cent in 2004.

US growth continues to be driven by consumption, with spending growth of 0.7 per cent in 2003Q2 and contributing 0.7 percentage points to GDP in the same period. Government spending and investment made modest contributions to GDP in the second quarter after a weak performance in the first quarter. Stocks made a negative contribution to GDP and exports were a small negative component of GDP.

In the third quarter US growth was above trend with household consumption increasing by 1.6 per cent (compared to 0.9 per cent in the second quarter). This was helped by finance incentives, strong car sales and income tax cuts. It is likely that the rate of growth of consumption

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will slow slightly in the fourth quarter. Domestic demand remained strong in the third quarter.

Employment growth picked up in the first half of 2003 after a weak performance in the previous year. While the US labour market has improved it remains relatively weak. This higher output and weak employment performance demonstrates the strong growth in labour productivity in the US. This is leading to an increase in corporate profits and should lead to higher investment. There should also be benefits to households in higher incomes. The relatively weak labour market is, however, a constraint on some households and is restraining consumption. Non-farm employment has declined by one million since the end of the recession in 2001 and the unemployment rate is up by 0.5 percentage points. Average earnings in the year to the second quarter grew by 3.3 per cent. This is a small decrease of 0.2 percentage points over the previous quarter. In 2002 earnings growth had continually declined so this is an improvement on the previous year. Unemployment increased to 6.0 per cent in December 2002 but peaked at 6.4 per cent in June 2003. It has been declining steadily and reached 6.1 per cent recently.

Inflationary pressures increased slowly, having started to climb in October 2002 due to oil concerns, but have fallen back slowly over the course of 2003. Inflation was 3.1 per cent in March, but has declined significantly since then. Producer prices have also fallen. There is little concern for inflation in the US at this time.

The outlook for the US economy is relatively good. Some commentators have cast doubt on the sustainability of recovery but there is little evidence to support this. There are some mixed signals but that is the nature of economic data. The main concerns over the US economy are the drift of the dollar and the size of the US deficit. Our forecast is for US growth of 2.7 per cent this year and 3.5 per cent in 2004. We have taken into account the upturn in the ICT investment cycle, tax cuts and the buoyant housing market. We expect US domestic demand to remain strong and investment to recover in 2004.

Europe

The Euro Area remains a major concern in the world economy. After a contraction of 0.2 per cent in the second quarter in both France and Germany there was only a relatively small rise in real GDP in the third quarter. Germany grew by 0.2 per cent and France by 0.4 per cent in 2003Q3. This only offsets previous declines in real GDP in these countries. Overall Euro Area GDP remained flat. The weakness of Europe is concentrated in Germany, which is responsible for 30 per cent of Euro Area output. As previously mentioned, forward indicators are improving and suggest that the Euro Area will recover in 2004, but will not return to trend growth rates until 2005.

The Euro Area weakness is problematic for its trading partners and is a constraint on the UK economy but why is the Euro Area so weak? A slowdown in exports and

Table 1: Forecasts of the main world economy indicators

	% growth in real GDP				Unemployment rate (%)			
	2002	2003	2004	2005	2002	2003	2004	2005
US	2.4	2.7	3.5	2.8	5.8	6.1	6.0	5.7
Japan	0.1	2.2	1.1	1.5	5.4	5.5	5.2	5.0
Euro zone	0.8	0.5	1.7	2.4	8.4	8.9	8.8	8.5
Germany	0.2	0.0	1.3	2.1	8.6	9.3	9.1	8.8
France	1.2	0.4	1.4	2.2	8.7	9.4	9.5	9.0
OECD	1.8	1.8	2.9	2.5	6.4	6.7	6.6	6.4

	Inflation rate (%)				Short term interest rate (%)			
	2002	2003	2004	2005	2002	2003	2004	2005
US	1.4	2.1	2.9	2.3	1.7	1.1	1.4	2.4
Japan	-1.6	1.2	0.6	0.4	0.1	0.2	0.2	0.5
Euro zone	2.3	1.9	1.5	1.4	3.3	2.3	2.2	2.8
Germany	1.4	0.9	0.8	0.7	n/a	n/a	n/a	n/a
France	1.6	1.7	1.8	1.4	n/a	n/a	n/a	n/a
OECD	1.6	1.7	2.4	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, 186, October 2003.

investments was seen in 2001. Some unexpected price increases then led to a decline in real incomes thus depressing consumption. GDP growth picked up in 2002 but this was primarily due to temporary factors. The recent appreciation of the Euro has had an adverse effect on net trade.

Forward-looking indicators are more promising. Both consumer and business confidence display a rising trend. Survey data also suggested that Euro Area GDP did not fall in 2003Q3. Both the manufacturing and service Purchasing Managers Index (PMIs) for the Euro Area were above 50 in September. They rose again in October and were still above 50 in November. Official data highlights poor performance and because of this the official assessment of the Euro Area in the short-run is that, since the last quarter, prospects have worsened slightly. Evidence leads us to believe future economic growth will show signs of recovery.

German domestic demand remains weak, although there was higher third quarter GDP growth due to an increased level of exports, which increased by 3.2 per cent on a quarterly basis. Consumption spending fell by 0.3 per cent in the third quarter. German GDP growth is forecast to be flat in 2003 and 1.3 per cent in 2004.

In France the service PMI strengthened to 56 in September 2003 and was close to 60 in both October and November. In November the French manufacturing PMI rose to 52.7. GDP growth is forecast to be 0.4 per cent in 2003 and 1.4 per cent in 2004.

Both France and Germany breached the Stability and Growth Pact (SGP) rules. ECOFIN has decided not to impose sanctions. This is worrying because it implies there may be further breaches of the SGP and that the credibility of the SGP is now weakened.

The ECB reduced interest rates to 2.0 per cent in June. Interest rates are expected to stay close to 2.0 per cent over the next six months but to increase slightly thereafter. There are few inflationary pressures.

Euro Area unemployment is forecast to remain high compared to other major economies, at 8.9 per cent in 2003. Only a marginal decline in the following year is expected. Both Germany and France are forecast to have slightly higher unemployment than was previously expected (see Table 1).

Japan

Since 1997 Japan has had low or negative growth (except 2000 when growth was 2.7 per cent). GDP data suggest a much stronger recovery in Japan than most commentators expected. Other data suggest the recovery is weaker. GDP growth was 1 per cent in the first quarter of 2003 compared to 0.6 per cent in the same quarter of 2002. The improvement was due to better export and investment performance. Annual growth for 2002 was only 0.1 per cent, but the forecast for 2003 is for growth of 2.2 per cent. Growth in the second quarter was the highest of the G7 countries.

Household consumption remained flat, as was government consumption. There was stronger growth in the later quarters of 2002 in consumption, but this was still relatively weak. The stimulus to growth has come from consumer demand, stock building and a rebound in exports.

Deflation is still a slight concern although the forecast for 2003 is for inflation of 1.2 per cent. Interest rates are forecast to be 0.2 per cent in both 2003 and 2004, rising to 0.5 per cent in 2005.

Employment losses seen in the previous 8 quarters have been reversed in the year to the second quarter. This represents employment growth of 0.1 per cent. Earnings, which have been in decline since late 2002, have picked up over the last three quarters. Unemployment was 5.1 per cent in August, down 0.2 percentage points and an improvement on March-May. Unemployment is forecast to be to 5.5 per cent this year and 5.2 per cent in 2004, a significant improvement since the last quarter.

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