Developments in the World Economy

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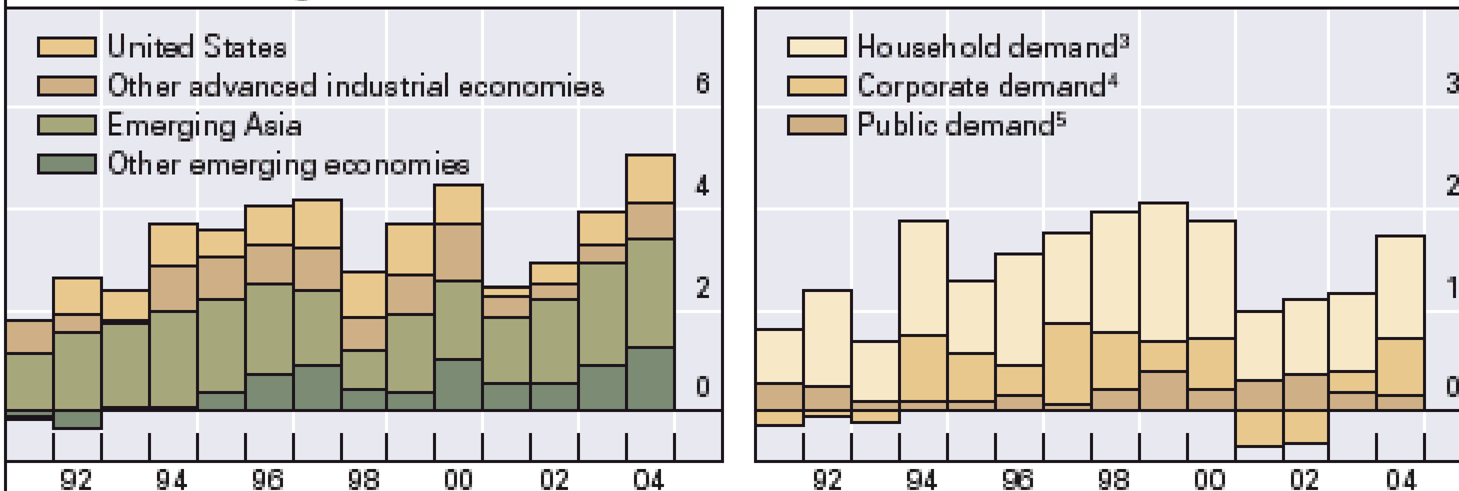
global imbalances, policy responses & pitfalls

* World demand remains unbalanced: growth slow in Euro Area, high in US and Asia; a slight recovery in Japan; and steady growth in the UK.
* Inflation is broadly stable but higher oil prices are squeezing margins.
* Unemployment remains high in Europe.
* Tighter monetary and fiscal policies likely over next couple of years, along with a falling dollar.
* The main possible pitfalls for the world economy are posed by housing markets, oil prices, and China-US imbalances.

recent growth performance

Contributions to world growth[1]

By economy/region | By demand component[2]



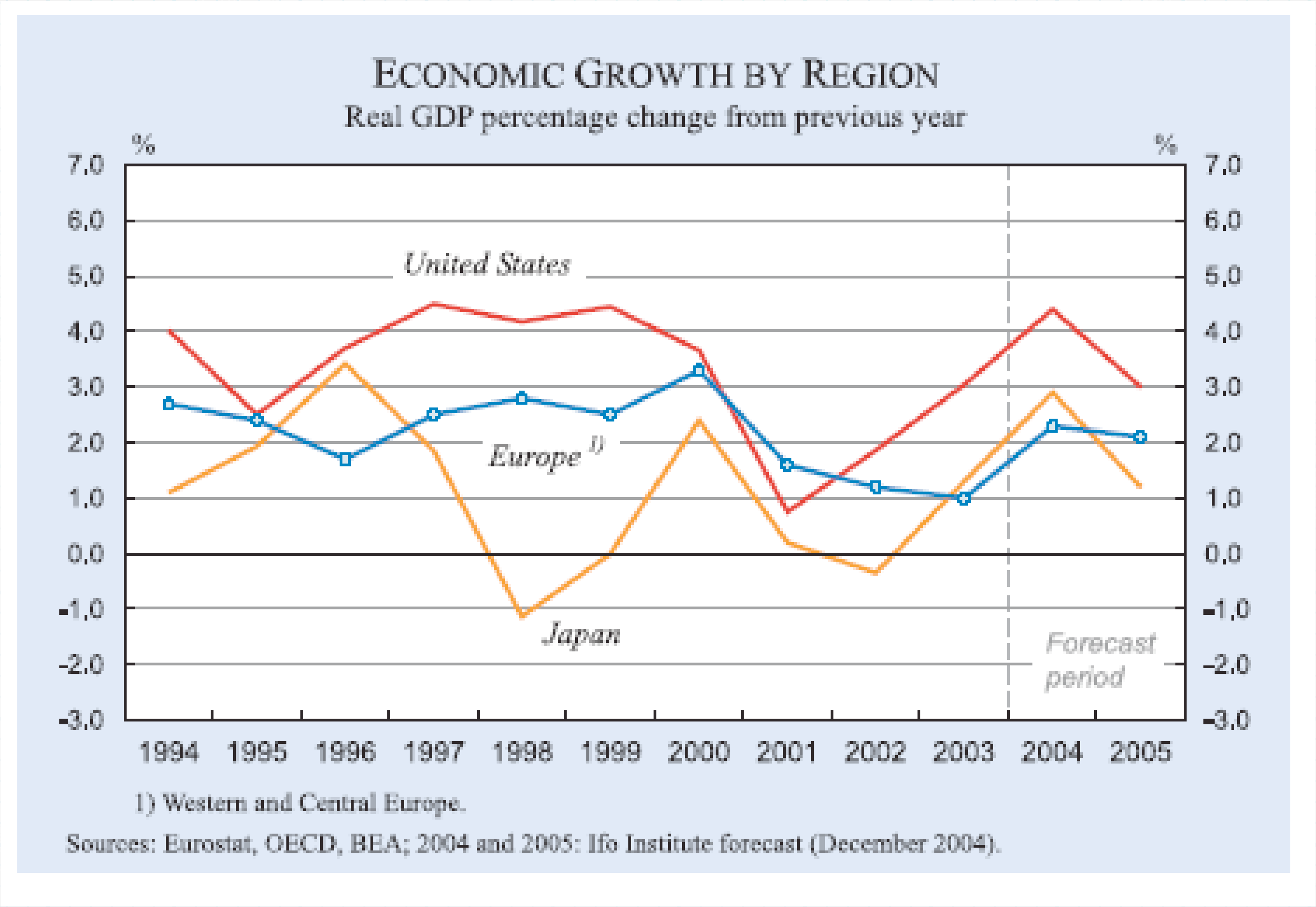
[1] In percentage points. [2] Advanced industrial economies. [3] Private final consumption expenditure plus private residential gross fixed capital formation. [4] Private non-residential gross capital formation. [5] Government final consumption expenditure plus government gross fixed capital formation.

Sources: IMF; OECD; national data.

Graph II.1

Source: BIS 75th Annual Report.

not much sign of a European recovery

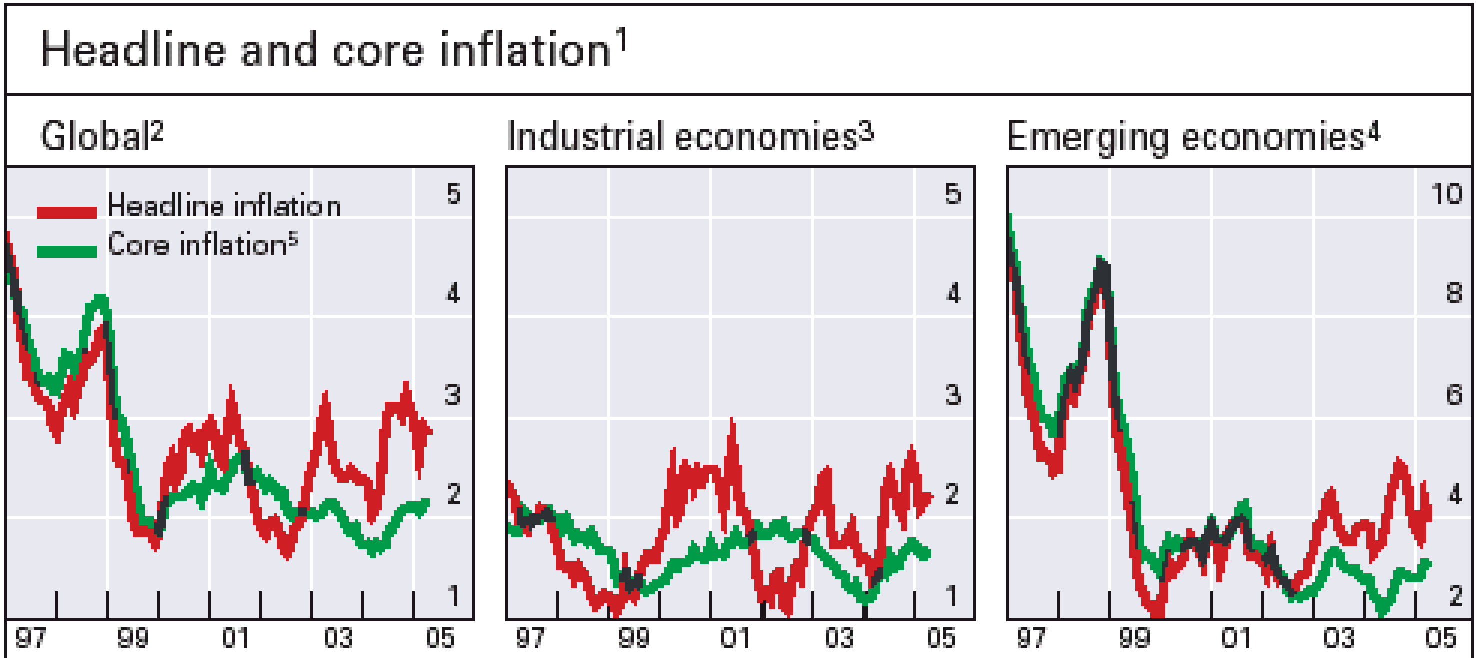


Source: CESifo Report on the European Economy 2005

the Phillips Curve

* In 1958, A.W. Phillips of the LSE found relation an empirical relationship between unemployment and inflation in the UK - the Phillips curve.
* Original interpretation:
  – There is a permanent trade-off between inflation and unemployment.
* Problem:
  – After sustained inflation, the empirical relationship broke down.
* New interpretation:
  – There is a trade-off between unemployment and unexpected inflation in the short-run.
  – But in the long-run, there is no such trade-off.

not much sign of inflationary pressure



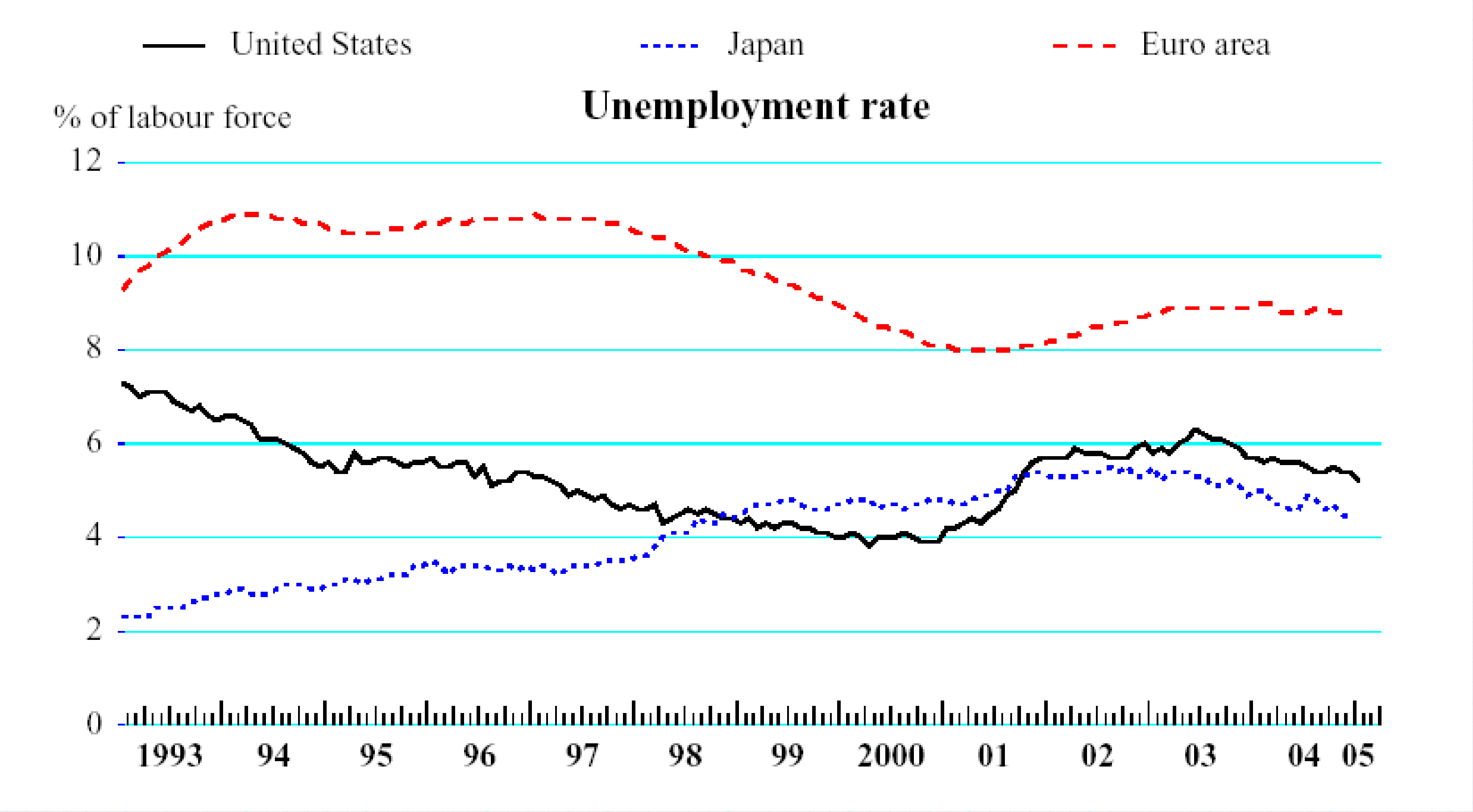
1 Uncentred 12-month moving averages of annualised monthly changes in consumer prices, in per cent; weighted averages based on 2000 GDP and PPP exchange rates. 2 Industrial and emerging economies cited. 3 Canada, Denmark, the euro area, Japan, Norway, Sweden, the United Kingdom and the United States. 4 Brazil, Chile, China, Hungary, India, Indonesia, Korea, Mexico, Poland, South Africa and Thailand. 5 CPI excluding food and energy components.

Sources: OECD; CEIC; national data; BIS calculations.

Graph II.4

Source: BIS 75th Annual Report.

unemployment remains high



Source: OECD Interim Economic Outlook 2005

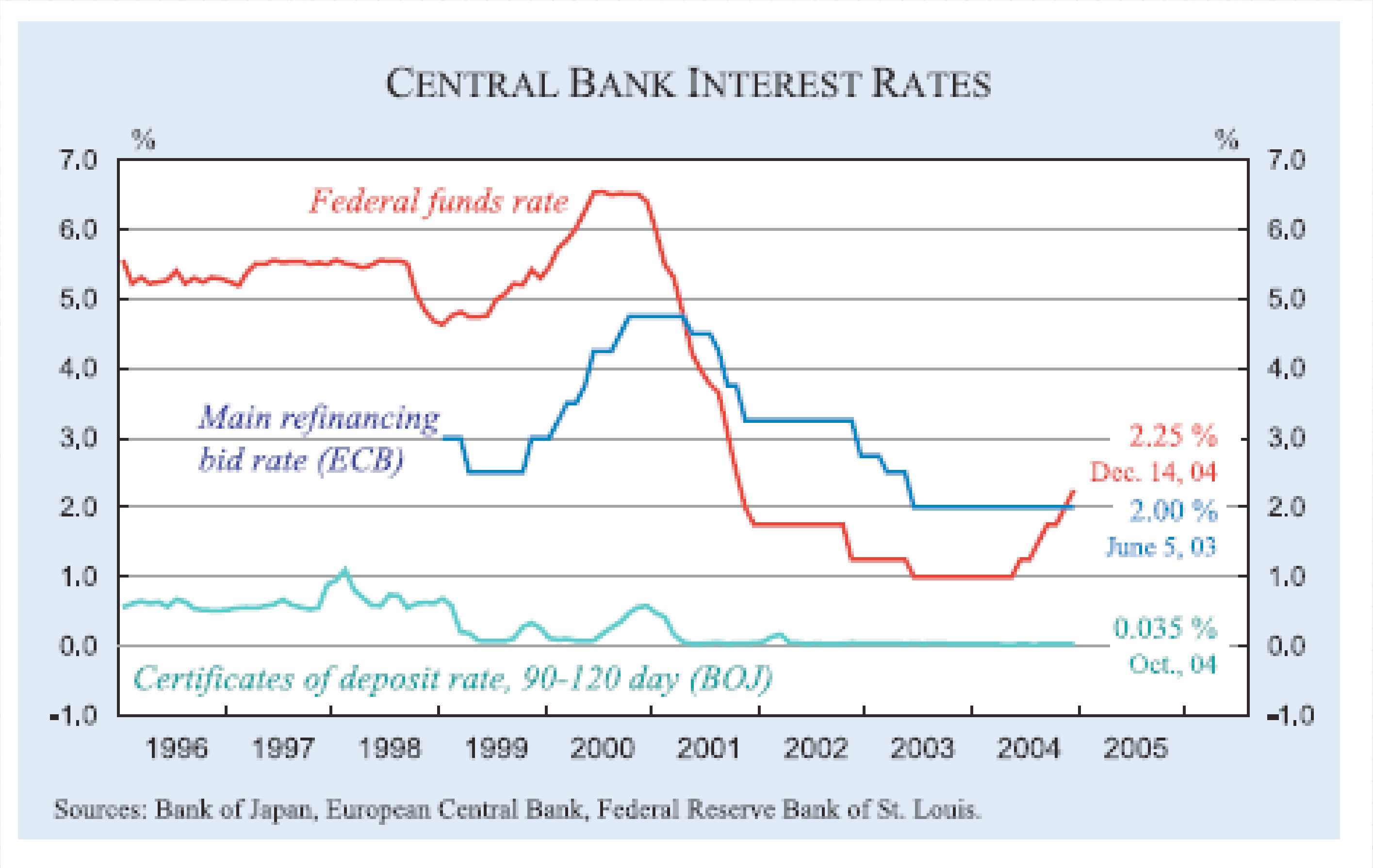
Taylor rules and inflation targeting

* After the inflationary difficulties of the 1970s and 1980s, many countries moved towards having independent central banks and the use of inflation targets.

* This form of 'constrained discretion' seems to work because it takes control of monetary policy out of the hands of politicians!

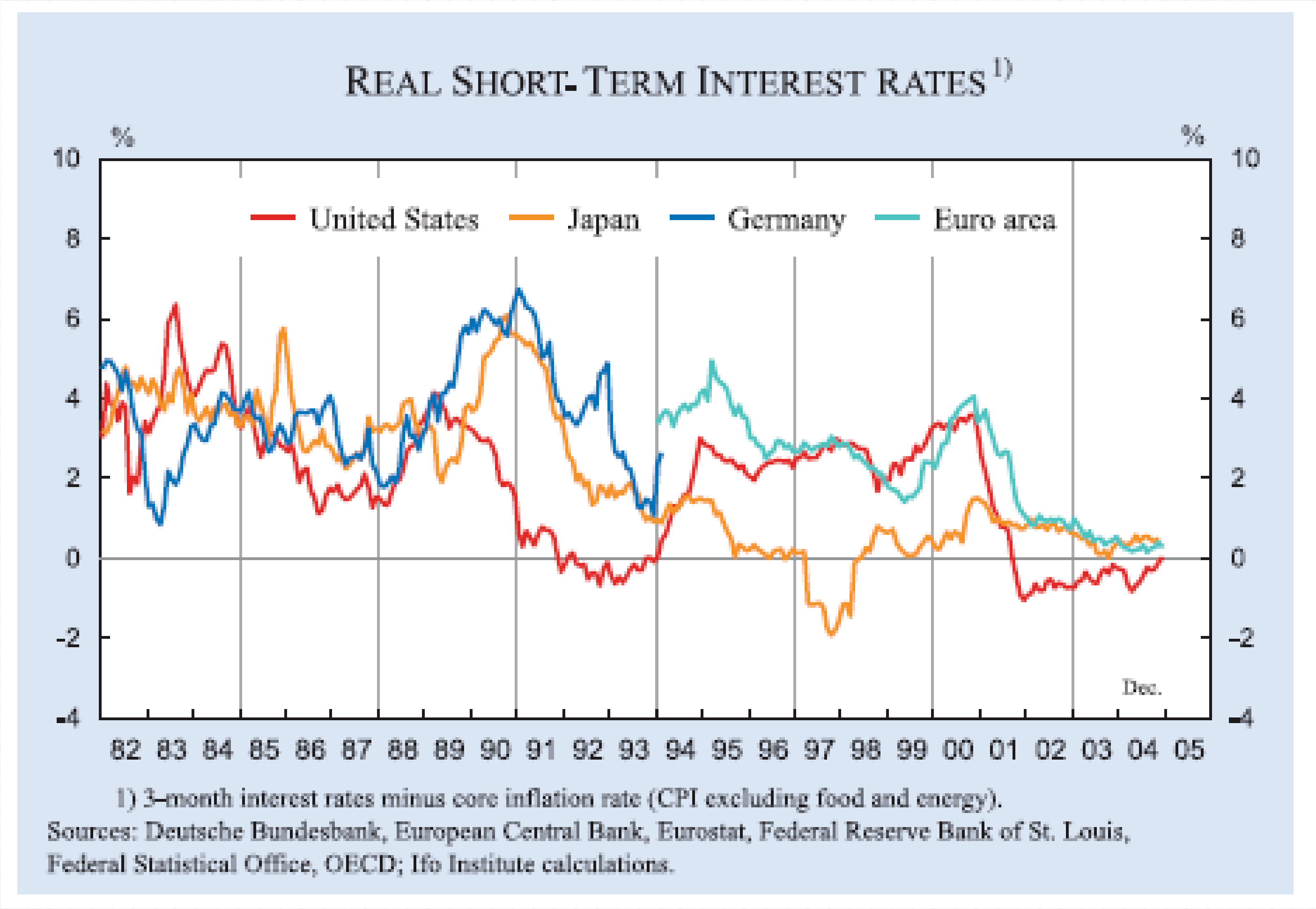
* In practice, most monetary authorities operate something called a 'Taylor rule.' That is, they raise the real interest rate (the nominal rate minus expected inflation) whenever inflation is above target or when capacity constraints appear in the economy (since these may predict future inflation).

recent loose monetary policy



Source: CESifo Report on the European Economy 2005

...even on a real basis



Source: CESifo Report on the European Economy 2005

fiscal rules

* Even now that most monetary policy is conducted by independent monetary authorities, there is still the problem that politicians may pursue fiscal policies that are incompatible with stable inflation.

* Consequently, some countries have adopted fiscal rules. The two most famous are:

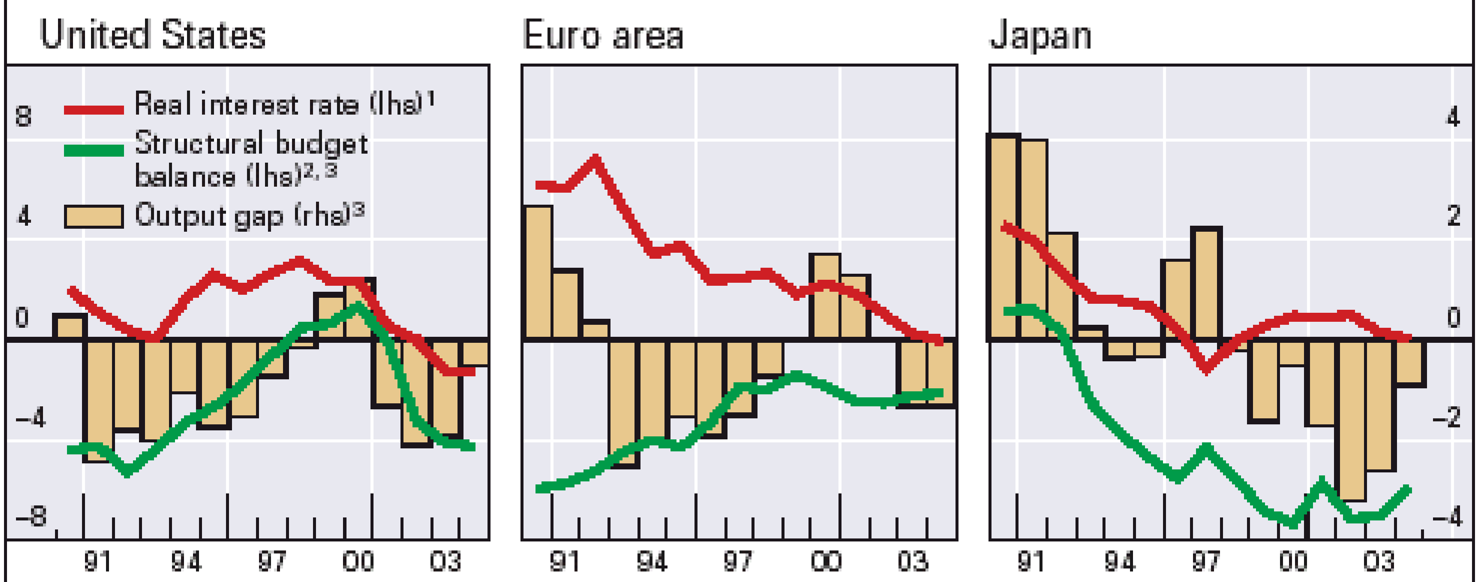
  – The Stability and Growth Pact (revised!): countries should aim to run no more than a 1% deficit over the business cycle; cannot borrow more than 3% of GDP (cf. France and Germany!) in any one year; government debt should be kept below 60% of GDP.

  – Gordon Brown's Golden Rule: over the business cycle borrowing should equal net government investment; government debt should be kept below 40% of GDP

* Both of these are showing signs of strain. Experience suggests rules better formed as symmetric target zones.

breaking the rules?

Real interest rate, structural budget balance and output gap



[1] Short-term interest rate deflated by annual consumer price inflation. [2] General government cyclically adjusted financial balance. [3] As a percentage of potential GDP.

Sources: ECB; OECD; Eurostat; national data.

Graph II.3

Source: BIS 75th Annual Report.

current forecasts

Table 1.2. Advanced Economies: Real GDP, Consumer Prices, and Unemployment
(Annual percent change and percent of labor force)

	Real GDP				Consumer Prices				Unemployment			
	2002	2003	2004	2005	2002	2003	2004	2005	2002	2003	2004	2005
Advanced economies	**1.6**	**2.1**	**3.6**	**2.9**	**1.5**	**1.8**	**2.1**	**2.1**	**6.4**	**6.6**	**6.3**	**6.1**
United States	1.9	3.0	4.3	3.5	1.6	2.3	3.0	3.0	5.8	6.0	5.5	5.4
Euro area[1]	0.8	0.5	2.2	2.2	2.3	2.1	2.1	1.9	8.5	8.9	9.0	8.7
Germany	0.1	−0.1	2.0	1.8	1.3	1.0	1.8	1.3	8.7	9.6	9.7	9.5
France	1.1	0.5	2.6	2.3	1.9	2.2	2.4	2.1	8.9	9.4	9.4	9.0
Italy	0.4	0.3	1.4	1.9	2.6	2.8	2.1	2.0	9.0	8.7	8.3	8.2
Spain	2.2	2.5	2.6	2.9	3.9	3.0	2.8	2.7	11.4	11.3	11.1	10.3
Netherlands	0.6	−0.9	1.1	1.8	3.9	2.2	1.4	1.1	2.5	4.3	5.3	5.8
Belgium	0.7	1.1	2.5	2.3	1.6	1.5	1.8	1.6	7.3	8.1	8.3	8.3
Austria	1.4	0.7	1.6	2.4	1.7	1.3	1.7	1.6	4.3	4.4	4.4	4.2
Finland	2.3	2.0	2.8	2.6	2.0	1.3	0.1	1.3	9.1	9.0	8.8	8.5
Greece	3.9	4.3	3.9	3.0	3.9	3.4	3.3	3.4	10.0	9.0	8.9	8.8
Portugal	0.4	−1.2	1.4	2.2	3.7	3.3	2.5	2.2	5.1	6.4	7.1	6.8
Ireland	6.1	3.7	4.7	5.0	4.7	4.0	2.3	2.1	4.4	4.7	4.4	4.1
Luxembourg	1.7	2.1	2.8	3.4	2.1	2.6	2.1	2.0	2.9	3.8	4.5	4.8
Japan	−0.3	2.5	4.4	2.3	−0.9	−0.2	−0.2	−0.1	5.4	5.3	4.7	4.5
United Kingdom[1]	1.8	2.2	3.4	2.5	1.3	1.4	1.6	1.9	5.2	5.0	4.8	4.8
Canada	3.4	2.0	2.9	3.1	2.3	2.7	1.9	2.2	7.7	7.6	7.2	6.8
Korea	7.0	3.1	4.6	4.0	2.8	3.5	3.8	3.8	3.1	3.4	3.5	3.6
Australia	3.8	3.0	3.6	3.4	3.0	2.8	2.8	2.5	6.4	6.1	5.7	5.7
Taiwan Province of China	3.6	3.3	5.6	4.1	−0.2	−0.3	1.1	1.5	5.2	5.0	4.7	4.5
Sweden	2.1	1.6	3.0	2.5	2.0	2.3	0.9	1.4	4.0	4.9	5.6	5.0
Switzerland	0.2	−0.5	1.8	2.2	0.6	0.6	0.7	0.8	2.5	3.5	3.4	3.0
Hong Kong SAR	1.9	3.2	7.5	4.0	−3.0	−2.6	—	1.0	7.3	7.9	6.7	5.8
Denmark	1.0	0.5	2.1	2.5	2.3	2.1	1.7	1.8	4.9	5.8	5.9	5.6
Norway	1.4	0.4	2.7	2.7	1.3	2.5	0.5	1.8	3.9	4.5	4.3	4.0
Israel	−0.7	1.3	3.6	3.5	5.7	0.7	−0.3	1.4	10.3	10.8	10.7	10.1
Singapore	2.2	1.1	8.8	4.4	−0.4	0.5	1.8	1.6	4.4	4.7	4.3	3.9
New Zealand[2]	4.3	3.4	4.2	2.0	2.7	1.8	2.4	2.8	5.2	4.7	4.6	5.0
Cyprus	2.0	2.0	3.0	3.5	2.8	4.1	2.2	2.6	3.2	3.5	3.4	3.2
Iceland	−0.5	4.0	4.4	5.3	4.8	2.1	3.3	3.2	2.5	3.3	3.0	2.3
Memorandum												
Major advanced economies	1.2	2.2	3.7	2.9	1.3	1.7	2.1	2.1	6.5	6.7	6.4	6.2
Newly industrialized Asian economies	5.0	3.0	5.5	4.0	0.9	1.4	2.4	2.6	4.1	4.3	4.1	4.1

[1]Based on Eurostat's harmonized index of consumer prices.
[2]Consumer prices excluding interest rate components.

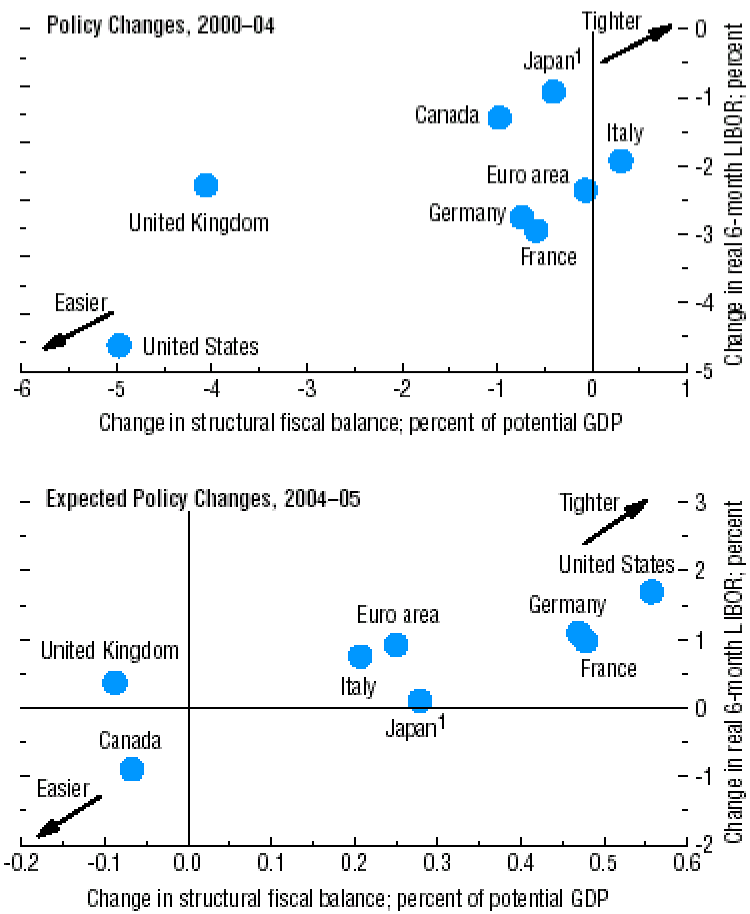
Source: IMF World Economic Outlook September 2005

cheap money is on the way out

* World monetary policy has been extraordinarily relaxed since 2000, with interest rates bottoming at around 0% in Japan, 1% in the USA and 2% in Euroland.
* But Alan Greenspan is committed to measured tightening, raising rates from 1% in June 2004 to their current 3.5%. Rates have also risen in the UK, Australia and Canada.
* Curiously though, yields on government bonds remain subdued. Some have tried to label this as either a global savings glut (especially in Asia) or an investment shortfall (especially in the US and Europe). The question is, will it persist?
* Meanwhile, in Japan and Europe, limited signs of economic recovery have not yet led to any decisive moves in monetary policy.

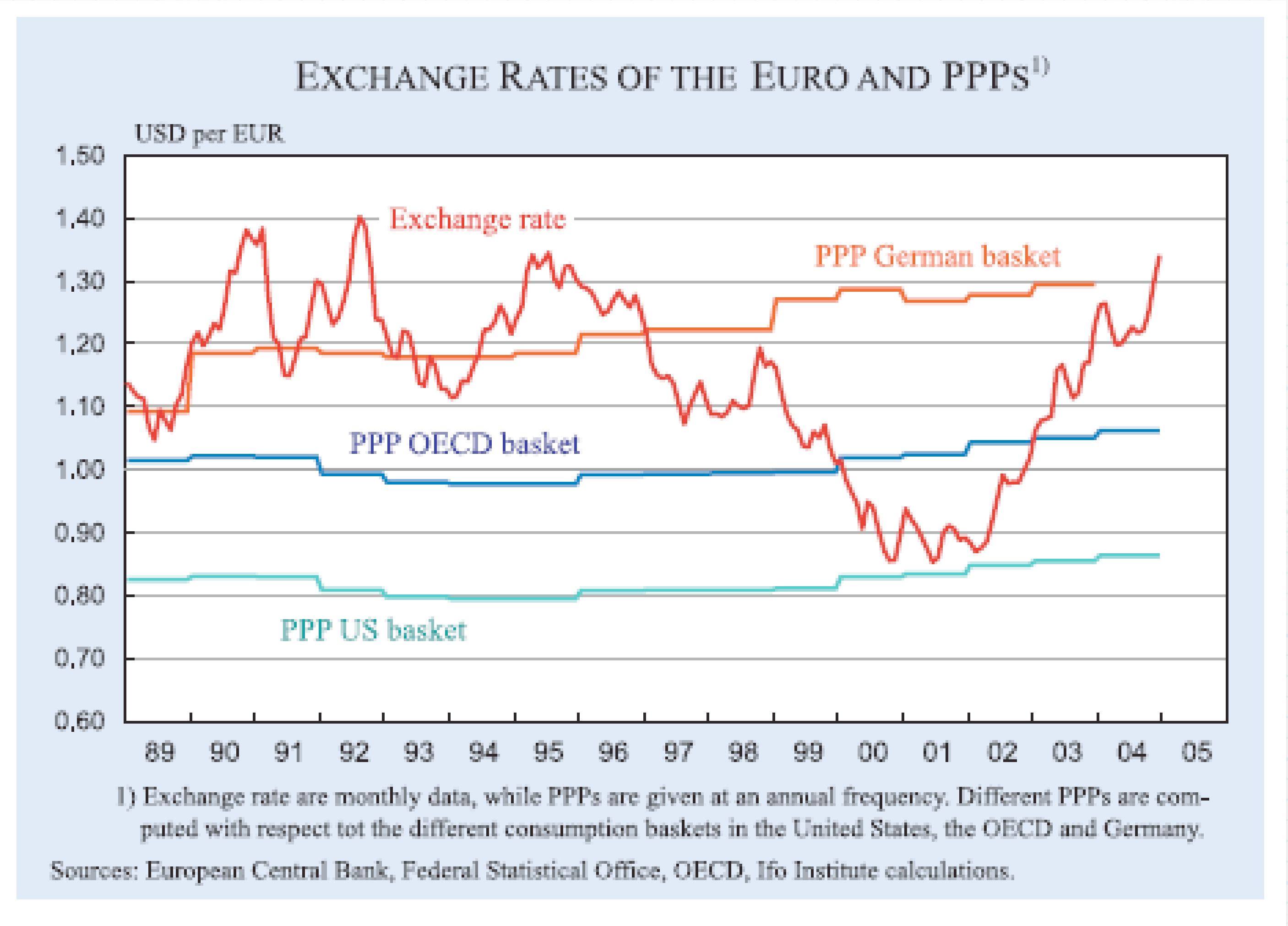
Figure 1.8. Fiscal and Monetary Easing in the Major Advanced Countries

Monetary and fiscal policies in most industrial countries are projected to tighten in 2005, most rapidly in the United States.



Source: IMF staff estimates.
[1]For Japan, excludes bank support.

the dollar weakens...



Source: CESifo Report on the European Economy 2005

house price bubbles?

* House price bubbles arguably exist in Canada, Ireland, Spain, Sweden, the United Kingdom and the United States. In the UK, house prices have doubled since 1999 only slowing since last summer.

* In the first quarter of 2005, double-digit house-price inflation was evident in 23 states of the USA plus the District of Columbia, as noted by Stephen Roach of Morgan Stanley.

* A recent paper by the BIS argues that a 1 percentage point rise in the short-term real interest rate reduces prices over a five-year period by more than 1.25% in German-style markets, 1.8% in US-style markets and 2.6% in UK-style markets.

* However, this likely understates the risks in those countries that are currently overvalued, since falling house prices can create their own feedback loops as expectations collapse and bank lending shrinks.

* Full-blown house price crashes might reduce growth by ½-¾ of a percentage point for a couple of years.

a Japan style meltdown?

* Fortunately for the slow-growing euro area economies, given their general lack of housing bubbles, the ECB should not face too many problems.

* US-style markets are rather more risky since the housing bubble has allowed households to become highly geared. When house prices fall, it is likely that households will want to rebuild their balance sheets and that real consumption will be affected. However, mortgage-backed securities (MBS) tend to spread the risk of house price falls throughout the financial system, although in the USA there are question marks about the roles played by the two federal institutions - Fannie Mae and Freddie Mac and there has been a recent rise in adjustable-rate mortgages & housebuying by investors.

* The most exposed markets are those, like the UK, where households typically hold a great deal of floating rate debt. The joint consequences of rising mortgage payments and falling house prices could be severe, especially if the financial system itself comes under stress due to the link between falling house prices and shrinking bank credit.

effects of the oil shock

Stagnation

- The oil shock reduces domestic demand in oil-importing countries, with a windfall transfer of income to oil-exporting countries.

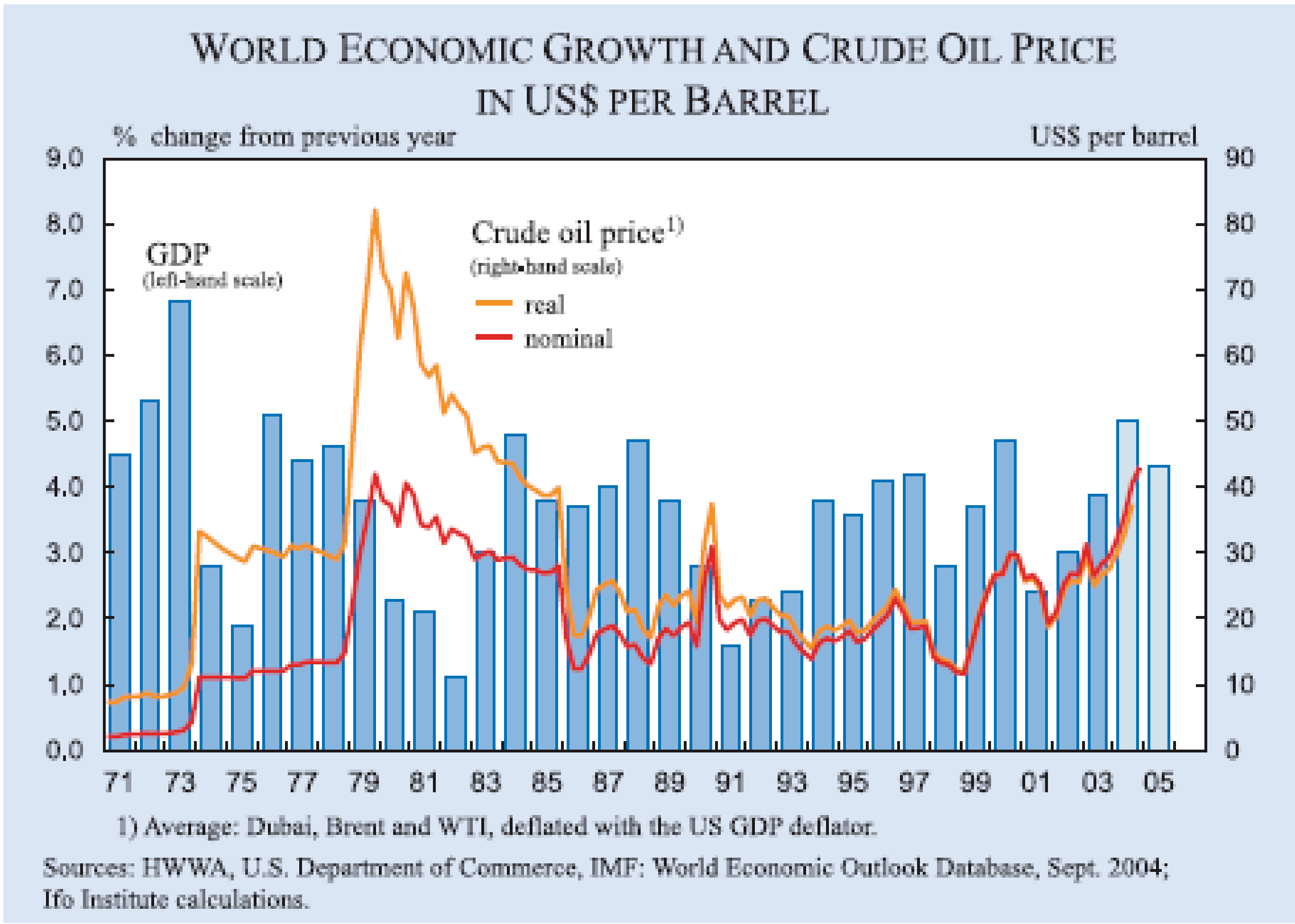
+Inflation

- The oil shock also puts upward pressure on inflation in oil-consuming industries.

=Stagflation

- Since real wages and real profits fall, it is also likely that equilibrium unemployment will rise.

oil shocks and GDP growth



Source: CESifo Report on the European Economy 2005

oil prices and inflation

Episodes of rising commodity prices and inflation

[1] World market; raw materials; in terms of US dollars. [2] Goods and services. [3] All urban consumers.
[4] Zero quarters correspond to 1973 Q4 (first oil shock), 1978 Q4 (second oil shock) and 2003 Q1 (current).

Sources: Hamburg Institute of International Economics (HWWI); national data. Graph II.5

Source: BIS 75th Annual Report.

global policy

* US needs a lower real exchange rate, higher real interest rates, and a lower government deficit - this would help to correct the trade deficit and crowd investment and exports back in. The UK needs this to a lesser extent.

* The counterpart of the US situation is that the euro area and Japan will have to accept higher real exchange rates. To some extent they also need lower real interest rates and larger government deficits, although these may be difficult to achieve. It is possible that euro area domestic demand could rise enough to boost euro area output and stabilize world output.

* China would also benefit from a higher real exchange rate and a higher real interest rate to help combat inflationary pressures. The Chinese economy also needs a gradual movement to market-based capital allocation and banking reform.

global pitfall summary

* Over-valued housing markets pose substantial risks in a number of countries, especially Australia, Canada, Ireland, Spain, Sweden, the United Kingdom and the United States.
* As interest rates rise over the cycle, there will be downward pressure on house prices and there is a risk that a number of housing bubbles will burst.
* This in turn will pose risks to the financial system and to macroeconomic policy, although given that the inflation outlook is still fairly benign there is scope for appropriate policy responses.
* There are also risks to financial markets. A fall in US asset prices could lead to a credit contraction elsewhere, and a big rise in US bond yields might raise bond yields across the whole world.
* Given the likelihood of a 'flight to quality', this would be especially marked for developing countries and other low grade debt (q.v. the Peso crisis of 1994), even if the effect on the US is only transitory.

more potential pitfalls

* Continued high and volatile oil prices - central banks have to choose whether to cut rates to boost growth or to raise rates to curb inflation, not an easy choice!
* In Europe, economic prospects are dependent upon the success of of structural reforms and the reform of the Stability and Growth pact. Failure might lead to the break-up of the Euro!
* China needs to take action to deal with problems in its banking system and with inflationary pressure;
* But...while the US continues to run such large 'twin deficits', there is the possibility of a disorderly correction to world imbalances.

syndicate topics

* How does monetary and fiscal policy affect demand in the economy?
* What is the trade-off between inflation and unemployment?
* How do central banks set interest rates?
* Which industries are most exposed to the effects of the oil shock?
* Which are most exposed to housing market risk?