The economic background

The world economy

Overview

Growth in the world economy was 5.3 per cent in 2006 driven largely by the US (3.3 per cent), China (10.7 per cent) and India (close to 9.0 per cent). Euro Area growth was 2.8 per cent in 2006 compared to 2.2 per cent in Japan. Trade made significant contributions to growth (world trade grew by 9.1 per cent in 2006), particularly in the Far East. The expectation for 2007 is that the world economy will continue to expand briskly. The forecast for the US economy is growth of 2.6 per cent in 2007 and in 2008. The Euro Area has strengthened significantly with growth forecast to be 2.5 per cent in 2007 and 2.3 per cent in 2008. Japan is recovering steadily and is forecast to grow by 2.3 per cent in 2007 then by 2.4 per cent in 2008. China and India continue to lead the emerging growth economies. Growth in China is forecast to be close to 10.0 per cent in 2007 and in 2008.

Financial markets suffered some volatility recently but all the signs are that this has passed and that there is no evidence of economic fundamentals being out of line, indeed it was because economic fundamentals are stable that markets were able to shrug off investor doubts. During this period the Chinese central bank raised its interest rate and there was a move into bonds but one of the underlying causes was concern over weak US data. However, financial markets have been re-pricing risks and long-term interest rates will probably rise again as stability returns.

Oil prices are once again at $60 per barrel and the high price looks set to stay for some time. The consensus view that the oil price will return to $45 per barrel looks increasing unlikely this year. Brent crude dropped from $78 per barrel in August 2006 to $52 per barrel in January 2007 but by March 2007 the price was back at $60 per barrel and is now closer to $65 per barrel. The significant volatility of these price movements makes interpretation and forecasting of the oil price very difficult. For business it causes a considerable degree of uncertainty. This makes the monetary policy decision difficult. Evidence from the National Institute of Economic and Social Research Council (NIESRC, 2007) indicates that temporary shocks have little effect on interest rates either in the US or the Euro Area. If policymakers believe the shock is permanent however they will respond quickly with interest rate increases. These typically will increase interest rates from base by about 0.4 per cent in year 1 and by 0.5 per cent in year 2. This is reinforced by the monetary authorities' reaction to the most recent oil price increase where they viewed this as a temporary shock whereas financial markets are down by about 0.6 per cent and therefore may have over-reacted.

Table 1: Forecasts of the main world economy indicators

	Growth in real GDP (%)				Inflation rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	3.2	3.3	2.6	2.6	2.9	2.7	2.2	2.6
Japan	1.9	2.2	2.3	2.4	-0.8	0.3	0.5	1.2
China	10.2	10.7	10.1	9.7	2.1	2.1	2.1	2.1
Euro Area	1.5	2.8	2.5	2.3	2.0	2.1	2.1	2.1
Germany	1.1	2.9	2.5	2.3	1.3	1.3	1.5	1.8
France	1.2	2.1	2.2	2.0	1.8	1.2	1.5	1.5
OECD	2.6	3.1	2.5	2.7	2.1	2.1	2.1	2.3

	Unemployment rate (%)				Short-term interest rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	5.1	4.6	4.7	5.0	3.5	5.2	5.3	4.8
Japan	4.4	4.1	4.1	4.3	0.0	0.2	0.7	0.8
China	9.8	9.0	4.2	4.1	-	-	-	-
Euro Area	8.6	7.8	7.4	7.2	2.2	3.1	4.0	4.4
Germany	9.4	8.4	7.7	7.3	n/a	n/a	n/a	n/a
France	9.7	9.4	9.1	9.3	n/a	n/a	n/a	n/a
OECD	6.6	6.0	5.6	5.5	n/a	n/a	n/a	n/a

Note: Inflation rate is measured by consumer prices. Chinese unemployment for 2005 and 2006 by survey but 2007 and 2008 only estimates for urban unemployment and excluded a significant number of the unemployed.

Sources: OECD Latest Release, www.oecd.org, the National Institute Economic Review, **200,** April 2007.

Table 2: Change in Components of Demand and Main Macroeconomic Indicators for the US, Japan, the Euro Area and the UK, 2005-2007

	The US			Japan			Euro Area			The UK		
	2006	2007	2008	2006	2007	2008	2006	2007	2008	2006	2007	2008
Consumption	3.2	2.8	1.9	0.9	0.9	1.2	1.8	1.9	2.2	2.0	2.7	2.0
Investment	7.2	4.2	4.9	7.7	8.5	6.7	5.4	4.9	3.7	6.5	6.7	3.7
Government	1.6	2.2	1.9	0.3	1.1	1.3	2.4	1.7	1.8	2.4	2.5	2.5
Domestic Demand	3.2	2.1	2.2	1.5	1.8	1.9	2.6	2.5	2.4	3.0	3.1	2.6
Exports	8.9	7.6	6.2	9.6	6.7	7.3	8.1	6.2	4.7	11.6	-5.4	5.8
Imports	5.8	3.0	3.1	4.6	3.4	5.3	7.5	6.4	5.1	11.8	-3.2	5.6
GDP	3.3	2.6	2.6	2.2	2.3	2.4	2.8	2.5	2.3	2.8	2.7	2.6
Unemployment	4.6	4.7	5.0	4.1	4.1	4.3	7.8	7.4	7.2	5.4	5.6	5.7
CA (% GDP)	-6.5	-6.2	-5.9	3.9	3.7	4.4	-0.2	-0.5	-0.5	-3.4	-3.5	-3.6
Effective Ex. Rate	93.5	90.9	89.1	71.6	65.9	64.4	121.3	124.5	123.2	102.6	106.0	104.3

Notes: US and Japanese investment is business investment, others are private investment. Effective Exchange Rate = 100 in the year 2000.
Forecasts are those of the National Institute for Economic and Social Research, see National Institute Economic Review, **200,** April 2007.

Table 1: Forecasts of the main world economy indicators

However the authorities should not lose sight of core inflation (or underlying inflation) as this needs to be brought under control, thus we can expect more rate rises in the second half of 2007.

With respect to downside risks, the housing market slowdown in the US has definitely made an impact on US growth but there does not appear to be any strong evidence that this will result in a hard landing for the US nor indeed that this will spread across the rest of the world economy. A severe unwinding of global imbalances could provide a damaging sequence of adverse impacts on growth but it is significantly more likely that this will not happen. The most likely adverse event is a prolonged high oil price where the monetary authorities do not control quickly enough and that wage bargainers allow a wage spiral to develop. Then the world would suffer a hard landing as GDP growth slowed considerably.

Outlook

The world economy is forecast to grow by 5.0 per cent in 2007 and 4.8 per cent in 2008. Growth in China, India and the US continues to drive world growth, although Euro Area output and Japan's recovery also contribute to world growth. US growth is forecast to be 2.6 per cent in both 2007 and 2008, while Japanese growth is forecast to be 2.3 per cent and 2.4 per cent respectively. China is forecast to grow at 10.1 per cent in 2007 and by 9.7 per cent in 2008. Euro Area growth is forecast to be 2.5 per cent in 2007 and 2.3 per cent in 2008. Within the Euro Area German GDP is forecast to increase in an identical manner to the Euro Area. French GDP growth is forecast to be 2.2 per cent in 2007 and 2.0 per cent in the following year.

In the US housing investment has slowed considerably cooling growth but consumption is expected to be remain quite strong this year although it will probably slow somewhat in 2008. As the economy recovers investment will become more important again. In the Euro Area investment continues to stimulate the economy and domestic demand is expected to strengthen over the next few years. Germany has coped much better than was expected with the VAT increase while Spain is forecast to grow strongly (3.9 per cent in 2006 and 3.5 per cent in 2007). Consumption (driven by higher wage income and employment), business investment, inventories and increased trade are all expected to contribute significantly to increased Euro Area growth. In Japan business investment remains a key driver of growth although growth in Japan is now much more broadly based than previously. Table 1 presents the forecasts of main economic indicators for the period 2005 to 2008.

Table 2 illustrates the components of demand and main macroeconomic indicators for the period 2005 to 2007 for the US, Japan, the Euro Area and the UK. The main points include: a slowing of US consumption growth in 2008, as a response to the housing slowdown. Investment slowed sharply in 2007 from 7.2 per cent the previous year to 4.2 per cent. Growth in US domestic demand is forecast to drop from 3.2 per cent in 2006 to 2.2 per cent in 2008. In Japan and the Euro Area consumption is forecast to rise steadily with investment remaining important. While domestic demand is either strengthening or remaining relatively static in these two areas the contribution of trade will diminish slightly over time.

United States

US real GDP (chained 2000 measure) grew by 3.3 per cent in 2006. In 2007Q1 US real GDP increased by 0.6 per cent after a significant downward revision of 0.7 percentage points due to a surge in imports and a considerable reduction in inventories. Clearly, corporate profits in the US have also slowed in the first quarter of 2007. This should be seen in context where US real GDP increased by 2.0 per cent in 2006Q3 and by 2.5 per cent in 2006Q4 on an annualised basis. Quarterly growth in the US has been revised with 0.5 per cent in 2006Q3 and 0.6 per cent in 2006Q4. US quarterly GDP growth for 2007Q1 was revised down from 0.3 per cent to 0.2 per cent.

Within the expenditure components consumption growth had been strong at 0.9 per cent in 2007Q1 but non-residential investment only grew by 5.5 per cent and government expenditure growth slowed. Residential investment declined sharply (by 4.6 per cent) and there was a small negative contribution from trade. Consumption is threatened by the housing slowdown, increased petrol prices and by employment growth not meeting expectations. The Institute of Supply Management's index had increased significantly in 2007Q2 and this indicates that the US economic situation may improve more quickly than expected. Further, non-farm employment growth remained strong (up 157,000 in May) and business investment and orders suggest that the slowdown in business investment seen over the recent period could be turning around more quickly than many had anticipated.

The US current account deficit was 6.9 per cent of GDP in 2006Q3 and improved to 5.8 per cent of GDP in 2006Q4. The slowdown in housing and in US domestic demand will help the current account position and it is expected to be below 6 per cent of GDP for 2007.

In the US, the Consumer Price Index (Urban) (CPI (U)) increased by 0.6 per cent in May 2007 and was 2.7 per cent up on May 2006 on an unadjusted basis. On a seasonally adjusted basis the May increase was 0.7 per cent and this compares to 0.4 per cent in April. In the 12 months to May 2007 energy increased by 4.7 per cent and food by 3.9 per cent. We should contrast this with the 22 per cent increase in energy prices seen in the first half of 2006. For the first five months of 2007 CPI(U) increased at a seasonally adjusted annual rate of 5.5 per cent compared to 2.5 per cent for all of 2006. It is expected that strong monetary policy and the relative decline in energy prices will push inflation for 2007 down significantly. Producer prices rose by 0.9 per cent in May 2007 after a smaller increase of 0.7 per cent in April. US average hourly earnings rose by 0.3 per cent in May 2007 and there are no signs of earnings creating inflationary pressures in the system. Average earnings grew by 4.7 per cent last year and are expected to increase by 4 per cent in 2007.

Since June 2003 the Federal Reserve Open Market Committee has raised the federal funds rate 17 times by 25 basis points from 1.00 per cent to 5.25 per cent in June 2006. Rates have remained at this level for a year now but it is exceedingly likely that they will be increased to 5.75 or 6 per cent by the end of this year.

In the US the total civilian labour force has grown from 152.784 million in February 2007 to 152.762 million in May, although it was 152.979 million in March 2007. The May participation rate was 66.0 per cent. Total employment in May 2007 was 145.943 million compared to 145.786 million in April. The employment to population ratio was 63.0 per cent in May 2007. Non-farm payroll employment increased from 137.594 million in March 2007 to 137.831 million in May 2007, rising by only 80,000 in April but by 157,000 in May 2007. Over 2006 employment grew by 1.9 per cent and it is forecast to grow by 1.8 per cent in 2007 (using 2007Q1 data). Unemployment rose from 6.801 million in April to 6.819 million in May, easing the unemployment rate up from 4.4 per cent to 4.5 per cent. Non-farm business productivity increased by 1.0 per cent in 2007Q1 compared to 2.1 per cent in 2006Q4. Unit labour costs rose by 1.8 per cent and by 8.9 per cent in the same time periods.

Given the significant slowing in the US housing market the economy appears to have performed relatively well, the exception being that real GDP growth slowed sharply in the first quarter. Despite some weak data early on there are signs of improvement that will probably mean economic activity picking up later on. Employment growth remains relatively strong and inflation is not a major worry. The outlook for the US remains positive. As before the main risks to the US economy are: the CA deficit; the wider effects of the housing market slowdown on the rest of the economy and the problems of sustained higher oil prices.

Europe

Real GDP growth in the Euro Area was 0.6 per cent in 2007Q1, slightly ahead of expectations. This is consistent with the first ‘flash’ estimate of growth. In the previous quarter growth was recorded as 0.9 per cent. The latest data also incorporates a statistical revision from 2006Q4 data where German inventories had to be corrected. This was a sizeable technical revision that shifted growth downwards. The change in German inventories increased by 0.5 per cent in 2007Q1 and offset the decline of 0.4 per cent in 2006Q4. The correction allows for statistical factors not included in the two figures above.

Euro Area investment rose by 2.5 per cent in 2007Q1 compared to 1.5 per cent in 2006Q4 while consumption slackened by 0.1 per cent after the VAT increase in January 2007. Consumption growth in 2006Q4 was 0.4 per cent. Exports slowed drastically to growth of 0.3 per cent in the first quarter of 2007 compared to 9.8 per cent in 2006Q4. Import growth was slightly below the rate in the previous quarter. Thus net exports made a negative contribution to real GDP growth in 2007Q1. Government spending in the Euro Area slowed from 2.2 per cent in 2006Q4 to 1.9 per cent in the first quarter.

GVA growth in the Euro Area in 2007Q1 was 0.8 per cent compared to 0.7 per cent in 2006Q4. Agriculture contracted by 1.7 per cent; retail, hotels & catering and transport services increased by 0.4 per cent and growth in public services was only 0.5 per cent in the first quarter. The strongest first quarter growth came from construction at 1.9 per cent or 7.4 per cent on an annual basis. Using these data it is expected that Euro Area growth could be 3.1 per cent for 2007.

Business surveys in the Euro Area expect growth to continue at its current pace or to strengthen slightly in the second quarter. The pick up of the Euro Area economy is a welcome boost for trade and there is an expectation that a stronger Euro Area will deliver benefits to other non-Euro Area countries. Industrial production grew by 0.9 per cent in March compared to 0.7 and -0.4 in February and January respectively.

Table 3 presents growth and inflation forecasts for the Euro Area; the three main economies; the four top growth economies and the four poorest growth economies (ranked by growth forecast for 2009-2013 but only). Ireland has the strongest growth forecasts but also the 3rd highest inflation forecasts. Similarly, Greece has the 2nd highest growth forecast and the top inflation forecast. These are the only countries that demonstrate a positive relationship. Germany has the fourth lowest growth forecast and the 2nd lowest inflation forecast. This is the only country to be in the bottom half for both indicators. Finland has the 4th top growth forecast but the best (lowest) inflation forecast. Sweden has the 3rd highest forecast of growth but the 3rd lowest inflation forecast. Clearly, a position more countries might want to be in. The UK, Belgium and the Euro Area perform close to the average on both sets of data. Portugal has the poorest growth forecast but the 2nd highest inflation forecast. Similarly, France has the 3rd poorest growth forecast and the 4th highest inflation forecast. These positions are not what countries will be looking for.

Indeed the point is that, although three of the top four are small countries (ranked by growth) it does not necessarily follow that all economic performance is good. It is only Sweden and Finland that have strong growth and low inflation forecast. Likewise, nations with a historical track record on controlling inflation are not necessarily those that continue to have a better performance with inflation

Table 3: European Growth and Stability (HICP) 2005-2008

	Growth in real GDP (%)				Inflation rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
Ireland	5.5	6.2	5.3	4.4	2.2	2.7	2.7	2.7
Greece	3.7	4.2	3.2	3.1	3.5	3.3	3.5	3.4
Sweden	2.9	4.7	3.4	3.1	0.8	1.5	1.9	2.1
Finland	3.0	5.5	2.7	2.8	0.8	1.3	1.4	1.5
Denmark	3.1	3.2	2.4	2.0	1.7	1.8	1.9	1.9
UK	1.9	2.8	2.7	2.6	2.1	2.3	2.6	2.1
Belgium	1.5	3.0	2.5	2.4	2.5	2.3	1.9	1.7
Euro Area	1.5	2.8	2.5	2.3	2.0	2.1	2.1	2.1
Germany	1.1	2.9	2.5	2.3	1.3	1.3	1.5	1.8
France	1.2	2.1	2.2	2.0	2.5	2.3	2.7	2.6
Italy	0.2	1.9	1.7	1.4	2.2	2.2	2.0	2.2
Portugal	0.5	1.3	1.5	1.8	2.1	3.0	3.0	2.7

Source: *National Institute Economic Review*, **200**, April, 2007.
Note: The countries are chosen using 2009-2013 forecasts to show long-run performance and then short to medium-term performance is examined. Countries are ranked by the growth forecast for 2005 to 2008.

forecasts or have strong real GDP growth. It may be that the countries in the middle have the best outcomes with stability and growth of moderate proportions. If unemployment is added to the list of variables, then UK, Danish and Irish performance improves while that of Germany, Greece and France worsens.

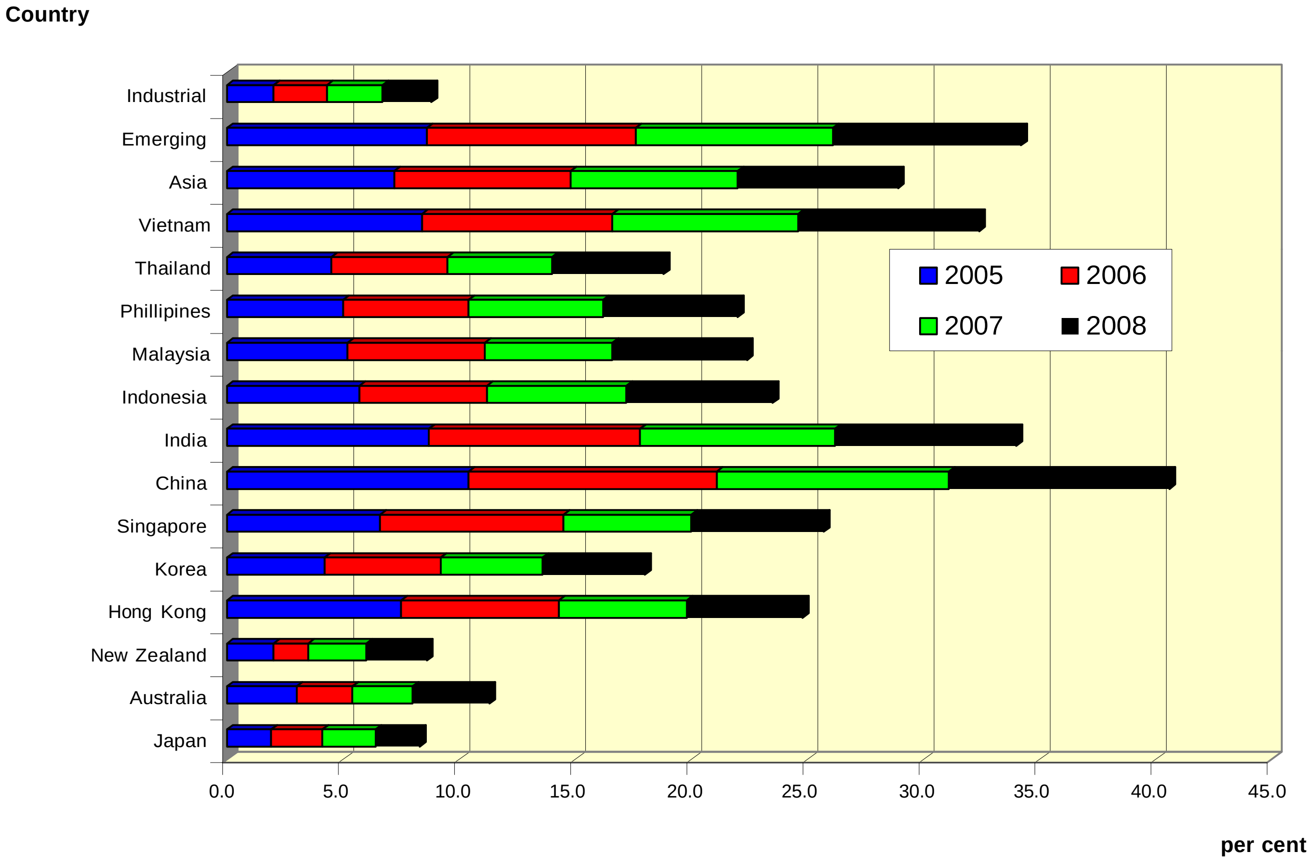
German GDP rose by 0.5 per cent in 2007Q1 compared to 1.0 per cent in 2006Q4. This was mainly due to a weak trade position and the slowing of household spending. However, Germany had strong growth in industrial production and investment growth. In France, real GDP increased by 0.5 per cent in 2007Q1. This was due to the slowdown in manufacturing investment and a stronger net trade situation. 2006 was a good year for the German economy with a record current account surplus, very export growth, increasing profitability, a falling general government deficit and real progress being made with real GDP growth. The current account surplus is projected to be close to 4-5 per cent of GDP. Although it is expected that CPI will rise it is forecast to be below 2 per cent over the forecast horizon. Germany is forecast to grow by 2.5 per cent in 2007 and by 2.3 per cent in 2008. Real GDP growth in 2006 was 2.9 per cent in 2006 (about 0.4 percentage points higher than expected). Consumption is expected to be the main driver of the economy by 2008 replacing net trade. Unemployment is forecast to reduce from 8.4 per cent in 2006 to 7.3 per cent in 2008.

French real GDP increased by 2.1 per cent in 2006 and by 0.5 per cent in 2007Q1 compared to 0.4 per cent in 2006Q4. French GDP is forecast to grow by 2.2 per cent in 2007 although it could be lower if the current pace of progress is not maintained. Consumption returned to grow at 0.5 per cent in 2007Q1 (same as 2006Q3) after dipping to 0.2 per cent in 2006Q4. Government spending grew by 0.3 per cent (same as 2006Q3 again) but marginally lower than the 0.4 per cent seen in 2006Q4. Investment grew by 1.3 per cent in 2007Q1 while exports increased by 1.0 per cent in the first quarter. Investment is likely to be the main driver of the economy in 2007 as opposed to consumption. French exports grew by 6.2 per cent in 2006 (almost double the growth in 2005) but this was largely due to a pick–up in the German economy. Annual CPI was 1.2 per cent in 2006 and is forecast to be 1.5 per cent in 2007. Most of the increase is probably going to come from higher energy prices. The rate of employment growth is forecast to be the same and that unemployment will remain close to 9.0 per cent in the medium-term.

In the Euro Area employment growth is forecast to pick up due to economic recovery. Both wages and employment are expected to grow significantly. This will mean higher unit labour costs however and they will most probably feed into inflation at a later date. Unemployment has been on a declining trend since 2005 and in April 2007 it dropped to 7.1 per cent. The number of unemployed people in the Euro Area declined by 95,000 in April; slightly below the monthly average of 150,000 (for the first three months of the year).

HICP inflation in the Euro Area was 1.9 per cent in May 2007, identical to the two previous months. The main forecast for Euro Area CPI is 2.1 per cent for both 2007 and 2008. Energy in April 2007 increased by 0.4 per cent while the rise for unprocessed food was 3.9 per cent. Producer prices across the Euro Area are being forced down. Price pressures as reported by surveys appear to have hardened over the recent few months. The ECB increased the interest rate by 25 basis points to 3.75 per cent in March 2007 and it remained at that rate in April and

Figure 1 Growth in Asia (%) 2005-2008



Source: IMF (2007), April.

May. The ECB then raised the rate by another 25 basis points in June 2007 to 4 per cent.

The forecasts for the Euro Area are for real GDP to grow by 2.5 per cent and 2.3 per cent for 2007 and 2008 respectively. German growth is forecast to be identical. French growth for 2007 and 2008 is forecast to be 2.2 per cent and 2.0 per cent respectively. There are few downside risks to the Euro Area and the outlook is good. One potential risk is the prospect of labour markets improving leading to greater than expected wage bargains which will simply feed into inflation as costs are passed on. The other main risk is the possibility of sustained high oil prices.

Japan

Real GDP grew by 0.8 per cent (revised up from 0.6 per cent) in 2007Q1 or 3.3 per cent at an annualised rate. This was aided by consumption and exports but business investment which had been strong, contracted in the first quarter. Consumption expanded by 0.8 per cent in 2007Q1 and exports accelerated by 3.3 per cent. Imports only grew by 0.4 per cent so the gain from net trade to GDP was relatively large. Investment only increased by 0.3 per cent and did not make a significant contribution to GDP in the latest quarter. Domestic demand rose by 0.3 per cent on a quarterly basis and by 0.6 per cent on an annual basis.
In May 2007 the Japanese CPI increased by 0.3 per cent and stood at 100.4. Inflation is forecast to be 0.5 per cent in 2007 and 1.2 per cent in 2008. In 2006 the latest data demonstrate that Japanese inflation for 2006 increased by 0.3 per cent on the previous year. The latest Tankan survey for May 2007 indicates that business conditions are improving across large, medium and small enterprises as well as in manufacturing and non-manufacturing. The rise in the June survey was not as great as in the March survey but was very close to it. The ratio of current profits to sales is increasing and input prices are rising faster than output prices.

Total employment increased in May 2007 by 510,000 to 64.99 million, a rise of 0.8 per cent. In May 2007 employment in agriculture increased by 10,000;

construction declined by 190,000 to 5.64 million; manufacturing increased by 250,000 to 11.73 million and services expanded by 290,000 to 43.32 million. Unemployment decreased in May 2007 by 190,000 to 2.58 million (a drop of 6.9 per cent) giving an unemployment rate of 3.8 per cent (no change on the previous month). Unemployment is forecast to be 4.1 per cent in 2007.

China

Real GDP in China increased by 11.1 per cent in March 2007 compared to 10.4 per cent in at 10.6 per cent for 2006Q4. Exports had risen by 27.9 per cent in 2007Q1 compared to 26.5 per cent in the first three months to 2006Q1. Investment rose by 25.3 per cent in 207Q1 compared to 24.5 per cent in 2006Q1. There was 4.4 per cent growth in the primary sector in 2007Q1; 13.2 per cent in the secondary sector and 9.9 per cent in the tertiary sector. CPI increased by 1.5 per cent in 2006 and the target is not to let inflation increase by more than 3 per cent in 2007. In March 2007 inflation accelerated by 3.3 per cent compared to 2.7 per cent in February 2007. The forecast is for the central bank to raise interest rates by 25 basis points and to lift the reserve requirement by 1.5 per cent. The unemployment rate in China was quoted as 9.8 per cent in 2005 and 9.0 per cent in 2006. The forecast rate is only for urban unemployment and therefore cuts out a very large number of the unemployed but it is forecast to be 4.2 per cent (7.75 million people) in 2007 . There is a considerable degree of concern about how unemployment is measured in China.

Figure 1 presents growth rates for Asian countries for 2005 and 2006 and forecast growth for 2007 and 2008. The industrial countries are taken as Japan, Australia and New Zealand. Asia is all the countries and the emerging economies are Asia minus the industrialised group. Clearly the strongest growth is forecast to come from China, India and Vietnam. New Zealand, Australia and Japan are forecast to have the lowest growth. The Phillipines, Malaysia, Indonesia, Singapore and Hong Kong are all forecast to perform well growing at more than 5 per cent per annum.

Overall the outlook for the world economy remains good especially with the recovery in the Euro Area and the continued performance of the Japanese and Chinese economies. Inflation is not a main threat and it appears that US economic activity will pick up later in the year. Trade is forecast to remain robust and labour markets also appearance to be buoyant but are not too tight so they too will induce inflationary pressures.

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