LETTER

Liberté • Égalité • Fraternité
RÉPUBLIQUE FRANÇAISE

N°1
October 2006

TRÉSOR-ECONOMICS

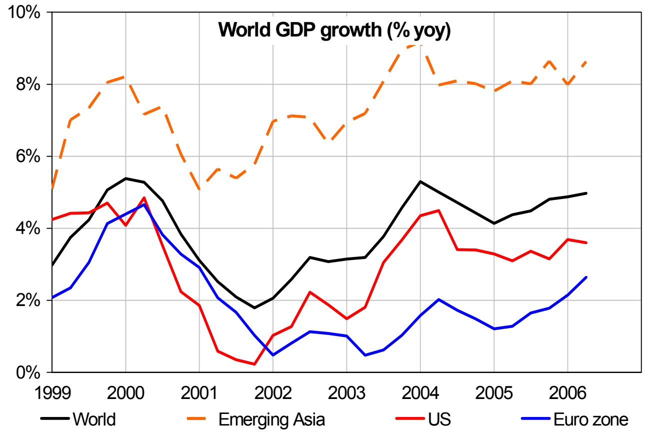
The global economic outlook in autumn 2006

- Growth in the global economy in the first half of 2006 was geographically better balanced than previously: it remained very robust in the emerging countries of Asia, while the euro zone enjoyed a strong domestic demand-led rebound. Growth slackened in both the United States and Japan in the second quarter.

- Looking ahead, global growth is expected to slow in 2007. Less accommodating monetary policies designed to combat inflationary pressures are raising the cost of debt, in particular household debt. Until now, lending had helped counteract the negative effects on domestic demand of dearer oil (up 100% since 2003). Looking ahead, assuming by convention that the price of oil remains stable, persistently high energy prices will continue to hold back growth in 2007.

- In addition to these global factors, for the American economy the housing market slowdown will weigh on residential investment and consumption (via the wealth effect and declining mortgage equity withdrawal volumes). In the euro zone, Germany and Italy will have to continue to make substantial efforts to cut their public deficits. However, European companies are in strong financial health, and this will help to sustain investment and limit the slowdown in the euro zone. Growth in 2007 will be below potential in the United States, and very slightly so in the euro zone. Now that it has put deflation behind it, Japan will again be carried along by its own dynamic and enjoy above potential growth.

- There will be no deterioration in the global imbalances, i.e. the US current account deficit, Asia's and the oil exporters' surpluses, but these will remain substantial. The risk of a brutal adjustment of exchange rates and risk premiums cannot be ruled out.



Source: National Accounts.

TRÉSOR-ECONOMICS is a new publication and replaces the former : «Diagnostics, Prévisions et Analyses Économiques»

DGTPE
DIRECTION GÉNÉRALE DU TRÉSOR ET DE LA POLITIQUE ÉCONOMIQUE

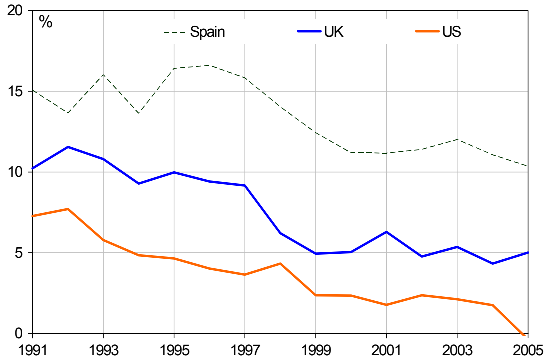
1. The euro zone has partially closed the growth gap with the United States and significantly contributed to global growth in first-half of 2006

The global economy has registered very rapid growth since 2003, at an annualised rate of between 4 and 5%. A key feature of the first half of 2006 was Europe's return as a significant contributor to global growth. At the same time, the high-growth regions of recent years maintained their momentum (chart 1), i.e. the United States since 2001, emerging Asia since 2003 and Japan since 2005.

Three main factors account for the vigour of the global economy in recent years, namely:

- **Debt-driven consumption in the developed countries.** This has been stimulated by the wealth effect fuelled by rising asset prices (property especially) and low interest rates. Household savings rates have been falling over several years in the United States, the United Kingdom and Spain (Chart 1).

Chart 1: Households' saving ratio



Source : OECD, Pers 79.

- **Ever more intensive international specialisation,** with a regional dynamic in Asia largely dependent on export price competitiveness and with China as the central link in the chain (see box 2 on next page).
- **An investment boom driven by industrialisation in the emerging countries**, and capital spending to reduce pressures on productive capacity. Until 2005, this boom was concentrated mainly on China, and less in the United States or Europe, where firms have focused mainly on reducing their debt after the excesses of the 1990s.

These factors are wholly or partly present in the structure of growth in the different regions of the world in the first quarter of 2006.

1.1 All of the world's major regions grew very vigorously in the early part of 2006

For instance, the US economy accelerated in the first quarter of 2006 (with an annual rate of 5.6%), driven by consumption and investment, thus pulling back from the slowdown recorded at the end of 2005. Despite declining, mortgage refinancing (see box 1) still continued to buoy consumption.

Growth in Japan too was very robust in the first quarter (at an annual rate of 3.2%). Business investment continued to rise now that balance sheets have been cleaned up, and job creation helped keep household consumption buoyant.

In the United Kingdom, the economy returned to trend growth (at an annual rate of 2.8% in the first quarter) as investment recovered. Moreover, after slowing sharply to mid-2005, house prices resumed their upward path at a brisk pace, contributing via the wealth effect to an acceleration in household consumption at the end of 2005.

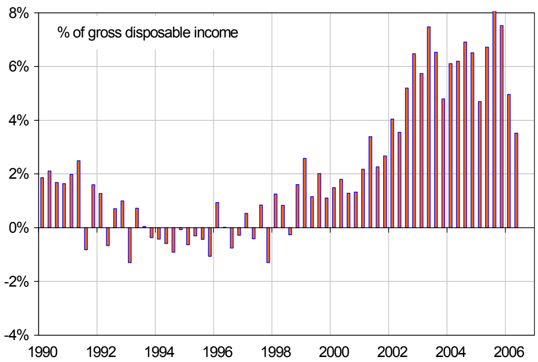
In the euro zone, finally, after a disappointing fourth quarter in 2005, when GDP grew at an annualised rate of 1.6% (0% in Italy), growth bounced back in the first quarter 2006, at 3.2%.

Box 1: **How house prices support consumption in the United States**

Mortgage Equity Withdrawal (MEW) is, by construction, the difference in a given period between the flow of investment in housing and the flow of household mortgage borrowing. It thus measures the proportion of mortgage borrowing utilised for purposes other than home purchases or renovation. This additional borrowing may be used for consumption (cash out refinancing), to buy financial assets, or to repay non-property debt.

Source : FED, DGTPE calculations.

Chart 2: «MEW» (quarterly data)



Box 2: **Nature of growth in the emerging countries of Asia**

The importance of Emerging Asia

According to the IMF terminology, Emerging Asia (used in this study) consists of countries referred to as the "newly-industrialised" countries (South Korea, Hong Kong, Singapore and Taiwan) and so-called "developing" countries (China, India, Malaysia and the Philippines; Indonesia and Thailand). This region now accounts for 16% of world trade, and 31% of global GDP (in purchasing power parity terms). Thanks to this region's vigorous economic growth, it is contributing more than half of total world growth, rising from around 40% at the end of the 1990s to nearly 60% since 2003.

Table 1: The relative weight of emerging Asia in 2005

World GDP* (PPP)	31%	US Foreign demand **	19%
growth in world GDP*	57%	Growth in US foreign demand**	24%
World trade**	16%	Euro zone's foreign demand**	11%
Growth in world trade**	24%	Growth in euro zone's foreign demand**	16%

** DGTPE calculations for 2005, from a selection of countries representing 83% of world GDP (PPP) in 2003.*
*** DGTPE calculations, from a selection of countries representing 90% of world trade (2003 numbers for the levels of world trade and foreign, 2005 numbers for growth).*

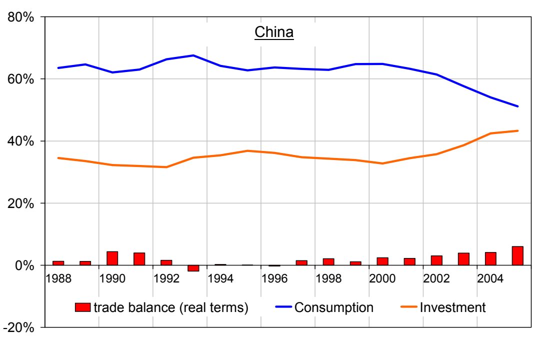
The impact on the rest of the world

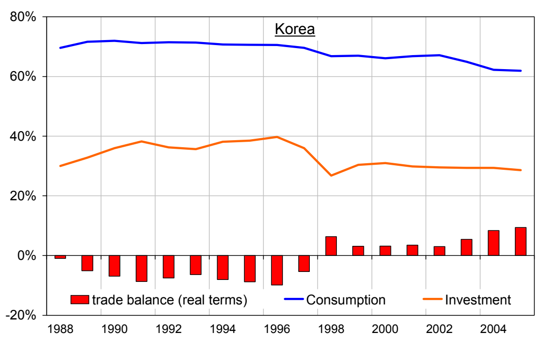
Asia's economic growth affects the economies of the United States and the euro zone by creating new outlets for their firms' exports (this applies especially to the United States, European exports being less directed to Asia, as witnessed by Asia's smaller contribution to foreign demand). The increased US and European household purchasing power made possible by greater international specialisation is another highly significant factor influencing the American and European economies. Asian growth, mostly based on exports, actually benefits from off-shoring and outsourcing from developed countries, in particular Japan and the US.

Nature of the Asian growth

The importance of exports as a share of GDP has made them the driving force behind growth in Asia, and this relative importance has amplified since the 1997 crisis. This was because tougher lending conditions and reduced short-term borrowing by firms on the international capital markets in the wake of that crisis drastically curbed investment rates and, consequently, reduced imports (ouside China). Relocation has gone hand in hand with a sharpening of the division of labour since China's entry into the WTO. This country has emerged as the prime transit point for emerging Asian countries' exports to the developed countries. The reason is that the Asian countries export semi-finished goods to China, which then completes the fabrication process and exports them to the Triad-the United States, European Union and Japan. As a result, direct exports from these Asian countries to the latter have declined, while their exports to China have risen. Because of this division of labour, the value added in each individual country-notably for those countries where the skilled labour content is lowest, China among them-is very low.

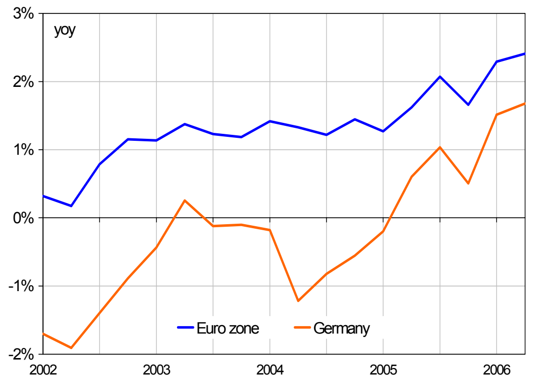
Chart 3: Structure of GDP by type of demand (source : *Global Insight*, DGTPE calculations)





Given the relative importance of exports in growth, competitiveness plays a key role. The Asian countries compete among themselves just as vigorously as they cooperate in the division of labour. There are two main ways in which these countries seek to preserve their competitiveness: the first consists in holding their currency down against the dollar; the second is to keep unit labour costs low. This helps to explain the moderate share of household consumption in GDP (chart 3). The ratio of consumption to GDP has fallen everywhere, and especially in China, where it lost 12 percentage points between 1994 and 2004. There is an apparent contradiction, here, between development of the domestic market and preserving external competitiveness, with wage costs kept low in order to preserve this competitiveness.

Chart 4: euro zone domestic demand (excl. inventories)



Source : Eurostat, National accounts

Domestic demand was particularly robust, maintaining the acceleration that began at the start of 2005, driven in particular by Germany (Chart 4). Consumption benefited from a sharp rebound in Q1 in Italy, where it had previously been flat, and from improving labour markets in France and Germany. In Spain, on the other hand, the pace of growth in consumption slackened distinctly in early 2006, moving more closely in line with incomes, as household debt stabilised (from a very high level), growth in house prices slowed, and the wealth effect faded. Where businesses are concerned, bright reports from qualitative surveys (manufacturers' optimism about the current situation is at a historical high) are materialising in the shape of vigorous industrial output in most countries (Germany, Italy, Spain and France notably) and accelerating investment.

Alongside this global growth, world trade also spurted in Q1 2006. After a somewhat mixed year in 2005 (when trade slipped relative to 2004, though even then it was more vigorous than its long-term average), world trade in Q1 2006 was fuelled by strong German, Spanish, British and Japanese imports, which boosted exports by the other euro zone countries, the United States and the emerging countries of Asia.

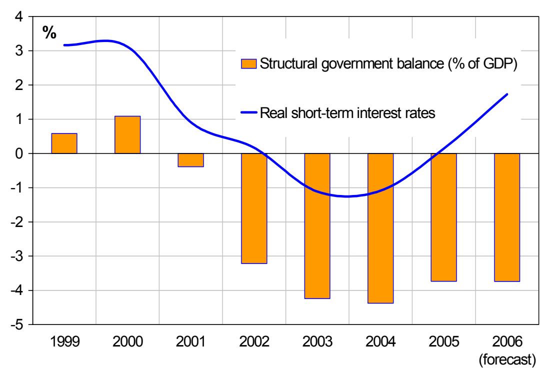
1.2 Q2 2006 witnessed the beginnings of a shift in the geographical balance of global growth

The second quarter of 2006 probably marked a turning point in the structure of global growth. While Asia maintained its own momentum, the US slowdown, which some have wrongly been predicting for some years, now appears to have set in. At the same time, the euro zone acceleration is now clear-cut and has been contributing increasingly to global growth since 2005.

The slowdown in the United States was clear-cut in Q2 (with annualised growth of 2.6%, down from 5.6%), with slower public spending, household and business investment, and consumption. The US economy has probably peaked: the policy mix is now less accommodating (Chart 5) and house price slowdown is making itself felt.

The Japanese economy too slowed in the second quarter (recording an annual 0.8% growth), probably due to a temporary slackening of exports (partly as a result of the US slowdown) and inventory rundowns.

Chart 5: policy-mix In the US



Source : OECD

Growth accelerated in the euro zone, on the other hand (at an annual rate of 3.2% in Q1 and 3.6% in Q2), with all the major countries in the zone contributing. Thus for the first half as a whole, the gap previously between very strong business confidence survey findings and actual GDP growth rates narrowed.

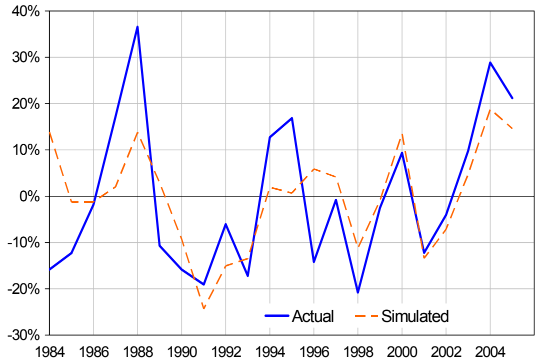
2. Faster global growth since 2003 has driven up comodity prices and has increased inflationary risks

2.1 Increased demand and supply pressures are leading to dearer raw materials

Faster global growth since 2003 has greatly boosted demand for raw materials, especially since this growth has been driven by economies heavily dependent on manufacturing, hungry for raw materials, and relatively little dependent on services. Faced with this partly unexpected growth in demand, supply has had difficulty keeping pace in the short term due to the necessary lead times for new capital projects to be brought on stream. If inventories or unused production capacity are insufficient, then prices will rise. Consequently, we can thus see a link between global growth and metals prices, which have risen steeply since 2003. Chart 6 shows metal prices in real terms (deflated by the CPI in G7 countries) and a simulated index based on an econometric equation with GDP world growth as an explanatory variable[1].

The price of oil, meanwhile, has risen (very sharply until last summer), this increase being largely driven by growth in demand, as for metals. But there are a number of additional factors specific to the oil market:

Chart 6: metal prices growth reate (in real terms)



Source : IMF, DGTPE calculations.

- longer times of installation of new production capacity that for metals,
- a producer cartel (OPEC) which uses production quotas to keep prices high,
- geopolitical tensions in the regions where the bulk of additional production capacity and reserves are located, which explains much of the price volatility.

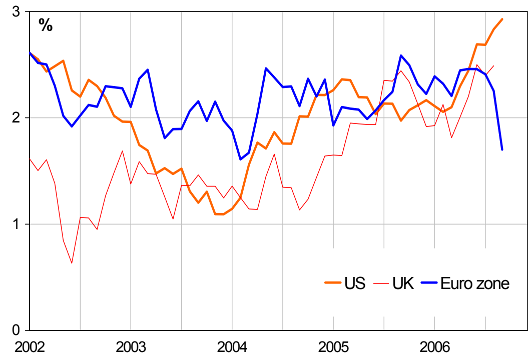
2.2 The return of inflation is perceptible in the United States but appears to be limited in the euro zone and Japan

The very sharp rise in commodity prices since 2003, which continued in the first half of 2006, theoretically constitutes a supply side shock for the oil consumer countries, impacting GDP growth and pushing up inflation.

Up to now, however, inflation has been kept more or less in check (Chart 7), notably thanks to imports of cheap goods from emerging countries. Even so, inflation has picked up distinctly in the United States since 2004. In Japan, inflation risk is limited since the country has only recently emerged from deflation, and inflation is still practically nil.

The main risk posed by this rise in prices and feared by the monetary authorities is that it could trigger an inflationary spiral, as workers demand higher wages in response to higher prices, and prices then rise to finance the wage increases, and so on. This second round effect would be further accentuated if the labour market was already tight, where unemployment is low as in the United States.

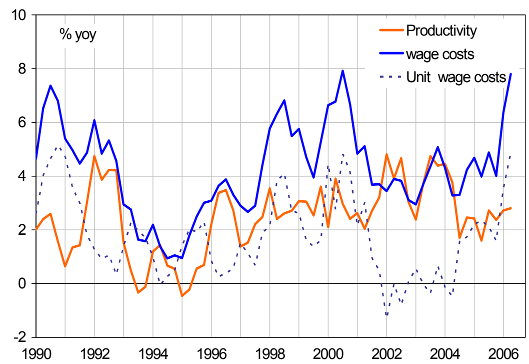
Chart 7: core inflation (% yoy))



Source : Eurostat, National data.

In the United States, precisely, the recent revised wage and productivity statistics now show that unit wage costs (defined as the ratio of total wage bill to value added) are rising. This is happening as a result of both the slowdown (partly cyclical) in productivity gains and accelerating wages (Chart 8).

Chart 8: Unit wage costs in the US



Source : BLS

This rise in unit wage costs need not necessarily trigger an inflationary spiral if firms are able to absorb the rise in wages (by reducing their margins) and do not raise their sale prices. US firms can afford to adopt this behaviour, given their historically high margins, though there is no guarantee they will do so.

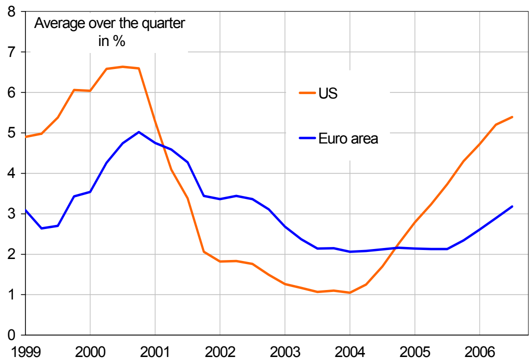
3. The expected US slowdown over the coming quarters should not unduly affect global growth

3.1 Less accommodating policy mixes and a housing market slowdown are expected to curb US growth and, to a lesser extent, growth in the euro zone

The monetary authorities have responded to inflationary risk-partially arising from the business cycle, but partially also from rising raw materials prices-by raising their key rates, which had fallen to historical lows in real terms.. In the United States, the monetary tightening began in 2004 and is probably now virtually completed. In the euro zone (Chart 9), tightening began more recently, in mid-2005, while Japan has only just set out on this path.

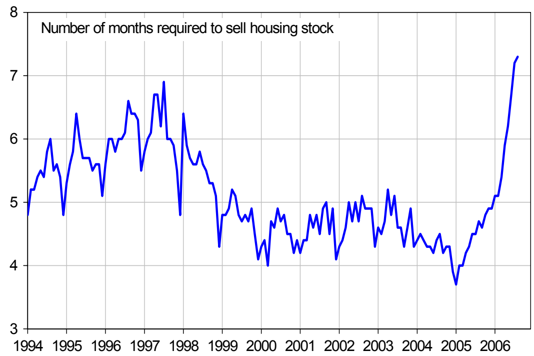
(1) This equation is ΔLOG(IMETAL)-ΔLOG(INFLATIONG7) = 11.75*ΔLOG(IGDPW) – 0.42 where IMETAL is the metal price index, INFLATIONG7 the CPI in G7 countries and IGDPW the World GDP index in real terms (IFM sources).

Chart 9: 3-month interest rates



Source : Datastream.

Chart 10: Stock of unsold houses in the United States



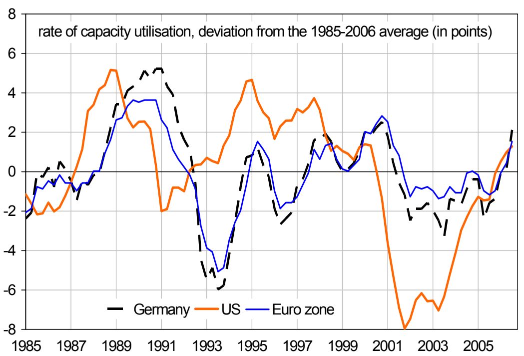
Source: NAR

The main effect of this rise in short-term rates has been to raise the cost of credit. Until now, however, lending[2] has helped counter the negative effects of higher oil prices on domestic demand. Further, cheap credit stimulated housing demand and contributed to the rise in property prices and hence to the growth in investment and consumption via the wealth effect.

In the United States, the housing market has already clearly gone into reverse; in particular, price rises have slowed markedly, while developers report a sharp drop in confidence and the stock of unsold housesN.d.T. has soared (Chart 10).

However, the US economy is still being driven by rising business investment, even if less vigorously than in earlier years; moderate long-term rates together with high profit and capacity utilisation levels - see Chart 11 - continue to encourage investment, but the expected slowdown means there are fewer outlets. Public spending too remains high, perhaps partially offsetting the forecast slowdown in household consumption.

Chart 11: production capacity (manufacturing sector)

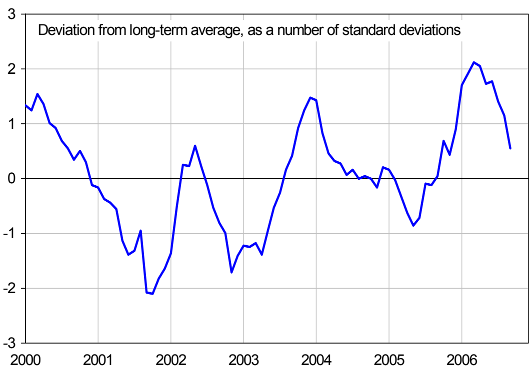


Source : FED, Eurostat.

The European economy, meanwhile, is globally less exposed to the property cycle (except in countries such as the United Kingdom and Spain), and investment is expected to continue to grow thanks to high profit levels and high levels of capacity utilisation (see Chart 11 for Germany). In addition, the European economy is being driven by robust household consumption, thanks to job creation and relatively docile inflation, which is boosting purchasing power.

In 2007, on the other hand, it will have to contend with fiscal tightening in several of the big countries, e.g. the United Kingdom, Germany, Italy and France notably). In Germany, the prospect of a 3 percentage point rise in VAT[3] on 1 January 2007 is clouding businessmen's prospects for the coming 6 months according to the IFO survey (Chart 12).

Chart 12: business outlook in Germany (IFO survey)



Source : IFO.

3.2 The uncertainties surrounding this global economy scenario: weaker growth in the US, stronger in the euro zone

In the baseline scenario, world growth is expected to decline slightly from 4,8% in 2006 to 4,2% in 2007. Two factors could help boost global growth more than expected, namely cheaper oil, and if fiscal tightening were to have a smaller than expected impact on consumption in the euro zone.

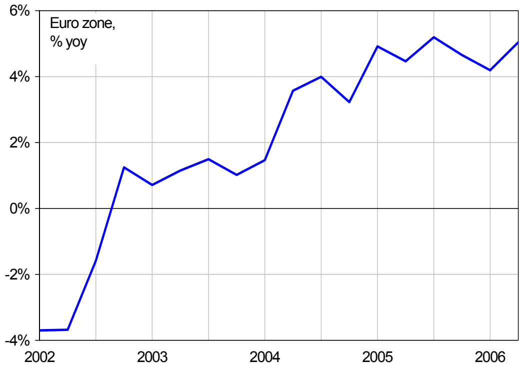
(2) Along with tax cuts for households and businesses, and falling prices as a result of international competition and imports from the low-wage countries.

(3) A third of which will be offset by lower social security contributions.

The global growth scenario for 2007 described above was built on the conventional assumption that oil prices remain frozen at their level in the lead up to the framing of these forecasts, i.e. $70 a barrel for Brent. However, the oil market eased since late-August, and the price of oil is currently more than $10 below the assumed price. This price fall could prove shortlived, since it is not based in any clear change in oil market fundamentals (inventories, forecast demand, new production capacity in the short run, etc.). But if this were to be the average price for 2007, this would add around 0.2-0.3 percentage point to global growth over the next two years and help dampen inflationary pressures.

Concerning the euro zone, more particularly, the impact of budget tightening on household consumption could prove less negative than expected. In Germany especially, businesses could opt to absorb practically the entire VAT increase by reducing their margins, in order to maintain or increase market share. In that case German consumption would not decline in 2007, which would in turn limit the economic slowdown forecast for the euro zone as a whole. This demand would provide an additional incentive to business to maintain the investment momentum begun in 2003 (Chart 13).

Chart 13: Euro zone investment (machinery and equipment)



Source : Eurostat

Factors that could on the contrary hold back global growth (aside from a further oil price hike) are more likely to come from the United States.

A sharp slump in the housing market would depress construction investment and consumption severely, probably pushing savings back up to levels more in line with their classical determinants.

Another risk lies in the current account imbalances. The US deficit exceeds 6% of GDP and is expected only to stabilise in 2007 in the baseline scenario. A rise in long-term rates fuelled by fears over the sustainability of this deficit would weigh distinctly on both investment and consumption.

In either case, a sharper than expected US slowdown would impact on the rest of the world not only by curbing outlets for exports to the United States and the countries tied to it economically (Canada, Mexico, and even China) but also through its repercussions on financial markets (a dollar slump would eat into the competitiveness of the euro zone and a general rise in risk premia) and through reduced US investment abroad.

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Appendix

Table 2: international scenario, main results

Annual change (%)	2004	2005	2006 (f)	2007 (f)
GDP growth				
Unisted States	**3,9**	**3,2**	**3,5**	**2,6**
Japan	**2,3**	**2,6**	**2,6**	**2,4**
UK	**3,3**	**1,9**	**2,5**	**2,1**
Euro zone	**1,9**	**1,4**	**2,5**	**2,0**
Germany	1,2	0,9	2,3	1,3
France	2,3	1,2	2-2,5	2-2,5
Italy	1,1	0,0	1,5	1,0
Spain	3,2	3,5	3,4	2,8
Netherlands	2,0	1,5	2,5	2,7
Belgium	2,6	1,2	2,7	2,2
CEECs and Russia	**6,3**	**5,6**	**5,5**	**4,8**
Latin America	**6,2**	**4,3**	**4,6**	**4,0**
Emerging Asia	**8,5**	**8,0**	**8,2**	**7,8**
World	**4,8**	**4,4**	**4,8**	**4,2**
Gobal demand for French goods and services	9,4	6,4	9,1	5,9
World trade	11,6	7,7	9,7	7,3
Price of oil (Brent, in $)*	38,0	55,0	68,0	70,0
Euro-dollar exchange rate*	1,24	1,24	1,25	1,28

* Oil price and exchange rate forecasts are based on the assumption that these are frozen at their August 2006 level.

(f) forecast.

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139, rue de Bercy
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Publisher:

Philippe Bouyoux

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Page layout:

Maryse Dos Santos

ISSN proceeding

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