The economic background

The world economy

Overview

As stated in the previous quarter we still believe growth in the world economy is relatively strong (despite the weak data in the summer and a slight slowing in China). There signs of strong growth in the US, China and Japan although the Euro Area remains relatively weak. The world economy is expected to grow at a considerable pace (close to 4 per cent) in 2004 but growth is forecast to be slightly less in 2005. The Euro Area is expected to grow more strongly in 2005 as it is currently lagging the other regions of the world. World trade is forecast to grow rapidly in both 2004 and 2005 (just below 10 per cent for both years). Chinese trade flows and the importance of trade in Asia are the most significant contributions to this growth. Emerging markets are also expected to have strong trade growth in 2005. Sadly, while the human costs of the Tsunami were both tragic and huge the economic impact on the world economy will be relatively minor.

Outlook

US growth is forecast to be 4.2 per cent in 2004 and by 3.5 per cent in 2005, again similar to the forecast of the 2004Q3. Japan is expected to move towards long-term growth in 2005. China remains strong even taking into account the slight slowdown in growth seen in 2004. Chinese growth will be close to 10 per cent in both 2004 and 2005. The Euro Area is forecast grow at 1.8 per cent in 2004 and 2.1 per cent in 2005. The Euro Area urgently needs some labour market reforms if it is to perform like the UK. While inflation is relatively muted, inflationary pressures are beginning to be felt in the world economy especially by those who import a substantial amount of oil. The weakness of the dollar is constraining inflation because oil is priced in dollars. We believe that in the medium-term the oil price will be $35. Our forecasts for the world economy are presented in Table 1.

The downside risks to the world economy remain the same as the previous quarter:

- sustained high oil prices;
- increased inflationary pressures particularly from capacity constraints and
- the widening imbalances in the world economy, (particularly the US deficits).

United States

Third quarter growth was revised up to 1 per cent in the fourth quarter. Annualised US growth in the fourth quarter was 3.5 per cent compared to 4 per cent in the third quarter. US growth has been above 3.3 per cent over the last 10 years. Some commentators believe that growth in the US will be close to 4 per cent in the next two years while others are forecasting growth of 3-3.5 per cent. There was considerable growth in consumption spending, ICT goods and services as well as

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corporate investment. Growth in the US for 2004 is as was expected. It is expected however that with steadily rising interest rates in the US and the continued decline of the dollar (feeding into domestic and import prices) that consumption growth will slow slightly from that seen in 2004. Investment growth is expected to remain strong in 2005 and 2006.

US Consumer Price Inflation (CPI-U) at a seasonally adjusted annual rate (SAAR) increased by 3.3 per cent for the last quarter of 2004. CPI (excluding food and drink) was 2.0 per cent in the last quarter. The index for energy rose by 16.6 per cent in 2004 and this was the single largest growth component in the index. This was primarily due to the large increases in the beginning of the year as energy prices fell in December 2004. Producer Prices (PPI) declined by 0.7 per cent in December compared to an increase of 0.5 per cent in November and 1.7 per cent in October. The employment cost index grew by 0.9 per cent for June-September 2004 while wages and salaries grew by 0.7 per cent (close to trend since 2002). The US Federal Reserve (Fed) has increased interest rates from 2.0 per cent to 2.25 per cent in December

The current account (CA) widened to 5.9 per cent of GDP ($670 billion) in the fourth quarter from 5.6 per cent of GDP in the third quarter. Clearly there are worries over the size of the deficit. The main sign is the weakness of the dollar and a crucial question is how much further will it decline by before the situation is stabilised? This is very difficult to tell as any corrective action may slow down growth. There are no clear signs form either President Bush nor Alan Greenspan that there will be any immediate and significant action to deal with the deficits. Indeed given that the dollar is the world's reserve currency it would be natural for the US to run a CA deficit. Also the deficit in the US has allowed other countries to run a surplus and to change their currency into dollars thus maintaining exchange rate competitiveness. The US fiscal deficit improved slightly in December but remains a problem in the medium-run and is forecast to be 4.3 per cent in 2005 compared to 4.5 per cent in 2004. Weaker tax revenues, large defence commitments, fiscal expansion and low saving are all contributing to this position.

In December non-farm payrolls grew by 157,000 and have averaged 186,000 per month over 2004. This is the strongest growth since 1999. The buoyant labour market has supported consumption growth in the US with increased incomes and good employment prospects. With increased domestic demand further jobs growth is forecast and this will boost wages salaries, which will in turn lead to increased consumption spending. It is likely however that this rate of growth will slow towards long-term growth (3.5 per cent). The US Labor Department considers a job change of less than 108,300 (seasonally adjusted) as statistically insignificant given a workforce of 132 million. The US economy has created 1.5 million jobs over 1989-2003 (9,000 jobs per month).

Weak employment in the US has been attributed to technical progress and productivity growth but towards the end of the year employment gains were strong. This is expected to push down unemployment in 2005, as unemployment in the US was

Table 1: Forecasts of the main world economy indicators

	Growth in real GDP (%)				Unemployment rate (%)			
	2004	2005	2006	2007	2004	2005	2006	2007
US	4.2	3.4	3.2	2.9	5.6	5.5	5.3	5.2
Japan	3.8	2.6	2.4	2.1	4.6	4.2	4.0	3.7
Euro area	1.8	2.1	2.6	2.5	8.9	8.9	8.6	8.4
Germany	1.3	1.8	2.6	2.5	9.8	9.9	9.2	8.9
France	2.4	2.4	2.5	2.4	9.4	9.3	8.9	8.7
OECD	3.3	2.9	3.0	2.9	7.0	6.8	6.4	6.3
	Inflation rate (%)				Short-term interest rate (%)			
	2004	2005	2006	2007	2004	2005	2006	2007
US	2.2	2.4	2.7	2.3	1.5	2.7	3.4	4.2
Japan	-0.8	1.8	1.7	1.6	2.1	2.6	3.2	3.8
Germany	1.8	2.1	1.2	1.3	n/a	n/a	n/a	n/a
France	1.7	2.2	1.6	1.5	n/a	n/a	n/a	n/a
OECD	2.0	2.2	1.9	2.1	n/a	n/a	n/a	n/a

Note: Inflation rate is measured by consumer prices.
Sources: OECD Latest Release, www.oecd.org, the National Institute Economic Review, 190, October 2004.

relatively constant in 2004 at 5.5 per cent. At the end of 2004 there were 8 million people unemployed or 5.4 per cent. Unemployment is forecast to be 5 per cent by 2008.

We are forecasting US growth of 4.2 per cent this year and 3.4 per cent in 2005. The outlook for the US is good despite a slight slowing over 2005 and 2006.

Japan, China and Asia

GDP growth in Japan in 2004Q2 and Q3 (0.1 per cent compared to –0.1 per cent in the second quarter) was broadly flat but the data for consumption growth was more upbeat. There are signs now that in fact, consumption growth is not as strong as previously thought and there are some worries over the economy. Domestic demand overall however, was weak and did not replace the fall off in external demand (mainly from China). The latest Tankan survey suggests that consumers are still confident and that consumer confidence is holding up. The outlook for the private sector is also encouraging. The December survey did show a slight deterioration in the business sector. Trade data show that export performance at the end of 2004 was good. The main thrust of the data from Asia is that non-Japan Asia may be slowing although many of the data from China are difficult to interpret. In Japan CPI price index increased by 0.5 per cent in October to 0.8 per cent in November. Overall we expect the economic recovery to continue in 2005 despite the poorer performance in the middle of 2004.

We are forecasting growth of 3.8 per cent in 2004 and 2.6 per cent for 2005 in Japan. We also believe that inflation will be positive (but only just) in both 2005 and 2006. Unemployment is forecast to decline steadily over the forecast period (see Table 1).

China is expected to experience recovery in its ICT sector in 2005 thus further boosting exports to Asia. Domestic demand may also strengthen in 2005. There is undoubtedly significant pressure for the Chinese authorities to revalue the renminbi. Any sudden appreciation of the Yen will be bad news for the Japanese economy, as would any premature fiscal tightening. Chinese industrial production was 14.8 per cent in November after 15.7 per cent in October. Inflation eased significantly in November to 2.8 per cent from 4.3 per cent in October.

Europe

Euro Area GDP growth was 0.3 per cent for 2004Q3 and was not revised from the preliminary estimate. Growth in the first half of 2004 was 0.6 per cent. Growth in the fourth quarter is expected to be similar to 2003Q3. Retails sales were down in October and were flat in November. The appreciation of the Euro against the US dollar will have dampened trade slightly. Both weaker exports and consumption have led to poorer economic performance in the third quarter. Euro Area industrial production declined by 0.6 per cent in October, although over August to October industrial production was relatively unchanged. Survey data suggests that over the fourth quarter that industrial production remained low but was positive. We expected a bounce-back in the French economy but this was not forthcoming but Germany was relatively static. We are forecasting that growth in the Euro Area will be 1.8 per cent in 2005 and 1.7 per cent in 2006.

Euro Area HICP inflation was 2.3 per cent in December 2004 (the same as it was in August but marginally up on the November figure (2.2 per cent). PPI declined to 3.6 per cent in November from 4.0 per cent in October. The ECB have kept interest rates at 2 per cent, which was widely expected. HCIP inflation is expected to remain above 2 per cent in 2005 and 2006.

Industrial confidence was low but picked up slightly in the fourth quarter according to the latest data. The Purchasing Managers' Index (PMI) for manufacturing in December 2004 recovered slightly but was relatively flat for the services survey.

Any improvement in the Euro Area labour market is difficult to detect. Unemployment was 8.9 per cent in November 2004, having increased by 9,000 people. Employment growth was 0.1 per cent for 2004Q3, similar to the rate at the start of the year. Services showed stronger job gains whereas construction and manufacturing shed labour. As output growth slowed in the third quarter and employment increased then productivity growth also declined at the same time. Forward-looking indicators point to further employment growth in the final quarter of 2004. The main factors that are promising are the ongoing world trade growth, driving EU exports, signs of growing private consumption growth, a recovery in Euro Area investment, increased corporate profits and favourable financing conditions.

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