The economic background

The world economy

Overview

All the major economies grew more strongly in the first three quarters of 2002 compared to 2001 but growth slowed in the last quarter of 2002. At the beginning of 2002 the outlook for the world economy was marginally weaker than in the third quarter. The uncertainty over geopolitical tensions has had a substantial effect on equity markets. The UK FTSE 100 is close to an 8 year low; the Dax is now close to 2,200 points, which suggests that this is more severe in relative terms than the Great Depression in Germany during the 1930s. In Tokyo the Nikkei is near a 20 year low and only the Dow and the Nasdaq remain above crisis levels. Equity markets have lost 15 per cent of their value in the third quarter of 2002. The markets urgently require an injection of confidence but this will only happen when the situation in Iraq is resolved.

Oil prices are also suffering from the heightened uncertainty and oil prices are being squeezed upwards. The outlook for the world economy is that recovery will be led by the US in 2003, followed by the Euro Area. Both domestic demand and external demand are likely to strengthen while world trade is forecast to grow significantly. Growth is forecast to be stronger in 2004 as economic activity strengthens across the globe.

Outlook

We are forecasting that the world economy will recover in 2003 with full recovery apparent by 2004. The exception is Japan where growth is forecast to remain weak but to improve. Germany is relatively weak and in the short-term is forecast to be a drag on Euro Area growth. Inflationary pressures do not pose a threat to the world economy at this time nor are they forecast to but interest rates are forecast to rise from 2003 onwards. Unemployment is forecast to remain at relatively high levels especially in the Euro Area despite relatively promising output growth. In Japan unemployment is forecast to rise over the period of the forecast.

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United States

US real GDP grew by 0.2 per cent in the fourth quarter of 2002 and this indicates that growth for the year 2002 is 2.4 per cent. This is a significant improvement on the 0.3 per cent growth for 2001. The slowing of growth in the final quarter of 2002 suggests that growth in 2003 will be stronger than expected. Our forecast of growth for 2002 in the previous quarter slightly underestimated the strength of recovery in the US economy during 2002. We have only revised our 2003 forecast marginally however.

US growth is primarily underpinned by relatively strong growth in consumer spending, government spending and the completion of the inventory cycle. Consumption grew by 1.5 per cent on a seasonally adjusted annual rate in 2002Q4 while government expenditure grew by 11.2 per cent on the same basis. Exports decreased by 4.4 per cent in the last quarter of 2002 but imports increased by 7.2 per cent at a seasonally adjusted annual rate. Consumer spending increased by 1.0 per cent in 2002Q3 and 75 per cent of GDP growth in that quarter came from consumption. The recent tax cuts ('Jobs for Growth' package) worth $670 billion over ten years is expected to stimulate both domestic and external demand. The recovery in equity prices, a strengthening housing market and increased earnings are also expected to stimulate domestic demand, particularly consumption.

Industrial production increased by 2.0 per cent for January 2003 on January 2002. In January industrial production rose by 0.7 per cent compared to a decline of 0.4 per cent in December. There were strong sales in autos due to aggressive discounting and retail sales increased by 1.2 per cent in December 2002. The strongest growth was experienced in consumer goods, materials, non-industrial supplies and utilities. The Beige Book data is slightly less encouraging with economic activity relatively subdued but some districts did report modest growth. Importantly tourism and travel activity strengthened. Business investment remains weak however and manufacturers remain cautious.

Costs increased slightly in January and February primarily due to inventories, energy, raw materials and transportation costs. Gasoline prices at the pump reached their highest ever level in February 2003. This reflects uncertainty in oil markets. Inflation increased to 2.2 per cent in November 2002 compared to 1.5 per cent in September and 2.1 per

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	2.6	3.1	4.8	5.8	5.9	5.6
Japan	0.3	-0.2	0.5	0.9	5.0	5.3	5.5	5.9
Euro zone	1.4	0.8	1.4	2.2	8.0	8.3	8.4	8.3
Germany	0.7	0.2	0.8	1.7	7.8	8.2	8.3	8.2
France	1.8	1.0	1.6	2.3	8.5	8.7	8.9	8.8
OECD	0.7	1.5	2.2	2.6	6.5	6.4	6.5	6.4

	Inflation rate (%)				Short term interest rate (%)			
	2001	2002	2003	2004	2001	2002	2003	2004
US	2.1	1.4	1.8	1.5	3.7	1.7	1.5	2.2
Japan	-1.5	-1.5	-0.8	0.2	0.1	0.1	0.1	0.2
Euro zone	2.5	2.2	1.7	1.3	4.3	3.3	2.8	3.0
Germany	2.4	1.4	1.0	0.8	n/a	n/a	n/a	n/a
France	1.8	1.9	1.5	1.5	n/a	n/a	n/a	n/a
OECD	2.1	1.7	2.1	1.9	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, 183(1), January 2003 and the Bank of England Monetary Policy Committee Minutes, 5th and 6th February 2003.

cent in October. We forecast that inflationary pressures will remain relatively subdued. Interest rates are forecast to be low in 2003 but to rise thereafter.

Average earnings grew by 3.2 per cent in 2002 while real personal disposable income (rpdi) grew at a seasonally adjusted annual rate of 0.2 per cent in January compared to 0.3 per cent in December. Growth in November and February was 2.5 per cent and 4.2 per cent respectively. The monthly data on incomes has been rising for 5 months now. Lower earnings growth is probably due to the weaker labour market. The US labour market weakened in the fourth quarter of 2002 when total employment (by household survey) fell by 0.2 per cent. Service sector job creation was less than the number of jobs lost in manufacturing. Employment was 0.6 per cent lower than during 2001. Unemployment increased by 0.3 per cent to 6.0 per cent in November 2002. This is the highest unemployment rate for 8 years and the increase is the greatest since April 2002. We expect unemployment to rise slightly compared to our previous forecast.

Europe

Euro Area GDP growth was slower than that of the US in 2002. External demand and government spending have driven growth. Weak domestic demand remains a problem although investment and consumption are forecast to strengthen. Employment growth remains weak while unemployment is relatively high and we do not expect it to reduce significantly. Inflationary pressures are subdued. There are however clear signs of recovery for the Euro Area and the outlook is slightly more promising than previously.

Euro Area GDP was 0.3 per cent in 2002Q3 and remains largely unchanged over the first three quarters of 2002. It is the composition of GDP that has altered. In the first quarter the main contributions to GDP were from external demand, government spending and inventories. The contribution by government spending has declined steadily over the three quarters. In the third quarter stocks made a negative contribution to GDP. The most important two developments however are probably that consumption has increased its contribution significantly to GDP over the last two quarters and that in the third quarter investment did not make a negative contribution to GDP. The recent appreciation of the Euro may make it more difficult for exports to make an early contribution to GDP.

Despite these encouraging signs domestic demand in the third quarter only increased by 0.1 per cent compared to 0.2 per cent in the second quarter. Consumption however grew by 0.3 per cent during 2002Q2 and by 0.5 per cent in 2002Q4. Clearly the Euro Area is showing some signs of recovery and we forecast growth of 1.4 per cent in 2003.

Consumer confidence has decreased significantly in Januar y 2002 although industrial confidence remained steady. The lack of investment demand particularly in the German construction industry is of some concern. Indus- trial production increased by 0.4 per cent in October 2002 but the previous two months were weak. The main issue for consumers is the uncertainty over Iraq.

Unemployment in December 2002 was 8.5 per cent with the November figure revised upwards by 0.1 percentage points. The rise in the number of unemployed (70,000) in the fourth quarter was twice that in the third quarter. Unemployment was 8.1 per cent in December 2001. Employment data for the fourth quarter is not available but third quarter employment declined slightly. Despite the quarterly decrease in employment the annual rate of employment growth is estimated to be 0.3 per cent for 2002. During 2002Q3 all sectors including services contributed to the decline in employment. The outlook for employment remains fragile.

In November 2002 the current account surplus in the Euro Area increased to 10.3 billioneuros from 2.7 billion euros in November 2001. This is explained by a 4.1 per cent contraction in imports and a 2.1 per cent increase in exports. The surplus in services increased by 10.3 billion euros. The refi rate has been reduced by 0.25 percentage points to 2.5 per cent. Inflationary pressures remain weak.

Japan

Growth in Japan resumed in 2002 with real GDP growth of 0.9 per cent in the second quarter and 0.8 per cent in the third quarter. Growth weakened in the fourth quarter to 0.5 per cent and may be substantially less. The consensus forecasts for Japanese real growth for 2002 range between –0.6 per cent to 0.6 per cent. We expect the economy to be relatively flat with a further contraction of 0.2 per cent. In 2003 real GDP growth is forecast to be 0.5 per cent, slightly down on the forecast of the previous quarter.

In Japan very weak domestic demand and deflation are the main problems. External demand supported growth in the first half of 2002 but this has weakened in the second half of the year. Consumer spending and inventories are growing slowly and are estimated to make a significant contribution to GDP during 2003. The government appears committed to eliminating non-performing loans (NPLs) in order to stabilise and promote economic growth. While there will be negative impacts from this, the main benefits will accrue to the corporate sector in terms of increased profits and a lower cost of capital.

Economic conditions have deteriorated in Japan at the beginning of 2003. Government spending will probably still be the most important stimulus to GDP in 2003. Business investment is forecast to strengthen slightly and consumption will remain significant although it is forecast to contract slightly in 2003. Industrial production has declined reflecting the decrease in exports. Exports to Asia and the US are relatively flat while there is a clear decrease in exports to the EU. Retails sales also remain weak.

Unemployment rose by 0.2 per cent in December 2002 to 5.5 per cent. Although the number of job offers increased the employment situation is still very weak. Earnings are down slightly from the previous month. Wholesale and consumer prices are declining. Deflation is now regarded as ‘mild’ but the problem still exists. Inflationary pressures are forecast to remain absent in the next two years.

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