The economic background

The world economy

Overview

The risks to the world economy are now perhaps greater than in the previous quarter with the added tensions of a potential conflict in the Gulf. On the up side there are clear signs of a slow but steady recovery in the US and the UK despite the dip caused by the stock market correction. We expect growth in the Euro Area to pick up following a more sustained pattern of growth in the US towards the end of this year and into 2003.

The US appears to have a slow sustained recovery in place that has been hampered by a significant stock market correction. Economic performance is forecast to be considerably better in 2003. There are still risks to the economy including further falls in equity prices. On balance however the outlook for the US looks relatively promising. The recovery in Europe is weaker than expected but the economic situation is improving. Inflationary pressures remain weak while external demand is beneficial to growth prospects. Unemployment remains relatively high. Japan continues to be a serious concern for the world economy particularly the persistent deflation and the underlying weakness of the financial sector.

As we warned in the last Quarterly Economic Commentary a significant stock market correction has taken place, adversely affecting economic growth across the globe. War with Iraq will increase oil prices and this may significantly add to inflationary pressures, depending on the length of any conflict.

Outlook

Growth for most economies has been revised downwards following the significant losses on the world's main stock markets. Growth in the US is now forecast to be 2.2% this year compared to 2.5% forecast last quarter and in the Euro Area the forecast is 1.2% only slightly down on the previous forecast of 1.3%. Again we observe that India and China have contributed significantly to world GDP growth although some emerging economies (Brazil and Argentina) are forecast to do less well as they try to stabilise their economies. Japanese performance is expected to continue to be poor relative to the other main economies of the world. Table 1 summarises forecasts for a number of international indicators using the latest available data.

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Table 1: Forecasts of the main world economy indicators

	% Growth in real GDP				Unemployment rate (%)			
	2001	*2002*	*2003*	*2004*	*2001*	*2002*	*2003*	*2004*
US	1.2	2.2	2.9	3.1	4.8	5.8	5.6	5.3
Japan	-0.5	-0.1	0.4	1.0	5.0	5.5	5.7	5.8
Euro zone	1.4	1.2	2.4	2.7	8.1	8.4	8.2	8.0
Germany	0.7	0.8	2.1	2.4	7.7	8.2	8.1	7.8
France	1.8	1.3	2.2	2.5	8.6	9.0	8.9	8.7
OECD	1.2	1.8	3.0	2.6	6.5	6.9	6.7	6.5
	Inflation rate (%)				*Short term interest rate (%)*			
	2001	*2002*	*2003*	*2004*	*2001*	*2002*	*2003*	*2004*
US	1.9	1.4	2.0	1.5	3.7	1.8	2.3	3.3
Japan	-1.6	-1.7	-0.6	0.4	0.1	0.1	0.1	0.2
Euro zone	2.1	2.4	2.2	2.1	4.3	3.4	4.0	4.5
Germany	1.8	1.6	1.2	1.5	n/a	n/a	n/a	n/a
France	1.4	1.8	1.5	1.4	n/a	n/a	n/a	n/a
OECD	2.1	1.5	2.1	2.4	n/a	n/a	n/a	n/a

Note: Inflation rate is measured by consumer prices.

Sources: OECD Economic Outlook, 71, 2002; the National Institute Economic Review, 181(3), July 2002 and the Bank of England Monetary Policy Committee Minutes, September 2002.

United States

The US economy demonstrated strong GDP growth of 1.4% in 2002 Q1 (5.6% at an annualised rate). Growth in the second quarter is estimated to be only 0.3% confirming that first quarter growth was driven by the inventory cycle turnaround. Leading indicators and provisional August data suggest that the third quarter may also be relatively weak. Equity markets have shown some signs of stabilisation after large losses in July although weak business data in September led to a further decline. The encouraging news is that, both US and UK price-earnings ratios continue to remain high compared to historical levels. The outlook for the US is relatively promising from 2003 onwards.

The recession in the US although longer and slightly deeper than expected is still one of the mildest that it has experienced. Fiscal and monetary policies have both been extremely supportive and fiscal policy is expected to add 0.8% to GDP in 2002. This has had the strongest effects in construction, defence and anti-terrorist activities. Real consumption increased by 0.8% in July after a 0.4% rise in June. Consumption is being supported by strong sales of autos and because of increased mortgage refinancing activity. This has come about because of low interest rates.

Exports are forecast to contract by 2.1% in 2002 with import growth of 0.7%. By 2003 the forecast is for export growth (9.6%) to outperform import growth (6.9%). Net trade is forecast to reduce GDP by 0.3% in 2002 but be neutral in 2003.

Industrial production increased by 1.1% in the second quarter but investment fell by 0.3%. Manufacturing increased by 0.1% in July, with auto production up by 4.2% and ICT production increasing by 0.1%. The Conference Board measure of consumer confidence fell to 93.5 in August from 97.4 in July. Beige book data up to August 2002 indicate mixed fortunes in the US economy with consumption holding up but manufacturing performing relatively poorly. While the US deficit is forecast to be 4.4% of GDP in 2002, it is expected to reduce to 3.5% in 2003. Similarly the general government deficit is forecast to be 1.7% in 2002 (compared to a surplus of 0.5% in 2001) but to decline to 1.1% next year. These forecasts are taken from the first nine months of the fiscal year where expenditure increased by 7.8% but total receipts decreased by 11.4% (income tax has declined by 19.5% and corporate tax by 16%).

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US headline inflation increased to 1.5% in July from 1.1% in June whereas core inflation (excluding food and energy) fell to 2.2% from 2.3%. US producer prices have continued to fall from their 2001 levels. The lack of inflationary pressures is unlikely to put upward pressure on rates and most commentators do not believe rates will rise until 2003.

The labour market has been relatively flat with productivity accounting for most of the recent increases in output. The unemployment rate fell from 5.9% in July to 5.7% in August but most of this reflects unemployment benefit changes. Unemployment is forecast to be 5.3% in the medium-run. 160,000 jobs a month were shed in the year up to February 2002 and since then there has been relative stability in employment levels. Employment is only forecast to rise modestly in 2003 and is currently 0.5% below the 2001 level of employment. Average earnings have only increased by 0.75% in both the first and second quarters but are forecast to rise by 4% in 2003 as economic conditions improve.

The main risks to the US economy are a further drop in equity markets, a significant widening of imbalances and any further corporate shocks. There are also risks that the decline in household wealth (from the fall in equity markets) could lead to a reduction in consumption and ultimately to lower economic growth. On balance however the outlook for the US looks relatively promising with economic performance forecast to improve significantly in 2003.

Europe

Real GDP growth in the Euro Area was 0.3% for the first quarter of 2002 compared to 0.1% in 2001 Q4. For 2002 Q1 government spending increased by 0.6% while exports rose by 0.5%. Imports fell by 0.8% and inventories decreased by 0.3% in the same period. Consumption ominously however remained flat, similar to its performance in the last quarter of 2001. The improvement in external demand is the main stimulus to the Euro Area at the moment and leading indicators suggest that this pattern will be repeated in the second quarter of 2002.

Harmonised consumer prices have remained at 1.9% in June and July while cost pressures are also falling. Producer prices have declined below their 2001 levels. This suggests that the ECB will hold rates at 3.25% at least until the end of the year. Given the problems in the Euro Area economies there is a temptation to relax fiscal discipline, which will add to inflationary pressures in 2003.

In May Euro Area unemployment was 8.3%, unchanged from April but up from 8.0% in 2001Q2. During the recent months the number of unemployed has continued to rise suggested that the Euro Area unemployment rate will rise in 2002 Q2 and possibly again in the third quarter. Employment growth has been stable over the last four quarters at 0.2% with services being the only broad sector to stimulate employment growth. This is being driven by business and financial services.

Germany is under-performing the Euro Area generally while France is doing marginally better. In Germany real GDP growth was 0.3% in 2002 Q2 and is forecast to be 0.8% in 2002. In France the figures are 0.4% and 1.3% respectively. In Germany government spending and inventories are positive contributions to GDP but investment has declined by 2.5%. Unemployment is above the four million mark and is forecast to be 8.2% in 2002. The main risks to the German economy are weak domestic demand and the rigidities in the labour market. In France inflation is forecast to be 1.8% in 2002, as headline inflation has fallen but core inflation remains stable at 2.2%. Investment and exports have recovered significantly but consumption has remained flat. Unemployment has also increased slightly in France and is forecast to be 9.0% in 2002.

The main risks to the Euro Area economy include a double dip recession in the US that may stall global growth and reduce external demand and further falls in the US stock markets that would have significant effects in European stock markets and significantly reduce the prospects of increased GDP growth.

Japan

Japanese real GDP grew at an annualised rate of 5.7% in 2001 Q1 compared to 5.6% in the US suggesting that Japan might be recovering. With initial estimates of GDP growth in the first quarter of 1.4% it was disappointing to see 2002 Q2 growth of only 0.5%. This has become a seasonal bounce with this the third consecutive year that first quarter data has been misleading. As the Monetary Policy Committee of the Bank of England commented in their September meeting “Japanese economic developments are difficult to interpret.” This is because there are conflicting signals emerging from the world’s second largest economy.

The positive news was dominated by the strong growth exhibited by the Asian region, which indicates that it is not as dependent on the US economy as previously thought. This strong growth is underpinned by relatively strong domestic demand in China, Korea and India. As a result of this Japanese exports have increased by 14.6% in the year to July 2002 and consequently industrial production also increased in the same period. More significantly exports to Asia increased by 27.9% and to China by 45.5%. The Japanese stock market outperformed both the US and European markets with an impressive rally again based on Japan’s export performance. Recent events however have shown that the Japanese economy is not experiencing a sustainable recovery at all.

The bad news was that the GDP growth figure for 2002Q1 has been revised down to zero and second quarter growth is only 0.5%. Private consumption is estimated to have grown by only 0.3% in the second quarter while investment contracted by 0.6% and inventories made no contribution to GDP growth in the same period. In July 2002 retail sales fell by 2.2% on the previous month while the consumer price index fell by 0.8% on a year earlier in July. Industrial production also fell by 0.4% in July on a year earlier. Unemployment has also remained unchanged. It is clear that the World Cup has not had the sustained effect that many thought it would have on the economy.

A major concern over the Japanese economy is that a pattern is emerging of economic data that is optimistic in the first quarter of the year with a suggestion of recovery in the spring only for first quarter data to be revised downwards and subsequent quarters having relatively poorer performance. Why is this? There are two major problems here. The first is the data collection process itself where subtraction of negative inflation (deflation) makes real growth look larger and the method of estimating consumption (55% of Japanese GDP) on a narrow survey produces an upwards bias. The second problem is that the persistent deflation is because the financial balance sheets of firms are consistently being eroded and the Japanese government is issuing even more debt (debt is now 140% of GDP). Most of Japan's debt is held domestically but if this level of debt becomes too great to be absorbed by Japanese investors then this burden will fall on the Japanese themselves and this will causes significant concerns in global financial markets. Government bills have such a low interest rate that they are becoming similar to cash. Ultimately the Bank of Japan will have to increase the money supply to meet increasing demands for cash deposits or it will have to risk that some banks will be unable to meet their liabilities. The latter painful choice however would see the Japanese create a necessary condition for a sustained economic recovery and that is a financial sector that is underpinned by solid balance sheets and solvent banks.

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