

# The economic background

## The world economy

### Overview

Growth in the world economy is now clearly recovering with the US, Japan and China demonstrating strong economic growth. The US growth is considerably boosted by the decline in the US dollar but this will not continue in the medium-run. When US employment data shows a significant rise in employment then we can expect US interest rates to increase. Europe remains relatively weak but there are signs of recovery and we expect full recovery in the Euro Area by 2005. As in the previous QEC the forecasts for world growth have improved. There are very few inflationary pressures in the world economy. The outlook for the world economy is lightly better than in the previous quarter. *Terrorist attacks in the west, the size of the US deficit and the continued weakness in Europe* are the only downside risks of any significant concern.

### Outlook

US growth is forecast to lead world economic growth but strong balanced growth is expected across the world economy by 2005. In 2004 growth is forecast to be relatively strong in Japan and the Euro Area although German growth will remain slightly weaker than that elsewhere in the Euro Area. Japanese growth is forecast to be greater than 2.0 per cent in 2005 and OECD growth is forecast to be 2.8 per cent in 2006. Central banks will continue to focus on low and stable inflation and interest rates will start to increase in the world economy from 2004 onwards. Unemployment is forecast to decline marginally across OECD countries but in some countries unemployment may remain relatively stable. As economic prospects improve we expect the US current account deficit to narrow towards the end of the forecast period.

### United States

US real GDP growth grew by 1.0 per cent in the final quarter of 2003 compared to 2 per cent in the third quarter. This gives US growth of 3.1 per cent for 2003 compared to 2.2 per cent in the previous year. However, over 2003 industrial production only grew by 0.3 per cent. The significant decline in the dollar has substantially increased growth in the US particularly in the second half of 2003 and the first quarter of 2004. We forecast that for 2004 growth will be 3.9 per cent and 3.1 per cent in 2005.

Consumption growth in the fourth quarter is estimated to have declined to 0.6 per cent after an artificial boost to personal incomes in the third quarter from child tax credit. The trade balance was negative but slightly better than anticipated and investment has slowed slightly in the fourth quarter. Exports increased by 4.2 per cent while

imports grew by 2.7 per cent. Government spending (investment and consumption) only increased by 0.2 per cent in the last quarter of 2003. These factors all contributed to the lower rate of real GDP growth in the final quarter of 2003.

The implicit price deflator for GDP grew by 0.3 per cent in the last quarter of 2003. Within producer prices the price index for total finished goods increase by 3.2 per cent in 2003 compared to 4.2 per cent for consumer goods. Consumer prices increased by 1.9 per cent in 2003. We forecast that this year prices will rise by 2.1 per cent and that this rate of increase will be relatively stable. Over the 12 months to January 2004 CPI inflation increased by 1.9 per cent.

The University of Michigan Confidence Board recorded another increase in January and employment is expected to increase significantly in the latter half of 2004. Non-farm employment had fallen by 400,000 in 2003. Non-farm payroll increased by 112,000 in December and by 138,000 in both January and February. These increases are not substantial however and we are unlikely to see interest rates rise before there is a marked improvement in employment performance. Unemployment is forecast to decline from 6.0 per cent in 2003 to 5.8 per cent this year and is expected to remain close to this rate in the medium run. Unemployment was estimated to be 5.6 per cent in February 2004.

The US will continue to drive world growth during this year and next. There are significant concerns over its widening current account deficit but we believe these will be addressed in the medium run. The prospects for the US economy are very good and we expect strong growth to continue here.

The movement of the US dollar to UK Sterling exchange rate can be seen in Figure 1. Over the period 1997 to 1999 sterling traded in the range of 1.6 to 1.7 US dollars to the pound. From 2000 onwards there was a significant depreciation of sterling until the first quarter of 2002. Since then there has been a rapid and dramatic appreciation of Sterling against the US dollar as it reached a peak of \$1.91 on the 18<sup>th</sup> February 2004. Since the 1<sup>st</sup> January 2002 to its peak the US \$/£ exchange rate has risen by 31 per cent and from the 1<sup>st</sup> of July 2003 the increase is 15 per cent. There have been some short periods of relaxation but most commentators agree that with little prospect of an increase in US interest rates in the near future it is more likely that the rate will rise to close to \$2/£1. Clearly, it is evident that this substantially boosts net trade to the US and makes it cheaper for tourists to visit the US further strengthening US economic activity. It also makes it more difficult for UK goods to remain competitive in the US market.

**Table 1: Forecasts of the main world economy indicators**

			<i>% growth in real GDP</i>				<i>Unemployment rate (%)</i>		
	2003	2004	2005	2006	2003	2004	2005	2006	
US	2.9	3.9	3.1	2.9	6.0	5.8	5.9	5.9	
Japan	2.1	1.9	2.1	2.2	5.3	5.4	5.6	5.5	
Euro zone	0.4	2.0	2.4	2.6	8.8	8.8	8.7	8.5	
Germany	-0.1	1.6	2.1	2.4	9.3	9.1	8.9	8.7	
France	0.2	1.9	2.4	2.5	9.4	9.8	9.8	9.7	
OECD	2.2	3.0	2.9	2.8	7.1	7.0	6.8	6.6	
				<i>Inflation rate (%)</i>				<i>Short term interest rate (%)</i>	
	2003	2004	2005	2006	2003	2004	2005	2006	
US	1.8	2.1	2.2	2.3	1.2	1.4	2.5	4.0	
Japan	-1.3	-0.2	0.2	0.4	0.0	0.1	0.4	0.6	
Euro zone	2.0	1.7	1.8	2.3	2.3	2.8	3.3		
Germany	0.9	0.9	0.8	n/a	n/a	n/a	n/a		
France	1.7	1.4	1.5	1.6	n/a	n/a	n/a	n/a	
OECD	1.7	2.1	2.2	2.4	n/a	n/a	n/a	n/a	

Note: Inflation rate is measured by consumer prices.

Sources: OECD Latest Release, [www.oecd.org](http://www.oecd.org), the National Institute Economic Review, 187, January 2004.

## Europe

As previous stated the Euro Area is still a significant problem within the world economy. Growth is not forecast to pick up strongly until 2005 and 2006. There are very few inflationary pressures in Europe with inflation dropping from 2.3 per cent in 2002 to 2 per cent in December 2003. Unemployment remains a problem however. We do not believe that unemployment will fall significantly until 2006 at the earliest. The ECB are very unlikely to lower interest rates despite the threat of the Euro appreciating further against the dollar.

Export performance has been surprisingly good but domestic demand remains weak. Both Germany and Italy have pulled out of recession. GDP increased by 0.2 per cent in the third quarter of 2003. Again exports contributed significantly to this but industrial production, consumption and domestic demand all declined. German investment also decreased. We had believed that French growth would have been better than what it was. Real GDP growth was only 0.5 per cent in the second half of 2003. We have therefore revised down our forecast for French growth. In France however most components of domestic demand increased slightly in the second half of 2003. This bodes well for growth in 2004 and we forecast growth of 1.9 per cent in 2004. Investment is widely anticipated to recover strongly in France and government spending has also increased significantly.

As was widely expected the ECB held rates at 2 per cent at its meeting on 5<sup>th</sup> February. The strength of the Euro and poor economic performance are dampening any prospects of inflation. Elsewhere growth has stimulated the Euro Area economy slightly but there is little prospect of the Euro moving significantly against the dollar. As the Euro Area economy recovers in 2005 the expectation is that the Euro will appreciate against the dollar.

Unemployment is still high in Europe and is unlikely to fall significantly until 2006. The standardised unemployment rate for the Euro Area was 8.8 per cent in the second half of 2003 and has remained stable for six months. Unemployment only fell in two European countries last year. We believe that unemployment will be above the Euro Area unemployment rate in France, Germany, Italy and Spain in 2004.

## Japan

Japanese growth has been unexpectedly strong with growth of 2.1 per cent in 2003. Growth has been above trend for the last six quarters and is forecast to be 1.9 per cent in 2004 and 2.1 per cent next year. External demand has stimulated growth significantly but there are also signs that consumption and investment, are recovering. We expect consumption to grow by approximately 1 per cent in 2004

Figure 1: US\$/UK£ exchange rate



and business investment by about 2 per cent. Government spending growth is declining slightly as recovery takes a hold and we estimate that this will be 1.5 per cent in 2004. Potential growth in the Japanese economy could be 2 per cent and this is weaker than the US but Japan remains the world's second economy and as such 2 per cent growth is significant.

Given Japan's recent economic performance we can expect the deflationary pressures to decrease. Our forecast assumes deflation is reversed in 2005 but any price increases are going to be relatively weak. Industrial production is rising and more significantly in the high technology sectors. This reflects the increased demand for exports. The Tankan Survey indicates an improving business situation, a significant rise in activity for non-manufacturers and a falling number of bankruptcies.

Unemployment remains close to 5.4 per cent and will probably increase marginally over the next year. Personal income is increasing slowly as consumers exhibit slightly more confidence. The most recent retail sales and personal consumption data demonstrate a decline in activity. They are forecast to rise however in 2004. Employment has fallen slightly but is forecast to recover in 2004. The number of new job offers is on a rising trend.

Kenneth Low  
10 March 2004

## Business Forecasting

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