THE WORLD ECONOMY

World Economic Prospects and the Risks from Oil Prices

World Growth

Growth in the world economy looks robust, with growth averaging over 4 per cent a year in the last 2 years and in the first two years of our forecast. Strong demand in North America is a major factor behind this growth, and it has been associated with increasing current account deficits for the US, as we can see in Chart 1. The emerging imbalances that this strong growth has produced present a major risk to the world economy as they may induce major realignments of exchange rates. We analyse the implications of a major shift in the risk premium on the dollar in Al-Eyd, Barrell and Pomerantz in this *Review*. The demand pressure from this strong growth has led to a rise in oil prices to around $48 a barrel. We expect prices to stay at this level for some time, and this will slow world activity especially amongst oil dependent economies and those with weak trade links with the oil producers. We estimate it may reduce US growth by up to ¼ a per cent in each of the next 3 years and reduce Euro Area growth 0.15 per cent a year over the

Table 1. Forecast summary *percentage change*

	Real GDP[a]												
	World	OECD	NAFTA	EU–25	Euro Area[b]	USA	Japan	Germany	France	Italy	UK	Canada	World trade[c]
2001	2.4	1.0	0.8	1.7	1.6	0.8	0.2	1.0	2.1	1.7	2.3	1.8	0.0
2002	3.0	1.7	1.9	1.1	0.9	1.9	–0.3	0.1	1.1	0.4	1.8	3.4	3.5
2003	3.9	2.2	2.8	0.9	0.5	3.0	1.4	–0.1	0.5	0.4	2.2	2.0	4.7
2004	4.6	3.2	4.3	2.2	1.8	4.4	2.6	1.0	2.4	1.0	3.1	2.8	9.0
2005	4.3	2.6	3.3	2.0	1.6	3.5	0.9	0.9	2.2	1.2	2.7	2.9	7.7
2006	4.2	2.8	3.3	2.2	2.1	3.3	1.9	1.5	2.3	1.7	2.7	2.9	5.3
1995–2000	3.9	3.2	3.8	2.7	2.6	3.8	1.4	1.8	2.6	2.1	3.1	3.9	8.5
2007–2011	3.9	2.6	3.1	2.1	2.0	3.2	1.7	1.8	2.1	1.4	2.3	2.2	6.1

	Private consumption deflator											World prices	
	OECD	NAFTA	EU–15	Euro Area[b]	USA	Japan	Germany	France	Italy	UK	Canada	Exports ($)	Oil($ per barrel)[d]
2001	2.3	2.7	2.4	2.4	2.1	–1.0	1.6	1.5	2.8	2.4	1.8	–2.2	23.6
2002	1.7	2.0	2.1	2.2	1.4	–1.2	1.2	1.7	3.1	1.6	2.1	0.5	24.4
2003	1.8	2.3	2.0	2.0	1.9	–0.7	1.0	1.8	2.5	1.9	1.6	9.4	27.8
2004	2.0	2.5	1.9	2.0	2.2	–0.5	1.6	1.4	2.2	1.3	1.4	7.9	35.9
2005	2.2	3.0	1.8	1.8	2.9	0.6	1.2	2.0	2.1	2.0	1.6	6.0	47.5
2006	2.6	3.6	1.9	1.8	3.8	0.2	1.1	2.1	2.2	2.4	1.4	4.1	47.6
1995–2000	3.1	3.5	2.1	2.1	1.8	–0.1	1.4	1.2	3.3	2.4	1.6	–1.4	18.6
2007–2011	1.6	1.9	1.7	1.5	2.0	–0.3	0.9	1.7	1.4	2.4	1.0	–0.2	47.8

Notes: (a) GDP growth at market prices. Regional aggregates are based on PPP shares. (b) All Euro Area numbers reported in these tables include Greece unless otherwise specified. (c) Trade in goods and services. (d) Average of Dubai and Brent spot prices.

Chart 1. Current Account Balances

(per cent of GDP)

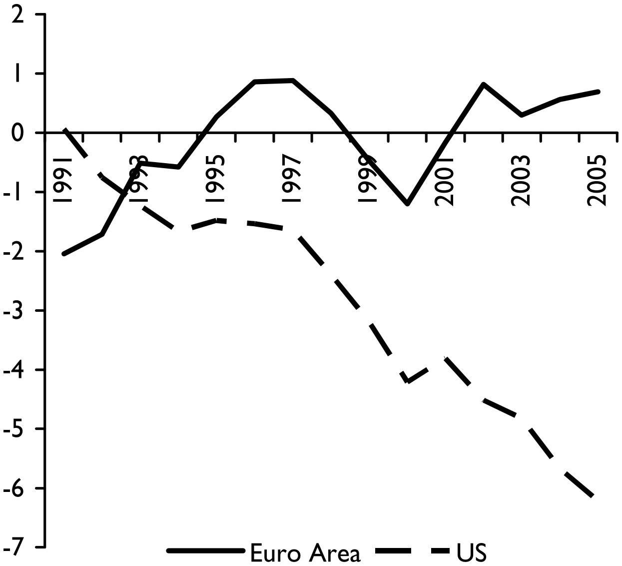
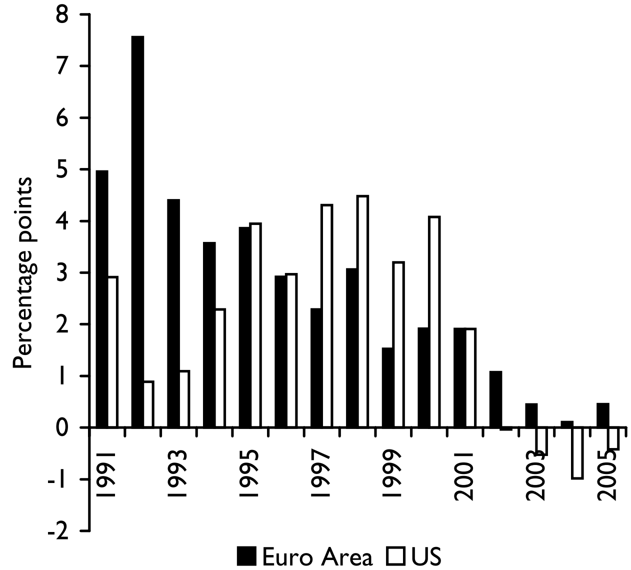


Chart 2. Real Interest Rates in the US and the Euro Area

(three month rate less the outturn for inflation)



same period. Our forecast for the world is set out in Table 1. Growth in the OECD is expected to slow in 2005 as a number of economies, such as the US reach full capacity. In addition we expect growth in the Euro Area to slow down as the impacts of the appreciation of the exchange rate feed through. Although inflation is expected to increase in most countries, and most markedly in the US, we anticipate that slower growth and an appreciating currency will put downward pressure on Euro Area inflation.

Recent increases in oil prices from their already relatively high levels have led once again to a discussion of their consequences for the world economy. While the current high levels of oil prices can be explained, to a large extent, by a surging demand for oil, particularly from China and the US, supply concerns have also affected prices, particularly during the past several months. A permanent increase of $10 a barrel is likely to reduce output growth across OECD, although the US is likely to suffer more than the Euro Area, both in terms of slower output growth and higher inflation. The price of crude oil is now more than double that at the end of 2001 with the UK Brent crude prices reaching a historical high of $56 per barrel in early April.

Although various agencies including the OPEC and the US Department of Energy are projecting a slowdown in worldwide oil demand growth from the 3.2 per cent in 2004 to around 2½ per cent over the next several years, the oil market is likely to remain relatively tight so that the current high oil prices are likely to be sustained. The International Monetary Fund (IMF) predicted in their latest World Economic Outlook published in mid April this year, that the oil market will remain tight and vulnerable to shocks from now until 2010 while oil prices will remain high and continue to be subject to the risk of large, unexpected price changes.

Increased oil demand in recent years has eroded much of the spare production capacity such that OPEC is now producing close to its capacity. Furthermore, sustained high oil prices have also led to a rapid reduction in the sizable emergency stocks held by OECD countries. While non–OPEC supply from the Commonwealth of Independent States has grown steadily, many fields in the non–OPEC region are now mature and have high decline rates. It is not clear whether non–OPEC production growth can be sustained in the long run, particularly beyond 2010.

Geopolitical and economic uncertainties about oil production in Russia – the world's largest non–OPEC oil producer – has contributed to fears of supply shortages and helped to push oil prices higher in recent months. Russian oil output remained unchanged in March from February of this year, extending a spell of stagnation and increasing fears that Russian oil industry is unable to meet the increase in global demand for oil. Investment in Russian oil industry has shied away from complex infrastructure projects, while increased production requires the development of new fields in Siberia, which are more complex geologically. The Kremlin's break–up of Yukos, Russia's largest oil producer, has done little to reduce the political uncertainties required for long–term field development investment. Capital continues to leave the country at a rapid pace, with capital flight growing four fold last year as compared to 2003, according the country's central bank data.

The oil price projection in our model follows the growth path of the future prices of the West Texas Intermediate (WTI) spot average. The April release of the Short Term Energy Outlook by the Energy Information Administration of the US Department of Energy showed a significant jump of the per barrel WTI spot average from $49.8 in the first quarter of this year to $56.9 in the second quarter with prices sustaining at around $55 until the end of 2006. Accordingly our projections now see the oil price averaging about $10 per barrel more in 2005 and 2006 than we anticipated three months ago, and it is expected to remain about 15 per cent higher than previously forecast over the next decade.

Impact of a permanent $10 rise in oil prices

To assess the impact of considerably higher oil prices on global economic activity, we have undertaken a simulation on the new version of our model NiGEM, with oil price increased by $10 permanently. In a rational expectations model such as NiGEM, with forward looking labour markets, long rates, exchange rates and equity markets, the impact of an oil price rise of this magnitude from already relatively high levels is quite pronounced across the OECD. Charts 3 and 4 summarise the results of this exercise.

Output growth in the Euro Area slows by almost 0.2 per cent per annum in the first year of the shock and output is more than 0.5 per cent below base by 2007. GDP growth in the US slows down even more, partly as a result of greater oil intensity of the US economy. Oil intensity – defined as the amount of oil consumed by an economy to generate a unit of output – has declined considerably since the first oil price shock of the early 1970s, as we discussed in Barrell and Pomerantz (2004). In general, it is substantially lower in the industrialised countries as compared to the emerging market economies of Latin America and the Far East. However, within OECD there remains considerable diversity in terms of how efficient economies are in their use of crude oil resources. In particular, the US economy is considerably more oil intensive today as compared to most countries in the Euro Area. Part of the slower output growth results from a change in the terms of

Table 2. Interest rates *per cent per annum*

	Short–term interest rates					Long–term interest rates				
	USA	Canada	Japan	Euro Area	UK	USA	Canada	Japan	Euro Area	UK
2002	1.7	2.6	0.1	3.3	4.0	4.6	5.2	1.2	4.9	4.9
2003	1.2	2.9	0.0	2.3	3.7	4.0	4.7	1.1	4.2	4.5
2004	1.6	2.2	0.0	2.1	4.6	4.3	4.5	1.5	4.2	4.9
2005	3.5	2.8	0.2	2.3	5.0	4.4	4.5	1.5	4.0	4.9
2006	4.4	3.9	0.4	2.9	5.2	4.5	4.7	1.7	4.2	5.2
2007	4.7	4.3	0.7	3.4	5.3	4.6	4.9	1.9	4.4	5.3
2008–2011	5.0	4.7	1.5	4.2	5.3	4.7	5.0	2.3	4.7	5.3
2004Q1	1.0	2.2	0.0	2.1	4.1	4.0	4.3	1.4	4.2	4.8
2004Q2	1.3	2.0	0.0	2.1	4.5	4.6	4.8	1.8	4.4	5.1
2004Q3	1.7	2.2	0.0	2.1	4.9	4.3	4.6	1.4	4.2	5.0
2004Q4	2.3	2.5	0.0	2.2	4.8	4.2	4.4	1.4	3.8	4.7
2005Q1	2.8	2.5	0.1	2.1	4.9	4.3	4.3	1.4	3.7	4.7
2005Q2	3.3	2.4	0.2	2.3	5.0	4.4	4.5	1.4	4.0	5.0
2005Q3	3.7	2.9	0.2	2.4	5.1	4.4	4.6	1.5	4.1	5.0
2005Q4	4.0	3.4	0.3	2.6	5.1	4.4	4.6	1.6	4.1	5.1
2006Q1	4.2	3.6	0.3	2.7	5.2	4.5	4.7	1.6	4.2	5.2
2006Q2	4.3	3.8	0.4	2.8	5.3	4.5	4.7	1.7	4.2	5.2
2006Q3	4.5	4.0	0.4	3.0	5.3	4.5	4.8	1.7	4.3	5.3
2006Q4	4.6	4.2	0.4	3.1	5.3	4.5	4.8	1.8	4.3	5.3

Chart 3. The impacts of a permanent $10 rise in oil prices on output

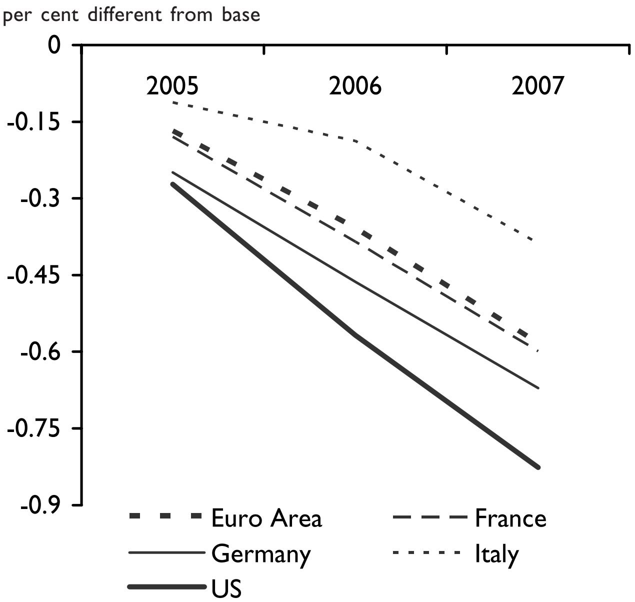
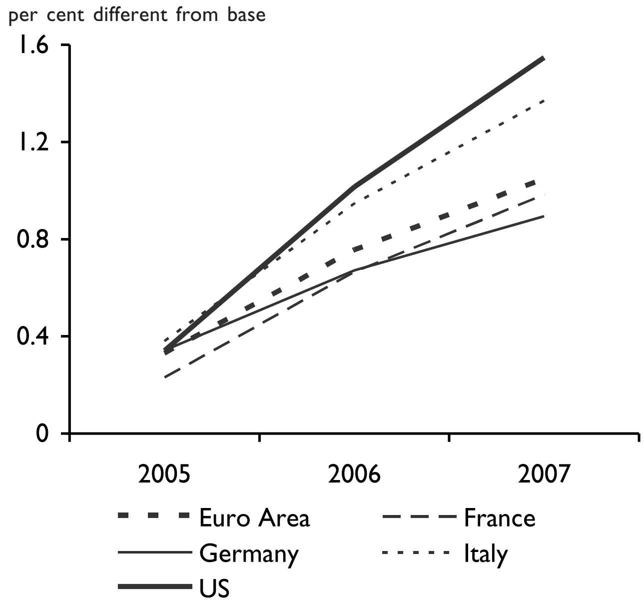


Chart 4. The impacts of a permanent $10 rise in oil prices on prices



trade, but also because the monetary authorities respond by increasing interest rates to combat higher inflation.

In the long run higher oil prices contribute to a change in the balance of saving and investment in the OECD countries, as they must pay more for their imports from oil producers. This raises potential output and raises real interest rates. In a forward looking world, real interest rates therefore rise now, and this will have an additional depressing effect on short term output growth. The impact of higher oil prices on inflation depends upon the monetary response. We expect the impacts to be limited, unlike the experience of the 1970's.

Monetary policy seems to be relatively loose, as we can see from our chart of real interest rates, which suggest that these are currently well below what might be seen as a long run sustainable level of three per cent. It is unlikely that inflation in the US, for instance, will fall, and hence we would presume that nominal interest rates need to rise in the medium term. Table 2 details our assumption on interest rates, which are based on the yield curve in the market. They suggest a relatively relaxed monetary stance for some time, raising the risks of a significant increase in inflation rates.

Interest rates and exchange rates

Long term interest rates fell through the second half of 2004, but began to rise from the middle of the first quarter of this year as the prospects for higher oil prices became firmer. Long term real interest rates appear to be positive, but we suspect that the markets are underestimating the risks of higher inflation in the medium term. We anticipate that short term and long term interest rates will rise to around 5 ¼ per cent, but we do not expect to see these rates in most countries for several years. However, in the UK we expect long rates to rise above 5 per cent later this year, leading other markets.

Our exchange rate forecasts are set out in tables 3 and 4. Over the first 2 or 3 quarters of the forecast, we assume exchange rates are constant. After that, we presume that these rates move in line with interest differentials starting at their current levels, and hence we do not forecast any major realignments. However, pressure is building up for a revaluation of the Renimbi and other Asian currencies. We argue that such a revaluation may not be necessary, except that it might help to reduce inflationary pressures that are building up in the region. An appreciation induced by a float or by re–pegging would reduce inflationary pressures but cannot be expected to bring more than short term relief to the US. If the Asian economies revalue, their inflation rates would subside, and their prospective real exchange rate would return to where it would otherwise have been, and hence a change in the exchange rates will have no long run impact on current account surpluses[1] .

Table 3. Nominal exchange rates

	Percentage change in effective rate								Bilaterial rate per US dollar			
	USA	Canada	Japan	Euro Area	Germany	France	Italy	UK	Canadian dollar	Yen	Euro	Sterling
2002	3.0	–0.8	–0.4	7.5	2.9	3.4	4.8	2.5	1.57	125.2	1.063	0.667
2003	–6.0	10.6	3.9	13.8	6.6	6.4	7.1	–2.7	1.40	115.9	0.886	0.612
2004	–4.7	6.3	4.2	5.4	2.3	2.3	2.7	5.3	1.30	108.2	0.805	0.546
2005	–3.8	5.0	1.2	2.0	0.6	1.2	1.1	–0.9	1.23	104.4	0.765	0.530
2006	–0.1	0.3	3.0	0.9	0.6	0.5	0.6	–1.6	1.22	101.4	0.756	0.535
2007	–0.2	0.5	3.9	1.1	0.6	0.6	0.6	–1.5	1.22	97.4	0.746	0.538
2004Q1	–1.9	–0.8	0.4	3.4	1.5	1.3	1.7	4.6	1.32	107.2	0.800	0.544
2004Q2	2.2	–2.7	–1.7	–2.7	–1.4	–1.3	–1.4	0.4	1.36	109.8	0.831	0.554
2004Q3	–0.8	3.9	0.0	1.1	0.4	0.5	0.5	–0.1	1.31	109.9	0.818	0.550
2004Q4	–3.7	6.4	2.0	3.1	1.3	1.6	1.6	–1.6	1.22	105.8	0.773	0.536
2005Q1	–1.1	–0.8	–0.2	–0.2	–0.2	0.0	–0.1	0.3	1.23	104.7	0.765	0.530
2005Q2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.23	104.7	0.765	0.530
2005Q3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	1.23	104.7	0.765	0.530
2005Q4	0.1	–0.2	0.9	0.3	0.2	0.2	0.2	–0.5	1.23	103.8	0.763	0.531
2006Q1	0.0	0.2	0.9	0.3	0.2	0.2	0.2	–0.5	1.23	102.8	0.760	0.533
2006Q2	0.0	0.2	0.9	0.3	0.2	0.2	0.2	–0.5	1.23	101.9	0.758	0.534
2006Q3	–0.1	0.2	0.9	0.3	0.2	0.2	0.2	–0.5	1.22	100.9	0.755	0.535
2006Q4	–0.1	0.2	1.0	0.3	0.2	0.2	0.2	–0.4	1.22	99.9	0.752	0.536

Table 4. Real effective exchange rates

(2000=100)

	USA	Canada	Japan	Euro Area	Germany	France	Italy	Spain	UK
2001	104.5	96.7	89.0	100.9	98.9	99.3	100.4	101.3	98.0
2002	106.1	96.2	85.3	107.5	100.1	101.6	105.0	105.9	99.4
2003	98.9	105.9	85.5	120.7	105.0	107.0	111.8	112.3	96.1
2004	93.8	111.6	86.1	126.1	106.6	108.3	114.1	115.0	100.2
2005	90.4	115.8	84.7	126.8	106.0	109.0	114.5	116.1	98.8
2006	90.8	113.4	83.3	125.2	104.7	108.7	114.1	115.8	96.7
2007	89.9	112.9	83.1	124.3	103.7	109.0	113.2	115.9	95.2
2008–2011	91.9	111.3	87.5	125.7	102.5	109.7	112.7	118.2	94.7
2003Q1	102.6	99.1	85.5	117.2	103.6	105.7	109.9	110.4	97.4
2003Q2	98.8	105.9	84.0	121.5	105.3	107.4	112.1	112.3	95.1
2003Q3	98.7	107.4	84.1	120.5	104.9	106.8	111.7	112.6	95.2
2003Q4	95.5	111.2	88.4	123.7	106.2	108.2	113.3	113.9	96.8
2004Q1	93.7	110.1	87.8	127.5	107.4	109.1	114.9	114.8	100.7
2004Q2	95.8	107.1	85.6	123.7	105.7	107.4	113.2	113.7	100.8
2004Q3	94.7	111.3	84.9	124.8	106.0	107.5	113.5	115.1	100.5
2004Q4	91.1	117.9	86.1	128.2	107.2	109.2	114.7	116.6	98.6
2005Q1	89.9	117.0	85.8	127.8	106.6	109.5	114.5	116.4	99.2
2005Q2	90.2	116.4	85.1	127.2	106.2	109.0	114.5	116.2	99.1
2005Q3	90.6	115.5	84.1	126.4	105.7	108.7	114.4	115.9	98.7
2005Q4	91.0	114.3	83.7	125.9	105.4	108.7	114.5	115.8	98.0
2006Q1	91.1	113.7	83.5	125.6	105.1	108.7	114.5	115.8	97.4
2006Q2	91.0	113.4	83.3	125.3	104.8	108.7	114.2	115.8	96.9
2006Q3	90.7	113.3	83.2	125.0	104.5	108.8	114.0	115.8	96.5
2006Q4	90.4	113.3	83.1	124.8	104.3	108.8	113.7	115.8	96.1

House Prices, Consumption and Growth in North America

The two largest economies of North America finished 2004 strongly: the US economy expanded by over 4.4 per cent on an annual basis, while its northern neighbour, Canada, grew by 2.8 per cent. Growth was driven by domestic demand, with private consumption and business investment expanding briskly. Trade reduced GDP growth in both economies, albeit to a different extent. Private consumption grew by 3.8 per cent per annum in the US and only marginally slower, at 3.5 per cent in Canada. We expect both economies to record solid growth this year, with Canada expanding at a rate comparable to that recorded last year, while growth in the US is forecast to slow to about 3½ per cent per annum and remain just above 3 per cent per annum in the medium term.

On the back of historically low domestic interest rates and therefore a low cost of mortgage borrowing, the strength of the housing markets has underpinned robust consumer spending in both the US and Canada for the past several years. A typical existing home in the US is estimated to have cost 3.5 times a median family's annual income at the end of last year, as compared to a stable historical average of 2.7 times. Consumer expectations lend further evidence to the rapidly overheating US housing market: a 2003 survey conducted in several major US cities found that homebuyers anticipate price increases of 10–15 per cent per annum, implying an aggregate home price/income ratio of almost 8 per cent by 2015, which is clearly unreasonable. In Canada, the housing market is similarly buoyant – house prices on existing homes grew by 9.2 per cent last year, on top of solid gains in the preceding two years. Since the beginning of the current decade, housing investment has been stronger in Canada than in the US, growing by an average of 9.2 per cent per annum as compared to the 4.9 per cent annual growth recorded in the US. We expect housing investment growth to slow to about 5 per cent per annum this year in both countries, as interest rates in the US and Canada continue to rise from their historically low levels, making mortgages less attractive.

It should be noted that while domestic interest rates are near historic lows in both countries, monetary

Table 5. Canada *percentage change*

	2001	2002	2003	2004	2005	2006	average 2007–2011
Consumption	2.7	3.4	3.1	3.5	3.8	3.1	3.1
Private sector investment	3.1	1.3	4.6	7.1	6.8	4.8	3.1
Government expenditure	4.4	3.6	4.2	2.5	2.3	2.4	2.5
Stockbuilding(a)	–0.1	0.0	0.0	0.0	0.1	0.0	0.0
Total domestic demand	3.0	3.0	3.7	3.9	4.2	3.3	3.0
Export volumes	–2.8	1.1	–2.4	4.9	4.9	4.3	4.8
Import volumes	–5.0	1.4	3.8	8.2	10.6	5.2	6.3
GDP	1.8	3.4	2.0	2.8	2.9	2.9	2.2
Private consumption deflator	1.8	2.1	1.6	1.4	1.6	1.4	1.0
Unemployment, %	7.2	7.6	7.6	7.2	7.0	6.8	6.2
Govt. balance as % of GDP	1.1	0.3	0.6	1.3	2.0	2.3	0.9
Govt. debt as % of GDP	81.7	75.7	72.4	68.7	63.8	59.7	49.5
Current account as % of GDP	2.2	2.0	2.0	2.6	1.4	–0.1	–0.7
Net Overseas Assets as % of GDP	–18.4	–16.9	–18.0	–17.5	–14.8	–13.7	–5.8

Note: (a) Change as a percentage of GDP.

conditions differ markedly in Canada as compared to the US. Since the beginning of 2002, the Canadian dollar has appreciated by well over 20 per cent against the US dollar. As Canada's imports accounted for around 30 per cent of its GDP in value terms last year, a stronger national currency exerts significant downward pressure on import prices and by extension on domestic inflation. This helps to explain why Canadian inflation remained subdued through much of last year and during the first quarter of this year, despite strong employment growth and rapidly rising energy prices. This represents a marked contrast to the inflationary pressures in the US, where the consumer price index rose by over 3 per cent on an annual basis in the first quarter of this year.

We expect the slowing housing market to lower US consumer spending to about 3¼ per cent this year because US consumers have relied on sharply rising housing prices to support current spending for some time. In Al–Eyd, Barrell and Pomerantz (2005), we find that a 10 per cent fall in US house prices is likely to reduce US consumption growth by about 1.5 per cent in the short term and even more in the long term. Private consumption in Canada is forecast to be somewhat more resilient to slower house price gains, partly as a result of stronger employment performance there. Employment growth in Canada is expected to remain robust this year, increasing by over 1¾ per cent over 2004 levels, which were already very high. Indeed, the Canadian employment rate – a share of population aged 15 and over in the workforce – was higher than the US employment rate, despite a more favourable calculation technique utilised in the US. By contrast, US employment growth remains slow and there are few signs that this situation will improve this year as during the first quarter of 2005 US employment growth remained sluggish. As a consequence, the share of long–term unemployed in total unemployment climbed to 21.5 per cent, while the average duration of unemployment remained over 19 weeks – its longest run at these levels since official statistics began. The unemployment rate in the US continues to decline, as many long–term unemployed exit the workforce and are therefore not counted in the official figures.

United States

Fuelled by burgeoning domestic demand, US GDP growth remained robust at the close of last year, decelerating slightly to just under 3.9 per cent per annum in the final quarter of 2004. There are few signs that economic activity in the US will shift away from consumer and government spending and toward manufacturing and exports this year, as monetary policy remains extremely accommodative and there is little indication of fiscal prudence in the current federal budget negotiations between the White House and Congress. As a result, we expect US GDP growth to be around 3½ per cent this year and slightly less in 2006.

As the dollar continues on its downward trajectory while the Fed aims to tighten at a "measured pace", we forecast the annual rate of inflation in the US to be somewhat higher than in the recent past, perhaps reaching over 3 per cent per annum by next year. Taking into account not only the instrument of monetary policy but also the transmission channels, the US monetary policy was by some measures looser in the first quarter of this year, than in May of last year – one month before the Fed began the current cycle of tightening. In spite of this, there are few indications that the US monetary authorities are prepared to raise the federal funds rate at anything other than "the measured pace". We forecast short–term US interest rates to reach only 3.5 by the end of this year, rising further to just over 4.4 per cent in 2006, a level which hardly qualifies as neutral. Our interest rate projections are based on market expectations, and in this situation we would think it necessary for the Fed to raise rates more quickly than is currently planned. This, in combination with a weaker dollar suggests that annual inflation in the US will grow somewhat faster than in the recent past.

Supply–side indicators also point to a rise in the inflation rate in the US over the next several years. The deceleration in productivity growth is well underway – non–farm labour productivity grew by 2.5 per cent on an annual basis as compared to the annual growth rate of 5.5 per cent as recently as during the first half of last year. As a direct consequence, labour costs per unit of output have begun to increase, adding further impetus to inflation and raising the chances it will be higher this year than in 2004. Indeed, both producer and consumer price indices registered strong price growth in the first quarter of this year, even when the higher energy prices are taken into account.

The US imbalances – external, government and household – continue unabated. In the final quarter of last year, the US current account deficit, driven by a massive trade deficit, widened to over 6.3 per cent of the country's GDP for the first time. Preliminary data for the first several months of this year suggest that the US trade

Table 6. United States

percentage change

	2001	2002	2003	2004	2005	2006	average 2007–2011
Consumption	2.5	3.1	3.3	3.8	3.3	2.4	2.7
Investment: housing	0.4	4.8	8.8	9.7	4.6	2.8	2.9
: business	–4.2	–8.9	3.3	10.6	9.0	7.3	7.2
Government: consumption	3.1	4.0	2.9	1.7	2.7	2.8	3.1
: investment	4.9	6.0	2.1	2.8	2.6	1.8	2.8
Stockbuilding(a)	–0.9	0.4	–0.1	0.4	–0.2	0.0	0.0
Total domestic demand	0.9	2.4	3.3	4.8	3.7	3.0	3.4
Export volumes	–5.4	–2.3	1.9	8.6	7.4	7.4	7.0
Import volumes	–2.7	3.4	4.4	9.9	7.4	4.4	6.9
GDP	0.8	1.9	3.0	4.4	3.5	3.3	3.2
Savings ratio	1.8	2.1	1.4	1.2	0.5	0.4	1.4
Average earnings	3.9	3.7	4.4	4.2	4.3	5.3	4.3
Private consumption deflator	2.1	1.4	1.9	2.2	2.9	3.8	2.0
RPDI	1.9	3.4	2.5	3.6	2.6	2.2	3.1
Unemployment, %	4.8	5.8	6.0	5.5	5.3	5.2	4.9
General Govt. balance as % of GDP	–0.4	–3.8	–4.6	–4.4	–4.6	–4.2	–3.6
General Govt. debt as % of GDP	57.4	59.4	61.1	62.0	62.6	63.5	64.8
Current account as % of GDP	–3.8	–4.5	–4.8	–5.7	–6.2	–6.1	–6.5
Net Overseas Assets as % of GDP	–22.6	–24.0	–23.5	–23.6	–28.9	–31.9	–39.3

Note: (a) Change as a percentage of GDP.

deficit continues to widen, as import growth outpaced that of exports in the first months of this year. However, it should be noted that the continuing dollar depreciation against major currencies – with the notable exception of China – is beginning to affect the external imbalance, as trade deficits with key trading partners such as Canada and Europe are beginning to narrow. A trade deficit with China was further exacerbated in the first quarter of this year as textile quotas expired on 31 December, 2004.

It is difficult to see how the US current account can move to a more sustainable level without adjustment in US domestic absorption. Although it is common to look at the bilateral deficit with China, this is a reflection of the problem not the cause of it. Al–Eyd, Barrell and Choy (2005) argue that a revaluation of the Chinese currency would do little to improve the US current account position. A shift in the peg would only change prospective inflation in China. Apart from a short run impact, Chinese competitiveness would not be altered. The US current account deficit is a serious structural problem, and can only be dealt with by changing US net absorption. Al–Eyd, Barrell and Pomerantz (2005) investigate the impact of a rise in the risk premium on the US current account. Their findings suggest that a rise in real interest rates of 3 to 4 per cent from their current very low levels would be a necessary part of the adjustment.

The US Treasury announced a record monthly deficit, which brings the total deficit for the first five months of fiscal year 2005 on par with the deficit recorded for the comparable period of fiscal year 2004. The lack of improvement in fiscal outlook underscores the difficulty of cutting spending, as revenues rose by 10 per cent in the first five months of fiscal year 2005. We do not expect the US fiscal position to improve significantly over the next several years, given the ongoing difficult negotiations over the federal budget for 2006, during which the Senate has already rejected spending curbs on Medicaid and pay–as–you–go rule for implementing tax cuts. The last measure effectively enables the US government to implement politically popular tax cuts without the corresponding curb in spending.

Rebalancing Growth in Asia

Despite the sustained increase in oil prices in 2004, growth in Asia excluding Japan remained considerably resilient last year. Growth has indeed slowed down from the highs achieved in the first half of 2004 to a more sustainable rate as the economies enter a growth consolidating phase. Most importantly, economic fundamentals within the region continued to improve as economies slowly shift their reliance on export led growth to internally generated Asian demand growth. Much of this growth comes from China which has become the engine of growth for the region while levels of domestic demand in individual Asian economies are also benefiting from low real interest rates and appreciating currencies. While downside risks have recently increased from the relentless rise in oil prices, the simmering political tensions in North Asia and the onset of the US Federal Reserve tightening, these risks are manageable and are expected to have only a slight dampening effect on the region.

The one key risk that has a pivotal effect on the region's growth remains to be the continuing macroeconomic tightening in China. Per annum economic growth in China was brought down from almost 10 per cent in early 2004 to 9.3 per cent in the second half of 2004 while CPI inflation slowed from over 5 per cent in the middle of last year to around 2 per cent in January 2005. However recent data releases suggest that there remain some sources of overheating that are not yet under control while inflation expectations may not have been fully contained, as CPI inflation jumped back up to almost 4 per cent in February. The Chinese authorities have grown increasingly concerned over a possible property bubble in the making across major Chinese cities, especially in Shanghai where property prices grew by 10 per cent in 2004 after growing by almost 29 per cent in 2003. In response to these concerns, the People's Bank of China, which has already raised the benchmark loan rate by 27 basis points in October last year, increased the home loan down–payment ratio from 20 to 30 per cent and further raised the housing loan rate from 5.31 to 6.12 per cent in mid March. While the result of this latest efforts to cool China's overheated sectors remains to be seen, preventing an asset bubble is likely to be the key challenge for the Chinese authorities in the coming year as pressure for the Renminbi to appreciate continues. Assisted by the weak US Dollar, Chinese exports have shown renewed signs of strength in the latest data releases, we expect growth in China to remain strong at 8.9 per cent in 2005 before slowing down to around 7.5 per cent in 2006. This forecast does not factor in any revaluation of the Renminbi in the near term but expects both the export sector and domestic demand to continue to support the economy.

Barring any hard landing in China, growth in the region is expected to soften slightly in the next two years compared to last year with growth in the newly industrialised economies (NIEs) growing at around 5 and 4 per cent in 2005 and 2006 respectively. This forecast is based on the assumption that the recent appreciating trend in Asian currencies, which saw the New Taiwan Dollar and South Korean Won appreciating by 4.1 and 6.5 per cent in the first quarter of this year compared to the previous quarter, will continue. We remain optimistic that this consolidating phase over the next two years would set the stage for the rebalancing of growth from the export sector to the domestic sector, especially for the NIEs. Asian policy makers should take this opportunity to accelerate the evolution of the Asia economic model such that advancement in the domestic knowledge based sectors especially the financial services sector could release the region from its current reliance on the de facto peg to the US dollar for growth and stability. The evolution of the Asia economic model and its impact on global realignment of exchange rates are discussed further in Al-Eyd, Barrell and Choy (2005).

Japan

The latest revisions to the newly applied chain–linked year Japanese national accounts data showed that economic growth not only softened from the second quarter of 2004 but the economy was in fact in a technical recession as it contracted by 0.3 per cent in both the second and third quarter of last year. While the economic contraction did not extend to the fourth quarter, the economy grew only by an anaemic 0.1 per cent in the last quarter of 2004. These data reinforce our view that the Japanese recovery remains fragile despite

Table 7. Japan *percentage change*

	2001	2002	2003	2004	2005	2006	average 2007–2011
Consumption	1.1	0.5	0.2	1.5	0.3	0.6	1.3
Investment: housing	–5.3	–4.3	–1.1	2.2	1.5	0.5	0.9
: business	0.6	–6.6	6.6	5.7	3.2	5.1	3.0
Government: consumption	3.0	2.6	1.2	2.7	1.9	1.6	1.7
: investment	–4.6	–4.3	–10.6	–10.8	–9.6	–1.7	0.8
Stockbuilding(a)	0.1	–0.2	0.2	0.1	0.0	0.0	0.0
Total domestic demand	0.7	–0.9	0.8	1.8	0.6	1.4	1.6
Export volumes	–6.0	7.2	9.1	14.4	7.6	6.6	4.3
Import volumes	–0.7	1.2	3.8	8.9	6.5	3.6	4.7
GDP	0.2	–0.3	1.4	2.6	0.9	1.9	1.7
Savings ratio	3.8	4.0	4.3	4.4	4.4	4.1	4.2
Average earnings	0.1	–1.2	–0.7	–0.7	2.2	0.1	1.3
Private consumption deflator	–1.0	–1.2	–0.7	–0.5	0.6	0.2	–0.3
RPDI	–2.0	0.7	0.6	1.6	0.3	0.2	1.3
Unemployment, %	5.1	5.4	5.2	4.7	4.6	4.7	4.1
Govt. balance as % of GDP	–6.1	–7.9	–8.0	–6.2	–6.1	–6.3	–6.7
Govt. debt as % of GDP	144.6	149.4	156.5	163.0	165.7	168.8	180.7
Current account as % of GDP	2.1	2.8	3.2	3.7	3.1	3.4	3.7
Net Overseas Assets as % of GDP	33.8	35.9	35.0	36.7	35.6	33.8	29.4

Note: (a) Change as a percentage of GDP.

the significant structural improvements in the corporate and banking sector. In particular, consumer and business confidence in the economy appeared to be easily quelled by temporary external shocks – global inventory adjustment in areas of importance to Japan within the IT sectors in 2004. Although there emerged signs of a rebound in the economy in the last few months as various coincidental and leading indicators took a turn for the better, we forecast growth to remain weak in 2005 as a whole with the economy expanding by 1 per cent as corporates and households rebuild their confidence. Barring any further negative shocks, we expect economic momentum to pick up somewhat in the near term with GDP growth reaching around 1¾ per cent in the medium term.

Much of the economic weakness over the second half of last year came from net exports and private consumption, both of which contributed negatively to GDP growth. While the direct effect of net exports on Japanese GDP is relatively small given that it accounted for under 3 per cent of GDP in 2004, its spill–over effect on the domestic economy is significant. Net exports contributed a 0.1 percentage point drag to GDP growth in both the third and fourth quarter of last year bringing with it a dampening effect on domestic production and investment as well as business and consumer sentiment. Private consumption expenditure which accounted for 56 per cent of Japanese GDP in 2004, contracted by over 0.2 per cent consecutively in the last 2 quarters of 2004 after a promising rebound of 1.5 per cent growth in the last quarter of 2003. The latest Tankan survey released in late March also showed that the downturn in external demand has led to a significant deterioration in the perception of business conditions which had been improving since 2002. The volatility of consumption growth which tends to correlate with the ups and downs in the external sector especially in this recovery cycle, and the fragility of business sentiment, underscores the vulnerability of the current recovery to changes in the general economic environment.

From the disappointing national accounts data, one would never have guessed that the Japanese corporate sector is actually at its healthiest in the post–bubble era. While further structural reforms are indeed needed to create favourable conditions for sustainable medium term growth, there has already been much improvement in fundamentals. Balance sheet restructuring and non–performing loans disposal have more or less been completed while double digit corporate profit growth since end of 2003 have resulted in high levels of free cash flow. These would usually translate into higher labour compensation and in turn higher consumption as well as higher investment as capacity expansion activities pick up. However in the current deflationary environment in Japan, both the corporate and household sector remains extremely cautious. Cash flow rich companies have yet to invest significantly in human capital, land and machinery. The more accommodative lending attitude among the strengthened banking sector has yet to translate into a marked turnaround in loan growth due to the lack of corporate appetite for financial gearing. Hence the transmission mechanism in both the real and monetary sector of the economy continued to be undermined. The current investment recovery has therefore been patchy with year–on–year private sector investment growth falling from 8.6 per cent in the last quarter if 2003 to 1.6 per cent in the fourth quarter of 2004.

Despite the disappointing headline figures, there appeared to be some tentative signs of improvement in the labour market. As the restructuring of workforce to increase the share of part–time employees by Japanese corporates comes to an end, the diffusion index for employment conditions reported in the Tankan survey has moved from "excessive labour" to "insufficient labour" for the first time since the end of the bubble era. Furthermore, companies expect the labour market to tighten further in the coming quarter. The tightening pressure is coming from both the demand and supply of labour. Although the current recovery has been somewhat patchy, it has run for an extended period of over 2½ years, this has generated some increase in labour demand across the economy. Replacement demand for labour is also starting to accelerate with the retirement of baby boomers. On the supply side, the Japanese labour force has been declining since 1999 due to demographic reasons as well as poor job prospects in the stagnant economy such that the labour force in 2004 is around 2 per cent less than that in 1998. Furthermore, there appears to be increasing job mismatches in the economy as the pool of unemployed, who are mainly redundant older workers from sunset industries and young entrants without experience or training, lack the skills that companies require.

This increased mismatch has raised the natural rate of unemployment in Japan so much so that the unemployment rate actually rose from 4.5 per cent in January to 4.7 per cent in February this year despite signs of labour market improvements. The tightening in labour market could put some upward pressures on wages. This together with the recent jump in commodity prices could lead to a rise in the consumer expenditure deflator this year. Our model based forecast is of a ½ per cent inflation in consumer expenditure in 2005. However, given the entrenched deflationary tendency in the Japanese economy, as well as the expected appreciation in the Yen due to its large current account surplus, we do not forecast any significant inflation for Japan in the medium term.

Box A. Is the Renminbi Peg Preventing Stable Growth?

It has been widely suggested that any departure from the current de facto dollar pegging regime in Asia has to be coordinated and that, in particular, as long as the Chinese Renminbi peg is maintained, central banks in other Asian countries will be reluctant to abandon their dollar pegging behaviour as doing so will reduce their competitiveness. However, this argument does not take into account the considerable difference in stages of economic development and the diversity of economic relationships across Asia. Despite the rapid headline growth in China over the last decade, its per capita GDP based on purchasing power parity in 2004 is still only around one fifth of that in the newly industrialised Asian economies. The rapidly growing region in the east coast of China has only one third of China's 1.3bn population while the provinces in China's western region are among the poorest in Asia. Furthermore, while China is still slowly transforming from a fully command economy to a partially market economy, many Asian economies are already largely market based. These highlight the differences in economic issues and priorities facing governments within Asia and therefore their optimal strategies in dealing with economic shocks will necessarily be different. The call for a coordinated change in exchange rate policies across Asia is hard to justify.

The economic relationship between China and the rest of Asia ranges from highly competitive to highly complementary. Economies that compete with China in the production of labour intensive manufactured exports such as Vietnam would benefit most from a Renminbi revaluation as China's relative unit labour costs increase. Economies which are in the middle of the competitive/ complementary range such as Thailand and Malaysia will feel mix impact from the Renminbi revaluation as the positive effects felt in their labour intensive industries will be coupled with the negative effects from more expensive Chinese intermediate goods export into the economies' higher value added industries. Newly industrialised Asian economies with mostly complementary economic relationship with China will experience only negative impacts from the Renminbi revaluation as the cost of inputs to their industries which are primarily sourced from China will increase. Apart from these price effects, the revaluation will also bring along negative income effect to all economies regardless of their economic relationship with China as the less developed economies export energy products and agricultural staples to China while the more advanced economies export capital goods to the country.

Using our NiGem model to simulate the impact of a 10 per cent revaluation of the Chinese Renminbi with other currencies floating, the New Taiwanese dollar and the South Korean Won depreciate rather than appreciate. Even though these economies benefit from an immediate improvement in competitiveness as the Chinese revalue, these positive effects are very small and short–lived as the income effects offset the price effects such that economic growth actually falls below base after the first year or so. Our findings are similar to those obtained by McKibbin and Stoeckel (2004) which suggest that the aggregate implications for other Asian economies of a 10 per cent Renminbi appreciation are very small on balance with the income effects offsetting the price effects.

Chart 5. GDP per capita based on PPP

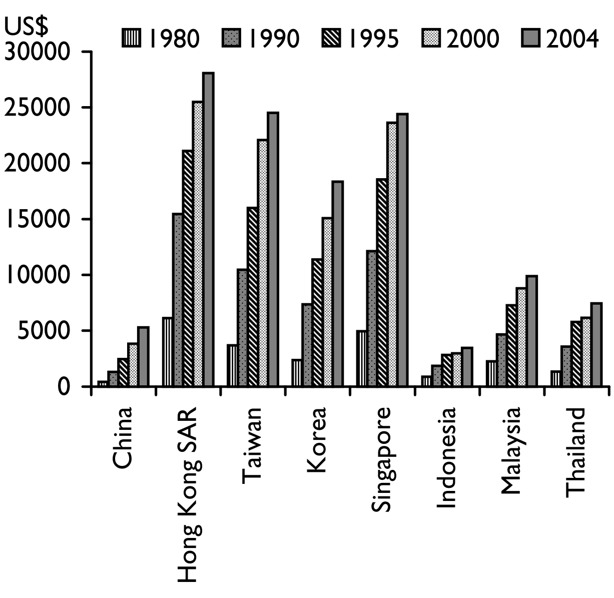
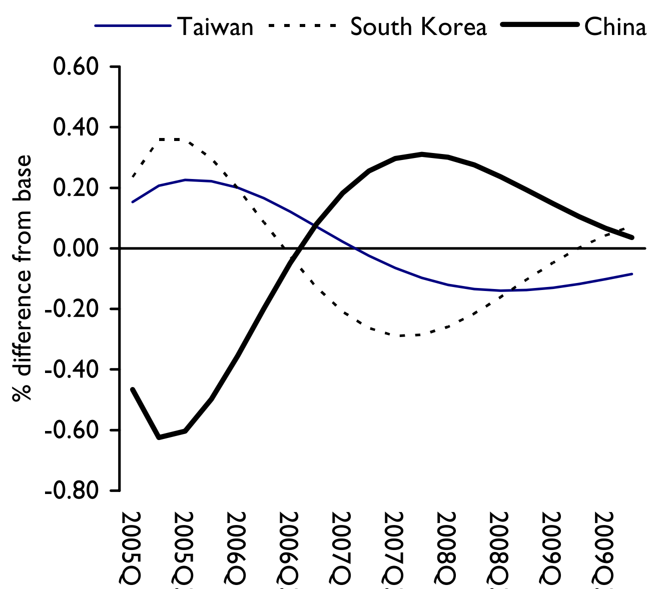


Chart 6. The impact of Renminbi revaluation on GDP growth



The Stability and Growth Pact and Slow Growth in Europe

The Euro Area economy slowed considerably in the second half of 2004 and the outlook for a sustainable economic recovery continues to be restrained by weak domestic demand and a moderation in global economic activity. High and volatile oil prices and structural rigidities have contributed to stagnant growth in private investment and consumption, while fiscal prudence induced by the Stability and Growth Pact has meant that national governments may not have been able to adopt the more expansionary stance they would have otherwise liked. Despite the ability of some Euro Area countries to maintain their export market shares (as reported in the January *Review*), the continued rise of the euro will dampen the contribution of net trade to overall growth. Against this backdrop, we have revised down our growth estimates since January. We now expect real annual growth of just over 1½ per cent this year increasing to about 2 per cent in 2006 with risks weighted strongly to the downside and stemming mainly from sustained oil prices and persistent global imbalances.

European growth outside the Euro Area remains strong and is supported by robust economic activity in central Europe as well as in the Scandinavian economies. However, a weakened outlook for the Euro Area will drag down overall EU–25 growth, which is expected to reach only 2 per cent per annum this year, down from our estimate of 2¼ per cent made in January. In the new member countries, strengthened export growth and healthy investment has helped to buttress a moderation in private consumption. Loose labour markets, strengthened currencies, and subdued wage pressures will see inflationary pressures ease in these countries. However, major policy challenges along the road to Euro adoption remain a concern. In particular, worsening current account and fiscal deficits must be addressed by the authorities in the near term and a weaker Euro Area means that annual growth in the new member countries is expected to moderate to just under 4½ per cent this year before falling to about 3¾ per cent in 2006.

Table 8. Euro Area *percentage change*

	2001	2002	2003	2004	2005	2006	average 2007–2011
Consumption	1.9	0.7	1.1	1.1	1.4	1.6	1.9
Private investment	–0.4	–3.3	–0.9	1.8	2.0	2.3	2.8
Government expenditure	2.3	2.9	1.6	1.7	1.0	1.2	1.9
Stockbuilding[(a)]	–0.5	–0.1	0.4	0.4	0.1	–0.1	0.0
Total domestic demand	1.0	0.3	1.2	1.8	1.5	1.5	2.1
Export volumes	3.5	1.9	0.5	5.8	5.7	4.9	4.8
Import volumes	1.8	0.5	2.3	6.0	5.5	3.7	5.2
GDP	1.6	0.9	0.5	1.8	1.6	2.1	2.0
Average earnings	3.6	3.3	2.8	2.7	1.9	2.6	3.6
Harmonised consumer prices	2.4	2.3	2.1	2.1	1.6	1.8	1.5
Private consumption deflator	2.4	2.2	2.0	2.0	1.8	1.8	1.5
RPDI	2.6	1.2	0.9	1.5	1.7	1.6	2.3
Unemployment, %	7.9	8.3	8.7	8.9	8.8	8.6	8.3
Govt. balance as % of GDP	–1.7	–2.4	–2.7	–2.7	–2.4	–2.3	–1.7
Govt. debt as % of GDP	69.6	69.5	70.8	71.3	73.2	72.5	69.0
Current account as % of GDP	–0.2	0.8	0.3	0.6	0.7	0.9	1.6

Note: (a) Change as a percentage of GDP.

Table 9. Prospects for the European Union

	GDP growth (per cent)						Harmonised consumer price inflation (per cent)					
	2002	2003	2004	2005	2006	2007–2011	2002	2003	2004	2005	2006	2007–2011
Austria	1.4	0.7	1.9	2.0	2.3	2.1	1.7	1.3	2.0	2.2	1.7	1.5
Belgium	0.9	1.3	2.7	2.1	2.1	1.8	1.6	1.5	1.8	1.7	2.2	1.8
Denmark	1.0	0.4	2.0	2.9	1.3	2.3	2.4	2.0	0.9	1.4	2.0	1.9
Finland	2.2	2.5	3.4	3.0	2.9	2.0	2.0	1.3	0.2	0.4	1.5	1.9
France	1.1	0.5	2.4	2.2	2.3	2.1	1.9	2.2	2.3	1.4	2.1	1.7
Germany	0.1	–0.1	1.0	0.9	1.5	1.8	1.3	1.1	1.7	1.4	1.1	0.9
Greece	4.4	4.7	4.2	3.9	3.8	3.6	3.9	3.4	3.0	3.3	2.9	2.6
Ireland	6.1	3.6	4.9	5.3	5.4	5.0	4.7	4.0	2.3	1.4	2.1	2.3
Italy	0.4	0.4	1.0	1.2	1.7	1.4	2.6	2.8	2.3	1.7	2.2	1.4
Netherlands	0.6	–0.9	1.3	1.0	2.3	2.1	3.8	2.2	1.4	1.5	1.6	1.5
Portugal	0.4	–1.1	1.0	1.6	2.8	2.3	3.7	3.3	2.5	1.2	2.4	2.3
Spain	2.2	2.5	2.7	2.6	2.6	2.2	3.6	3.1	3.1	1.8	2.0	2.3
Sweden	2.0	1.6	3.0	2.8	2.7	1.4	2.0	2.3	1.0	1.0	2.0	2.0
UK	1.8	2.2	3.1	2.7	2.7	2.3	1.3	1.4	1.3	1.8	2.1	2.1
EU	1.0	0.8	2.0	1.8	2.2	2.0	2.1	2.0	2.0	1.6	1.8	1.6
Euro Area	0.9	0.5	1.8	1.6	2.1	2.0	2.3	2.1	2.1	1.6	1.8	1.5
Accession–10	2.4	3.7	5.0	4.4	3.7	4.0	2.7	1.9	4.1	3.2	3.2	1.4
EU–25	1.1	0.9	2.2	2.0	2.2	2.1	2.2	2.0	2.2	1.7	2.0	1.6

	Fiscal balance (per cent of GDP)(a)						Standardised unemployment rate(per cent)(b)					
	2002	2003	2004	2005	2006	2007–2011	2002	2003	2004	2005	2006	2007–2011
Austria	–0.2	–1.0	–1.3	–1.8	–1.8	–1.6	4.1	4.3	4.5	4.7	4.5	4.8
Belgium	0.1	0.3	0.1	0.2	0.2	0.0	7.3	7.9	7.8	7.8	7.6	7.6
Denmark	1.6	1.2	0.9	1.0	1.9	0.4	4.6	5.5	5.4	4.6	4.9	5.5
Finland	4.3	2.1	2.5	2.9	2.4	0.8	9.1	9.0	8.9	9.0	8.7	9.6
France	–3.3	–4.1	–3.6	–2.9	–2.6	–2.0	8.9	9.4	9.6	9.8	9.5	8.9
Germany	–3.7	–3.8	–3.5	–3.4	–3.5	–2.4	8.2	9.1	9.6	9.3	9.0	8.6
Greece	–3.7	–4.6	–4.9	–4.9	–3.6	–2.3	10.3	9.7	10.3	9.8	9.4	9.1
Ireland	–0.2	0.2	0.5	–0.4	–1.2	–0.8	4.4	4.6	4.5	4.0	3.1	3.4
Italy	–2.4	–2.5	–3.0	–3.1	–2.7	–2.2	8.6	8.4	8.1	8.2	8.5	8.3
Netherlands	–1.9	–3.2	–2.9	–1.8	–2.2	–2.2	2.8	3.8	4.6	4.7	4.3	3.2
Portugal	–2.7	–2.8	–2.8	–3.2	–2.6	–1.2	5.0	6.3	6.7	7.0	6.5	7.5
Spain	–0.1	0.4	–0.3	0.2	0.3	0.1	11.3	11.3	10.8	10.2	10.2	10.2
Sweden	–0.3	0.1	0.5	1.1	1.0	1.0	4.9	5.6	6.4	7.0	7.6	7.4
UK	–1.6	–3.3	–3.3	–2.7	–2.9	–2.1	5.2	5.0	4.7	4.9	4.9	5.2
EU	–2.1	–2.6	–2.6	–2.3	–2.2	–1.7	7.6	8.0	8.0	8.0	7.9	7.7
Euro Area	–2.4	–2.7	–2.7	–2.4	–2.3	–1.7	8.3	8.7	8.9	8.8	8.6	8.3

Notes: (a) General government financial deficit, calendar year (b) Eurostat standardised rate.

Euro Area growth in the second half of last year was weak, but the composition of growth was somewhat encouraging as overall domestic demand, boosted by France and Spain, shows signs of recovery. Supported by favourable financing conditions and subdued cost pressures, Euro Area investment is expected to pick–up in the latter part of this year to yield an annualised growth rate of 2 per cent. However, this view has been tempered by the fact that there is still strong evidence of profit building by firms in some of the larger countries, notably Germany. Investment spending in Germany has fallen markedly in the past five years and this is due to the structural problems discussed in Metz, Riley, and Weale (2004). Germany's structural problems have reduced current trend growth in that country, which we estimate to be around 1 per cent at present[2]. This reduces our estimate of current trend growth in the Euro Area to around 1.6 percent. However, the growth of productive capacity is not a constant, and as the impacts of German labour market problems associated with unification recede and the Hartz labour market reforms proceed we expect trend growth in Germany to rise over the next three to four years back to around 2 per cent a year. This should help raise Euro Area trend growth back to around 2 per cent a year.

There have been attempts to address these structural problems, especially in Germany, but changes to the social security system and to labour markets may be increasing uncertainty. These continued restructuring efforts and other structural rigidities are having knock–on effects on the rest of domestic demand by reducing the growth of consumption as workers become less certain about their future income prospects and employment security. In addition, sluggish employment growth and low wage increases are affecting household income growth and dampening private consumption. Moreover, increased competition from the new members of the European Union, as well as from other emerging economies, will limit wage growth. This situation is not likely to ease soon and Euro Area consumption growth is expected to average only 1½ per cent over the next two years.

Euro Area headline inflation remains stubbornly above core inflation and, given that food prices have recently declined, this is mostly down to rising energy costs. However, the strength of the euro, as well as base effects stemming from the removal of indirect taxes and a reduction in administered prices in some large Euro Area economies, has seen the HICP fall at the turn of the year. Harmonized consumer prices will grow at just over 1½ per cent this year. We expect this subdued trend to continue since there are no immediate signs in the economic fundamentals which suggest any significant upside risks to this assessment in the short term. Of course, unfavourable developments in oil and other commodity prices remain a concern over the medium term. Moreover, attention must be given to the inflationary impacts stemming from further and unanticipated movements in indirect taxes and administered prices as national governments court the ceiling on fiscal deficits.

External pressures from sustained oil prices are not currently promoting second round cost–push effects. The current level of unemployment in the Euro Area stands at 8.8 per cent and, given excess slack in the labour market, wage pressures will remain subdued. As a result, and in conjunction with the recent period of margin building and a desire to remain competitive, further rises in oil prices are likely to be absorbed by firms rather than passed–on to consumers. There is, however, a strong case for medium term price risks as growth in liquidity and credit has accelerated in recent months. These developments are due, in part, to the historically low level of interest rates, but also stem from base effects associated with the adoption of euro notes and coins. Sustained growth in money and credit are not viewed as being compatible with non–inflationary growth. However, given the deficient state of Euro Area domestic demand it is unlikely that these factors will contribute to inflationary pressures in the near term. At the present time, inflationary pressures remain contained. However, medium term risks to price stability stemming from second round cost–push effects as well as accelerating money and credit growth will remain a concern for the ECB in the coming months, especially given the time lag inherent in the transmission of monetary policy.

European finance ministers met in mid March to decide on revisions to the Stability and Growth Pact (SGP), which were subsequently agreed by the European Commission, as we discuss below. This move was greeted with disdain from the ECB and other Euro Area central banks as a weakened SGP could compromise the harmonization between monetary and fiscal policies. In turn, easier fiscal rules may force the ECB to strengthen its already hawkish stance on interest rates. The easing of the SGP has been welcomed by new EU members of central Europe as these countries have been trying to rein in large budget deficits with the aim of adopting the euro in 2009. Importantly, the full costs of pension reforms can be written off in successive years against budget deficits and this will be an advantage to the likes of Poland, which is estimated to have spent close to 2 per cent of GDP on reforming its pension system. For the current members of monetary union, any radical changes to current budget outlooks are unlikely.

European Fiscal Policy

The Stability and Growth Pact (SGP) has come under considerable strain since 2002. Most countries were forced to revise their budget projections sharply downwards in their December 2004 Stability and Growth Pacts, as can be seen in Table 10, which compares the 2002 targets with the December 2004 revisions of Stability and Growth Pacts.

For the Euro Area as a whole, these downward revisions push the aggregate fiscal target as a per cent of GDP down by more than 1½ per centage points for 2004. All countries have revised their budgets downwards, with the notable exceptions of Belgium, Finland and Ireland. Belgium has kept its fiscal targets unchanged, whereas

Table 10. Fiscal balance targets in 2004 and 2002.

	SGP Dec. 2004				SPG Dec. 2002			Actual(b)
	2004	2005	2006	2007	2004	2005	2006	2004
Austria	–1.3	–1.9	–1.7	–0.8	–0.4	–1.5	–1.1	–1.3
Belgium(a)	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.1
Finland	2.0	1.8	2.1	2.2	2.1	2.6	2.8	2.1
France	–3.6	–2.9	–2.2	–1.6	–2.1	–1.6	–1.0	–3.7
Germany	–3.75	–2.9	–2.5	–2.0	–1.5	–2.7	0.0	–3.7
Greece	–6.1	–3.5	–4.4	–3.0	–0.4	0.2	0.6	–6.1
Ireland(a)	0.9	–0.8	–0.6	–0.6	–1.1	–1.4	–1.1	1.3
Italy	–2.9	–2.7	–2.0	–1.4	–0.6	–0.2	0.1	–3.0
Netherlands	–3.0	–2.6	–2.1	–1.9	–0.1	–0.1	–0.1	–2.5
Portugal	–2.9	–2.8	–2.5	–1.8	–1.9	–1.1	–0.5	–2.9
Spain	–0.8	0.1	0.2	0.4	0.0	0.1	0.2	–0.3
Euro Area	–2.7	–2.3	–1.8	–1.3	–1.1	–0.6	–0.2	–2.7

(a): Spring 2003 Revision of 2002 SGP (b) Eurostat 18 March 2005.

Ireland and Finland have revised theirs upwards. Spain's fiscal target for 2004 changed from a balanced budget in 2002 to a deficit of 0.8 per cent of GDP in 2004, since the Spanish government assumed the debt of two troubled state–owned firms, RNFE and TVE. The actual deficit for 2004 reached 0.3 per cent of GDP and was in fact lower than expected in the Stability and Growth Pact. Netherlands is the only other country whose actual deficit for 2004 turned out to be lower than projected in the SGP, 2.5 per cent of GDP against 3 per cent of GDP. Germany and Portugal revised their budget deficit downward by 2.0 percentage points. France and Italy lowered their targets by 2.5 and 2.3 percentage points, respectively.

France, Germany and Greece were in breach of the Maastricht Treaty in 2004, whilst Italy and Portugal were very close to the 3 per cent threshold. France has taken effective steps to redress its public stance in 2005, mostly by the use of one–off measures. Although public finances appear vulnerable in the long–term in the eyes of the European Commission, we expect the French fiscal deficit to be within the confines of the Maastricht criteria over the forecast horizon, as discussed in more detail in the section on France. Germany's fiscal deficit, on the contrary, is unlikely to improve in the short term. Sluggish economic growth and stagnating domestic demand allied with unfavourable labour market conditions are forecast in 2005 and 2006, and may result in tax shortfalls and increased unemployment insurance costs. Trend growth in Germany may be as low as 1 per cent, and hence it is difficult to see how budget deficit can be reduced without serious measures. The German government is implementing substantial structural changes in government expenditure, like the new social benefit system (Hartz IV–package) and the health sector reforms introduced in the beginning of 2004. These measures should produce their full impact in the medium term, and hence, we anticipate that Germany's fiscal deficit will revert to levels around 2½ per cent of GDP on average in 2007–2011.

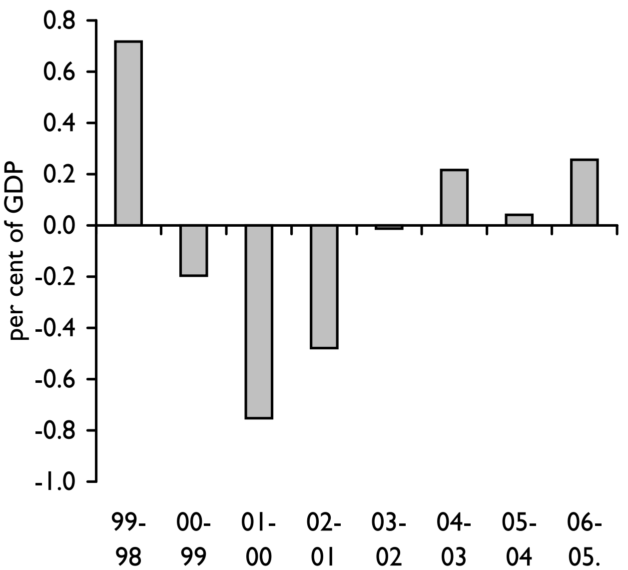
Italy and Greece are in a delicate position, as Eurostat has not validated the figures presented by these two countries. Discrepancies exist between the recording of flows between Greece and the EU budget, and data on government expenditure for the Olympic Games have not been finalised. The Greek general government balance is estimated to have recorded a deficit of 6.1 per cent of GDP in 2004. This deficit is 0.8 percentage points higher than the figure of 5.3 per cent of GDP forwarded by the Greek government in September 2004. This can be accounted for by higher than expected interest payments (0.3 percentage points), tax shortfalls and expenditure overruns representing about 0.5 percentage points. The latest assessment of the Greek SGP by the European Commission in March 2005 casts doubts on

Table 11. "One–off" budgeting measures (% GDP)

	2002	2003	2004	2005	2006
Belgium	0.2	1.9			
Denmark			1.2	0.5	
France			0.5		
Germany			0.1	0.4	0.2
Greece	3.4	2.8			
Ireland	0.2	0	0.5	–0.4	–0.2
Italy	1.6	2.0	1.0	0.5	
Portugal	1.4	2.5	2.0	1.4	0.7
Spain			–0.7	0.1	

Sources: Koen and van den Noord (2005) , Stability and Growth Pacts 2004

Chart 12. Structural Fiscal Impulse in the Euro Area



the long–term sustainability of public finances. As for Italy, Eurostat points to statistical inconsistencies in the government accounts, whereas the European Commission's assessment of the Italian SGP highlights the uncertain impact of one–off measures on public finances beyond 2005.

Chart 12 shows the structural component of change in budget deficits in the Euro Area, i.e., after removing cyclical components, and more importantly, the impact of the one–off measures. Clearly, the Euro Area fiscal impulse in the short run is mildly expansionary relative to the past two years. This reflects the fact that cyclical factors eventually account for a modest part of deficit in most Euro Area countries, and highlights the need for broader structural reforms of public finances.

Since the Stability and Growth Pact has come under considerable strain in recent years, it has been suggested that it should be reformed. The Ecofin Council of 20th March 2005 finally agreed to increase the flexibility of the implementation of the Stability and Growth Pact, and to take into account the heterogeneity of member countries. Although the agreement reiterated the reference values of 3 per cent of GDP for the deficit ratio and the 60 per cent for the debt ratio, it acknowledged that some of its rules were too restrictive. For instance, the medium term deficit target is now to be set to 1 per cent of GDP rather than in balance or surplus. The Amsterdam Treaty provides for an exception if the excess deficit over 3 per cent of GDP results from unusual events outside the control of the member state, e.g., a severe economic downturn, which was defined as an annual fall of real GDP of at least 2 per cent. The recent agreement now accepts that a lengthy period of very low growth or stagnation may justify a temporary breach of the Amsterdam criteria. Several aspects of the agreement have been interpreted by some as a victory for countries currently breaching the Stability and Growth Pact, France, Germany and Italy. In effect, the assessment of countries' SGP will now have to take into consideration "other relevant factors". Amongst them is the implementation of the Lisbon agenda and policies aimed at fostering R&D and innovation– pushed by France– and the budgetary effort towards the unification of Europe if it had a detrimental effect on the growth and fiscal burden of a Member State, a clear reference to German reunification.

The agreement does not introduce fundamental changes to the Treaty, but rather adds more flexibility in its implementation. This can be viewed as a positive development, considering the increase in the number of excessive deficit procedures from 2 in 2003 to 10 in 2004, and the intensive use of one–off measures by some member countries, as we report in Table 11.

Germany

The German economy has experienced years of stagnant growth in real domestic demand, and the minor upturn registered in the first half of last year has failed to sustain itself. Momentum in investment spending remains restrained and confidence indicators are weak. Slow output growth is having a commensurate impact on employment and personal income growth, subduing private consumption. External demand has, until recently, provided the impetus for the economic recovery. However, as the impact of the appreciation of the euro begins to bite, net contributions from trade are expected to diminish. As a result, we expect substantially slower growth in the German economy this year and next. We now estimate annual growth of just less than 1 per cent for 2005 and 1½ per cent for 2006.

A protracted rebound in the German economy is dependent upon a return to solid investment growth. Uncertainty over external conditions, including the volatility of the oil market and global demand, as well as the drive by German firms to improve internal cost structures continues to hamper spending plans. Moreover, according to the IFO survey, business confidence has steadily eroded since the beginning of the

Table 13. Germany *percentage change*

	2001	2002	2003	2004	2005	2006	average 2007–2011
Consumption	1.8	–0.7	0.0	–0.8	0.4	0.5	1.2
Private investment	–4.1	–6.5	–1.5	–1.6	0.0	0.5	2.1
Government expenditure	0.7	1.4	–0.6	0.2	–0.2	0.6	1.3
Stockbuilding(a)	–1.0	–0.4	0.9	0.8	0.0	–0.1	0.0
Total domestic demand	–0.6	–1.9	0.5	0.0	0.3	0.4	1.4
Export volumes	6.1	4.1	1.8	7.5	5.5	5.8	5.5
Import volumes	1.3	–1.6	3.9	5.4	4.6	3.6	5.3
GDP	1.0	0.1	–0.1	1.0	0.9	1.5	1.8
Average earnings	2.7	2.0	1.5	0.4	0.0	1.2	3.0
Private consumption deflator	1.6	1.2	1.0	1.6	1.2	1.1	0.9
RPDI	2.3	–0.4	0.3	–0.3	0.6	0.4	2.4
Savings ratio	10.1	10.4	10.7	11.2	11.3	11.2	13.9
Unemployment, %	7.4	8.2	9.1	9.6	9.3	9.0	8.6
Govt. balance as % of GDP	–2.8	–3.7	–3.8	–3.5	–3.4	–3.5	–2.4
Govt. debt as % of GDP(b)	59.4	60.8	64.2	65.9	68.1	70.1	71.4
Current account as % of GDP	0.2	2.3	2.2	3.8	3.5	3.9	6.1
Net Overseas Assets as % of GDP	8.7	6.1	6.7	9.9	7.8	6.8	7.7

Notes: (a) Change as a percentage of GDP. (b) Maastricht definition, end–of–year basis.

year. On present trends, we expect zero annual growth in private investment this year and only very moderate growth of ½ per cent for 2006.

This outcome, however, seems slightly at odds with the investment environment currently facing German firms. In particular, profit margins are substantial, the cost of capital is very low by recent German historical standards, and, given the slack in the labour market, there is little upward pressure from real wages. This all bodes well for corporate profits and helps German firms to remain competitive. Therefore, we remain positive on investment growth over the medium term and we expect annual growth rates above 2 per cent to be strong drivers of domestic demand.

The current lack of investment spending and hiring by firms is having an impact on private consumption, which remains weaker than anticipated. And this situation is compounded by persistent uncertainties over the impact of the Hartz IV labour market reforms which have seen an increase in savings rates. Although some recent short term figures suggest that consumption has stabilised, we expect only modest annual growth of just less than ½ per cent this year and slightly higher in 2006. Given the feedback effects from investment spending to consumption, we do not expect to see healthy growth in consumption for several years.

Inflationary pressures are subsiding in most Euro Area countries, but this is most clearly evident in Germany. Core inflation has fallen in the face of weak domestic demand and a stronger euro, while headline inflation remains buoyed by volatile energy and commodity prices. We expect core inflation to grow by just less than 1¼ per cent this year and to remain subdued over the near term.

Despite a series of one–off measures and a relaxation of the fiscal pact, the German fiscal balance will remain in breach of the SGP recording a deficit of nearly 3½ per cent of GDP in 2005 and making this the fourth consecutive year of fiscal violation. Meagre government revenue growth is the result of weak domestic demand and, therefore, continued structural reform efforts remain crucial. However, with an election pending, it is unlikely that Chancellor Schröder will make any major efforts to improve the public finances. Consequently, barring any major one–off measures, we do not see a significant improvement in Germany's fiscal position in the near term.

France

French economic performance strengthened in the fourth quarter of 2004. GDP rose by around 0.9 per cent,

Table 14. France *percentage change*

	2001	2002	2003	2004	2005	2006	average 2007–2011
Consumption	2.7	1.8	1.6	2.3	2.0	2.0	2.0
Private investment	2.5	–2.5	–0.9	3.3	3.6	3.5	3.3
Government expenditure	2.5	4.3	3.1	2.9	1.3	1.3	1.9
Stockbuilding(a)	–0.5	–0.2	–0.2	1.0	–0.3	–0.2	0.0
Total domestic demand	2.0	1.5	1.4	3.6	1.7	1.9	2.2
Export volumes	1.9	1.7	–2.5	3.3	6.2	4.1	3.1
Import volumes	1.6	3.3	0.2	7.5	4.6	2.7	3.4
GDP	2.1	1.1	0.5	2.4	2.2	2.3	2.1
Savings ratio	11.5	12.1	11.1	11.4	11.5	11.4	10.2
Average earnings	4.8	4.0	2.8	3.2	3.5	3.4	3.6
Private consumption deflator	1.5	1.7	1.8	1.4	2.0	2.1	1.7
RPDI	3.3	2.5	0.5	2.6	2.1	1.9	1.6
Unemployment, %	8.7	9.1	9.8	10.0	10.2	9.9	9.3
Govt. balance as % of GDP	–1.5	–3.3	–4.1	–3.6	–2.9	–2.6	–2.0
Govt. debt as % of GDP(b)	56.5	58.7	63.7	66.1	66.5	66.0	64.5
Current account as % of GDP	2.2	1.0	0.3	–0.2	0.1	0.0	0.3
Net Overseas Assets as % of GDP	11.5	8.6	7.0	3.1	–2.2	–3.1	–2.8

Notes: (a) Change as a percentage of GDP. (b) Maastricht definition, end–of–year basis.

following an exceptionally weak third quarter. Between the third quarter of 2003 and the first half of 2004, French output has been growing at an average quarterly rate of 0.8 per cent. As in other major Euro Area countries, the external sector made a negative contribution to growth in 2004. Although French exports accelerated in the fourth quarter of 2004, export of goods and services have closed the year 2004 at only 3.3 per cent above the levels reached in 2003. Export performance has been weak over the last 5 years, and we do not expect France to regain its market share in the short term, as we reported in January Review. Imports have increased by 7.5 per cent for the year as a whole. The outlook for 2005 and 2006 remains mildly optimistic. Domestic demand should continue to underpin economic growth, with private consumption rising at an average of 2 per cent per annum, and private investment increasing at about 3½ per cent per annum over the forecast horizon. However, our short–term projections have been revised downward, owing to a less buoyant global environment, rising unemployment and deteriorating household confidence[3]. Output growth should remain around 2¼ per cent in 2005 and 2006.

French unemployment reached the critical 10 per cent threshold in February, although standardised unemployment remained at 9.8 per cent. We expect unemployment to rise by 0.2 percentage points this year but to fall below 10 per cent again in 2006. Business confidence[4] has worsened in recent months. Firms are indicating that they expect industrial production to be low or stagnant in 2005. In 2004 job creation was quite modest in the private sector despite strong output growth. In the public sector, jobs were being destroyed in order to rebalance public finances. During the previous economic boom, between 1998 and 2001, 1.5 million jobs were created, bringing down the number of unemployed by 500,000. In 2004, only 39,000 jobs were created. Retiring workers are not being replaced at a one–to–one rate in most firms, and when this occurs, younger workers are preferred. In January, for instance, the unemployment rate among the under 25 decreased by 1 per centage points.

Several factors point to an improvement of the labour market conditions in the medium term. In September 2004, the Minister of Social Cohesion, M. Borloo, announced an ambitious programme (Plan Borloo) to raise social cohesion, and, in particular, to help people living on income support back to work in short–term part–time contract in the public sector or in non governmental organisations. These measures should have a positive impact on the labour market at the end of 2005 and in 2006. In addition, the 2003 pension reform (Loi Fillon) allows people who began to work before 16 to retire before 60. Although in 2004 only workers from the depleted Second World War cohorts were affected by this arguably job–creating measure, it should have more impact in the medium term, when baby–boomers reach retiring age.

Regarding public finances, the French government has recently been adopting two seemingly irreconcilable stances. Following three years of deficit above the Maastricht threshold, the government decided to redress public finances in 2005. The 2005 Budget law, the 2005 Social Security law and the December 2004 Stability and Growth Pact included strong measures destined to cut and rationalise public spending. Among them is the decision to replace only 50 per cent of retiring public servants, and increase their salaries in 2005 by less than the inflation rate. These measures, allied to the transfer of EDF/GDF pension funds worth 0.5 per cent of GDP, would theoretically bring the French deficit back to levels below 3 per cent of GDP. The December 2004 Stability and Growth Pact projects a deficit of 2.9 per cent of GDP in 2005, 2.2 per cent of GDP in 2006 and 1.6 per cent of GDP in 2007. However, the French government is concomitantly approving laws that may result in more public spending. The above–mentioned Borloo Plan should cost about 13 bn over 5 years (4.2 per cent of GDP), 1.1 bn of which have been voted for 2005. Recent social tensions have forced the government to review its commitment to wage moderation in the public sector. In the wake of several largely followed demonstrations and strikes, the government decided to open wage negotiations with public servants trade unions. Finally, the Social Security administration[5] is anticipating a deficit of 5.4 bn for the first half of 2005, 1 bn above the amount estimated by the 2005 Social Security law for the whole year.

Our view on the outlook for public finances is circumspect, and indecision by the government is a major risk to the health of the economy. We expect the deficit to reach 3 per cent of GDP in 2005, but we do not follow the government's optimistic projections for 2006. As some of the cost–cutting measures in public healthcare management have already been implemented, and considering that the French economy should grow above 2 per cent, it is likely that public deficit will remain below 3 per cent of GDP in 2006. However, it is unlikely to improve to the extent anticipated by the Stability and Growth Pact, and should reach 2.6 per cent of GDP in 2006, before stabilising around 2 per cent of GDP in the medium term.

Italy and Spain

Spanish growth has been accelerating steadily since the second quarter of 2003, from 0.6 per cent then to 0.8 per cent in the fourth quarter of 2004. The Atocha bombing in March 2004 had a strong impact on GDP growth, which decelerated from 0.8 per cent in the first quarter of 2004 to 0.5 per cent in the second quarter. However,

Table 15. Spain *percentage change*

	2001	2002	2003	2004	2005	2006	average 2007–2011
Consumption	2.8	2.9	2.9	3.5	3.1	2.7	2.9
Private investment	2.6	–0.2	2.3	5.9	3.9	2.4	3.5
Government expenditure	3.9	4.2	3.9	4.7	3.3	2.4	2.3
Stockbuilding(a)	–0.1	0.3	0.2	0.0	0.1	–0.2	0.0
Total domestic demand	2.9	2.8	3.2	4.2	3.3	2.3	2.9
Export volumes	3.6	1.2	2.6	4.5	6.7	5.3	5.7
Import volumes	3.9	3.1	4.8	9.0	8.2	4.1	7.0
GDP	2.8	2.2	2.5	2.7	2.6	2.6	2.2
Private consumption deflator	3.3	3.4	3.1	2.9	2.5	2.0	2.3
Unemployment, %	10.6	11.3	11.3	10.8	10.2	10.2	10.2
Govt. balance as % of GDP	–0.4	–0.1	0.4	–0.3	0.2	0.3	0.1
Govt. debt as % of GDP(b)	57.5	54.4	50.7	55.3	54.8	51.9	42.8
Current account as % of GDP	–2.8	–2.4	–2.8	–3.7	–4.4	–4.4	–5.2
Net Overseas Assets as % of GDP	–28.1	–33.9	–40.0	–46.8	–55.2	–58.8	–61.2

Notes: (a) Change as a percentage of GDP. (b) Maastricht definition, end–of–year basis.

exports of services were the only component of GDP affected by this event, and recovered quickly in the following quarters of the year. The recovery of the Italian economy consolidated in the third quarter of 2004. Although GDP declined by 0.4 per cent in the fourth quarter of 2004, output rose by 1 per cent for the year as a whole after two years of sluggish growth.

As in France, economic growth in Spain has been sustained by robust domestic demand. It has also been aided by robust export performance, as we discussed in the January *Review*. Household consumption has been rising at an annual rate of around 3 per cent between 2001 and 2003. In 2004, it picked up and reached 3.5 per cent. Government consumption rose by 4.7 per cent in 2004, accelerating from the historical annual growth rate of about 4 per cent. Domestic demand is expected to rise by 3¼ per cent in 2005, decelerate by one percentage point in 2006 before stabilising just below 3 per cent on average in the medium term.

Output growth in Italy has been weak over the last 4 years, and export performance has been poor. Italian economic activity in 2004 was mostly sustained by private investment, which increased by 2.5 per cent. Government expenditures and household consumption increased at an annual rate of 1 per cent. Fundamental changes in the determinants of Italian economic activity are unlikely. Household consumption has been anaemic, in part in response to reforms in the pension system that have shifted burdens away from the state. Private consumption forecast is to increase at an annual rate of around 1 per cent in 2005 and 1½ per cent in 2006 and the medium term.

The outlook for 2005 and 2006 remains optimistic in Spain, and slightly better for Italy. Private investment is expected to support Italian growth over the forecast horizon. Private investment should rise by less than 2½ per cent in 2004, and pick up in 2005 and the medium term. However, this is well below the rate of the previous period of moderate growth, between 1997 and 2000, when investment increased by an average of 4.5 per cent per annum. Government expenditure should remain as subdued as possible due to budgetary constraints.

Table 16. Italy *percentage change*

	2001	2002	2003	2004	2005	2006	average 2007–2011
Consumption	0.8	0.4	1.4	1.0	1.2	1.5	1.5
Private investment	1.0	1.2	–2.7	2.5	2.3	3.1	3.2
Government expenditure	4.0	1.9	2.4	1.0	0.9	0.6	2.5
Stockbuilding[(a)]	–0.2	0.4	0.4	–0.5	0.2	0.0	0.0
Total domestic demand	1.4	1.3	1.3	0.8	1.5	1.6	2.0
Export volumes	1.6	–3.2	–1.9	3.2	4.9	3.7	2.7
Import volumes	0.5	–0.5	1.3	2.5	6.2	3.4	4.7
GDP	1.7	0.4	0.4	1.0	1.2	1.7	1.4
Private consumption deflator	2.8	3.1	2.5	2.2	2.1	2.2	1.4
Unemployment, %	9.1	8.6	8.4	8.1	8.2	8.5	8.3
Govt. balance as % of GDP	–2.7	–2.4	–2.5	–3.0	–3.1	–2.7	–2.2
Govt. debt as % of GDP[(b)]	110.6	107.9	106.1	105.4	105.3	103.8	99.3
Current account as % of GDP	–0.1	–0.8	–1.4	–0.5	–0.4	–0.3	–1.5
Net Overseas Assets as % of GDP	2.5	–5.6	–5.4	–0.5	–1.4	–1.8	–2.3

Notes: (a) Change as a percentage of GDP. (b) Maastricht definition, end–of–year basis.

Notes

[1] Many of the issues on Asian exchange rates are discussed in Barrell and Choy (2005)
[2] Metz et al (2004) estimate that TFP growth between 1997 and 2003 was as low as 0.8 per cent a year. This is consistent with the results we present here.
[3] INSEE survey of household confidence March 2005.
[4] INSEE survey of business confidence March 2005
[5] See www.acoss.fr. Acoss (Agence centrale des organismes de sécurité sociale) is the government agency coordinating the social security administrations (healthcare, pensions, child and family benefits).

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