The economic background

The world economy

Overview

Growth in the world economy is still relatively strong, although US growth has slowed slightly. Inflationary pressures are clearly more visible than previously and the general trend for global monetary policy is for a tighter stance. Prices continue to be driven by energy prices, although there are few signs of this feeding through into wage bargains. Japan and China once again have performed strongly in the East while the Euro Area has shown significant improvements. There is still some concern over the pace of private consumption growth in Germany. The outlook for the world economy is still optimistic over the next two years.

Oil prices reached a record high hitting $78.2 in August 2006, although they have fallen back to $60 more recently. While prices are about 10 per cent below this peak they remain approximately 22 per cent above prices at the beginning of 2006. The main factors behind these movements are civil unrest in Nigeria, supply-side problems elsewhere, the shutdown of some of bp's North American fields and the uncertainty, followed by the resolution of the Lebanon crisis, in the Middle East. As there is little slack in the capacity of the industry to meet demand then oil prices are expected to remain at their current level.

The main risks to the world economy continue to come from current account imbalances, rising oil prices (particularly if sustained) and any sudden house prices correction. Of course the imbalances in the world economy (US deficit and the German/Japanese and Chinese surplus) still require the attention of policymakers. The Euro remains relatively strong although many commentators think the dollar is still over-valued despite its recent slight depreciation.

Outlook

US real GDP growth in the US is forecast to be 3.6 per cent this year and be 3.1 per cent in 2007, an increase from the previous forecast. Growth in the US remains strong despite a slight weakening since the first quarter of 2006. As previously stated the housing market has contributed to a slight slowing of US growth. Japanese growth is forecast to be 3.1 per cent and 2.6 per cent in 2006 and 2007 respectively. Given Japan's strong economic performance it is perhaps unsurprising that the forecasts have shifted upwards. A critical breakthrough is the forecasts for the Euro Area where this year growth is expected to be stronger than in previous forecasts. The strengthening of domestic demand in Europe and the improved performance of the manufacturing sector has convinced most commentators that the Euro Area is returning to trend growth. 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 significant slowing of investment in the US; a strengthening of trade this year although the growth tends to decline slightly in 2007 and a strengthening of both Japanese and Euro Area performance. In the US the current account is expected to improve given the significant imbalance that already exists but only slightly. Unemployment in the US, Japan and the Euro Area is forecast to decline.

United States

US real GDP (chained 2000 measure) increased by 2.6 per cent on an annualised basis in 2006Q2 (or 0.6 per cent on the preceding quarter) compared to 5.6 per cent (1.4 per cent) in 2006Q1. It was always recognised that the growth seen in 2006Q1 was not going to be matched by second quarter growth because it was an unsustainable rate of growth in the first quarter. As stated previously US growth is still strong despite a slight weakening. The main reasons for the weakening of GDP growth were: a significant fall in investment; a softening of the US housing market and a major revision to US national accounts that goes back to 2003.

US consumption increased by 2.6 per cent (on an annualised basis) in 2006Q2 compared to 4.8 per cent in 2006Q1 or by 0.6 per cent and 1.2 per cent respectively on a quarter-by-quarter basis. Spending on durable goods also declined in the second quarter but households increased spending on services. The change in investment in the second quarter was significant where investment (on an annualised basis) fell from 16.2 per cent in 2005Q4 to 7.8 per cent in 2006Q1 and to 1.0 per cent in 2006Q2. Quarterly investment growth was only 0.2 per cent. Government spending in the US fell from 4.9 per cent in the first quarter to 0.8 per cent in the latest quarter or 1.2 per cent and 0.2 per cent on a quarterly basis respectively. US exports grew significantly during the second half of 2005 and into the first quarter of 2006, but growth was only 1.5 per cent in the second quarter on the previous quarter compared to 3.3 per cent in 2006Q1. Import growth declined sharply in 2006Q2 at 0.4 per cent whereas growth was 2.2 per cent in 2006Q1. On an annualised basis this growth is 1.4 per cent and 9.1 per cent respectively.

Productivity growth increased by 1.5 per cent in the business sector and by 1.6 per cent in non-farm business compared to an increase of 2.6 per cent in manufacturing for August 2006. Manufacturing productivity was driven by a 3.7 per cent increase in durables manufacturing, although the preliminary estimate for manufacturing productivity had been 3.0 per cent.

Table 1: Forecasts of the main world economy indicators

	Growth in real GDP (%)				Unemployment rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	3.5	3.6	3.1	2.8	5.1	4.7	4.6	4.7
Japan	2.6	3.1	2.6	2.1	4.4	4.0	3.9	3.7
Euro zone	1.4	2.1	1.9	2.1	8.6	8.0	7.9	7.8
Germany	1.2	1.7	1.3	1.6	9.5	8.5	8.4	8.4
France	1.2	2.0	2.0	2.1	9.5	9.0	9.0	8.8
OECD	2.8	3.1	2.8	2.6	6.5	6.2	6.0	5.9

	Inflation rate (%)				Short term interest rate (%)			
	2005	2006	2007	2008	2005	2006	2007	2008
US	2.8	3.0	3.3	2.7	3.5	5.2	5.7	5.4
Japan	-0.8	-0.3	0.0	0.4	0.0	0.2	0.9	1.5
Euro zone	2.1	2.2	2.5	2.1	2.2	3.0	3.9	4.5
Germany	1.3	1.6	2.5	1.9	n/a	n/a	n/a	n/a
France	1.8	1.6	1.7	1.8	n/a	n/a	n/a	n/a
OECD	2.1	2.4	2.6	2.4	n/a	n/a	n/a	n/a

Sources: OECD Latest Release, www.oecd.org, the National Institute Economic Review, **197,** July 2006

Note: Inflation rate is measured by consumer prices.

Table 2: Change in Components of Demand and Main Macroeconomic Indicators for the US, Japan, the Euro Area and the UK, 2004-2006.

	The US			Japan			Euro Area			The UK		
	2005	2006	2007	2005	2006	2007	2005	2006	2007	2005	2006	2007
Consumption	3.5	3.3	2.9	2.1	1.9	1.9	1.4	1.9	1.6	1.4	1.9	1.9
Investment	7.1	3.3	1.0	-0.7	3.4	1.1	1.9	3.6	3.3	3.0	5.3	3.2
Government	1.5	2.2	2.4	1.7	1.4	2.6	1.3	2.0	1.9	2.6	2.0	2.8
Domestic Demand	3.6	3.7	2.9	3.0	2.5	2.2	1.6	2.2	1.9	1.8	2.5	2.4
Exports	6.9	6.7	5.2	7.0	10.6	7.7	4.0	6.4	4.0	6.5	9.8	2.8
Imports	6.3	6.0	3.7	6.3	7.1	5.6	4.9	6.9	4.1	5.9	9.2	2.3
GDP	3.5	3.6	3.1	2.6	3.1	2.6	1.4	2.1	1.9	1.9	2.5	2.6
Unemployment	5.1	4.7	4.6	4.4	4.0	3.9	8.6	8.0	7.9	4.8	5.4	5.5
CA (% GDP)	-6.3	-6.4	-6.2	3.7	3.5	3.1	-0.3	-1.0	-1.0	-2.2	-2.8	-3.0
Effective Ex. Rate	91.7	91.0	90.3	79.3	73.0	71.5	122.2	121.6	122.5	98.6	98.0	97.8

Notes: US investment is housing 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 NIER (2006) July, **197**.

The US trade deficit widened by 2.7 per cent in August 2006 to a record $69.9 billion. This was surprising as it had been forecast to narrow to about $66.4 billion from $68 billion in July. The first 8 months of 2006 show the US trade deficit reaching $552.8 billion compared to $457 billion at the same time last year. Again imports rose faster than exports with the US importing $26.7 billion from China in August alone. The trade deficit with China has reached a record $22 billion in August 2006 compared with $18.5 billion at the same time last year. The US current account deficit remains a significant concern at 6.6 per cent of GDP.

The US current account deficit widened to $218.4 billion in 2006Q2 compared to $213.2 billion in the first quarter. The main component of this again was the deficit on goods and services. It increased to $193.8 billion in 2006Q2 compared to $191.1 billion in the first quarter. Services showed a surplus of $16.8 billion, virtually unchanged compared to the previous period. The US current account deficit was unchanged in terms of per cent of GDP from the first quarter. The expectation is that it will stabilise in the second half of the year due to growth in exports and a relative decline in the dollar. Against the world's major currencies the dollar has decreased in value by 2.7 per cent this year. The US current account has deteriorated by $650 billion or by 4.5 per cent of GDP between 1997 and 2005. The main components of this change are China (23 per cent), NAFTA (21 per cent), the EU (16 per cent) and OPEC (13 per cent) (see *NIER*, **197**, July, 2006 p33).

CPI (not seasonally adjusted) increased by 0.2 per cent in August 2006 with the index at 203.9 (1982-84=100) and this is 3.8 per cent higher than August 2005. Seasonally adjusted CPI in the US also rose by 0.2 per cent in August 2006 compared to 0.4 per cent in July. A similar rise in core inflation was seen in both July and August in the US (0.2 per cent) giving a 3.0 per cent increase for the three months ending in August and 2.8 per cent over twelve months. Within total inflation energy increased by 9.4 per cent and by 15.1 per cent over 3 and 12 months respectively. This was reflected in transportation price increases where the figures were 6.6 per cent and 6.1 per cent respectively. PPI grew by 0.1 per cent in August 2006, the same as July but significantly down from the 0.5 per cent growth in June. The 12 month increase in PPI was 3.7 per cent, compared to 4.9 per cent in June. The Federal Reserve Beige Book reports that there are little signs of inflation feeding through into price rises for final consumers.

During August 2006 the Federal Reserve decided to keep the Federal Reserve rate unchanged at 5.25 per cent for the first time in two years. The rate was increased in July from 5.0 per cent in June.

The US labour market remains buoyant with non-farm employment increasing by 128,000 in August which was in line with the 4 monthly period for April to July of 117,000. Prior to this job changes had averaged 169,000 for the 4 month period ending in March 2006. The biggest increases in employment came in education and health. However job growth in September was only 51,000. Total employment increased to 144.6 million giving an employment to population ratio of 63.1 per cent. Non-farm employment rose to 135.5 million and manufacturing employment stood at 14.225 million, although this was a decline of 11,000 jobs. The participation rate is 66.4 per cent and the unemployment rate is 4.7 per cent (7 million people unemployed). The unemployment rate was unchanged in

August from the previous period. Average earnings grew by only 0.1 per cent in August and overtime was relatively unchanged from the previous period.

US economic growth is forecast to remain relatively strong in 2006 at 3.6 per cent but slowing to 3.1 per cent in the following year (see Table1). The forecast is for inflation to continue its upward trend in the US. Monetary policy has been tightened regularly in the US so there is little danger that inflation will be a serious threat to the economy. Despite a forecast narrowing of the current account we see that has widened again and surely this must be the focus of policy attention in the coming years.

Europe

Euro Area GDP grew by only 1.4 per cent in 2005 but is forecast to pick up significantly in 2006. This is primarily due to the considerable pick up in investment and exports this year. Euro Area real GDP growth was 0.9 per cent in 2006Q2 compared to 0.6 per cent in the first quarter and 0.3 per cent in the last quarter of 2005. Clearly activity is strengthening in the Euro Area. The annual growth rate has increased from 2.1 per cent in 2006Q1 to 2.6 per cent in the current quarter.

In the Euro Area consumption growth remains doggedly low with growth of only 0.3 per cent in 2006Q2 compared to 0.7 per cent in the first quarter. Annual growth has now slipped to 1.7 per cent on the latest release. Government spending growth has slowed from 0.8 per cent in the first quarter to 0.4 per cent this quarter but annual growth is still close to 2.0 per cent. The most significant improvement in the Euro Area this quarter has been the substantial increase in investment which grew by 2.1 per cent in the latest quarter lifting the annual growth rate to 2.7 per cent. Investment grew by 0.9 per cent in the previous quarter with an annual growth rate of 2.1 per cent. Overall domestic demand strengthened to grow at 0.8 per cent this quarter compared to 0.4 per cent in the first quarter. Annual growth of domestic demand increased to 4.6 per cent. The second most important development in the Euro Area was the relative change in exports compared to the change in imports. Exports increased by 1.3 per cent this quarter (up 3.9 per cent in the last quarter) giving annual growth of 9.0 per cent. Imports rose by 1.2 per cent (2.9 per cent in the previous quarter) to give annual growth of 8.3 per cent. In this quarter annual import growth outstripped export growth for the first time since 2004, when it was marginal. The relative contribution of exports to GDP continues to be positive but has reversed the trend of a declining positive balance. The contribution to GDP of net trade in 2006Q2 was 0.4 percentage points compared to only 0.1 percentage point in the previous quarter.

In Germany real GDP grew by 0.9 per cent in 2006Q2 compared to 0.7 per cent in 2006Q1. Disappointingly, consumption contracted by 0.4 per cent and government spending decreased by 0.2 per cent. The resilience of investment in the Euro Area however is strong and German investment is no exception growing at 3.5 per cent in the current quarter. Overall, domestic demand in Germany grew by 0.9 per cent this quarter. Exports grew by 0.7 per cent compared to import growth of 0.5 per cent. The worrying component of the German economy remains consumption, which is still fragile. It is interesting to note that agriculture (-0.7 per cent) and private services (-0.2 per cent) were the only sectors of the economy to contract. Elsewhere manufacturing grew by 1.6 per cent; construction by 0.5 per cent and financial services by 1.4 per cent. The German labour market demonstrated employment growth with 39.0 million in employment in August 2006 (an employment rate of 68.7 per cent) compared to 38.67 million in August 2005 (an employment rate of 67.9 per cent). Unemployment declined to 3.62 million (8.5 per cent) compared to 3.99 million (9.4 per cent) in August 2005. German confidence, new business (both manufacturing and services) and the boost from the World Cup meant that the outlook for Germany is relatively good. Given the promising economic conditions it may be that consumption will increase significantly in the next 6 to 12 months time. The decline in consumption may partly reflect the VAT increase and increased competition which has restricted wage growth (inflation concerns have also impacted on wage moderation).

In France GDP increased by 1.2 per cent in 2006Q2 compared to 0.4 per cent in the previous quarter. Consumption remains strong growing at 0.8 per cent in 2006Q1 and by 0.9 per cent in 2006Q2. Consumption had declined in July (-0.9 per cent) but increased by 3.3 per cent in August. Government spending growth remained at 0.8 per cent in the second quarter, identical to the first quarter change. Investment in France grew by 1.7 per cent compared to no growth in the previous quarter. Overall domestic demand increased by 1.0 per cent this quarter compared to 0.7 per cent in 2006Q1. French exports increased by 1.6 per cent (3.2 per cent in 2006Q1) compared to import growth of 3.2 per cent (1.4 per cent in 2006Q1). Employment increased to 15,592,200[1] in June, a 0.3 per cent increase on the previous quarter and a 0.9 per cent change on an annual basis. There were 2,445,000 people unemployed (an increase of 0.4 per cent on the month and a decline of 9.7 per cent on an annual basis). The unemployment rate was 9.0 per cent, which is an increase of 0.1 per cent on the previous month and a decline of 0.9 per cent on a year ago. Within services PMI survey data indicate that strong expansion in services still exists including recruitment and new business. French manufacturing PMI data indicates further new orders and output gains.

The European PMI survey and the ifo index continue to show strong signals of a healthy economic environment looking forward. The Euro Area PMI output, new orders and employment indices are all higher than the 2005 average but the September values have all dropped below the July peak (see RBS, PMI Euro zone, October 2006).

The ifo index for September is relatively unchanged and is optimistic about the growth of both services and manufacturing (see ifo Institute, Munich, September survey).

In the Euro Area annual HCIP inflation was 2.3 per cent in 2005 in August compared to 2.4 per cent the previous month. The ECB estimates inflation will remain above 2 per cent for the whole of the second half of 2006 and into 2007. While labour costs have moderated in the Euro Area the price developments in energy are on a rising trend and this is expected to continue throughout 2007. The main components pushing up inflation are the price of energy and the contribution from indirect taxes. A weaker contribution to inflation comes from increases in wage settlements. The forecast for Euro Area inflation is 2.2 per cent this year and 2.5 per cent next year. The ECB raised the base rate in June 2006 and August 2006 by 25 basis points each time. The ECB refinancing rate now stands at 3.0 per cent.

The future prospects for the Euro Area are now much more encouraging. The ECB forecasts GDP growth in the range of 2.2 to 2.8 per cent in 2006 and 1.6 per cent to 2.6 per cent in 2007. Our forecast for Euro Area GDP growth is 2.1 per cent this year and 1.9 per cent in 2007, both relatively unchanged from the previous quarter's forecast. Inflation is forecast to be 2.2 per cent in 2006 but to rise to 2.5 per cent in 2007. In order to combat inflation the ECB is expected to increase short-term interest rates to 3.0 per cent in 2006 and to 3.9 per cent in 2007. The main risks to Europe remain any sharp corrections to the housing market but probably more importantly if oil prices were sustained at a high level then this would make a significant impact on the forecast growth profile.

Japan

In Japan real GDP grew by 0.2 per cent in 2006Q2 compared to 0.7 per cent in the first quarter and to 1.1 per cent in 2005Q4. Consumption grew by 0.5 per cent in 2006Q2 compared to 0.2 per cent in the previous quarter and 0.6 per cent in 2005Q4. Private domestic demand remained strong, contributing 0.5 percentage points to GDP growth. Private domestic demand is the driving force of the Japanese economy and the expectations are for a better performance in the third quarter of the year. Domestic demand increased by 0.3 per cent in 2006Q2 compared to 0.7 per cent in the first quarter. Public investment is on a downward trend (2005Q4 growth was 0.6 per cent; in 2006Q1 it was 0.2 per cent and in the latest quarter it contracted by 0.4 per cent) while exports have cent in the previous quarter. Although import growth was also positive, up by only 1.8 per cent compared to 2.5 per cent in 2006Q1 net exports contributed positively to GDP in the current quarter. The Japanese trade surplus has narrowed slightly but this was expected given it has significant costs of higher oil prices and raw materials. The decline in the trade surplus has however been partly offset by the increase in repatriated profits.

In Japan CPI was flat in the second quarter as it was in the previous quarter. Increases of 0.2 per cent were observed in both June and July for CPI. Producer prices continued to rise by 3.4 per cent in July. At its August meeting the Bank of Japan kept its base rate at 0.25 per cent after ending its zero interest rate policy in July. There are clear signs that deflationary pressures are close to being eliminated from the system.

The Tankan survey indicates a modest expansion of the economy (both for manufacturing and services) in the September survey. Business conditions, recruitment and new business/orders are all optimistic. Within manufacturing firms are less optimistic about prices however with a balance of 45 indicating they have experienced a change in input prices, but only a balance of 2 expressing that they have been able to increase output prices. Surprisingly they are more optimistic about future profits. Japanese unemployment was 4.1 per cent in 2006Q2 compared to 4.2 per cent in 2006Q1. Unemployment is forecast to be 4.1 per cent this year and 3.7 per cent in 2007. On balance the prospects for the Japanese economy remain good.

The Chinese economy continues to drive forward at a considerable pace, stimulating trade in the Far East. Preliminary data estimate growth in China for 2006Q2 to be 11 per cent on the same quarter last year giving rise to fears of overheating. Chinese demand for household appliances and in particular digital appliances is very strong. The demand for computers has slowed slightly. The yuan remains under-valued but there are no signs of the Chinese allowing any further appreciation to the currency. In June this year the Chinese saw foreign exchange reserves increase by $30 billion and currently household and corporate savings are close to $4 trillion. As the Chinese economy introduces further liberalisations over the years there will be an increase in private sector financial outflows seeking greater returns. This may mean that there is a significant slowing of the buying of US treasury bonds, which will lead to difficulties for the US in funding its current account deficit at a level close to 7 per cent of GDP.

Kenneth Low
12 October 2006

Endnote

[1]Note: excludes agriculture and public services' employment.