The economic background

The world economy

Overview

Global growth is forecast to slow to 4.2 per cent in 2008 (from 4.7 per cent in 2007) but this better than expected and performance is driven largely by the Asian economies. US growth is forecast to slow to 1.3 per cent this year (compared to 2.2 per cent last year) while in the Euro Area, growth is forecast to be only 1.5 per cent in 2008 after growth of 2.6 per cent in 2007. China and India are forecast to continue to grow rapidly in 2008 (10.4 per cent in China). Japan and the rest of Asia are also doing well mainly due to the stimulus of Chinese demand and trade.

The main concern for the world economy is the strength of inflationary pressures, as a result the recent global slowdown. Oil prices show no sign of returning to below $100 a barrel in the near future and commodity prices continue to rise. Households and business are now facing increased energy, transport and food costs. With considerable slowing growth in the US and Europe (including the UK) this stagflationary situation is acutely worrying, particularly in the US where unemployment is also rising. On top of this housing prices have deteriorated significantly while financial market volatility continues to be a problem. The risks to the global economy are weighted on the downside.

This poses a significant dilemma for policy makers. On the up-side central banks have responded quickly and aggressively to the slowdown in growth. They have injected liquidity into the banking system and the Federal Reserve has lowered rates to try to achieve a ‘soft landing’ for the US. The White House has released a fiscal stimulus to help households and businesses. Even if recovery begins in the second half of 2008 there are significant concerns about stoking up inflation with looser monetary policy. Inflation is rising strongly in Asia, is significantly higher in the US (4.3 per cent inflation coupled with growth of only 1.3 per cent) and remains a problem in Europe. The ECB have not lowered interest rates, in order to combat inflation and as the Euro has appreciated against the dollar exporters will undoubtedly face tough conditions. The outlook for Euro Area inflation may be more promising than that of the US or the UK.

Oil prices continue to rise fuelled by increased demand, although the rate of increase in Chinese demand is slower than last year. Supply is not keeping up with demand because OPEC refuse to increase production; there has not been enough investment in non-OPEC production; geopolitical instability still exists; stocks have dwindled and some governments are agreeing contracts with nation states to sell oil at below its market price thus leaving the rest of the oil to the market where price is bid up above the clearing price.

Table 1: Forecasts of the main world economy indicators

	Growth in real GDP (%)				Inflation rate (%)			
	2006	2007	2008	2009	2006	2007	2008	2009
US	2.9	2.2	1.3	1.7	2.8	2.5	4.3	2.9
Japan	2.4	2.0	1.8	2.0	-0.3	-0.5	0.3	0.7
China	11.1	11.3	10.4	10.5	1.5	4.8	8.5	9.4
Euro Area	2.9	2.6	1.5	1.9	2.1	1.8	2.4	2.3
Germany	3.1	2.6	1.5	2.0	1.4	1.7	2.2	2.1
France	2.2	1.9	1.6	1.8	1.4	0.8	1.9	2.0
OECD	3.1	2.7	2.0	2.1	2.1	2.0	3.1	2.7
	Unemployment rate (%)				Short-term interest rate (%)			
	2006	2007	2008	2009	2006	2007	2008	2009
US	4.6	4.6	5.5	6.1	5.2	5.3	2.9	2.7
Japan	4.1	3.8	4.0	4.2	0.2	0.7	0.8	1.1
China	9.0	4.2	4.1	4.1	2.5	4.6	5.3	-
Euro Area	8.3	7.4	7.0	6.9	3.1	4.3	4.7	4.4
Germany	9.8	8.4	7.2	7.0	n/a	n/a	n/a	n/a
France	9.2	8.3	7.9	8.2	n/a	n/a	n/a	n/a
OECD	6.1	5.4	5.4	5.3	n/a	n/a	n/a	n/a

Note: Inflation rate is measured by consumer prices. Chinese unemployment for 2006 and 2007 by survey but 2008 and 2009 only estimates for urban unemployment and excludes a significant number of the unemployed.
Sources: OECD Latest Release, www.oecd.org, the *National Institute Economic Review*, **204**, April 2008.

Table 2: Change in components of demand and main macroeconomic indicators for the US, Japan, the Euro area and the UK, 2006-2008

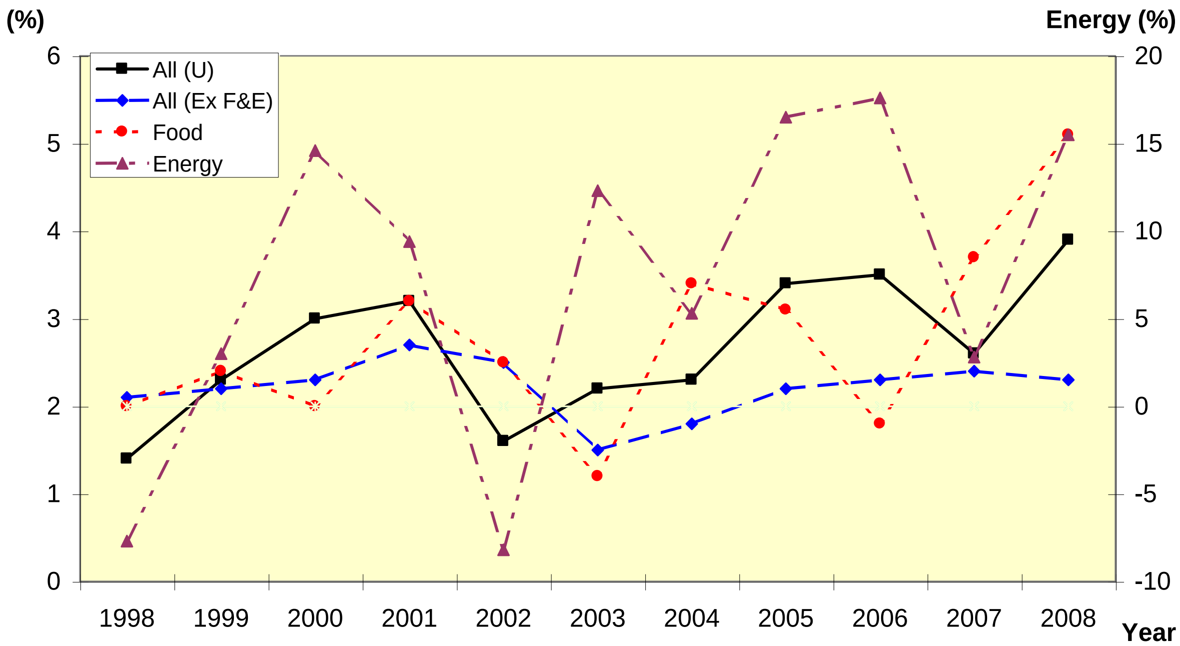
	The US			Japan			Euro Area			The UK		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
Consumption	3.1	2.9	0.7	2.0	1.5	0.8	1.8	1.5	1.5	3.1	1.2	0.6
Investment	6.6	4.7	3.3	4.3	2.1	4.9	5.0	4.5	2.5	6.2	2.4	0.7
Government	1.4	1.9	2.6	-0.4	0.8	1.8	2.1	2.4	1.4	1.9	2.3	2.0
Domestic Demand	2.9	1.7	0.1	1.6	0.9	1.1	2.6	2.1	1.6	3.7	1.4	0.9
Exports	8.4	8.1	7.5	9.7	8.8	5.9	8.1	6.0	2.5	-5.3	1.7	-2.9
Imports	5.9	1.9	-1.6	4.2	1.7	1.7	7.8	5.2	3.3	-2.9	3.1	2.6
GDP	2.9	2.2	1.3	2.4	2.0	1.8	2.9	2.6	1.5	3.0	1.8	1.8
Unemployment	4.6	4.6	5.5	4.1	3.8	4.0	8.3	7.4	7.0	5.4	5.4	5.2
Govt Bal. (% GDP)	-2.6	-3.0	-4.3	-2.9	-3.4	-3.9	-0.6	-0.8	-0.6	2.3	2.7	2.7
CA (% GDP)	-6.2	-5.3	-4.6	3.9	4.8	4.5	0.2	-0.2	-0.3	-3.9	-4.2	-3.5
Effective Ex. Rate	98.6	93.9	88.4	90.4	83.8	86.7	98.8	102.0	108.1	100.2	102.3	92.4

Notes: US and Japanese investment is business investment, others are private investment. Effective Exchange Rate = 100 in the year 2005. Forecasts are those of the National Institute for Economic and Social Research; see *National Institute Economic Review*, **204**, April 2008

Figure 1: US stagflation: employment change (000s), inflation, growth and unemployment (%), 1999-2008

Source: US Bureau of Labor Statistics and US Bureau of Economic Analysis, June 2008.

Figure 2: Inflation in the US economy, 1998-2008



Source: US Bureau of Labor Statistics, June 2008

A significant driver of the price change however is speculation, which is also affecting commodity prices.

Outlook

Despite the recent slowdown, world economic growth is forecast to remain relatively strong due to China, Asia and the resilience of some other economies. The US is forecast to grow by 1.3 per cent this year and by 1.7 per cent in 2009. Consumption and investment are expected to weaken significantly, especially in the developed economies. Trade is forecast to remain strong with growth of 6.6 per cent this year and 6.7 per cent in 2009. The Euro Area is forecast to slow during 2008 and pick up in 2009. Germany and France are expected to be the main drivers of growth in the Euro Area. The strength of recovery and resilience to shocks will depend upon labour market buoyancy and how the authorities respond to the financial crises. Table 1 presents the forecasts of main economic indicators for the period 2006 to 2009.

Table 2 illustrates the components of demand and main macroeconomic indicators for the period 2006 to 2008 for the US, Japan, the Euro Area and the UK. US consumption annualised growth fell to 1 per cent in 2008Q1 compared to 2.3 per cent in 2007Q4. Residential investment declined at an annualised rate of 26.7 per cent in the first quarter of 2008. This is the largest single contraction since the beginning of the US housing market slowdown. Consequentially US consumption growth is forecast to be 0.7 per cent in 2008 and investment growth is forecast to be 3.3 per cent. In the UK and Japan consumption growth is also expected to be low in 2008. The US current account deficit is forecast to improve significantly due to the depreciation of the dollar.

United States

The US is suffering from the most significant credit crunch and slowdown in the housing market since the 1930s after the banking sector experienced some of its worst losses in the sub-prime mortgage market. US real GDP growth was only 0.9 per cent at an annualised rate in 2008Q1 compared to a preliminary estimate of 0.6 per cent one month ago. The change is due to a decrease in imports, slightly higher personal consumption (non-durables) and a small increase in inventory investment. 2007Q4 GDP growth was 0.6 per cent and for 2007 as a whole it was 2.2 per cent.

The main problem in the US is that growth is slowing while inflation and unemployment are rising (see Figure 1). It is not clear that the US will achieve a 'soft landing' although clearly that is the aim of policymakers. Technically, the US is not in recession (two successive quarters of negative GDP growth) but growth has slowed sharply. Key questions are: how and when will the US recover? This will depend on two factors: firstly, the impact that financial crisis will have on the real economy e.g. how will reduced wealth affect employment, income and consumption etc. and secondly, how the labour market behaves. We know that in 2001 1.7 million jobs were lost and in 2002 0.5 million jobs disappeared. For 2008 only 324,000 jobs (up to the end of May) have been lost. So far the data suggests that the situation is not as bad as it was in 2001. Furthermore, most commentators believe that unemployment will have to rise to about 6 per cent before the economy begins to contract. Given that unemployment is considerably below this level, then this is unlikely.

A more difficult question to answer is 'what will be the impact of the financial crisis be on the real economy?' Losses are extremely difficult to quantify accurately but estimates range from $400 million, Greenlaw et al (2008) to $1,000 million, IMF (2008).[1] We already know that growth has slowed considerably and that employment losses (see below) are occurring at a significant pace. Unemployment is rising, but not alarmingly and wage growth is relatively subdued despite inflation pushing up energy and food bills. It is not clear yet how consumers will respond. If they are losing wealth due to falling house prices, loss of employment income etc. then they may entrench that position by curbing spending sharply, particularly if banks restrict lending even further. This would not be good for the economy and would push the US closer to a 'hard landing'. One sign is that banks are responding quickly to the credit crisis, as has the Federal Reserve. If banks can raise more capital then it is more likely that a 'soft landing' will be achieved. The economy may then experience a degree of recovery (even though this might be quite modest) in the second half of 2008. The GDP growth forecast for the US in 2008 is 1.3 per cent and this follows this scenario.

Inflation

Annual CPI (U) was 3.9 per cent in April 2008 compared to 2.6 per cent in April 2007. Annual food inflation was running at 5.1 per cent in April 2008 while energy prices increased by 15.5 per cent in the same month. With both commodities and oil pushing inflation higher than expected this is proving a real dilemma for the Federal Reserve who have already committed themselves to supporting growth by lowering the Fed Funds rate to 2.0 per cent (a 75 basis point decrease in March and a further quarter point in April). With a fiscal stimulus of approximately $150 billion (close to 1 per cent of GDP) and support ($30 billion) given to JP Morgan Chase to take over Bear Stearns as well as having lent $75 billion in its 13th short-term auction to the financial sector; there are growing concerns about the inflationary impact of these measures over the next two years.

US employment

US non-farm employment continued to fall in April 2008 when 28,000 jobs were lost. Over the first quarter of 2008 job losses totalled 247,000. This looked better than expected but in May non-farm payroll declined by 49,000 so the total number of jobs lost since the beginning of the year is 324,000. Construction employment has been falling since July 2007 and 381,000 jobs have been lost in this sector since then. Comparing the job losses in manufacturing the job losses in the first 4 months of 2008 are not as serious as those recorded in the years 2001 to 2003 but they are the next largest fall (down by 176,000 compared to -111,000 last year). Even within the service sector jobs are being lost in this slowdown: retail (Dec 07 to Apr 08); financial services (Aug 07 to Mar 08) and real estate (Nov 07 to Apr 08). However, overall the service sector has shown modest job gains over this difficult period (98,000 for the first 4 months of 2008 compared to 510,000 in 2007 and 712,000 in 2006).

US unemployment

US unemployment was 7.6 million persons in April 2008 with an unemployment rate of 5.0 per cent. In 2007 the figures were 6.8 million and 4.5 per cent. This is down marginally on the 5.1 per cent recorded in March (a decline of 189,000 persons). The expectation was that in May unemployment would increase to 5.1 per cent but instead it jumped by 0.5 percentage points to 5.5 per cent as unemployment soared by 861,000 to 8.5 million – the largest increase since January 1975. There has been little change to working hours or average earnings.

Overall the US labour market has declined and this will probably impact on personal incomes. This exacerbates the situation for retail sales and for the housing market. The fall in the labour market does appear to be slowing and there could be an upturn in the second half of 2008, although it is not likely to be large.

Current account, exports and the dollar

The US current account deficit is forecast to improve over the near term, largely due to the depreciation of the dollar against the Euro and the Yen. Over the last five years the dollar's real effective exchange rate has fallen by 15 per cent. The current account deficit is forecast to fall from -6.2 per cent of GDP in 2006 to -3.6 per cent of GDP in 2009. For 2007 as a whole exports increased, imports decreased and net financial inflows improved. The main problem is the US imbalance with China. One of the reasons that commentators were worried about the current account deficit was that it was driven by demand (and by a significant proportion of credit) while the personal saving rate was close to zero. These two factors came about because borrowing costs were low and house prices have been expanding briskly leading consumers to think they were permanently better off. Given that the financial crisis has occurred now, this has led to a slowing in consumption growth and the expectation is that savings will rise due to the crisis (this is far from certain – currently the personal saving rate is 0.7 per cent of disposable personal income for April 2008 but is negative as a percentage of GDP due to borrowing, investing from other periods etc.). A financial unwinding is a high-price and high-risk outcome to simply correct imbalances in the US economy and would not have been contemplated with a great deal of probability more than one year ago.

US outlook

The risks for the US economy remain on the down side although after the first quarter of data there are some signs that the economy may manage a 'soft landing'. The Institute of Supply Management (ISM) June index shows some signs of optimism. These include: employment, PMI, and manufacturing all up marginally in May 2008. The other optimistic indicators are the resolve of the Federal Reserve, the accompanying fiscal stimulus from the White House and the apparent ability of banks to replenish capital relatively quickly. The fact that labour market outcomes are better than expected and the economic imbalances are being corrected also helps. It is the transition process that the economy takes that will determine the amount of pain the US economy has to suffer. If risk is priced more highly and aggressively, if lending remains tight and cautious, if the labour market does not pick up as expected or if financial volatility persists then the US economy may well have a 'hard landing'. If commodity prices do not slow somewhat or if the price of oil remains considerably above $100 a barrel for a prolonged period of time then US inflation will be pushed hard and this will erode growth and impact on consumers. The US economy has some way to go yet before it is out of the woods.

Europe

In the first quarter of 2008 Euro Area real GDP growth was 0.8 per cent compared to 0.4 per cent in 2007Q4 and 0.7 per cent in the third quarter. Real GDP growth for 2007 was 2.6 per cent. The forecast for Euro Area GDP growth is 1.5 per cent in 2008 and 1.9 per cent in 2009. Most forecasters of the Euro Area indicate the same pattern of weakening growth in 2008 and pick-up in 2009. Some commentators however, believe that 2009 will be a worse year than 2008. Germany and France are the key drivers of Euro Area GDP. In 2007 German GDP grew by 2.6 per cent while French GDP increased by 1.9 per cent. In 2008 German growth is forecast to slow to 1.5 per cent but recover to 2 per cent in 2009. In France the forecast is for growth of 1.6 and 1.8 per cent respectively. Private fixed investment and exports are expected to be the main drag on economic growth in the Euro Area in 2008. This is primarily due to tougher credit conditions impacting adversely on investment while there is an expectation that the housing market will weaken significantly in most European countries except Germany. The Euro's appreciation will lead to a lower contribution of net trade to GDP. In 2009 the situation is expected to improve.

Consumption in the Euro Area fell slightly in 2007Q4. It is expected to fall again in 2008 mainly because of falling retail sales; changes in household saving (particularly in Germany where consumption contracted by 0.5 per cent in 2007 and is forecast to grow by 1 per cent in 2008) and a fall in construction activity. One of the positive factors supporting consumption growth is the expected strength of the labour market in 2008. Some economies (like Ireland and Spain) are more likely to suffer from sharp corrections in their housing markets. Euro Area house price growth was 5 per cent in the first half of 2007 and 4 per cent in the second half of 2007; 2006 growth was 6.5 per cent. The range of growth in the second half of 2007 across countries is sizeable (-3.9 per cent in Ireland to 9.1 per cent in Belgium).

Germany

Germany saw annual growth slow from 3.4 per cent in the first quarter to 1.6 in the fourth quarter. Growth in 2007 was 2.6 per cent compared to 3.1 per cent in 2006. The outlook for Germany is better than most European countries. Business investment is expected to hold up (growing by 4.5 per cent in 2008 and by 3.5 per cent in 2009); retail sales are holding up; turnover in manufacturing is rising on an annual basis; the ifo survey indicated that employment is to remain positive in industry and in trade; and that unemployment has reduced. Overall Germany has maintained most of its competitive gains made in the mid 1990s. Germany is forecast to have a trade surplus of 7 per cent of GDP and a current account surplus of 5 per cent of GDP.

France

France is in a slightly weaker position because the economy was driven by strong consumption and business investment. Both of these are likely to shrink in the face of adverse impacts from the housing and financial markets. House price growth in France is estimated to fall from 12.5 per cent in 2007 to 6.5 per cent in 2008. There is some research that suggests that France will not suffer from the same effects due to the housing market or financial corrections as housing wealth appears to have a minimal effect on consumption. France does not have the same contribution to GDP from net trade that Germany is forecast to have, due to relatively strong imports and weaker exports. Consumption is forecast to rebound back to 1.9 per cent in 2008 after declining to 0.8 per cent in 2007. Whether this can be achieved is a good question. Factors that will make this more difficult include rising inflation and wages, uncertainty over the path of the housing and financial market recovery as well as weakening public finances. It is important for the UK and for the rest of Europe that France and Germany do well as they are main markets for the exports of other countries.

Euro Area inflation

Euro Area inflation rose sharply in March to 3.6 per cent (3.4 per cent for 2008Q1) but dropped slightly to 3.3 per cent in April. HICP inflation in the Euro Area was 2.1 per cent in 2007 and was 4.4 per cent for the new member states (NMS). The lowest inflation in 2007 was in Finland, France and the Netherlands at 1.6 per cent. The highest (excluding NMS) was Greece at 3 per cent. In 2008 the forecast is for Euro Area inflation to be 2.5 per cent, and growing by 6.1 per cent in the NMS countries. Excluding NMS the highest inflation for 2008 is forecast for Spain (3.7 per cent) and the lowest for the Netherlands (2.1 per cent). The European Central Bank (ECB) does not have an exchange rate target and is unlikely to follow the accommodating monetary policy of the US. It traditionally will combat rising prices aggressively. The impact of high oil prices (energy prices increased by 10.8 per cent in 2008Q1 and by 11.2 per cent in March) is driving inflation in the Euro Area although the appreciation of the Euro is helping to dampen this effect. CPI inflation has been driven to its highest level since 1993. When energy is excluded, prices rose by 3 per cent in the first quarter of 2008. This compares to 2 per cent in 2007Q1. Non-energy commodity prices grew by 9.2 per cent in 2007, by 15 per cent in February and by 10.3 per cent in March. Given that rising commodity prices are determined globally there is little central banks can do to alleviate domestic inflation. Harmonised consumer price inflation (HICP) remains above the ECB target (2 per cent). Most commentators believe that the ECB's strong discipline will see inflation subside in the latter half of 2008 but nevertheless the risks for inflation in the Euro Area remain on the upside. The main risks include increasing oil and commodity prices, rising food prices and nominal wage growth. It is also expected that producers will pass on some costs to consumers as price pressures escalate further into 2008.

The ECB has left the main refinancing interest rate unchanged at 4 per cent since 13th June 2007. It is unlikely to cut rates soon in the face of rising price pressures although the appreciation of the Euro may affect their decision, or if demand weakens more than anticipated. Neither of these scenarios is likely and monetary policy will probably remain unchanged through 2008. The most feasible outcome is that Euro Area demand weakens in 2008 but there is little further appreciation of the Euro. The ECB may cut interest rates at this time by 25 basis points. As the Euro depreciates exports pick up and demand strengthens slightly but investors reappraise their holdings. It is likely that these will be the train of events that will unfold in the Euro Area during 2008. The Euro Area does not have the imbalances that the US economy has to deal with, therefore the situation is easier to manage.

Euro Area labour market

The Euro Area labour market has been performing much better than expected. Employment increased significantly in 2006 and

2007. It is expected to continue to expand in the first half of 2008 but at a more modest rate. PMI survey data report that at the beginning of 2008 up to April, job creation continued in both the industrial and the service sectors. Euro Area unemployment was 7.1 per cent in March (unchanged from the previous two months). The forecast for Euro Area unemployment is 7.0 per cent in 2008 and 6.9 per cent in 2009. German unemployment is forecast to fall but the French labour market is likely to see unemployment rising in 2009.

Japan, China and Asia

Real Japanese GDP grew by 2.0 per cent in 2007, slightly below the growth rate for 2006. The Japanese trade surplus was 10.7 million yen, up 2.9 million yen on the previous year. The contribution to GDP from net trade was very significant accounting for over half the increase in GDP. The buoyant demand for trade in the region is a welcome stimulus for the Japanese economy. Consumption edged up again in the last quarter but growth in consumption is likely to be slightly less this year compared to 2007. The Japanese economy is less affected by the credit crunch and housing market collapse in the US. Japanese exports to the US have been declining but exports to other Asian economies having been growing rapidly. Japan is forecast to grow by 1.8 per cent in 2008 and by 2 per cent in 2009.

Chinese GDP is expanding strongly at 11.3 per cent for 2007 and forecast to be 10.4 per cent this year. The current account surplus in China last year was 9.4 per cent of its GDP. China is also experiencing strong inflows of hot capital leading to foreign exchange reserves increasing by 17 per cent of GDP. Asian central banks are buying up excess foreign currency so China can avoid a sharp correction to its exchange rate. This has led to a faster growth of money supply than anticipated in China, Hong Kong, India, and Taiwan.

Japanese inflation was -0.5 per cent in 2007 but CPI inflation is forecast to be 0.3 per cent in 2008. Higher food and oil prices are expected to reduce personal disposable income and this is the main reason that there is unlikely to be a stronger growth in private consumption. Official Chinese CPI inflation was 3.1 per cent in 2007 and is forecast to be 3.7 in 2008. In Table 1 however, we note that forecast inflation in China is to be 8.5 per cent in 2008 and 9.4 per cent in 2009. This is a broader measure of inflation than that published by the People's Bank of China, which constrains inflation to a narrow urban measure. It also illustrates the realities of fast GDP growth, rapid expansion of money supply and persisting with low interest rates and an undervalued currency.

The Bank of Japan is unlikely to increase interest rates until the end of 2008. Most Asian economies have low interest rates, as does China. The combination of low interest rates and strong credit growth (bank lending increased by 52 per cent in 2007 in China) means that investment continues to grow at a brisk pace. 50 per cent of investment in the Asia region (excluding Japan) is in China and a significant proportion of this is devoted to the Beijing Olympics.

The biggest risk to the Asian economies is undoubtedly the prospect of an upswing in inflation due to the lax monetary policy operated across the region. In China in February 2008 inflation grew by 8.7 per cent, the fastest rate of growth in 11 years. There have been 'high inflation episodes' in the region before and the authorities should act now to prevent depositors (most of household financial wealth is kept as bank deposits and equals 70 per cent of GDP) suffering from negative real rates. This will only lead households to withdraw their savings. The expectation is that at least in China the interest rate will have to rise to offset inflationary pressures.

Endnote:

[1] Greenlaw, D., Hatzius, L., Kashyap, A. and Shin, H.S. (2008) 'Leveraged Losses: lessons from the mortgage market meltdown, US Monetary Policy Forum, February.IMF (2008) Global Stability Report, April.

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