LETTER

Liberté • Égalité • Fraternité
RÉPUBLIQUE FRANÇAISE

No. 12
March 2007

TRÉSOR-ECONOMICS

The Global Economic Outlook, spring 2007

This study was prepared under the authority of the Treasury and Economic Policy General Directorate and does not necessarily reflect the position of the Ministry of the Economy, Finance and Industry.

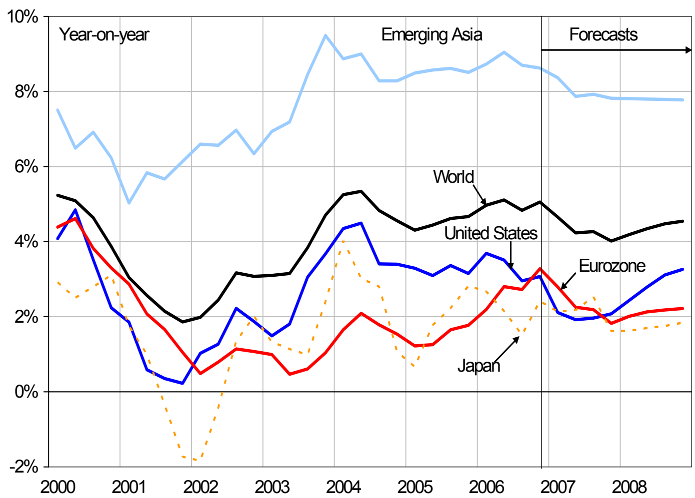
- The balance of global growth has shifted since summer 2006 in geographical terms. The United States has been experiencing a soft landing since the middle of last year, under the influence of the housing market downturn, which will probably continue to act as a drag on the economy for much of 2007. Eurozone growth (year-on-year) overtook the United States at the end of 2006, indicating a decoupling of the two regions.

- Moreover global growth at the end of 2006 has been depending more on consumption of services and housing demand (with the exception of the United States in the latter case), while industrial activity and trade have slowed significantly.

- The slowdown in US domestic demand and falling oil prices have lowered inflationary pressures, notably in the United States. Indeed, financial markets consider that the cycle of interest rate rises has probably come to an end in the USA and could be close to ending in the eurozone.

- The "decoupling" of the eurozone from the United States might come to an end, as fiscal tightening together with the delayed impact of rising interest rates and slacker world trade as a result of the American slowdown are likely to weigh on European growth.

- In 2008, as the main negative forces at work in 2007 in the main regions (US housing slowdown and fiscal tightening in the eurozone) fade, growth would likely go back to its potential rate without stoking inflationary pressures, and global trade would pick up once more.



Source: Feri and DGTPE.

DGTPE
DIRECTION GÉNÉRALE DU TRÉSOR
ET DE LA POLITIQUE ÉCONOMIQUE

1. Since summer 2006, the balance of global growth has shifted in geographical terms and the contributions from the different sectors have changed

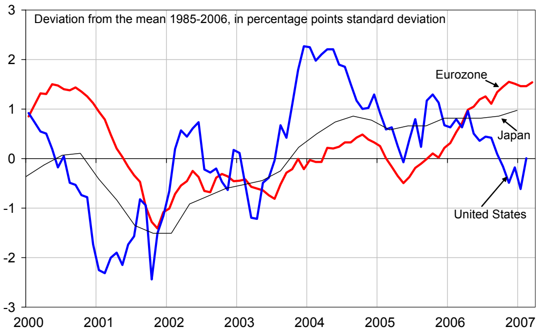
The global economic situation in 2006 was in line with the previous two years, with very robust global growth of 5.0%, coming after 4.5% in 2005 and 5.0% in 2004[1]. But it was in the mix itself–geographical and in industry terms–that 2006 marked a turning point.

1.1 The eurozone became decoupled from the US economy in the course of the year

The US economy has been experiencing a soft landing since mid-2006 and growth in emerging Asia appears to have slackened very slightly at year-end, after a year of exceptional growth (with China averaging 10.7% for the year 2006 as a whole). Conversely, the cyclical upturn that began at the end of 2005 in the eurozone appears to have been confirmed and to have gathered strength, with growth overtaking that in the United States at the end of 2006 (and very considerably outpacing that in Japan), for the first time since the 2000-2001 American recession.

Business climate indicators confirm this decoupling: whereas in the United States the composite manufacturing industry indicator fell perceptibly in 2006 to the point of indicating a contraction of activity, in the eurozone it advanced throughout practically the entire year (see chart 1).

Chart 1: Business climate, manufacturing industry

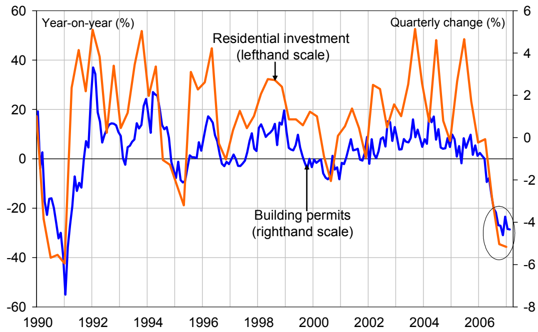


Source: European Commission, NAPM, TANKAN.

The reduction of the housing bubble is the main reason for the American slowdown. There is also a more cyclical component in the sense that the US economy has now closed its output gap, fiscal policy is tightening, and past interest rate rises are starting to bite.

Through its direct impact on housing investment, the housing market downturn has acted as a brake on growth since Q2 2006. This will probably continue to be the case for most of 2007, but the decline appears to have bottomed out at the end of 2006 (see chart 2). The negative impacts on consumption (through fewer jobs created and a diminished wealth effect) appear limited for the time being, however (see box 3), and have probably been offset by the rising financial markets, falling unemployment (dragging down the savings rate in its wake) and, in Q4, purchasing power gains thanks to lower oil prices.

Chart 2: US housing market indicators



Source: CENSUS.

In Japan too, the economy looks less vigorous, with slow growth in Q2 and Q3 2006 and a downward revision of 2005 growth. Despite bouncing back in Q4 2006, household consumption has been slowing since 2005. It had been sustained in recent years by falling savings, but these have been rising since 2005. Nor is consumption receiving any clear support from wages, since the distribution of value added remains distinctly to the disadvantage of wage earners.

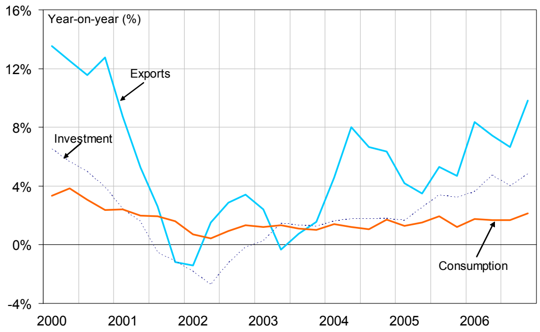
Contrary to the United States or Japan, the pace of growth in the eurozone remained strong throughout 2006. Growth rates inside the zone have converged since the end of 2005, notably as growth has picked up in Italy and Germany. In both these countries domestic demand has shaken off its torpor thanks to robust job creation.

This vigour stems mainly from the strength of domestic demand and, at year-end, exports (see chart 3). The most dynamic element within domestic demand has been investment (including residential sector), stimulated by a number of factors, i.e. low long-term interest rates, high production capacity utilisation rates and, in Germany, the abolition of subsidies for home buyers at the end of 2005 (many contracts signed before that date led to housing starts in 2006).

Consumption remained equally buoyant in 2006, driven by a high level of job creation. In Germany, however, consumption was weaker than expected at year end: the VAT rate hike on 1 January 2007 did indeed encourage consumers to bring forward some consumer expenditures in late-2006 (for cars notably), but total consumption grew by only 0.3% (coming after 0.7% in Q3).

(1) Respectively 5.3%, 4.8% and 5.3% according to the IMF, but covering a wider geographic area.

Chart 3: sources of eurozone growth



Source: Eurostat, national accounts.

1.2 Signs of an industry downturn are offset by buoyancy in other sectors of activity

At the end of 2006 industrial activity and trade between the developed countries were out of step with GDP growth.

Whereas global activity was very vigorous at the end of 2006, industrial output was flat in the United States and weak in the eurozone. Only in Japan was it brisk. Industrial output also slowed slightly in emerging Asia, in China and Korea notably. This trend is partly due to fine weather at the end of 2006, which depressed energy output, but it also reflects a slowdown in manufacturing output.

The trend for 2007 is no better, with sluggish orders for durable goods in Germany (foreign orders especially) and in the United States. It looks, therefore, as if growth in industrial output peaked in mid-2006, as a result of very high capacity utilisation levels.

These signs of an industrial slowdown went hand in hand with a weakening of global trade at the end of 2006, coming off its early-2006 peak. Global trade at the beginning of 2006 was driven by very fast global economic growth, and in particular by accelerating domestic demand in the eurozone. The United Kingdom also contributed powerfully, in Q1 especially, even if this dynamism partly reflected exceptional export flows connected with a VAT fraud mechanism (see box 2).

Trade then slowed, as the pace of US imports (down by volume in Q4 due to weakening domestic demand), Chinese imports (resulting from a slight flattening of investment due to tighter credit controls), and British imports (due to the decline in the abovementioned exceptional flows) slackened.

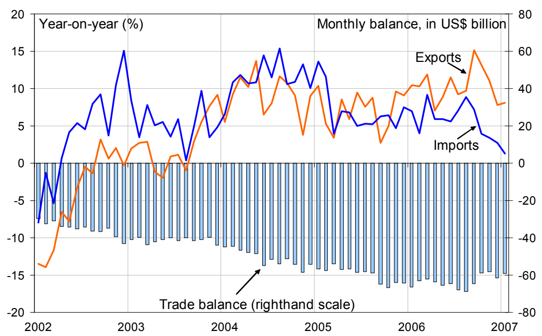
While eurozone imports remained fairly buoyant in the second half of 2006, with imports rising sharply notably in Germany (especially in Q3) and Spain, they nevertheless grew distinctly more slowly than exports. This difference was especially visible in Germany at the end of 2006, just as observers were expecting imports to be stimulated by advance purchases by German consumers ahead of the VAT rate increase on 1 January 2007.

Box 1: **Global imbalances were high throughout 2006, but they declined in Q4**

The US trade deficit set a new record in 2006, widening to US$762 billion, or nearly 6% of GDP. Consumption remained brisk despite the housing market downturn, with savings rate falling once again, by 1.1% in 2006 after a 0.4% decline in 2005. At the same time, Asia's surpluses continued to swell, especially towards the end of the year with the slowdown in imports as the pace of investment slackened somewhat. Finally, higher oil prices in 2006, averaging US$65 a barrel compared with US$55 in 2005, further boosted the producer countries' surpluses.

Except in Asia, these imbalances diminished slightly at the end of 2006, as witnessed by the change in the US trade deficit (see chart 3). This trend reflects effects not specific to the US, such as the fall in the price of oil to US$61 in Q4 2006, down from US$70 in Q3, reduced energy consumption due to a mild start to winter in the northern hemisphere.

Chart 4: US trade

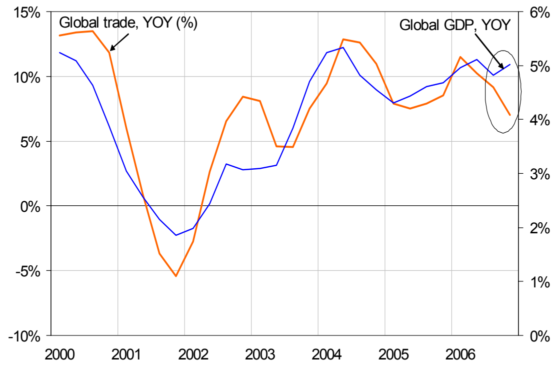


Source: BEA, Census.

It also reflects an improvement more specific to the United States, namely the slowdown in domestic demand and improved competitiveness of domestic output (due to lower core inflation and a weaker dollar). This trend could lead to slight reduction of imbalances in 2007, but an upturn in the US economy in 2008 would widen them once again.

As a result the spurt in eurozone growth in 2006 witnessed no equivalent trend in intrazone trade, and the vigour of exports reflects a pronounced increase with non-European countries such as Russia and China, each of which accounted for 4% of eurozone exports by value in 2006.

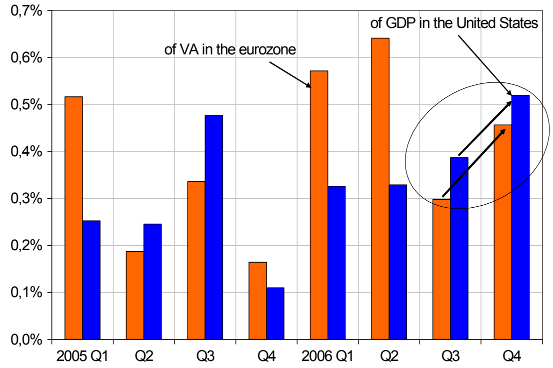
Chart 5: GDP and global trade



Source: Feri, DGTPE.

Overall, global trade was out of step with global GDP at the end of 2006 (see chart 5). The economies of the major developed countries appear to be increasingly dependent on domestic demand, and in particular on those components less likely to stimulate trade, i.e. the consumption of services and, except in the United States, still buoyant housing demand.

Chart 6: contribution of services to growth



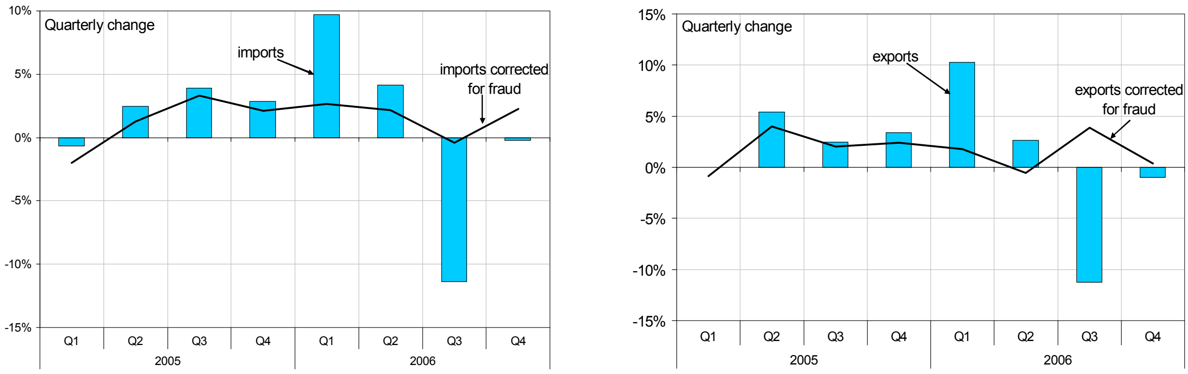
Source: Eurostat, BEA.

Much of the year-end growth in the United States, as well as in the eurozone, was attributable to service sector activity. It thus looks as if services were the main beneficiary of the additional purchasing power created by falling oil prices (see chart 6).

Box 2: **The impact of VAT fraud on trade statistics**

"Carousel" VAT fraud consists in importing VAT-exempt goods from an EU country and then adding VAT to their sale price without remitting the corresponding amount to the tax authorities (the firm that ought to have paid the VAT disappears). The goods sold are re-exported to an EU country (with the State "refunding" the VAT to the exporting company even though it never received the said VAT in the first place) and can then be traded fraudulently once again. This fraud concerns high value-added and highly mobile goods such as cellphones and computer chips. Considerable quantities of goods have circulated via this fraudulent mechanism, chiefly between the UK and third countries. The surge in this illicit trade between late-2005 and early-2006, followed by its decline in Q3 2006 as controls were tightened, appears in the statistics on both exports and imports (due to a statistical adjustment in the latter case), and thus affects global trade statistics to a considerable degree. The UK Office for National Statistics (ONS) has estimated import and export series not comprising these fraudulent flows (see chart 7 below), but the national accounts measure real flows, including those arising from VAT fraud.

Chart 7: UK imports and exports (by volume)



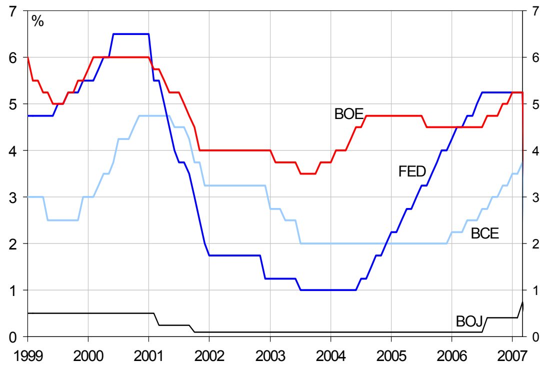
Source: ONS.

2. The global economic slowdown went hand in hand with falling oil prices and reduced inflationary pressures at the end of 2006

2.1 Monetary policy was tightened in 2006 in response to inflationary pressures

US interest-rate rises initiated in 2004 were interrupted in mid-2006 (at 5.25%, after rising by a total of 425 basis points), just as the housing market was going into reverse. At the end of 2005 the ECB began tightening monetary conditions and continued doing so throughout 2006, raising rates by a total of 175 basis points, with the refinancing rate rising to 3.75% in March 2007. The Bank of England, which was the first of the major central banks to begin tightening in 2003, further toughened its stance from mid-2006 onwards. Finally, the Bank of Japan raised its rate by 25 bp for the first time in July 2006, following this up with a second rise in February 2007, after five years of zero interest rates.

Chart 8: key interest rates



Source: Datastream

The UK and US central banks justified their monetary tightening primarily on grounds of core inflation trends (see chart 9). High capacity utilisation rates in most of the developed countries, linked to the fact that output gaps had turned positive (in the United States and the United Kingdom, and probably even in Japan), or are on the way to doing so (as in the case of the eurozone), also weighed in the decisions of the central banks, along with historically low unemployment rates (other than in Japan). Finally, central bankers also pointed to strong credit expansion (in the eurozone notably) and fast-rising asset prices, especially housing, as grounds for their action.

2.2 The abatement of inflationary pressures

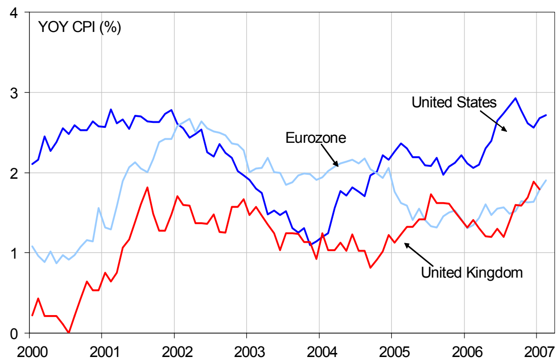
Inflationary pressures had abated by the end of 2006 (see chart 10). The global economic slowdown eased pressure on prices, including for commodities-oil especially-leading to a reduction in inflationary pressures (in the USA in particular).

In 2007, under the asumption of unchanged oil prices (at US$ 65), energy's contribution to inflation in most countries on an year-on-year basis would be negative in the first half of 2007 and virtually nil thereafter. Moreover, core inflation would be expected to lose momentum in the United States in 2007, chiefly due to slower house and energy price rises, thereby acting as a restraint on the rental component, but also as a result of the slowdown in economic activity, thereafter stabilising in 2008.

In the eurozone, Germany's 3-percentage point increase in VAT has automatically boosted core inflation in the beginning of 2007, with an estimated 0.3 percentage point impact on eurozone inflation in 2007. Core inflation would then abate in 2008 as the effects of the VAT rate rise wear off and as Spanish inflation slows. It would then pick up slightly again in late-2008 as growth rose slightly above its potential rate. Aggregate inflation is expected to remain below 2% in 2007 and 2008.

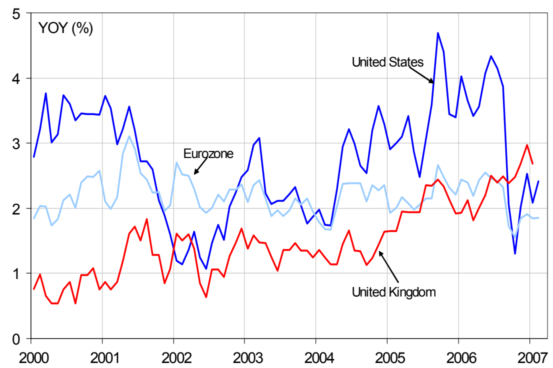
In Japan, inflation is expected to continue picking up over the time frame covered by this forecast, so financial markets expect the BOJ to raise its rates very progressively in parallel.

Chart 9: core inflation



Source: Data Insight.

Chart 10: global inflation



Source: Data Insight.

3. The "decoupling" between either side of the Atlantic should hardly persist

3.1 Once the beneficial effects of lower oil prices have faded, factors making for a slowdown are likely to come to the fore

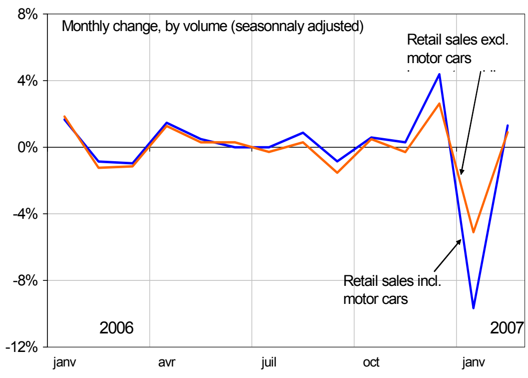
In the United States, the housing market slowdown is expected to last until Q3 2007, i.e. until inventories of homes for sale have reverted more closely to their historical average. This decline in housing investment is expected to cost around 0.7 percentage point of growth out of an annual average of 2.3% for 2007, and to bring with it a slight slowdown in consumption representing around -0.2/0.3 percentage point of GDP because of the wealth effect (see box 3). The United States can in any case be expected to carry out a fairly hefty fiscal adjustment in 2007 and 2008, aimed at achieving a structural reduction representing around 1 percentage point of GDP according to the Congressional Budget Office. These developments would lead to a slight fall in the current account deficit in 2007.

In 2008, the only restraints on growth would be the fiscal tightening and a moderate rise in unemployment, so that the economy is expected to grow by 2.9%, a rate close to its potential. The contribution of the external balance would turn slightly negative again and global imbalances would widen once more.

In the eurozone, fiscal tightening, chiefly in 2007, and the delayed effects of interest-rate increases, would prevent the decoupling vis-à-vis the United States from persisting in 2007.

Even if the German economy still seems little-affected by the VAT rate rise when one looks at aggregate inflation (thanks to base effects connected with energy prices), this has well and truly begun to feed partially through to prices (with an impact of 0.9 percentage point on inflation in our scenario, out of a potential 1.4 percentage points). Core inflation picked up distinctly in January (+0.7 percentage point according to the European Union harmonised index of consumer prices (HICP)), retail sales are dipping (see chart 11) and business climate surveys indeed point to a slight slowdown.

Chart 11: German retail sales



Source: Bundesbank

Add to this a fiscal tightening also at work in Italy, a property market slowdown in Spain, and slowing global trade, and the net result would be a marked eurozone slowdown in 2007. The eurozone will accelerate in 2008 mainly thanks to the German economy's cyclical bounce back, which has been in progress since the end of 2005, making up for the shortfall in growth in the years 2000-2005.

Against this background, global demand for French goods is expected to pick up starting in mid-2007, coming after a slowdown already well underway in 2006. Growth in global trade in early-2007 is expected to remain below its long-term average under the combined effects of slower growth in US, Asian, British, German and Italian imports mainly, before picking up in 2008.

3.2 Downside uncertainties in the United States and upside uncertainties in the eurozone, but these are unlikely to combine to maintain the eurozone's decoupling

The US soft-landing scenario in 2007 could be invalidated if a deterioration in the American housing slump in 2007 were to squeeze consumption sharply, leading to heavy job losses in other sectors of activity, in industry notably. High inventories of homes for sale on the one hand, sharply slowing corporate capital investment in 2006, and the adverse trend in orders for durable goods in 2007 on the other, show this scenario cannot be ruled out.

In the eurozone, conversely, the uncertainty concerns the possibility of stronger growth rather, in Germany chiefly. The impact of the German VAT rate rise on consumption could prove weaker than expected, thanks to pressure on companies' margins, which are currently at historically high levels (nearly 42% in 2006, versus 36% on average between 1991 and 2005). If at the same time business investment were to remain very strong in response to the additional household demand, notwithstanding the squeeze on margins, Germany could be one of the locomotives pulling the eurozone as it pursues its cyclical upturn in 2007.

However these two uncertainties are unlikely to combine to sustain the eurozone's decoupling from the United States. Indeed a hard landing in the USA could lead to a deterioration in financial conditions that could spread to all of the developed economies, including the eurozone.

3.3 In Asia, the slower growth scenario is subject to a positive uncertainty centred on Japan

In the central scenario adopted here, the United States' growth profile is replicated in Latin America and, albeit to a lesser degree, in the smaller emerging Asian countries, given the importance of trade in fuelling their growth.

Box 3: **Consumption and the wealth effect in the United States**

Household consumption has been one of the main drivers of US growth since 2002, with the savings rate slumping from 3% of disposable income at the start of 2002 to –1.2% in January 2007. Consequently, the prospect of a housing downturn was deemed to pose a considerable threat to US growth. Indeed a fall in house prices can depress household consumption via two channels, namely:

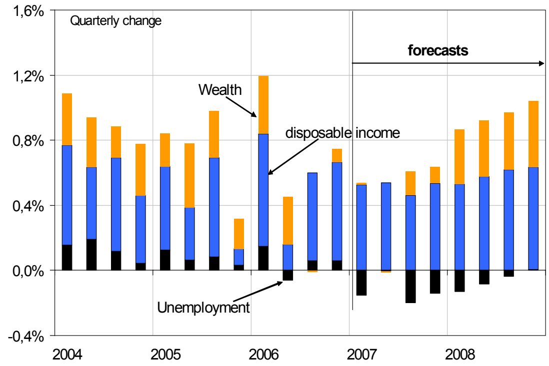
The wealth channel: when the price of real estate assets falls, people's wealth declines, all other things being equal; consequently they revise their permanent income downwards, which leads them to rein in their consumption;

The mortgage equity withdrawal (MEW) channel: when house prices decline, American households cannot refinance their mortgage to raise additional cash for purposes other than house purchasing. MEW is thought to have helped sustain consumption since 2002.

The rate of house price increase has slowed sharply since the beginning of 2006, from a year-on-year rate of 12% in 2005 to 5.9% in Q4 2006. The impact on consumption has so far been limited.

Thereafter, we have used an error correction model based on gross disposable household income (by volume), the real interest rate, house prices, and wealth. We thus estimate that a 5% drop in house prices would depress growth in consumption by 0.3% via the wealth channel and by 0.1% via the MEW channel.

Chart 12: contributions to consumption growth



Source: DGTPE

On this basis, the forecast slowdown in consumption for 2007 stems first of all from increased savings driven by rising unemployment (with the downturn in housing activity and the distinct slowdown in industrial activity). The deceleration in house prices, it is argued, also penalises consumption via a negative wealth effect , and to a lesser extent via reduced mortgage equity withdrawal.

China and India would slow down also in 2007 as a result of slackening global trade, but for domestic reasons as well. In China, any additional credit controls could further rein in investment, as happened at the end of 2006. Overheating at the end of 2006 in India drove the monetary authorities to raise interest rates, which will presumably curb domestic demand in 2007. China and India are forecast to continue decelerating in 2008, unlike the other Asian countries: China's market share gains following its entry into the WTO will shrink progressively, while in India the cyclical slowdown that began in 2007 will continue.

According to this scenario Japan will be penalised in 2007 by the slower exports to America and emerging Asia, so that growth would depend on domestic demand. consumption remains however fragile: in the central scenario, it would accelerate moderately in 2007 and 2008, while real wages would pick up progressively. Investment is expected to slacken as a result of slower growth and the likely tightening of monetary policy. The Japanese economy is then expected to re accelerate, but only slightly, at the end of 2008 with the upturn in global trade.

There is another, more optimistic, possible scenario for Asia. This would see a faster pick-up in wages and a drop in Japanese household savings, bringing the rate back down to its level of two years ago and more in line with reduced uncertainty over growth. Japanese consumption would be more buoyant, bringing with it more pronounced inflationary pressures. These demand shocks would be partially attenuated by monetary policy, which would revert more rapidly to normal, and by an appreciating yen. The rising yen would in turn help to lift all of the Asian currencies, including the Yuan. Effective European and American exchange rates would tend to depreciate as the Asian currencies appreciate, thus stimulating activity in both these regions. However, this scenario shows that even under somewhat optimistic assumptions in Asia and with a sharp appreciation of the Asian currencies, the positive impact on France would still be relatively weak, on the order of +0.1 percentage point of GDP.

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Aurélien Fortin, Fabrice Montagné

Appendix:

Table 1: main international scenario results

Annual change (%)	2005	2006	2007 (e)	2008 (e)
GDP growth (wda, sa)				
United States	**3,2**	**3,3**	**2,3**	**2,9**
Japan	**1,9**	**2,2**	**2,0**	**1,7**
United Kingdom	**1,9**	**2,7**	**2,6**	**2,4**
Eurozone	**1,5**	**2,8**	**2,3**	**2,2**
Germany	1,1	2,9	1,9	2,1
France	1,2	2,1	2-2,5	2-2,5
Italy	0,1	2,0	1,7	1,4
Spain	3,5	3,9	3,5	2,9
Netherlands	1,5	2,9	2,6	2,8
Belgium	1,5	2,9	2,3	2,3
Central and Eastern Europe	**4,2**	**5,3**	**4,4**	**4,6**
Russia	**6,4**	**6,7**	**6,0**	**6,6**
Latin América	**4,3**	**4,8**	**4,4**	**4,1**
Emerging Asia	**8,3**	**8,7**	**8,0**	**7,8**
.... of which China	**10,2**	**10,7**	**10,0**	**9,5**
World	**4,4**	**5,0**	**4,3**	**4,4**
Global demand for French goods	6,4	9,2	5,6	6,6
Global trade	7,7	9,4	6,3	7,6
Oil price (Brent USD)*	55	65	64	65
Euro-dollar* exchange rate	1,24	1,26	1,30	1,30

* Oil price and exchange rate forecasts assume that oil prices are frozen at their average level for 2006, and at their average level in January 2007 in the case of exchange rates.

(e): Forecasts on 23 February 2007.

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Page layout:

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ISSN 1777-8050

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