

The economic background

The world economy

Overview

The world economy has weakened slightly further again this quarter. This is primarily due to weaker economic data at the end of 2002 and for the first quarter of 2003. The expectation is for activity to strengthen in the latter half of 2003 and for GDP growth to intensify in 2005 relative to 2004.

The factors that have stabilised the world economy are the relative pick-up in global equity markets, the re-alignment of currencies (this may lead to an improvement in imbalances in the world economy) and oil price stability, although the fall in oil prices is smaller than was expected. Clearly the situation in Iraq has resolved according to the US plan and this has reduced uncertainty significantly. Despite this the West still has to be vigilant to any terrorist threat. The economic consequences of the war however are relatively minor.

Outlook

We are forecasting that the world economy will recover in the latter half of 2003 with full recovery apparent by 2004. Once again it is the US that is leading world economic recovery. Following some revisions to economic data and better than expected economic performance, Japanese growth is forecast to be significant in 2003. Germany remains weak especially when compared to France. Euro Area growth is forecast to be disappointing and is relatively weak compared to the other main regions in 2003. Growth in China, Asia and South America is forecast to be quite strong both in 2003 and 2004. There are some concerns over deflation particularly after Alan Greenspan's speech and clearly inflationary pressures are muted. Unemployment is forecast to decline slowly in the US but to rise slightly or remain stagnant in Japan and the Euro Area respectively. We expect imbalances in the world economy to narrow and that world trade will grow.

United States

US real GDP grew by 0.4 per cent in 2003 Q1 but this was lower than expected. This compares to 0.3 per cent in the final quarter of 2002. We are forecasting growth of 2.5 per cent in 2003 and 3.4 per cent in 2004.

Consumption was weaker in the first quarter of 2003 although there was a strong pick up in auto sales in March. Retail sales increased by 2.1 per cent in March (5.3 per cent on the year). Government spending increased by 0.2 per cent for 2003 Q1 on the previous quarter. Private investment increased marginally by 0.1 per cent in the same period. Of this, residential investment rose by 2.9 per cent whereas non-residential investment declined by 1.1

per cent. Net exports grew by 0.2 per cent whereas stock building fell by 0.1 per cent.

The ICT sector has seen significant signs of recovery with output increasing by 1.6 per cent in March on the previous month. Industrial production declined by 0.5 per cent in March 2003 on February 2003. The output of capital goods increased by 3.0 per cent in March. Industrial capacity utilisation fell slightly (by 0.5 per cent) in March relative to February. The Beige Book reports that overall economic activity expanded in April and May 2003. There was modest but uneven growth and most labour markets remained weak. The Institute of Supply Management manufacturing index rose from 46.2 in March to 49.4 in May (despite a slight decline in April). The non-manufacturing index rose to 54.5 in May from 50.7 in April. The Conference Board index rose to 81.0 in April from 61.4 in March while the Michigan index rose from 77.6 in March to 86.0 in April.

Headline CPI increased by 3.0 per cent in the year to March 2003 (the same as February) while core inflation (excluding energy) rose at an annual rate of 1.7 per cent. The CPI declined by 0.3 per cent in March 2003. US producer prices rose by 4.2 per cent for the year to March. In the month of March the increase was 0.9 per cent. Real household spending increased by 3.1 per cent last year but this has

slowed to 2.0 per cent this year. Alan Greenspan made it quite clear that there is room for a further rate cut if it is necessary to get the economy back on its feet. He also outlined his concerns with regard to deflation.

Non-farm payrolls have declined by 500,000 since October 2002 and fell by 48,000 in April with a further decline of 17,000 reported in May. The unemployment rate has increased from 5.8 per cent in March to 6.0 per cent in April and to 6.1 per cent in May. The weaker labour market might pose a threat to consumption but this is offset by temporary employment, which rose by 58,000 in May and this is an encouraging sign. Another positive sign is that private payrolls increased for both April and May.

Europe

Euro Area GDP growth continues to disappoint and is forecast to be 1.2 per cent in 2003. Growth was relatively flat for the first quarter of this year following 0.1 per cent growth in 2002 Q4. French GDP is estimated to be 1.2 per cent in 2002 compared to 0.2 per cent in Germany. Germany is forecast to have weak GDP growth compared to France where growth is forecast to be 1.3 per cent. Clearly the slowdown in the Euro Area was stronger than many commentators believed.

Table 1: Forecasts of the main world economy indicators

	% Growth in real GDP				Unemployment rate (%)			
	2001	2002	2003	2004	2001	2002	2003	2004
US	0.3	2.4	2.5	3.4	4.8	5.8	5.7	5.3
Japan	0.4	0.3	0.8	0.9	5.0	5.4	5.5	6.0
Euro zone	1.4	0.8	1.2	2.0	8.0	8.3	8.7	8.6
Germany	0.6	0.2	0.5	1.5	7.8	8.2	8.6	8.7
France	1.8	1.2	1.3	2.0	8.6	8.8	8.9	8.9
OECD	0.8	1.8	2.0	2.5	6.5	6.4	6.6	6.5

	Inflation rate (%)				Short term interest rate (%)			
	2001	2002	2003	2004	2001	2002	2003	2004
US	2.0	1.4	2.0	1.9	3.7	1.7	1.3	2.2
Japan	-1.5	-1.5	-0.6	0.2	0.1	0.1	0.1	0.1
Euro zone	2.5	2.3	1.6	1.2	4.3	3.3	2.6	2.8
Germany	1.9	1.4	1.0	0.7	n/a	n/a	n/a	n/a
France	1.4	1.5	1.3	1.5	n/a	n/a	n/a	n/a
OECD	2.1	1.7	2.1	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, 184, April 2003 and the Bank of England Monetary Policy Committee Minutes, 7th and 8th May 2003.

We expect the contribution of net trade to GDP to weaken but that consumption will strengthen in 2003. French consumption was 0.3 per cent in 2002 Q4 while government spending was 0.7 per cent (down from 1.1 per cent). French business investment fell by 1.8 per cent (in the first quarter it is estimated it declined by 0.7 per cent). Net trade has made virtually no contribution to GDP growth. Industrial production in the Euro Area rose by 0.2 per cent in February but this compares to an increase of 0.6 per cent in France, a decline of 0.4 per cent in both Germany and Italy. German manufacturing orders fell by 3.9 per cent in March.

The ECB has reduced interest rates to 2.0 per cent in a 50 basis point cut. However Wim Duisburg clearly stated that he did not think deflation posed any threat to the Euro Area economy, in direct contrast to Alan Greenspan. HCIP was 2.4 per cent in March (the same as February) and declined to 1.9 per cent in May. Annual core inflation slowed to 1.8 per cent in March compared to 1.9 per cent in February. German headline inflation is 1.2 per cent in both February and March.

The Purchasing Managers Index for manufacturing and services fell from 48.4 in March to 47.8 in April. Consumer confidence in April was -19 compared to -21 in March while business confidence dropped to -13 in April from -12 in March. The latest indices from ifo, Germany have declined.

Unemployment rose again in March to 8.8 per cent and remained there in April. Employment in the Euro Area grew

by 0.1 per cent in 2002 Q4 compared to no growth in the third quarter. Employment in industry fell by 0.4 per cent but services employment grew by 0.3 per cent.

Japan

GDP growth in Japan was stronger than expected with growth of 0.3 per cent in 2002 and 0.8 per cent forecast for 2003. Japanese growth is forecast to remain close to 1 per cent in 2004. Japan remains an economy that needs structural reform to give a sustained stimulus to the economy and to restore economic fundamentals.

Japan is still suffering from weak domestic demand with consumption forecast to decline from 1.5 per cent to 0.5 per cent. Government spending was 2.4 per cent in 2002. Investment declined by 4.1 per cent in 2002. It is probably going to fall by approximately 4.4 per cent in 2003 and is forecast to be 1.9 per cent in 2004. Export growth in Japan was 7.9 per cent in 2002 but is forecast to be 1.8 per cent in 2003. Imports are forecast to be 1.6 per cent in 2003 following growth of 3.7 per cent in 2002.

Equity prices in Japan have not risen to the same extent as those in other markets across the globe. Retail sales and household spending have both improved recently. Nominal sales increased by 1.6 per cent in the first quarter of 2003 on a quarterly basis.

Unemployment was 5.2 per cent in February but increased to 5.4 per cent in March. Unemployment is forecast to rise to 5.5 per cent this year and 6.0 per cent in 2004.

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