Global Macroeconomic Scenarios and World Trade Statistics and Forecast

for the

Panama Canal Authority

Contract SAA-146531

Global Macroeconomic Outlook:

Baseline Case

- World
- United States
- Canada
- Japan
- China
- Taiwan
- Hong Kong
- S. Korea
- United Kingdom
- Germany
- France
- Italy
- Venezuela
- Ecuador
- Chile

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TABLE OF CONTENTS

Executive Summary of the Project

The Panama Canal Authority (ACP) contracted with Global Insight in 2005 to update macroeconomic forecasts that were produced in 2001 for the ACP. At that time, the project, carried out under the corporate name of Global Insight, Inc., included the development of a baseline, or best estimate, of the long-term macroeconomic trajectory for the world, with a focus on particular nations of importance to the Canal. Additionally, Global Insight developed a more optimistic scenario as well as a more pessimistic one, and, consistent with each of these 3 scenarios, world sea trade projections were developed as inputs to the ACP's transit forecasting work.

In the current study, Global Insight developed 3 macroeconomic scenarios as well but used the latest versions of its econometric models, and updated historical databases. Also, the models themselves have been restructured to reflect economic developments in the last 4 years. The new scenarios are, then, fresher and they portray a more positive world outlook, in general, although the risks to the baseline forecast are many. No corresponding trade scenarios were developed for the best and worst cases; the trade projections provided in this study were based on the most probable, baseline, macroeconomic scenario.

General Methodology

This study was carried out using the latest econometric models and data available at Global Insight. It used the latest U.S. macroeconomic model with the most current values for all macroeconomic variables that tend to influence global markets at the local (U.S.) and international levels. The development of the study consisted primarily of three parts. For each country, Global Insight used its own country model and the most current information regarding economic, political, and social climate in each country and developed a baseline forecast – the most probable case. This forecast provides Global Insight's most recent expectations about these economies in the short, medium, and long terms. Second, we modified each country's model to incorporate a new set of positive assumptions (described below) regarding the most probable case and evaluated the results. These results were defined as the "Best Case". Third, we modified each country's "Most Probable" base case model to incorporate a new set of negative assumptions (described below) regarding the "Most Probable" case and evaluated the result. These results were defined as the "Worst case".

In developing the Most Probable Case, Global Insight first researched all economic conditions at a particular point in time and created a "present day" economic reality, and calibrated each country model to "present day" conditions. Then, Global Insight made several assumptions regarding the immediate future based on current data. Finally, we extended this forecast to the year 2025. In turn, the economic projection has a short term, based on current expectations and a long term projection based on long term trends. For example, we first look the current situation of the US and created a current-day scenario based on the extent of the economic recession and the impact of the terrorist attacks. Based on current assumptions we then developed a forecast for the short term and then extended the forecast to the year 2025.

Below is a summary of the short, medium, and long term outlooks for world economic growth under the base case, or most probable case. Global Insight assigns a 70% probability to this case.

Short-term World Growth

Global Insight's latest detailed baseline forecast projects world economic growth moderating to 3.9% year on year (y/y) in the third quarter of this year, after having peaked at 4.5% during the preceding quarter. The forecast calls for growth to moderate further, to 3.5% y/y in the fourth quarter and 3.3% by the final quarter of 2005. The forecast calls for average annual growth rate to decelerate from 4.2% in 2004 to 3.4% in 2005 and 3.2% in 2006.

The 2001 was completed during a recessionary period, which is now finished. Indeed, many economies, and principally the U.S., have rebounded well since then, and even the terrorist attacks of 2001 did not, in the end, set the U.S. back. Even corporate scandals in 2004-05 did not stop the US consumer from continuing his spending spree. Leading up to the early-2005 date of this study, the world's economies saw strength that had been missing for many years in most regions; and now, we see some areas of strength such as the U.S., and some "soft patches" including Europe and Japan. The huge US budget and trade deficits have also influenced the short-term, and the long-term, outlooks for that economy, and the dollar's steady decline will continue to shift the economic focus to matters of world trade and the importance of oil.

Medium-term World Growth

After five years of weak or uneven growth during 1998-2003, the global economy is now in the midst of a period of above trend performance. Global Insight's latest detailed forecast, which was completed in January, 2005, projects that the world economy will maintain an above-trend rate of growth for several more years, before edging back to its trend growth rate of 3.1% per year. Our projected average annual growth rate for the five years from 2004 through 2008 is 3.4%, compared with 2.6% for the preceding five years (1999–2003).

Long-term World Growth

The world economy's long-term growth prospects are generally favorable, but they are not so rosy as they appeared to be during the 1990s, when energy prices were low and the Soviet Union's collapse along with the prospects of economic reform in the former Communist world led to widespread euphoria about "a new world order." The current outlook appears even more sober when it is contrasted with the spectacular economic growth projections that were popular during the heyday of "new economy" in the late 1990s.

It is now widely accepted that the "new" economy operates on exactly the same principles as the "old" economy. While technological improvements in computers, telecommunications, biology, and other fields will likely lead to spectacular results in some sectors, their impact on overall economic growth will not be spectacular. Furthermore, the American economy's impressive productivity gains during the last ten years now appear to have been mainly the cumulative results of the country's market deregulation and corporate-sector restructuring in the 1980s, global trade liberalization in the 1990s, and an overinvestment binge in the 1990s, rather than any "new economy" magic.

Global Insight's latest detailed forecast of the world economy's GDP projects an average annual trend growth rate of 3.1% for the 20-year period through 2025. This is roughly in line with the average global growth for the past 30 years. (Unless noted otherwise, all world and regional GDP growth rates are based on country GDP numbers converted to US dollars at market exchange rates. Based on purchasing power parity exchange rates, the global economy's trend growth rate would be 3.8%.)

The key economic ***growth drives*** underlying the forecast is the productivity gains from new technological advances which will moderate the impact of the secular slowdown in factor accumulation. In other words, a combination of capital and labor productivity improvements—resulting from technological breakthroughs, incremental advances in production processes, and improvements in business organization and management techniques—would in the long term compensate for the slowdown in labor supply growth (due to demographic trends) and capital stock growth (due to a lower global savings rate). This is an important, even fundamental point, concerning the long-term structure of the world economy.

Other factors that affect the long-term economic picture, and that serve as growth drivers to the forecast, are listed below.

- Aggregate world population growth will continue its gradual, secular long-term decline, from 1.2% per year in recent years to 0.8% in 2025.
- Domestic saving rates increase as incomes rise in the early stages of economic development, but they moderate and decline in the later stages.
- The world economy will not face any extended, severe petroleum shortages over the next 25 years. Indeed, Global Insight believes there is plenty of oil still waiting to be discovered, on top of the huge quantities in previously discovered fields waiting to be developed.
- Crude oil prices will decline from their current, artificially-high levels over the next ten years, but recover gradually as OPEC's excess capacity fades away.
- The global economy will not fall into a deflationary trap. The current pockets of deflation will disappear during the next few years as the world recovery advances.
- The major industrialized countries do not allow their commercial disputes to frustrate global trade liberalization or to degenerate into a major, competitive trade war. In short, incremental trade liberalization will continue.
- After completing their current recovery, non-oil primary commodity prices will resume their secular long-term decline.
- Emerging markets will not backtrack on their economic reforms on any large scale, but instead will continue the trend toward greater openness, deregulation, and privatization.
- The global trend toward more flexible exchange rate regimes and greater capital mobility will continue without any major backtracking.
- Most industrialized countries will not completely shut their doors to immigration, but will become more selective in their immigration policies.

- There will not be any global calamity that depresses world population or capital stock, or leads to a prolonged depression in world output, such as a world war, medieval-scale plagues or epidemics, a giant meteor crash, or other planetary-scale disasters.

The projected regional pattern of growth is very similar to that of the last 20 years.

Selected Country and Regional Summaries

Among industrialized regions, the **United States and Canada** will remain the growth leaders thanks to a combination of favorable demographic factors, abundant natural resources, efficient financial institutions, high rate of immigrant absorption, huge market size, science and technology leadership, and a tremendous capacity for innovation and entrepreneurship. North America's more mobile workers and flexible labor markets are another strong competitive advantage over other major industrialized regions. Still another key factor in North America's superior economic performance is its relatively dynamic political and social institutions, particularly at the grassroots level. Thanks to these advantages, North America's economic long-term growth will easily outpace those of Western Europe and Japan and will remain the world's primary oil importer.

Western Europe and Japan will have major problems keeping up with North America. First, their demographic and natural resource endowments are not as favorable. Second, their markets are generally not as open or as flexible. Third, they are less attractive to skilled immigrants and less effective in integrating them. Fourth, their labor force is less mobile. Fifth, their political and social institutions are less dynamic. Finally, economic growth in both regions is to some extent constrained by burdensome social-welfare programs that will become more severe over the next few decades with the aging of their populations.

Western Europe's economic problems are of course in many ways quite different from those of Japan. For one thing, Western Europe is a much more heterogeneous society. The **United Kingdom** in particular is relatively more dynamic than the "old Europe" economies of Germany, France, and Italy. In addition, there is a substantial amount of cultural and ethnic diversity within Europe that reinforces the problems stemming from historical animosities and political and language barriers. While the European Union (EU) has broken most of the economic barriers among its current 15 member states, it has created other problems by imposing various centralized bureaucratic superstructures on the members. The cumbersome EU decision-making processes have made European political and social institutions less dynamic. Similarly, the European Monetary Union (EMU) and the EU Stability and Growth Pact have made European macroeconomic policy far too rigid. These institutional rigidities, which could become more acute as the European Union adds 15 new members to its roster in expanding eastward, will be a significant drag on the long-term growth of Germany, France, and Italy.

Among emerging-market regions, Asia and Oceania, led by non-Japan Far East, will continue to have the highest growth rates. In particular, the economic bloc known as "Greater China"—made up of the increasingly integrated economies of **China, Hong Kong, and Taiwan**—should be a growth leader. As in the past several decades, this is mainly due to the region's combination of openness to trade, high domestic saving rates, and a relatively well-educated labor force. Thanks to these favorable factors, Asia and Oceania is likely to receive the bulk of global foreign investment flows over the next few decades and is destined to become the world's dominant manufacturing center and the main consumer of non-oil primary commodities.

A summary of China's position now and how it has changed since 1980 can be seen in this table, showing the dramatic rise in consumerism, income, and exports.

	1980	2004
Real GDP per capita (2004$ billions)	181	1,597
Relative real GDP (% of U.S. level, 2004$)	3%	14%
Real GDP growth in previous 10 years	5.3%	8.6%
Population (millions)	981	1,300
Real per capita GDP (2004$)	171	964
Trade's share of GDP	15%	85%
Number of super markets	0	70,000
Current account surplus ($ billions)	1	14
Agriculture's share of GDP	30%	15%
Urbanization	20%	33%

The momentum of the last 5 years will be difficult to slow down; nevertheless, Global Insight assumes a moderate slowdown in China's growth, without a hard landing. The modification to the exchange rate procedures reinforces our thinking that a soft landing is feasible from the current heights.

If political and military risks stymie China's growth, however, **India** has the potential to become the dominant destination for foreign investment. Over the next few decades, India should be able to sustain a growth rate of 5% per year, but with accelerated economic reforms it has the potential to grow at 7-8%. Unfortunately, India's outlook also faces two major risks. India's tense relations with Pakistan could escalate into a regional nuclear Armageddon, and its internal Hindu-Muslim religious divide could degenerate into a fratricidal civil war.

Meanwhile, the Far East consumer sector continues to grow, and as incomes are expected to rise, so will purchases of consumer goods, especially automobiles. The economies represented in the following table are all expected to see improved domestic conditions in the baseline scenario, and consumers are spending large portions of their incomes and prior-year savings on automobiles and SUVs. In the Global Insight forecast of vehicle sales, below, China is rapidly approach Japan and will surpass it by 2006.

Note: In the table below, LCVs (Light Commercial vehicles) are all the trucks, SUVs and Vans with Gross Vehicle Weight of less than 6 metric tons. HCVs are all the Heavy Commercial Vehicles which includes heavy trucks and buses.

Vehicle Demand Overview - All Asia 2004, 2005, and 2010

(Thousands)

Country	CAR			LCV			HCV			ALL VEHICLES		
	2004	2005	2010	2004	2005	2010	2004	2005	2010	2004	2005	2010
Japan	4768	4809	5116	962	961	1014	124	118	117	5854	5888	6246
Korea	880	974	1214	203	215	293	38	39	41	1122	1228	1548
China	2471	2692	4172	2091	2211	2864	637	631	634	5199	5534	7671
India	804	912	1701	350	417	643	185	178	195	1340	1508	2539
Thailand	207	212	327	402	451	586	17	19	21	626	682	933
Malaysia	388	393	510	97	116	155	3	4	6	488	513	671
Taiwan	389	405	490	87	92	88	9	8	10	485	505	588
Indonesia	88	97	172	357	398	504	38	44	63	484	539	740
Philippines	34	37	83	53	55	102	2	2	3	88	94	188
Australia	593	596	620	343	372	429	19	16	16	955	984	1064
Pakistan	96	103	123	29	31	36	4	4	6	130	138	164
OTHERS	186	183	211	67	68	91	13	14	17	266	265	320
Grand Total	**10,904**	**11,413**	**14,740**	**5,041**	**5,388**	**6,804**	**1,091**	**1,078**	**1,127**	**17,036**	**17,878**	**22,672**

Among the other emerging markets, **Latin America's outlook** is constrained by its low saving rate, over-dependence on primary commodities, politicized labor forces, corruption, and policy instability (as a result of periodic upsurges in support for populist leaders). As oil exporters, **Venezuela and Ecuador** enjoy some benefits from high oil prices, but internal growth remains stymied by structural rigidities. **Chile** has had better luck at freeing its economy, and consequently has better growth potential, but it too suffers from policies and cultural attitudes that restrain progress. The **Middle East** and **North Africa's** prospects are frustrated by boom-bust growth patterns, overdependence on petroleum exports, burdensome social welfare and subsidy programs, low labor and capital productivity, increasing social tensions, and political uncertainty. Finally, most of **Sub-Saharan Africa** has little chance of breaking out of its poverty trap, given the region's problems of political instability and civil war, rampant crime and corruption, and widespread institutional failures.

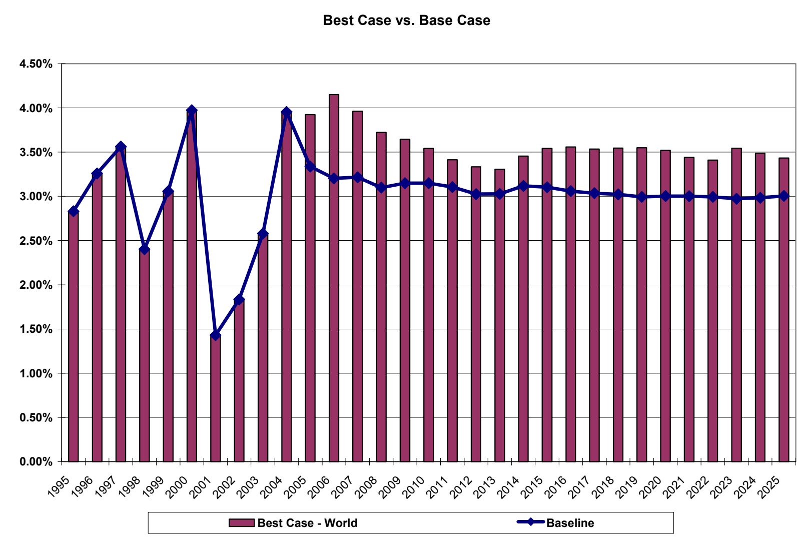
World Macroeconomic Outlook - Best Case

Global Insight used its global macroeconomic scenario model to generate a series of scenarios for the world, and the scenario driven by the assumptions below is called the Best Case scenario. Global Insight gives this scenario a 15% probability.

- Productivity growth is 0.5 percentage points higher every year than in the base case.
- Long-term interest rates are 1 percentage point lower every year than in the base case.
- World oil prices are 10 $/barrel lower every year than in the base case.

All of the scenario work was developed around the base case, which has a 70% probability. Therefore, the world macroeconomic outlook, below, shows the comparisons of this best case with the base case outlook.

Under the above assumptions, world economic output is improved.

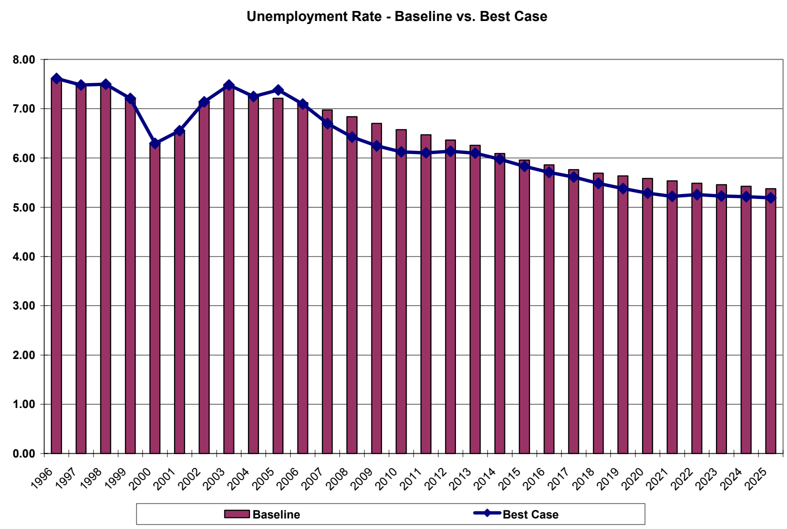


In the baseline, world economic growth is expected to average 3.1% per year over the full 2005-2025 forecast period, while in the best case, this growth is magnified to 3.5% per year, a significant difference on the positive side. In 2025, the difference in nominal terms is more than $8.5 trillion.

The major industrialized countries all contribute to this improved outlook, including the U.S., China, Europe, and Japan (to a lesser extent). Developing nations, such as Brazil, Chile, Malaysia, India, etc., also show improved performance in this best case as a result of open trade policies, and the pull-effect from the industrialized nations.

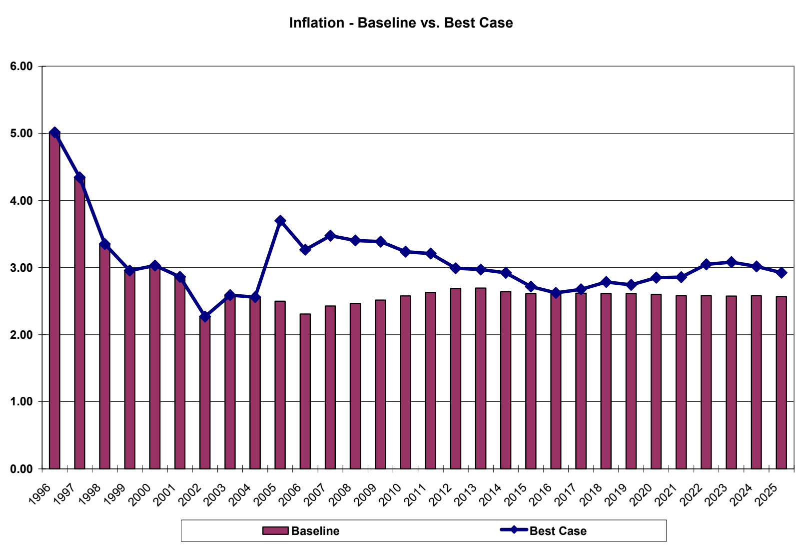
There are implications, as well, for unemployment and inflation in this best case scenario.

Unemployment is slightly lower than in the base case, under the best case assumptions, which include higher productivity. The amount by which the unemployment rate is lower is less than the amount by which it is higher than the baseline in the worst case scenario. This small difference in the unemployment rates in the best case and the base case is shown in the chart below.



The higher economic output is good for the jobs market; however, the assumed higher rates of productivity imply a lower demand for labor inputs. Hence, the best case shows only a modest improvement in unemployment.

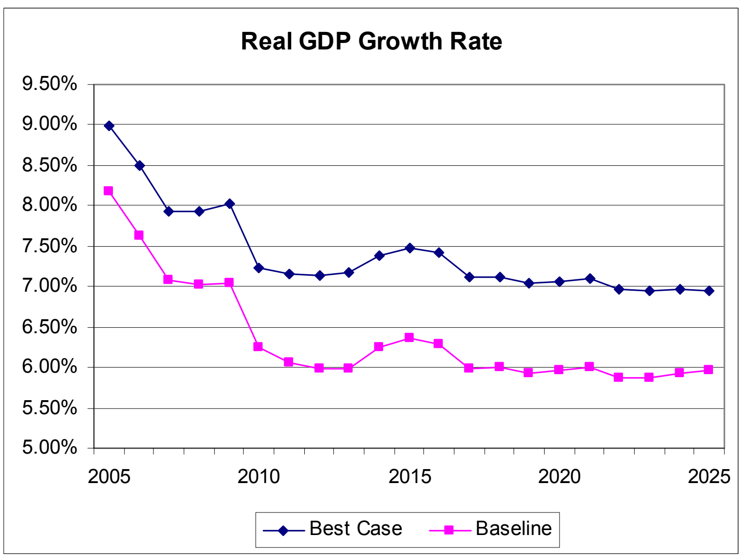
In terms of inflation, the higher rate of economic growth generates stronger increases in prices (CPI), as shown in the chart below.



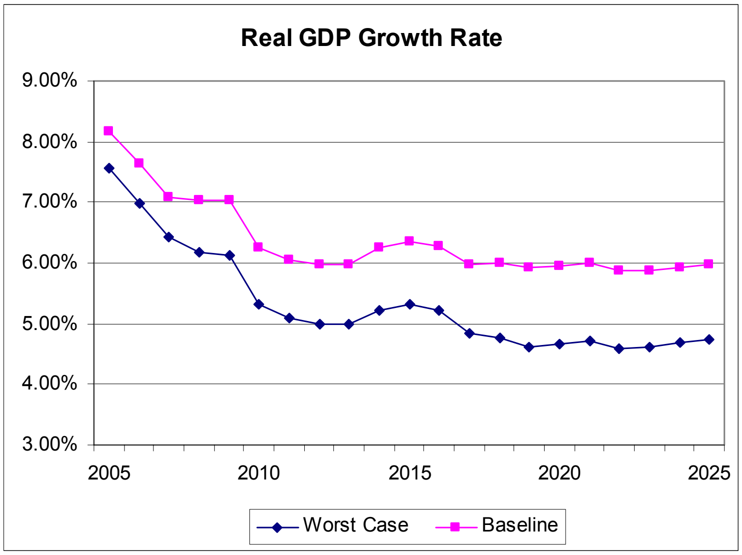
Higher demand produces increases in most inputs prices as well.

For the U.S., under the best case conditions, growth is much faster than in the baseline case: over the medium term, 2005-2010, GDP increases at an annual rate of 3.9%, significantly higher than the baseline growth rate of 3.2%. Over the entire forecast horizon out to 2025, average best case growth is 0.5 percentage points higher than baseline (3.5% vs. 3.0%). These gains reflect the benefits of higher productivity, moderate oil prices, low interest rates, and also faster growth overseas which assists US exports. The accumulated effect of faster growth means that, by 2025, GDP is 10% higher than baseline, equal to $2,062 billion (constant 2000 dollars) of additional output.

In the best case scenario, China's real GDP growth will average 7.4% from 2005 to 2025, one full percent point higher than in the base case. The economy will flourish mainly due to faster productivity gains. Improve efficiency through structural reforms has been the secret of China's economic success since 1978. Since China was moving from a highly inefficient central planning economy to a market based system, the country was able boost productivity substantially in the early stages of reform.



For China in the worst case scenario, real GDP growth will average 5.3% between 2005 and 2025, versus 6.4% in the base case. Mirroring the best case scenario, productivity loss is the main reason for China's economic woes in the worst case. And the biggest culprit for falling productivity is the lack of progress in economic reform.



Real GDP Growth Rate
9.00%
8.00%
7.00%
6.00%
5.00%
4.00%
3.00%
2005
2010
2015
2020
2025
Worst Case
Baseline

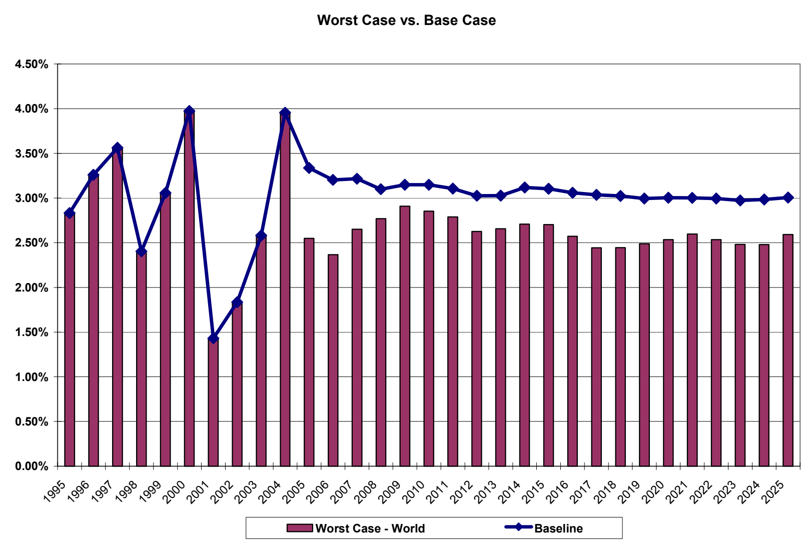
World Macroeconomic Outlook - Worst Case

Global Insight used its global macroeconomic scenario model to generate a series of scenarios for the world, and the scenario driven by the assumptions below is called the Worst Case scenario. Global Insight gives this scenario a 15% probability.

- Productivity growth is 0.5 percentage points lower every year.
- Long-term interest rates are 1 percentage point higher every year.
- World oil prices are 10 $/barrel higher every year.

All of the scenario work was developed around the base case, which has a 70% probability. Therefore, the world macroeconomic outlook, below, shows the comparisons of this best case with the base case outlook. Global Insight gives this scenario a 15% probability.

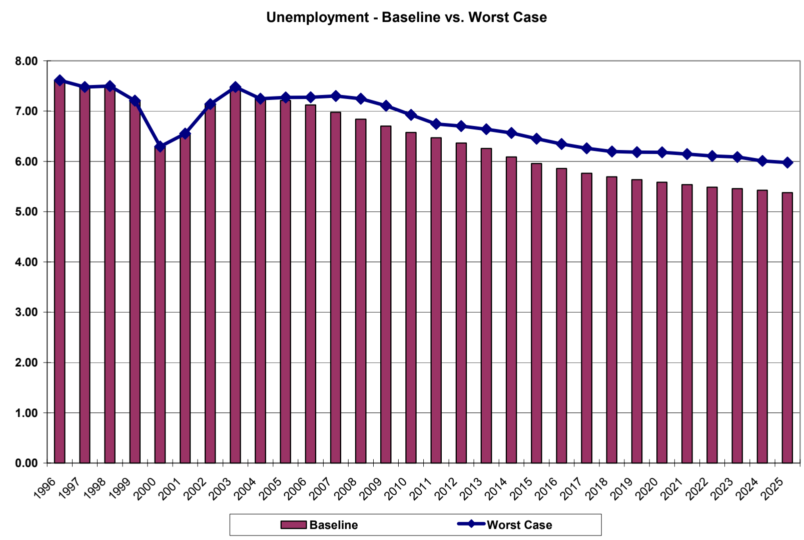
In this weaker outlook, real world GDP averages only 2.6% annually over the 2005-2025 period, representing a reduction in 2025 of about $17 trillion dollars in nominal terms in that year.



Oil prices are probably the single biggest threat to the global economy in the next couple of years. So far, record oil prices (in nominal terms) can be blamed for half to two-thirds of the deceleration in world growth from 4.1% last year to 3.2% this year. Simulations done using Global Insight's Global Scenario Model show that a sustained rise in oil prices to US$80 per barrel would be enough to push some economies (e.g., Japan, Germany, and Italy) into recession. Even in such an extreme scenario, however, some parts of the world economy would prosper, including the energy-producing regions of the United States (such as Texas, Alaska, Wyoming, Louisiana, and Oklahoma) and Canada (especially Alberta), Norway, Russia, and all other non-OPEC and OPEC oil-exporting countries

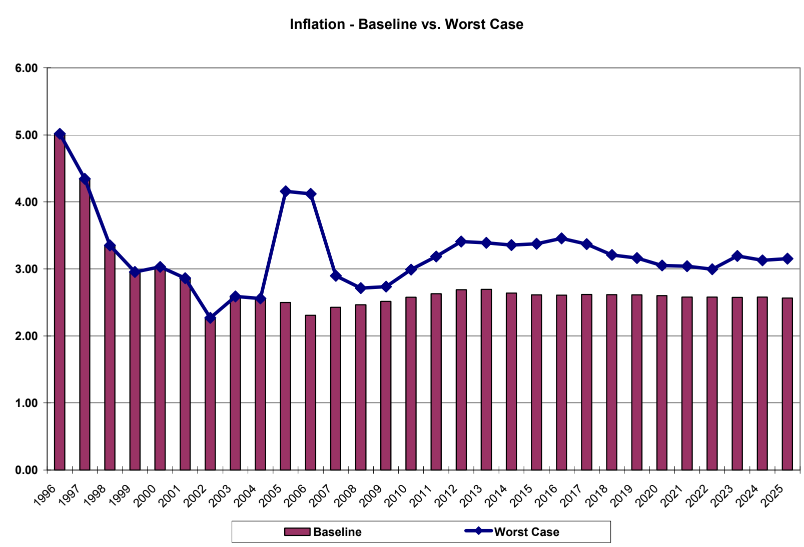
The weaker economic outlook is spread across most of the major industrialized nations (see below) with depressing effects on the economic performance of those developing nations that depend on economic growth in the industrialized world.

Under the worst case assumptions, unemployment worldwide does not improve as quickly in the long term. This can be seen in the chart below, where the line representing the rate of unemployment is higher than the baseline projection.



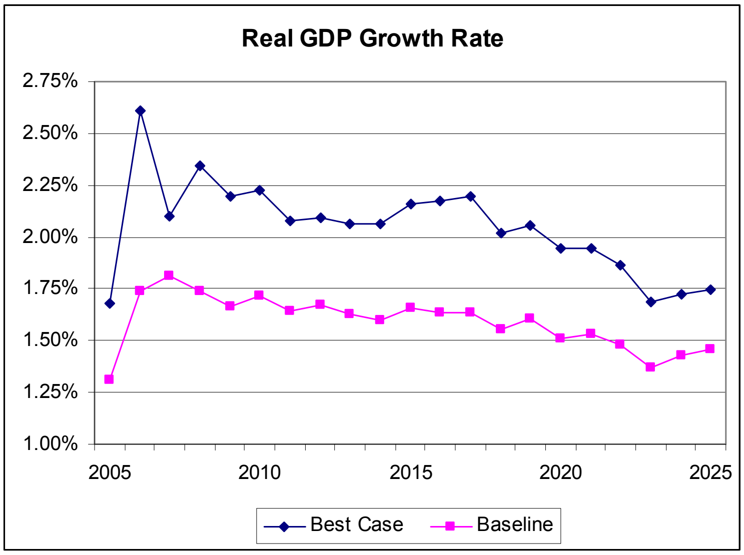
When economic output slows, the models produce less demand for labor, which translates into a high rate of unemployment.

For inflation, the weaker scenario produces higher prices, especially since one of the main assumptions behind this scenario is the higher price of oil, which later feeds through the economy. This higher rate of price changes is clearly shown in the chart below. The weaker rate of economic output in this scenario eventually pulls prices down but still not to the level of the baseline, most probable scenario.

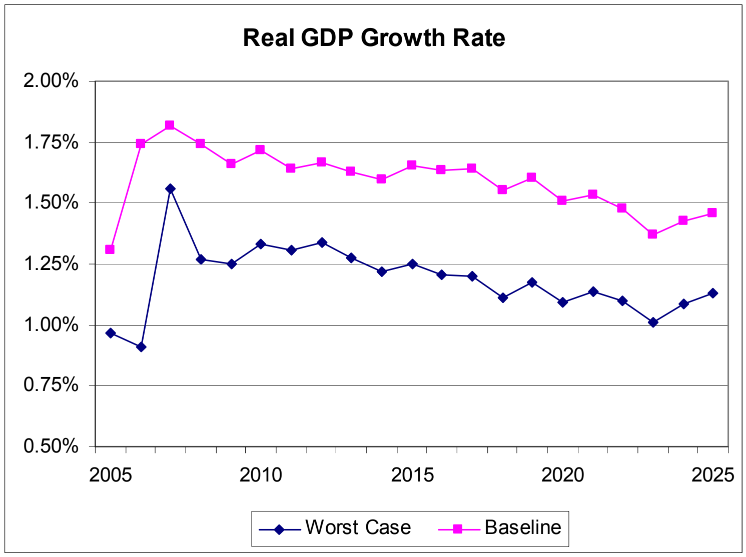


For the United States, growth is reduced significantly in the worst case scenario: real GDP growth out to 2025 falls by 0.4 percentage point to 2.6%. This means that at the end of the forecast period real GDP is more than 8% lower than the baseline forecast, a reduction of $1,715 billion in constant 2000 dollars.

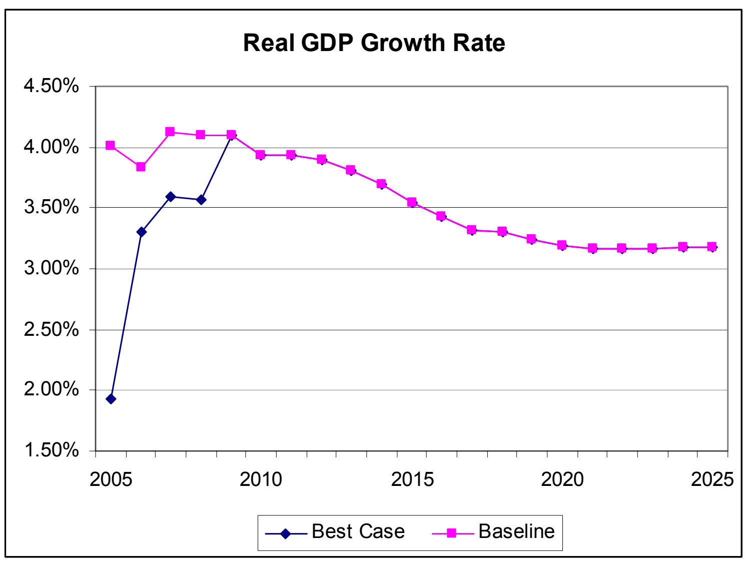
For Germany, representing the general effects of the positive scenario for Europe, Real GDP growth in Germany averages 2.2% per annum over the five-year period 2005-2009 in the best case scenario, representing a boost of 0.55 percentage points from the 1.65% average expansion rate achieved under the baseline. Consequently, real GDP stands at US$2.13 trillion in 2009 under the best case scenario, compared to US$2.07 trillion under the baseline.



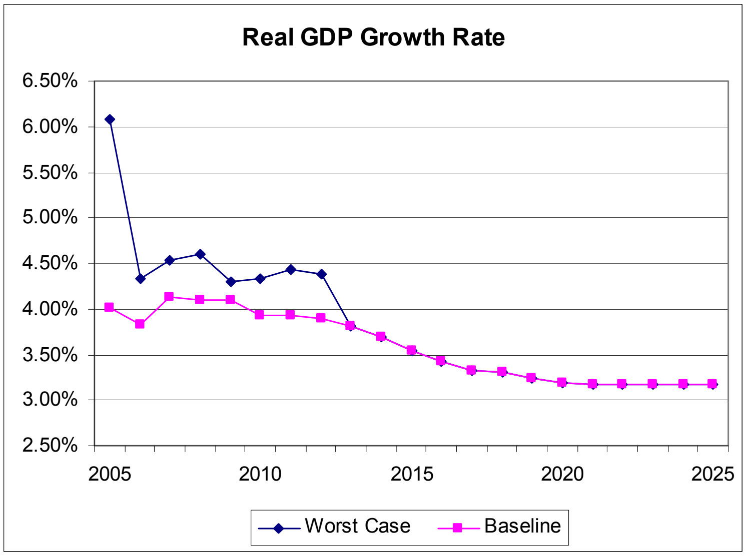
Under the worst case scenario, Germany's real GDP growth averages 1.2% per annum over the five-year period 2005-2009, representing a reduction of 0.5 percentage points from the 1.7% average expansion rate achieved under the baseline. Consequently, German real GDP stands at US$2.025 trillion in 2009 under the worst case scenario, compared to US$2.073 trillion under the baseline.



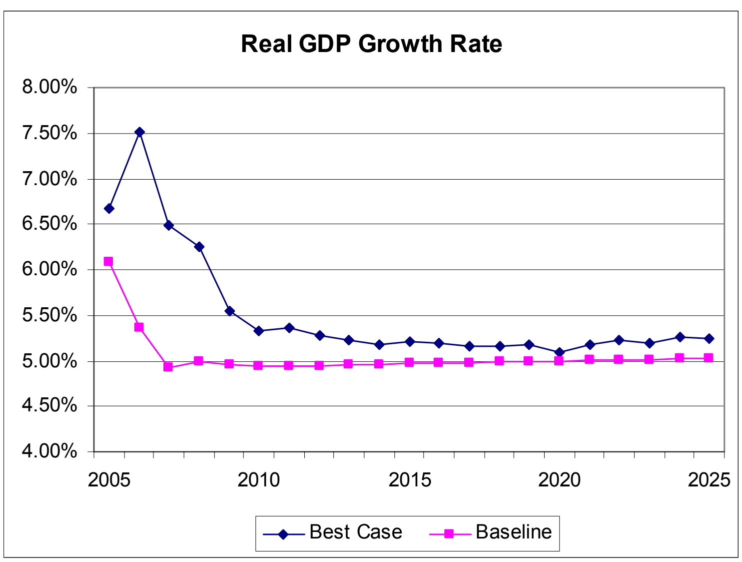
In the case of an oil exporter, like Venezuela, the tables are turned. Our world best case scenario represents a "bad" scenario for Venezuela, as lower oil prices more than offset any possible gain from lower international interest rates and faster productivity growth. Indeed, under the lower oil prices scenario, the Venezuelan economy growth rate reaches only 2% in 2005 or 2 percentage points below our baseline scenario.



On the other hand, the worst case, in which oil prices are higher than the baseline, represents good news for Venezuela. We have defined the worst case scenario as one in which oil prices increased by $10 per barrel, international interest rates rise by one percentage point and productivity growth decelerates. The impact of such shocks in any non-oil economy would be evidently negative in terms of GDP growth but not necessarily in the case of a net oil exporter country such as Venezuela, which depends to a great extend on the oil sector and the fiscal proceeds the government obtains from it.

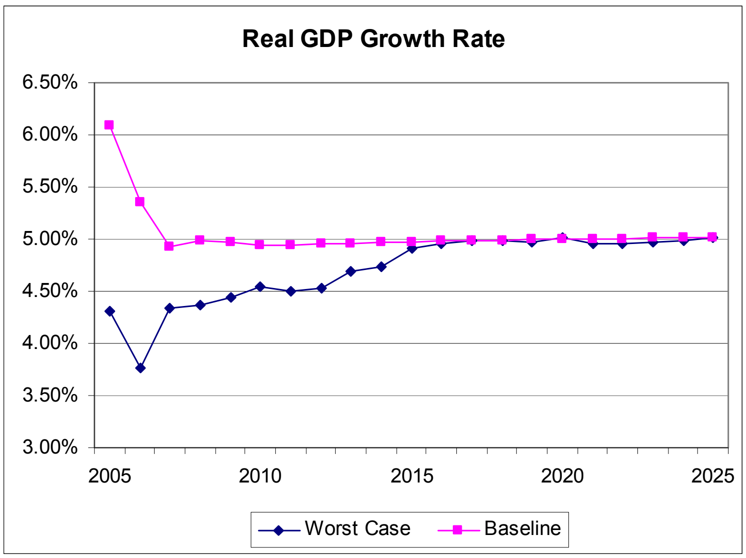


For Chile, which is South America's poster child economy in many ways, with remarkably stable politics, and sense of good organization in the government, and rising incomes, under the best case scenario, the productivity shock and lower oil prices push the already booming Chilean economy to an average growth rate of 6.5% in 2005-2009, which compares favorably to the 5.3% estimated in our baseline scenario. The favorable shock affects investment not only through lower interest rates but also by improving business sentiment, a key variable that shapes business cycles in the Chilean economy. Our model predicts fixed investment to increase rapidly during the second, third and fourth years after the shock. On average, gross capital formation would grow 7.5% in 2005-2009, compared to 6.3 in the baseline.



On the downside, when we examine the worst case scenario, a negative shock of lower productivity, higher oil prices and higher interest rates coupled with a less favorable international economic environment would slowdown output expansion in Chile, particularly due to lower investment. At Global Insight we estimate a deceleration in growth —during the

2005-2009 period— from 5.3% in the baseline scenario to 4.3% under the worst case assumptions. Expectations of an adverse economic climate and lower profitability would discourage new investment projects and also delay the replacement of relatively old machinery. On average, the rate of growth of gross capital formation would slowdown to 4.1% in 2005-2009, compared to 6.3% in the baseline. Government consumption would not suffer in the first year since the Copper Stabilization Fund has been replenished in 2004 and has the resources to finance public spending even if tax collection decreases as overall economic activity slows down; however, in the following years, prudent fiscal management would lead to change the fiscal budget assumptions on potential GDP growth and long-term copper prices, so expected government revenue should decline and therefore planned expenditure would shrink compared to the baseline.



World Macroeconomic Outlook

Since early last year, data from many countries have suggested that economic growth rates have decelerated considerably in some key regions. The slowdown was most pronounced in the United States and Japan during the second quarter of last year, and fairly alarming in the Eurozone during the third quarter. While Global Insight believes that global growth peaked earlier this year, we do not expect that this "soft patch" portends the beginning of a much deeper downturn.

Global Insight's latest detailed baseline forecast projects world economic growth moderating to 3.9% year on year (y/y) in the third quarter of this year, after having peaked at 4.5% during the preceding quarter. The forecast calls for growth to moderate further, to 3.5% y/y in the fourth quarter and 3.3% by the final quarter of 2005. The forecast calls for average annual growth rate to decelerate from 4.2% in 2004 to 3.4% in 2005 and 3.2% in 2006.

Despite high energy prices, *core* inflation will remain under control in the short-to-medium term because of moderating demand growth, overcapacity in many sectors around the globe, and the deflationary impact of dollar depreciation outside of the United States and dollar-linked currency areas. Average annual headline inflation of industrialized economies as a group should average less than 2.5% through at least 2005, while their core inflation should be even lower. Indeed, because of lingering deflationary forces in traded goods sectors, along with relatively weak service-sector inflation in most industrialized economies, inflation should not be a problem for the foreseeable future. The benign inflationary environment during the current economic cycle will allow most central banks to maintain relatively accommodative monetary postures through at least the middle of next year.

A major reason for the global economy's growth deceleration since the second quarter of this year has been the sharp rise in oil prices, which has reduced world growth by roughly 0.3% (annual rate). Contributing to this slowdown has been the lack of independent growth outside of the United States and China. Almost all of the Eurozone's growth in second quarter was due to exports, which have also played a big role in Asia's impressive economic performance during the current business cycle. Meanwhile, US domestic demand continues to outpace GDP.

Uncertainty about oil prices' future course and doubts about the sustainability of the global economy's growth have hurt stock markets in the United States and elsewhere and made companies more risk averse. This has weakened labor markets and discouraged business spending in most industrialized economies, particularly in the Eurozone.

Despite ample evidence of a "soft patch" during last summer (2004), G7 central banks have either begun to tighten or dropped broad hints that they might do so soon. There is a risk that monetary authorities might commit policy errors by raising interest rates more aggressively than warranted by macroeconomic conditions, given their eagerness to normalize their policy rates.

Nevertheless, the current global recovery appears to be sustainable. While oil prices in the \$45-55 range will certainly dent global growth, they are unlikely to derail it. It will take much higher oil prices than we have seen so far during the current cycle to seriously damage the global economy. For one thing, inflation remains rather tame, as the rise in oil prices has not translated into a substantial increase in *core* inflation. Unless oil prices continue to rise, the upward pressure on inflation will ease, given the considerable excess capacity in the global economy. This means that central banks are likely to remain somewhat accommodative for the next several quarters and to raise interest rates at a fairly leisurely pace. Furthermore, if China manages to engineer a soft landing, as we expect, it will continue to support the rest of Asia's growth.

Even if China suffers a "hard landing," the consequences will likely not be that dire for the region or most of the rest of the world. A China hard-landing will certainly have an adverse impact on primary commodity prices and commodity-exporting countries' economies; but its net impact on the global economy as a whole should be positive, since such a hard landing would boost world aggregate growth by lowering oil prices, inflation, and interest rates.

Finally, the US locomotive—on which numerous economies are counting for export-led growth—will probably not run out of steam soon. While consumer spending it set to slow, capital spending and exports will together likely generate enough additional demand to keep the US recovery moving along at a reasonably steady pace.

Regional Survey

Rising oil prices have created a dilemma for central banks around the world. On the one hand, none of them want to repeat the policy mistakes made during the oil shocks of the mid-1970s and early 1980s when high prices triggered sharp rises in inflation. On the other hand, with core inflation still low in most parts of the world, there is a risk that monetary authorities may over-react by being too focused on the potential (versus the reality) of rising inflation. In short, central bankers are struggling with a conundrum: Which is the bigger threat—stagflation or deflation? Predictably, the response has been different across the world.

In the **United States**, higher oil prices and slower growth will likely slow the process of monetary tightening. US monetary policy shifted gears in late June, when the Federal Reserve initiated the first of three rate increases, which took the target federal funds rate from 1.00% to 1.75% in the span of three months. This was in response to an acceleration in core inflation earlier this year, and a year-over-year real GDP growth rate of 4.6% in the first half of this year. However, with economy hitting a "soft patch" over the summer and core inflation easing back to around 1.5%, the Fed took a much more "measured" approach to tightening, and raised rates at its November meeting only after a sharp increase in US October payroll data suggested that the soft patch had ended. Furthermore, Global Insight now expects the federal funds rate to climb to no more than 3.00% by the end of next year, compared with our earlier prediction of 3.50%. For **Canada**, we forecast GDP growth to repeat at 2.8%, which is subject to a slight downside risk. The pace of growth over the past three quarters has been on a declining trend and inventories are relatively high. But Canadian interest rates should stay about the same, and the domestic economy remains reasonably strong.

The risks of an overly-tight monetary policy are higher in the **Eurozone**. The European Central Bank (ECB) has kept its key interest rate unchanged since cutting it to 2.00% from 2.50% in June 2003. Global Insight believes that the ECB should have cut interest rates further in the second half of 2003 to help the Eurozone recovery, and we fear that there is some chance that the ECB might jump the gun next year, tightening its monetary policy prematurely in response to higher oil prices. The ECB has periodically expressed concern about the potential "second-round" inflation risks stemming from high oil prices; but the risks of higher inflation appear to be low, and there is a very strong case for leaving interest rates unchanged well into 2005. Likewise, given the Eurozone's fragile recovery, the ECB should cut rates if Eurozone growth does not pick up soon.

The year 2003 marked the fifth consecutive one of rapid growth in the **CIS** following the Russian crisis in 1998. Moreover, the forecast for the coming years is also quite positive, with growth slowing only moderately, to 7.6% in 2004 and remaining at an average of 5.2% annually over the next five years. Growth within the region has undoubtedly been supported by the solid expansion in Russia, the largest economy in the region, accounting for three-quarters of the CIS's total GDP. Russia remains a major destination for exports from the other CIS economies. The Russian success story, in turn, stems from a combination of very high international prices for oil, natural gas, and metals, the key staples of Russian exports.

In **Central Europe and the Balkans**, average annual GDP growth is bound to recover strongly from a preliminary 4.6% in 2003 to 6.1% in 2004r, reaching its peak for this business cycle and driven by strong performances in the two largest economies (Turkey and Poland), as well as by strengthening GDP growth in most of the smaller countries in the region. Inflationary pressures, although more significant than in previous years, remain controllable. Economic policies of several Central European countries will be increasingly determined by the planned entry into the EMU later in the decade. Public sector deficits are expected to decline only gradually over the next several years.

After keeping monetary policy accommodative for the past several years, many of **Asia**'s central banks have finally started to rein in money growth, but only cautiously. One major exception is South Korea, where the bursting of the consumer credit bubble has combined with high oil prices to depress household spending. As a result, the Korean central bank has cut its policy rate twice this year. In most Asian countries, though, not only are exports flying high, as usual, but long-slumping business investment is also growing robustly. As a result, high oil prices have not yet become the dominating factor in the Asian central banks' policy calculations. Indeed, since most of Asia's central banks are more concerned about growth than inflation, they are more likely to keep monetary policy accommodative to spur growth, than to tighten to fight inflation. In short, we can expect most Asian central banks to pursue a very gradual pace during their current tightening cycle, despite the high oil prices.

The outlook for the **Latin America** region remains as positive as it has been in the last five years. Strong growth, supported by very high commodity prices and a growing external sector, will do the trick during this and next year. This growth will be supported by the region's currencies' competitiveness in international markets, and complemented by a strong comeback in domestic consumption. This will be the first time in decades where domestic and external markets will complement each other to secure strong economic growth. However, the long term prospects remain doubtful at best, especially if the region continues to retreat from the advances made during the 1990s and the political system does not perform the necessary reforms it badly needs. Thus, while the short- to medium-term prospects remain positive, the long-term ones have remained stable for the past several years.

With oil prices exceeding expectations in the first two months of 2005, and given their stable outlook for the rest of the year, the oil-exporting countries of the **Middle East and North Africa** (MENA) can expect another year of record-high oil revenues comparable to that seen in 2004. Although the oil sector of these economies will grow at a slower pace due to capacity limits, the non-oil sector will enjoy better growth rates thanks to strong domestic demand. The region's oil-importing countries, such as Levant and North Africa, will grow at a slower pace but should benefit from the spillover effects of the economic boom in oil-exporting countries. Growth prospects for **Sub-Saharan Africa** remain strong in 2005, on the back of continued positive growth in the world economy and relatively buoyant commodity prices. The external balances of the region's net oil exporters continue to improve as growth in oil prices during the first two quarters of 2004 exceeded that of 2003 by over 20%. The external balances for most of the region's non-oil exporters fared less well, as their gains from exports were partially offset by high energy import prices. We expect the trend in the external balances of the region's economies to continue on a similar path through the rest of 2005. The non-oil exporters will fare relatively better as oil prices moderate in the medium term.

Medium-Term Outlook

After five years of weak or uneven growth during 1998-2003, the global economy is now in the midst of a period of above trend performance. Global Insight's latest detailed forecast, which was completed in January, 2005, projects that the world economy will maintain an above-trend rate of growth for several more years, before edging back to its trend growth rate of 3.1% per year. Our projected average annual growth rate for the five years from 2004 through 2008 is 3.4%, compared with 2.6% for the preceding five years (1999–2003).

There are many risks to this forecast, however. The current expansion cycle may falter next year due to a weak investment and employment growth in the United States, which could lead to a retrenchment by the over-stretched American consumer. Assuming that the expansion proceeds without any major interruptions over the next few quarters, the medium-term outlook could still be at risk from potential inflationary pressures that have been suppressed since the Asia Crisis by a worldwide capacity glut. After years of horrendously weak pricing power and abysmal profits, there is a tremendous amount of pent-up pressure in the business sector to raise prices, particularly for traded goods. Under such circumstances, the risk of policy error by monetary authorities would be high, since they are very anxious to "normalize" their policy rates and unwind the huge amount of liquidity pumped into the global economy since January 2001.

The medium-term leadership of the global economy could change hands more than once over the next five years. With Japan out of contention—because of its huge public debt, long-term structural problems, shrinking labor supply, and political paralysis—the only major industrialized regions in the competition are US-led North America and Eurozone-led Western Europe. If the US economy's well-known macroeconomic imbalances slow the pace of North America's growth over the medium term, Western Europe could become the industrialized world's pace setter for at least a few years, providing a period of relief during which US consumers could rebuild their balance sheets. Meanwhile, progress in the US-led war against international terrorism should allow the United States to gradually shift some resources from the military back to civilian activities over the medium term. In the longer term, the American economy's structural superiority should allow it to regain its global leadership and get back to its long-term trend growth rate—which, at 3.0% per year, outpaces Europe by more than 0.5 percentage point per year.

Unfortunately, Europe's fiscal and monetary policy constraints could prevent it from taking a pace-setting role even in the medium term. For European growth to surpass that of the United States, the European Central Bank would have to abandon its overly conservative monetary policy posture and the core Eurozone economies—Germany, France, Italy, and Spain—would have to ignore the fiscal straitjacket of Europe's stability and growth pact. In the absence of more aggressive monetary and fiscal action, however, European economies would probably decelerate in line with any potential US economic slowdown (resulting from macroeconomic imbalances or other causes), since they have become overly dependent on the American consumer since the Asian crisis.

Long-Term Outlook

The world economy's long-term growth prospects are generally favorable, but they are not as rosy as they appeared to be during the 1990s, when energy prices were low and the Soviet Union's collapse along with the prospects of economic reform in the former Communist world led to widespread euphoria about "a new world order." The current outlook appears even more sober when it is contrasted with the spectacular economic growth projections that were popular during the heyday of "new economy" in the late 1990s.

The new economy hype was brought down to earth with the bursting of the high-tech and telecommunications bubbles in 2000. Most post-bubble assessments have concluded that potential boosts to aggregate productivity from technological advances would be much more modest than was frequently asserted in the late 1990s.

It is now widely accepted that the "new" economy operates on exactly the same principles as the "old" economy. While technological improvements in computers, telecommunications, biology, and other fields will likely lead to spectacular results in some sectors, their impact on overall economic growth will not be spectacular. Furthermore, the American economy's impressive productivity gains during the last ten years now appear to have been mainly the cumulative results of the country's market deregulation and corporate-sector restructuring in the 1980s, global trade liberalization in the 1990s, and an overinvestment binge in the 1990s, rather than any "new economy" magic.

Global Insight's latest detailed forecast of the world economy's GDP projects an average annual trend growth rate of 3.1% for the 20-year period through 2025. This is roughly in line with the average global growth for the past 30 years. (Unless noted otherwise, all world and regional GDP growth rates are based on country GDP numbers converted to US dollars at market exchange rates. Based on purchasing power parity exchange rates, the global economy's trend growth rate would be 3.8%.)

The key economic ***growth drivers*** underlying the forecast is that the productivity gains from new technological advances will moderate the impact of the secular slowdown in factor accumulation. (By factor accumulation we mean increases in quality and quantity of labor and capital stocks.) In other words, a combination of capital and labor productivity improvements—resulting from technological breakthroughs, incremental advances in production processes, and improvements in business organization and management techniques—would in the long term compensate for the slowdown in labor supply growth (due to demographic trends) and capital stock growth (due to a lower global savings rate).

The other major growth drivers underlying the long-term forecast is that the post-World War II global trends will remain intact over the entire forecast horizon. More specifically:

- Aggregate world population growth will continue its gradual, secular long-term decline, from 1.2% per year in recent years to 0.8% in 2025.
- Domestic saving rates increase as incomes rise in the early stages of economic development, but they moderate and decline in the later stages.
- The world economy will not face any extended, severe petroleum shortages over the next 25 years. Indeed, Global Insight believes there is plenty of oil still waiting to be discovered, on top of the huge quantities in previously discovered fields waiting to be developed.
- Crude oil prices will decline from their current, artificially-high levels over the next ten years, but recover gradually as OPEC's excess capacity fades away.
- The global economy will not fall into a deflationary trap. The current pockets of deflation will disappear during the next few years as the world recovery advances.
- The major industrialized countries do not allow their commercial disputes to frustrate global trade liberalization or to degenerate into a major, competitive trade war. In short, incremental trade liberalization will continue.
- After completing their current recovery, non-oil primary commodity prices will resume their secular long-term decline.
- Emerging markets will not backtrack on their economic reforms on any large scale, but instead will continue the trend toward greater openness, deregulation, and privatization.
- The global trend toward more flexible exchange rate regimes and greater capital mobility will continue without any major backtracking.
- Most industrialized countries will not completely shut their doors to immigration, but will become more selective in their immigration policies.
- There will not be any global calamity that depresses world population or capital stock, or leads to a prolonged depression in world output, such as a world war, medieval-scale plagues or epidemics, a giant meteor crash, or other planetary-scale disasters.

The projected regional pattern of growth is very similar to that of the last 20 years. Among industrialized regions, the United States and Canada will remain the growth leader thanks to a combination of favorable demographic factors, abundant natural resources, efficient financial institutions, high rate of immigrant absorption, huge market size, science and technology leadership, and a tremendous capacity for innovation and entrepreneurship. North America's more mobile workers and flexible labor markets are another strong competitive advantage over other major industrialized regions. Still another key factor in North America's superior economic performance is its relatively dynamic political and social institutions, particularly at the grassroots level. Thanks to these advantages, North America's economic long-term growth will easily outpace those of Western Europe and Japan and will remain the world's primary oil importer.

Western Europe and Japan will have major problems keeping up with North America. First, their demographic and natural resource endowments are not as favorable. Second, their markets are generally not as open or as flexible. Third, they are less attractive to skilled immigrants and less effective in integrating them. Fourth, their labor force is less mobile. Fifth, their political and social institutions are less dynamic. Finally, economic growth in both regions is to some extent constrained by burdensome social-welfare programs that will become more severe over the next few decades with the aging of their populations.

Western Europe's economic problems are of course in many ways quite different from those of Japan. For one thing, Western Europe is a much more heterogeneous society. The United Kingdom in particular is relatively more dynamic than the "old Europe" economies of Germany, France, and Italy. In addition, there is a substantial amount of cultural and ethnic diversity within Europe that reinforces the problems stemming from historical animosities and political and language barriers. While the European Union (EU) has broken most of the economic barriers among its current 15 member states, it has created other problems by imposing various centralized bureaucratic superstructures on the members. The cumbersome EU decision-making processes have made European political and social institutions less dynamic. Similarly, the European Monetary Union (EMU) and the EU Stability and Growth Pact have made European macroeconomic policy far too rigid. These institutional rigidities, which could become more acute as the European Union adds 15 new members to its roster in expanding eastward, will be a significant drag on the long-term growth of Germany, France, and Italy.

In contrast, it is cultural homogeneity that has made institutional rigidity a serious problem in Japan. In Japan's conformist society, cultural homogeneity reinforces conformity, thereby discouraging any form of risk taking, innovation, or dissent. These characteristics explain the country's relatively low level of entrepreneurship, the government's reluctance to deregulate local markets and open up the economy to external competition, and the Bank of Japan's fear of unorthodox monetary policy. These tendencies make it very unlikely that Japan would adopt bold measures to break out of its current deflation trap or overcome its long-term structural problems. Japan is therefore likely to be the laggard in economic growth among the world's major industrialized regions.

Among emerging-market regions, Asia and Oceania, led by non-Japan Far East, will continue to have the highest growth rates. In particular, the economic bloc known as "Greater China"—made up of the increasingly integrated economies of China, Hong Kong, and Taiwan—should be a growth leader. As in the past several decades, this is mainly due to the region's combination of openness to trade, high domestic saving rates, and a relatively well-educated labor force. Thanks to these favorable factors, Asia and Oceania is likely to receive the bulk of global foreign investment flows over the next few decades and is destined to become the world's dominant manufacturing center and the main consumer of non-oil primary commodities.

There are a number of major potential risks to this outlook, though. The biggest uncertainty is China's future politics. Unlike most European ex-Communist countries, China has done nothing structural to reform its political system. The ruling elite's refusal to open the political system means that a destabilizing political crisis cannot be ruled out.

Another major risk for Asia, and to some extent for the rest of the world, stems from China's growing military power and frustrated superpower aspirations. Given the country's strong sense of historical injustices at the hands of other major powers and its insecurity about its current world status, China has developed a tendency toward aggressive nationalism and excessive concern with "saving face" in international negotiations and diplomatic disputes. Furthermore, the country's Communist rulers sometimes encourage popular nationalist outbursts to intimidate or extract concessions from other countries (such as during the 2001 incident, when a Chinese jet accidentally collided with an American surveillance aircraft near the island of Hainan).

If political and military risks stymie China's growth, however, India has the potential to become the dominant destination for foreign investment. Over the next few decades, India should be able to sustain a growth rate of 5% per year, but with accelerated economic reforms it has the potential to grow at 7-8%. Unfortunately, India's outlook also faces two major risks. India's tense relations with Pakistan could escalate into a regional nuclear Armageddon, and its internal Hindu-Muslim religious divide could degenerate into a fratricidal civil war.

While Asia's bright economic outlook is somewhat clouded by potential risks, the prospects for the other emerging markets range from mediocre to dismal. Emerging European economies have the potential for rapid growth, but they also face severe challenges that could frustrate their progress. Many of the former Soviet Republics are politically unstable and would need huge amounts of foreign aid to rebuild their crumbling infrastructure and institutions. Most of the Baltic and Eastern European economies have better prospects thanks to their more developed economies, better-educated labor forces, proximity to the huge European market, and increasing ties with the European Union and NATO.

Among the other emerging markets, Latin America's outlook is constrained by its low saving rate, over-dependence on primary commodities, politicized labor forces, corruption, and policy instability (as a result of periodic upsurges in support for populist leaders). As oil exporters, Venezuela and Ecuador enjoy some benefits from high oil prices, but internal growth remains stymied by structural rigidities. Chile has had better luck at freeing its economy, and consequently has better growth potential, but it too suffers from policies and cultural attitudes that restrain progress. The Middle East and North Africa's prospects are frustrated by boom-bust growth patterns, overdependence on petroleum exports, burdensome social welfare and subsidy programs, low labor and capital productivity, increasing social tensions, and political uncertainty. Finally, most of Sub-Saharan Africa has little chance of breaking out of its poverty trap, given the region's problems of political instability and civil war, rampant crime and corruption, and widespread institutional failures.

I. North America

United States

Overview

Short Term

Growth: US consumers and, increasingly, businesses are spending aggressively, but only part of that spending is translating into US output and jobs. Some of that spending is going abroad in imports; while on the other side of the trade ledger, export growth has stalled. The global expansion remains too dependent on US spending.

Fourth-quarter growth illustrated the picture well: rapid domestic demand growth, but a huge drag from trade that restricted GDP growth to 3.1%. Upward revisions to exports and construction are likely to raise growth to around 3.5% (in line with original expectations), but will not change the big picture. We remain of the view that the leadership of the expansion will shift, with consumer spending and housing no longer in the driver's seat, and business fixed investment and exports playing a bigger role.

Although our growth forecast for 2005 is little changed overall (at 3.5%, down from 3.6% last month), the mix of spending has changed. More of the growth is now coming from domestic demand—consumption and business fixed investment—and less from exports.

Consumer Spending: Americans continue to spend freely. At 4.6% in the fourth quarter, consumer spending growth was little different from the third quarter's 5.1% pace. Spending continues to far outstrip income. We still expect that spending growth must and will slow to come into line with income and employment growth. The labor market is improving, but hardly dramatically, as illustrated by January's 146,000-job gain. We expect that consumer spending growth of around 3.0% will be the norm in future.

Investment: The expiration of the "bonus depreciation" provisions will affect some measures of corporate profits and taxes in 2005. Taxable profits (sometimes referred to as "book" profits) will rise due to a decline in deductions, and taxes will rise. Pretax profits with the capital consumption adjustment (sometimes described as "economic" profits) will not be affected, though, because this concept measures depreciation on an economic, rather than a tax-accounting, basis.

Government: Real federal purchases, which climbed 4.7% in 2004, are assumed to slow to 3.0% growth in 2005 and 1.8% growth in 2006.

Exchange Rates: The dollar has rallied since beginning of the year, but the worsening US current-account deficit implies that downside risks predominate for the greenback. The trade-weighted dollar index against major currencies fell by around 7% from the fourth quarter of 2003 to the fourth quarter of 2004, and we assume a similar 7% depreciation over the four quarters of 2005, followed by a shallower decline in 2006. This path assumes dollar rates of $1.45/euro, 97 yen/dollar and C$1.21/dollar at the end of 2005. We also assume that the dollar will decline gradually against the currencies of other important trading partners, and that the Chinese authorities will begin to allow their currency to drift upwards in 2006.

Monetary Policy: The Fed raised the federal funds rate another 25 basis points to 2.50% on February 2, as expected, and gave no indication of either slowing or speeding up its pace of tightening. Above-trend growth, combined with a gradual rise in core inflation, suggests further measured tightening ahead. We assume five rate hikes in total over the course of 2005, raising the funds rate to 3.5% by year-end. This implies that the Fed skips rate hikes at some meetings later in the year, but we assume that it raises rates by 25 basis points at its next two meetings (in March and May).

Energy We assume an average oil price of $43.46 per barrel (West Texas Intermediate) for 2005. We remain aware that the demand/supply balance is tight and that a burst of cold weather could potentially send prices sharply upward again. We expect the price to fall to around $36.50 in 2005.

Medium Term

Growth: The economic fundamentals of the United States, on balance, are still quite strong. Productivity growth continues to post strong numbers. In the forecast, we expect it to grow 2.5% between 2005 and 2010, or above the 2.3% average of past 50 years. Economic output will converge towards its potential level, with all resources fully utilized. As a result, the growth rates of output, real incomes, real expenditures, and the general standard of living of the population are determined by the growth rate of potential GDP. Between 2005 and 2010, economic growth averages 3.3%.

Consumer Spending: A slowdown in consumer spending growth is inevitable. The stimuli of 2001–03 tax cuts, low interest rates, and mortgage refinancing cash-outs are behind us. The saving rate is uncomfortably low—just 0.3% of personal income in November 2004. Rising interest rates are beginning to lift debt service burdens and discourage borrowing. Future gains in real consumption will depend primarily on employment and income growth. In the forecast, real consumer spending grows 2.9% between 2005 and 2010, which is slower than the economy's 3.3% growth rate.

Investment: Corporate finances remain the most robust in decades and profits growth is expected to be in the double digits again this year. As a result, Global Insight projects that capital spending growth will continue to be a powerful engine of growth, at least through 2006.

Government: The forecast assumes that Congress will not allow all of the recent personal tax reductions to expire as scheduled. But we are also assuming that Congress will tinker enough to raise federal personal income taxes, little by little, back toward their historical average of 8.2% of GDP.

In 2005–11, the budget deficit gets smaller, but never disappears, as taxes rise in the second half of the decade. An easy way for Congress to achieve this is to let the tax cuts sunset as scheduled; however, this seems unlikely regardless of who may be in the White House or in control of Congress. One way or another, the well-off will be forced to pay more, perhaps by applying the Social Security tax to all incomes, as well as by raising marginal rates.

Monetary Policy: Although core inflation should hold under 2.5% through 2008, we believe the Fed will want to move toward at least a 2.0% real funds rate, and to do so more quickly than we had previously anticipated. We expect the funds rate to reach 3.5% by the end of 2005 and 4.5% by early 2008.
Bond yields will generally move parallel to the funds rate over the forecast interval, but run somewhat higher. The yield on ten-year treasuries stays below 6.0% through 2008. It hovers afterward between 6% and 6.5%.

Energy Global Insight's Energy Service expects the average acquisition price of foreign oil to remain above $30 per barrel over the forecast period. With worldwide demand steadily increasing, the OPEC cartel will maintain some pricing power. Although it is impossible to predict the precise timing of price changes, the forecast assumes that oil prices will average $35.5 in 2010–20.

Long Term

Growth: The trend projection assumes that the US economy experiences no major mishaps between now and 2030. Annual real GDP growth averages 3.0% in 2004–30, about the same rate as the average of the past 25 years. The economy's underlying growth will slow after 2011, as baby boomers begin to retire, slowing labor force growth. Potential output growth should hold up fairly well in the future, with greater business fixed investment and R&D spending offsetting the slowdown in labor force growth. Eventually, though, the effects of weaker labor force growth become dominant and, in a sense, self-perpetuating. As output growth drops off, business fixed investment rises more slowly, limiting capital stock growth and thus future output gains.

Slower long-run increases in the labor force indicate more moderate long-run employment growth in the future. Total civilian employment will rise at an average annual rate of 1.0% from 2004 to 2030. Total establishment employment will rise from 131.5 million in 2004 to 172.0 million in 2030, an increase of 31%. Manufacturing's share of total employment will continue to decline over the forecast period, falling to 7.3% in 2030, from 10.9% in 2004. The broad service sector will generate an increasing share of employment growth in the forecast period, although the federal government's share of employment will decline during the forecast period.

Consumer Spending: Expenditures, in the long term, are primarily determined by the growth of real permanent income, demographic influences, and changes in relative prices. The share of personal consumption expenditures in GDP will stabilize at just under 70% of GDP. Real consumption expenditure growth will average 2.7% per year over the forecast. In per capita terms, growth will advance about 1.9% per year, down 0.3 percentage point from the 1978–2004 rate. The share of consumption devoted to services will rise, mainly because of rising health expenditures, while that for goods will fall over the forecast period.

Real personal disposable income, which climbed 3.2% in 1970–2003, will rise 3.1% annually over the next 25 years. This does not take into account the rising volume of withdrawals from existing retirement plans.

The demographic demand for housing will be about the same over the next 25 years as over the past 25 years. Thus, housing starts are projected to average 1.6 million units annually in 2003–29, about the same as during 1972–2004. Meanwhile, the housing stock will climb from 111.4 million units in 2004 to 142.5 million units in 2030.

Investment: Good profitability and solid demand growth should keep investment healthy over the next 25 years. The share of GDP devoted to business fixed investment will hover around 10.0–12.5% of GDP through most of the forecast period. The effective capital stock (in 2000 dollar terms) is projected to increase 3.7% annually, below the average growth rate recorded for 1970–2003. Inventory investment will remain a small percentage of GDP. Although inventories have played significant roles during past business cycles, inventory investment represents an average in the stable growth scenario and is thus artificially smooth. Capital inflow will contribute to net domestic investment throughout the forecast period, although the federal debt clearly hurt it in the later years of the forecast. The government saving projection assumes that state and local governments continue to run modest operating surpluses.

The composition of investment will continue to change in the forecast period; both structures' share of investment and equipment rise over the forecast period.

Government: We expect federal spending on defense, transfer payments, and federal aid to state and local governments to consume a good share of GDP. As a result, the federal government should post deficits in the unified budget over the forecast period. In the forecast, the deficit averages 0.8% of GDP in 2005–30. In the longer run, the baby boomers' retirement will cause deficits to grow, despite some increases in the Social Security tax rate.

Exchange Rates: A decline in the dollar relative to industrialized-country currencies, combined with modest unit labor cost growth, will stimulate US exports abroad and result in an eventual improvement in the US current account balance. Global Insight projects that real exports will expand at an average annual rate of 7.3% over the entire forecast period. Real imports, meanwhile, will grow at an average annual rate of 5.2%.

Monetary Policy: Over the long run, inflation is a monetary phenomenon. Its future course will be determined by policies implemented by Alan Greenspan and his successors. Since we do not know who his successors will be, we assumed the Fed will try to stabilize the inflation rate. The CPI is expected to average 2.6% annual increases in 2004–30, somewhat less than the 4.4% average in 1977–2003. The broader based GDP deflator will rise 2.3% per year.

Energy: Energy conservation efforts will continue. This stems partly from a stock/flow phenomenon: despite the trend toward minivans and sport/utility vehicles, for example, the average new vehicle is still more fuel-efficient than the existing stock. Gasoline usage per vehicle should fall for several more years, even if relative energy prices remain flat. Similar considerations apply to business capital and housing stocks. The ongoing employment shift from manufacturing to services also implies lower energy usage per unit of output.

Economic Growth

Last year was the strongest year for growth in the US economy since 1999; the pace of expansion will ease in 2005, but remain above trend. Fourth-quarter growth now seems likely to come in at a 3.6% annual rate, a touch lower than the 4.0% rate that we had anticipated a month ago. We expect the economy to maintain a similar pace in the first quarter of 2005. Fixed investment spending—both residential and nonresidential—looks softer in the fourth quarter than we had anticipated, more than offsetting stronger consumer spending, but this has not made us more pessimistic for 2005.

The final verdict on holiday retail sales is not yet in, but it does seem that the season did not turn out as weak as early reports had suggested. The consumer is still ready to spend—when the price is right. Consumer spending growth has slowed from the third quarter's unsustainable 5.1% pace, but should still come in at around 3.8% for the fourth quarter, better than we had thought a month ago. We expect that spending growth of around 3.0% will be the norm in future, though, since we do not expect the saving rate to fall forever.

Looking forward, consumer spending growth will be determined more by income and employment gains. Here, recent signals have generally been positive, despite November's disappointing jobs report. We believe that the 178,000 average monthly increase in payroll employment over the past three months is a better indicator of the underlying state of the labor market than November's 112,000 gain.

In fact, 2004 was the first year since 1997 that consumer spending rose less rapidly than overall GDP, and we expect this pattern to become the new norm. Housing activity, too, will no longer outgrow the economy. All key housing activity indicators—starts, new home sales, and existing home sales—are expected to retreat in 2005, from record 2004 highs in the case of sales. There were steep declines during November in both housing starts and new home sales, although we do not see them as signals of a severe downturn. Key leading indicators such as mortgage applications for purchase, builder confidence, and housing permits are still strong. The feared housing crash remains unlikely unless interest rates move sharply higher.

Neither the federal nor the state and local governments will provide more than minimal support going forward. Federal spending will be held down by the Republicans' need to appear fiscally responsible, while municipal spending is constrained by tight-fisted taxpayers.

Slower growth in consumption, housing, and government spending mean that overall growth in the economy will ease back, but there will be important support from a combination of business investment and net foreign demand. Business fixed investment may have disappointed some hopes last year, though, as companies were cautious about spending the cash piles that accumulated as profits surged. But capital expenditures should still register double-digit growth for 2004, and we anticipate a similar gain in 2005. The mix of growth will shift, though, with equipment spending growth slowing a little, while an improvement in nonresidential construction spending finally gets off the ground. Even though a year-end surge in equipment spending ahead of the expiration of the bonus depreciation rules did not seem to materialize, some equipment spending was likely brought forward to 2004 from 2005, with the implication that equipment spending growth will slow early this year.

Export growth should also provide an important support to economic growth during 2005 and beyond, stimulated by the weakening dollar. There may be some periodic corrective rallies, but we believe that the widening US current-account deficit will drive the dollar lower still—bad news for the Eurozone, in particular. Growth in the world economy will slow in 2005, but the declining dollar means a bigger market share for the United States.

Core inflation crept higher during 2004, and is likely to edge upward again in 2005, running just above 2% for the core consumer price index and just below 2% for the core consumption price index watched by the Federal Reserve. The global expansion has sent commodity prices sharply higher, and companies are passing on some of those costs—although they are finding it easier to pass costs on to other businesses than to the final consumer. The weakening dollar adds some upward pressure to prices, both directly via import prices and indirectly via stronger net foreign demand. Although core inflation should hold under 2.5% through 2008, we believe the Fed will want to move toward at least a 2.0% real funds rate; we expect the funds rate to reach 3.5% by the end of 2005 and 4.5% by early 2008.

Consumer Demand

A Strong Finish to 2004. The 2004 holiday season ended on a high note, with consumer sentiment and spending rising. An improving job market, falling gasoline prices, a rising stock market, and hefty incentives for auto buyers provided holiday cheer. After a 5.1% gain (annual rate) in the third quarter, real consumer spending rose an estimated 3.8% in the fourth quarter. Nominal retail sales advanced an estimated 7.8% from their year-earlier level in the fourth quarter, their best holiday performance since 1999. Digital cameras, iPod music players, plasma-screen televisions, DVD players, apparel, and home furnishings were strong sellers. Retail e-commerce sales surged 25% during the holidays, matching last year's gain. The growing popularity of gift cards will shift some holiday spending into the new year. According to the International Council of Shopping Centers, 35% of last year's gift cards were redeemed in the first two weeks after Christmas.

Multi-Fiber Arrangement (MFA) Expires. On January 1, 2005, the international agreement setting import quotas on clothing and textiles expired, foreshadowing significant reductions in import prices. Since 1974, the MFA had allocated shares of the US and European markets among 47 developing countries. In 1995, the United States and Europe agreed to a ten-year phase-out of quotas. The final phase was implemented on January 1, lifting quotas on 98 categories accounting for 80% of US clothing imports. The end of quotas will bring a massive shift in production to China and, to a lesser extent, India. The World Trade Organization estimates that China's share of the world market for textiles and apparel will increase from 17% in 2003 to 50% by 2007. Cheap labor, large modern factories, advanced logistics, and locally grown cotton give China a huge cost advantage over smaller developing countries.

American consumers will benefit from lower prices and better quality, as clothing production is consolidated in the most efficient factories. The end of the MFA will bring a reduction of at least 4% in consumer apparel prices over the next two years. Given the potential cost savings and a global oversupply of clothing, the price decline could be much greater. Lower prices and rising incomes will spark continuing robust growth in apparel demand. Real consumer spending on clothing and shoes is projected to increase 5.4% in 2005 and 4.8% in 2006, compared with average growth of 4.9% over the past decade. Thanks to falling prices, apparel's share of household budgets will continue its downward trend. Spending on clothing and shoes fell from 10.0% of total consumer spending in 1952 to 5.0% in 1994 and 4.0% in 2004; its share is projected to drop to 3.3% in 2014.

Business Investment

In light of the latest national income and product account (NIPA) estimates, it might seem a stretch to say that nonresidential construction is rebounding just fine. The NIPA data showed real spending dropping 4.3% in the fourth quarter—the second consecutive decline, and the 10th drop in the past 13 quarters. But indeed, the patient is doing just fine.

Based on December's strong construction put-in-place estimates, the fourth-quarter numbers will be revised up by about $4 billion, or 7%. The revised numbers will also show that nominal spending on nonresidential construction has been growing at double-digit rates on average for the past three quarters.

Unfortunately, the price deflator has also been growing at double-digit rates the past two quarters because of skyrocketing increases in the cost of raw materials. Here again, the prognosis is good. The producer price index for construction materials has stabilized the past four months. Should it stay flat or start dropping—which is an even bet—real spending growth on nonresidential construction may climb into the double digits.

The put-in-place revisions especially affected the manufacturing estimates. Based on preliminary data and a bit of guessing, the Bureau of Economic Analysis (BEA) had estimated that manufacturing construction grew 3.9% in nominal terms and dropped 3.0% in real terms during the fourth quarter. The revisions will raise the nominal growth number to about 60% (at an annualized rate) and push the real gain above 50%. Manufacturing should continue to post stupendous growth numbers over the next several quarters. Do not be misled by them, however. They are so strong because the level dropped so low, not because of a manufacturing construction boom.

One category that continues to struggle is office construction, unchanged in nominal terms for the past 15 months, and still dropping in real terms. The office vacancy rate, which peaked at 16.8% in third-quarter 2003, has inched down to 16.0% and is still falling. Unfortunately, it will have to drop much more before builders find reasons to put up new buildings.

We expect the rebound in nonresidential construction to continue. In February's forecast, real spending on nonresidential structures climbs 4.4% in 2005 and 7.7% in 2006. We expect the recoveries in "buildings and other" and in public utilities to be long and drawn out. But construction of mines and wells will flatten out, a result of lower energy prices.

Equipment and Software Had an Outstanding Fourth Quarter. This investment category grew 14.9%, boosting the annual number to 13.4%—the highest growth rate since 1997. These numbers will be revised down by an unknown amount, though, because of mistakes that Statistics Canada made in accounting for US exports to Canada. Since the BEA estimates most equipment and software (E&S) categories by deducting net exports from shipments, correcting these mistakes will raise US capital exports, and lower the E&S estimates.

It now appears that equipment spending growth will hardly slow as a result of the accelerated depreciation program expiring. Orders, shipments, and unfilled orders of nondefense capital goods (excluding aircraft) were still rising in December, suggesting strong ongoing demand. We will probably never know how much the bonus depreciation affected business investment (according to some accounts, even Bush's economic team did not expect it to raise capital spending very much). It is also unclear how much the program caused any shifting from 2005 into 2004.

In the forecast, E&S investment grows 7.9% in the first quarter of 2005, despite a 14.9% drop in transportation equipment. This drop mainly reflects fewer purchases by rental companies, a decline in consumer leasing, and rental companies unloading their stock of used cars. (In the national income accounts, when a consumer leases an auto, this counts as business investment, since the business is the purchaser. When a consumer decides to buy an auto he has been leasing, or if he buys an auto from a rental company, this counts as an increase in consumer spending offset by a decrease in business investment.)

If one looks beyond the quirks the BEA must use to account for autos, the outlook for business investment remains solid. In the forecast, the information, industrial, and "other" equipment categories post double-digit growth rates during the first quarter. For the year, information and "other" equipment post double-digit growth rates, while industrial equipment grows 8.7%. The outlook beyond 2005 is for solid spending over the forecast period.

Inflation

The Fed Expresses Its Concern. Resurgent energy prices and growing pockets of pricing power are raising fresh concerns about whether the rise in inflation will stay contained. Global Insight's view remains that it will remain contained, though upside risks have increased. Our April forecast shows CPI inflation at 2.7% for 2005, matching its rate for 2004. PPI inflation is now projected to be higher than last year. Strong energy prices and the lagged pass-through of accumulated cost pressures are forecasted to push up the finished goods index 4.2% this year, more than half a percentage point higher than in 2004. The outlook for core inflation is now slightly higher too, with the both core CPI and the core PCE deflator projected to move toward the upper ends of their desired ranges by 2006.

But we expect labor costs will remain contained, which provides a reason for optimism. Flat labor cost escalation comes from our belief that enough slack remains in labor markets to keep wage gains subdued. This, in combination with relatively good productivity growth, prevents escalation in unit labor costs from accelerating. Ultimately, it is the stability in unit labor costs that keeps inflation under control.

Notwithstanding Global Insight's optimism, the worry at the moment is the upside risk to inflation—it appears to be growing. In this regard, the minutes of the Federal Reserve's Open Market Committee meeting on December 14 were something of a Rorschach test for financial markets. The discussion of prices was widely seen as a sign of disagreement within the FOMC about its stated stable outlook for core inflation.

Without doubt, virtually every key measure of inflation has accelerated during the past year. But recent data on commodity prices—the underlying driver for much of this acceleration—suggest that these pressures will soon abate. Most notably, oil prices have retreated, with some immediate relief already apparent in gasoline prices.

Broader measures of commodity prices are also beginning to see some change. Both the CRB raw industrials index and our own Global Insight Industrial Materials Price Index, for instance, now show slightly lower year-over-year increases than they did this past summer. Futures indexes have also generally moved lower since summer.

And data from the Institute of Supply Management's (ISM) are pointing toward the type of supply-side response that traditionally marks the end of commodity price cycles. Indeed, December's manufacturing report went so far as to say that "while there is continuing upward pressure on prices, the rate of increase is slowing and definitely trending in the right direction."

Within the ISM manufacturing survey, the prices-paid index has declined in six of the past eight months, with its net higher component dropping steadily since April. Delivery lead times are also improving, with the percentage of firms reporting slower delivery times falling since May. The non-manufacturing survey chronicles this same shift, with the prices-paid index (in terms of net respondents reporting higher prices) and supplier delivery index down slightly from this past summer.

Still, the best news on inflation continues to come from labor markets. Despite the recent improvement in job growth, labor costs remain moderate. The rate of growth in average hourly earnings did tick higher over the fourth quarter, although year-over-year escalation—at 2.7% in December—is still below that recorded in the summer of 2003. Employment cost index data, a broader measure of labor market conditions, continued to show flat or decelerating compensation growth through the third quarter.

As the Fed made plain in the December 14 minutes, the moderate pace of compensation growth in the face of the recent energy price increases, coupled with several years of rapid productivity growth, is consistent with an economy still operating below its potential. And while employment growth is improving, there is probably enough spare labor ready to return to the labor force to prevent the unemployment rate from falling much below where it is now. This will keep compensation growth from accelerating, and when combined with falling goods price inflation, means that aggregate inflation should stay relatively stable. Our bottom-line thinking remains the same: that worries over a jump in inflation are overblown.

Labor Market and Demographics

For the 12 months of 2004, 2.2 million jobs were added, the best performance since 1999. The sole disappointment among the major categories was retailing, which shed 20,000 jobs. More sedate fourth-quarter growth, partly due to record-high oil prices in October, has trimmed payroll gains, but some pressure will be relieved by easing oil prices in 2005. We expect 549,000 job additions in the first quarter (on a quarterly average basis) followed by 689,000, 622,000 and 506,000 gains in the subsequent three quarters, respectively. That produces a year-on-year gain of 2.4 million in fourth-quarter 2005, up from 2.1 million in 2004. Although soft compared with the 1998–89 average of 3.1 million new jobs per year, this would still constitute a sustainable pace, as well as provide some recouping for the deficient job creation of 2001–03. The unemployment rate can then drift gradually lower from the current 5.4% in this environment. The jobless rate will not decline each month, but its steady improvement will neither trigger a labor shortage nor dampen consumer confidence.

How Fast Will the Labor Force Grow? The labor-force participation rate dropped from an early-2000 peak of 67.3% to 66.0% in December. That drop represents 2.9 million people. When, if ever, will they resume looking for work?

It is dangerous to make back-of-the-envelope labor-force calculations because of demographic changes in the United States. Workforce composition is dynamic, as two diverging trends demonstrate. In 1999, the participation rate for persons over age 65 was 12.3% out of a cohort of 32.5 million. For the first 11 months of 2004, the rate was 14.4% out of a total 34.6 million. The number of senior labor-force participants rose by one million, while the over-65 population cohort rose by two million in the official statistics, a grossly disproportionate increase. Unfortunately, this comparison overstates both gains because of sample adjustments caused by the 2000 Census. The participation rate appears to be unaffected, but the headcount numbers are unreliable. There was an offsetting decline in participation within the 16-19 year-old cohort over the same time span, with rates plummeting from 52% in 1999 and 2000 to about 44% in 2004. On the same raw basis as seniors, that trimmed the number of teenage labor-force participants by just over one million.

How does one account for these million seniors who remained in the labor force and the million teenagers who left? The gain in seniors represents both deferred retirements, and people shifting from full-time employment to voluntary part-time employment. Some are even in the final year of employment before retirement, and the cohort turning 65 each year is growing again. Still, raw demographics cannot account for rising senior participation.

The obverse of the coin is the drop in teenage employment. How much is temporary and how much is permanent? The number of jobs in retailing, accommodations, and food service now is almost the same as in 2001 (up less than 1% in three years). Are teenagers just not looking because of disappointing prospects? The Federal Reserve must negotiate a smooth transition toward higher employment and accommodate—but not be led by—anticipated labor-force increases. It can ill afford to anticipate labor-force gains based on the exceptional performance of the late 1990s. Some increase in labor-force participation is likely, though, and we expect that an equilibrium in the middle of the high and the low values of the last ten years will be reached.

Monetary Policy

Deficits, Deficits. Do deficits matter? We think so. And we are relieved to see that Treasury Secretary John Snow now says so. "Deficits do matter" was his one sentence answer recently on CNN. He later qualified that, but in a way with which we agree:

"You don't find that one-to-one correlation (federal deficits with interest rates)…But most economists will tell you, and I agree, that unless the government shows a disciplined approach, and we will, to deficits, it will lose confidence with the financial markets. And if you don't have the confidence of the financial markets, then the cost of borrowing will rise. So at some point interest rates rise. We're not going to let that happen. We're going to deal with the deficit."

President Bush has recently been highly visible leading executive branch demands for more spending restraint. Our forecasts show considerable progress on the federal deficit going forward, but mainly because tax receipts go up sharply. Our forecast shows the federal deficit for fiscal 2005 at 2.6% of GDP, as the end of bonus depreciation, more capital gains, and the alternative minimum tax generate greater revenues, while economic growth continues. There is also a modest, assumed slowdown in spending gains.

Which Deficit to Worry About? Which deficit matters most, the budget deficit or the foreign deficit? When both deficits are big, it might be difficult to sort out which is hurting market confidence more. The external deficit may actually be more important going forward. This view parts company with Federal Reserve chairman Alan Greenspan, who recently said that the budget deficit is more important, because it is less subject to corrective market forces.

The process can be viewed as follows. The budget deficit produces excess domestic demand, unless private saving is high. But private saving is the United States is low, not high. If monetary policy were lax, inflation would then rise. But if there is a balanced monetary policy, and a highly disinflationary supply-side global economy, then excess US demand pulls in more imports. The current account then acts as a safety valve absorbing the excess demand. An external currency crisis based on the rising external deficit—and a loss of foreign investor confidence—becomes a greater risk than inflation. The latter fits the future US situation better.

Unfortunately, we do not expect that the anticipated fiscal deficit improvement will translate into a shrinking current account deficit this time. While the fiscal deficit is one source of an external deficit, other savings shortfalls also contribute. In our forecast, the federal deficit improves and personal savings tick up a little, but these are more than offset by a decline in business savings. The projected 2006 external (current account) deficit of nearly $700 billion is about $40 billion higher than in 2004, and is about two-and-a-half times the fiscal 2006 budget deficit, which at $278 billion is down $134 billion from fiscal 2004.

Fiscal Policy and Public Finances

The second Bush administration has an ambitious agenda on tax reform, deficit reduction, and Social Security reform. In the first Bush term, the inherited budget surplus made policy-making easier. “Tough” decisions—creating losers as well as winners—were easily avoided. But now, the need to shrink the budget deficit means that future fiscal policy changes will create more losers than winners, requiring the hard choices that politicians find very difficult.

Tax Reform: What Does "Revenue Neutral" Mean? The general objectives of tax reform are well known: greater simplicity, as well as a shift of the tax burden towards consumption to encourage savings and growth. The end result could be as far-reaching as scrapping the income tax and replacing it with a consumption tax. Less ambitiously—and more likely—it could just extend previous incremental reductions in taxation on income from savings (e.g., through lower dividend and capital gains tax rates).

President Bush has appointed a bipartisan panel to investigate options and report back to the Treasury by the end of July. Chairman Mankiw of the Council of Economic Advisers has made clear that tax reform must be “revenue-neutral relative to the president’s budget.” In practice, this will mean more losers than winners. The president’s budget will almost certainly continue to assume a widening reach of the alternative minimum tax. One objective of tax reform will be to prevent the AMT expansion—but “revenue-neutral” reform will require some other tax hike to restore the revenues.

Deficit Reduction: From Which Starting Point? The administration remains committed to cutting the deficit in half over the next five years. Revenue-neutral AMT reform will do part, but not all, of the job. In addition, there will have to be very tight spending controls, or extra revenues over and above the AMT’s replacement.

The budget plan is due in February. Press reports claim that the administration will try to make its task easier by using last year’s (very pessimistic) projected $521-billion fiscal 2004 deficit as the starting point, rather than the actual $412-billion deficit. That means it can claim that it has accomplished almost half of its targeted reduction already! As usual, the administration will exclude future costs for wars in Iraq and Afghanistan.

As last year, the fiscal 2005 budget is likely to keep the projected growth in discretionary spending, excluding defense and homeland security, at roughly zero in nominal dollars (i.e., falling in real dollars). The crucial question will be whether such spending restraint can be achieved for long in practice—we think not—or whether additional revenues (i.e., taxes) will eventually be required—as we expect.

Social Security: How Much Medicine? The budget is also not expected to include the transitional costs of the president’s plan to introduce private Social Security accounts, which could amount to $1–2 trillion over the next decade. They may be "treated separately" to avoid blowing the budget apart, but the administration is convinced that these costs will be badly received by the markets (i.e., interest rates will rise) unless accompanied by the “medicine” of future benefit cuts to preserve the system’s solvency.

The administration is keen to create a sense of “crisis” surrounding Social Security, warranting tough medicine. But that will not be a straightforward "sell," since the Social

Security fund does not become insolvent until 2042, even under cautious assumptions about growth. It has been lending to the rest of the government (the general fund) since the mid-1980s. After 2018, the general fund must make good its obligations to Social Security. Is that a crisis for Social Security—or a crisis for a general fund that has used Social Security revenues to avoid budget discipline?

The Deficit Is the Key Constraint. In the end, all "reforms" must operate within the constraint of a large underlying budget deficit—and will of necessity create more losers than winners. It makes radical reform difficult, and creates high political stakes for members of Congress who (unlike the president) will answer to the electorate in 2006 and 2008. For the moment, the outcome is too unclear for us to incorporate Social Security or tax reform in our baseline scenario—apart from an assumption that, one way or another, tax reform will deliver the AMT revenues.

Exchange Rates

The dollar continues to weaken, hitting a new low against the euro of less than $1.36 shortly before year-end. So far, the reaction in other financial markets to the dollar's slide has been very muted. At some point, the dollar's decline could become so steep that it prompts a stampede out of US assets, sending long-term interest rates sharply higher and the stock market sharply lower.

The record-breaking (and still growing) current account deficit of the United States is leading the global trade and payments system into uncharted waters-creating new uncertainties for currency and financial markets. The US current account deficit is projected to have increased from $531 billion in 2003 to $662 billion in 2004, reaching an unprecedented 5.6% of GDP. And the burden of global adjustment has fallen on exchange rates, notably, the US dollar values of the euro, yen, Canadian dollar, sterling and other floating currencies. Meanwhile, the dollar pegs and managed floats of Asia's emerging markets are slowing the necessary adjustment process.

Despite the dollar's recent decline, the worsening US current account deficit implies that downside risks predominate for the greenback. The trade-weighted dollar index against major currencies depreciated by around 7% from the fourth quarter of 2003 to the fourth quarter of 2004, and we assume a similar 7% depreciation over the four quarters of 2005, followed by a shallower decline in 2006. This path assumes dollar rates of $1.45/euro, 97 yen/dollar and C$1.17/dollar at the end of 2005. We assume that the dollar will also decline gradually against the currencies of other important trading partners, and that the Chinese authorities will begin to allow their currency to drift upwards in 2006.

Trade and External Accounts

Another Record Current Account Deficit. The current account deficit came in at a record $659-billion annualized rate in the third quarter, fractionally wider than in the second quarter. The deficit would have been wider but for a one-time inflow of payments from foreign reinsurers of about $4 billion ($14 billion annualized) following this year's four destructive hurricanes.

A widening deficit trend continues to be driven by the balance on goods and services, which hit a record $621-billion deficit in the third quarter and will likely widen further in the fourth quarter, since the monthly trade deficit hit a new record in October.

The income balance remained positive, even though the United States is a major net debtor. The United States earns a better return on its assets overseas than foreigners do on their assets in the United States. The income balance will be helped in coming quarters by favorable currency translation effects, since the dollar's decline will boost the dollar value of foreign-currency earnings. But that will merely postpone the day when the income balance turns negative, likely during 2005 or 2006.

Financing the deficit once again relied heavily on foreign governments, although not quite as heavily as in the first half of the year. In the fourth quarter, the current account deficit almost certainly widened, and the dollar's decline indicates that finance was less readily obtained than in the third quarter. We believe that the dollar's decline has further to run, and that the decline is necessary (although insufficient in itself) to eventually put a lid on the current account deficit. We expect the deficit to peak at $718 billion (or 5.8% of GDP) in 2005.

Apparel Quotas Expire. The international Multi-Fiber Agreement (MFA) setting import quotas on clothing and textiles expired on January 1, 2005, lifting quotas on 98 categories accounting for 80% of US clothing imports. Cost savings on the affected import categories to the United States are likely to be about 10–25%, although these savings will not all come through immediately. The big winners will be China and, to a lesser extent, India. The World Trade Organization estimates that China's share of the world market for textiles and apparel will increase from 17% in 2003 to 50% by 2007. The big losers will be smaller developing economies, especially in the Asian region, that cannot exploit economies of scale like China or India.

For US producers, the expiration of quotas will extend the long, slow, and painful process of decline. Safeguard measures are likely to be invoked to restrain any flood of imports, delaying the full impact of the quota removals, and there may be some voluntary restraint by foreign producers (chiefly China) as well. Inevitably, though, the expiration of quotas will accelerate the shift of production overseas, especially at the lower-cost end of the market.

USA

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	9,816.98	12,429.64	16,070.69	35,293.41	4.8	5.3	5.4
Nominal GDP per capita, US dollars	34,714	41,880	51,822	100,655	3.8	4.4	4.5
Real GDP, billion real 2000 US dollars	9,816.66	11,246.85	13,108.43	20,442.09	2.8	3.1	3.0
Real GDP per capita, real 2000 US dollars	34,713	37,895	42,270	58,300	1.8	2.2	2.2
Real private consumption, billion real 2000 US dollars	6,739.06	7,889.13	9,088.66	13,831.04	3.2	2.9	2.8
Real government consumption, billion real 2000 US dollars	1,417.03	1,619.26	1,706.37	1,994.52	2.7	1.1	1.0
Real fixed investment, billion real 2000 US dollars	1,983.47	2,315.51	2,780.73	5,939.94	3.1	3.7	5.2
Real exports, billion real 2000 US dollars	1,096.23	1,190.97	1,869.72	4,926.15	1.7	9.4	6.7
Real imports, billion real 2000 US dollars	1,475.52	1,807.88	2,288.01	5,299.28	4.1	4.8	5.8
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	98.02	108.08	118.52	134.65	2.0	1.9	0.9
Mining	121.33	128.44	134.70	155.67	1.1	1.0	1.0
Manufacturing	1,542.95	1,590.68	1,872.61	2,803.88	0.6	3.3	2.7
Utilities	189.29	212.51	244.05	355.55	2.3	2.8	2.5
Construction	435.91	444.74	508.90	714.35	0.4	2.7	2.3
Wholesale & Retail Trade	1,515.56	2,015.93	2,356.75	3,589.62	5.9	3.2	2.8
Transport & Communication	572.92	676.10	825.31	1,410.93	3.4	4.1	3.6
FIRE	3,109.55	3,650.22	4,329.60	7,149.28	3.3	3.5	3.4
Other Services	2,231.43	2,629.51	2,982.65	4,279.54	3.3	2.6	2.4

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	68.7	69.7	69.1	69.8	1.1	-0.6	0.8
Government consumption share of GDP	14.4	15.3	14.2	11.5	0.8	-1.1	-2.7
Fixed investment share of GDP	20.2	20.0	19.3	20.0	-0.2	-0.7	0.7
Exports share of GDP	11.2	10.3	12.8	16.6	-0.8	2.4	3.8
Imports share of GDP	15.0	15.8	15.8	18.2	0.8	-0.1	2.4
Net extports share of GDP	-3.9	-5.5	-3.0	-1.6	-1.6	2.5	1.4

Canada

Overview

Canada had stronger growth than the United States in each of the years 1999–2002. However, in 2003 the United States outpaced Canada, with growth of 3.0% versus 2.0%. For 2004, Canada's economy should register an expansion of 2.7%, compared with 4.4% for the United States. Canadian exports have been a driving force of the economy, as strong global demand and strong commodity prices over-whelm the impact of the recent appreciation of the Canadian dollar. Historically low interest rates, which did not start to move up until September, continue to support residential construction.

Job creation is expected to be almost as strong as the 2.0%-plus levels of previous years. Interest rates remain considerably higher than in the United States, even after three increases by the Fed in mid-2004. The Fed is expected to increase rates further, whereas the Bank of Canada will likely hold rates near the current 2.50% level for some time. Canada had both a fiscal surplus and a current account surplus last year, and should again this year and for several years to come—unlike the United States.

The prospects for any significant debt reduction and/or tax reduction over the medium term are not promising. Canada's competitiveness will be challenged by a Canadian dollar in the 80 cent range over the next several years, relative to the 64 cents of 2001 and 2002. As well, labor productivity has been much stronger in the United States than in Canada over the past year, which will likely continue to provide a competitive challenge for Canada.

Canadian exporters are very fortunate that, just as they are in the early stages of adjusting to a 25% appreciation of the Canadian dollar, strong global growth and stronger US dollar commodity prices (especially oil) came along to rescue their loss of profits and price competitiveness. On net, Canadian exports will increase, but will not be nearly as strong as they normally are when US growth hits the 4%-plus level, due to the crimping effects of the higher Canadian dollar.

Canada's political situation has rarely seen so many changes in such a short period at both the provincial and federal levels. The minority Liberal government, elected on June 28, 2004, will probably last between one and two years. In the mean time, it will focus on day-to-day coalitions and position itself to regain their majority. This will require taking more seats in Quebec—a reality likely to dominate fiscal policy decisions over the coming year.

Short term

2005 will see GDP growth of 2.8%, a similar pace as in the previous year. A slowdown in private consumption, private and public fixed investment and exports will be roughly offset by stronger government expenditure. A lower increase in import growth will also provide some offset. The unemployment rate is expected to remain at slightly above 7%, which will keep inflation well contained and contribute to stable long-term interest rates.

The trade balance is forecasted to improve due to stronger export prices than import prices. Combined with strong fiscal surpluses, this economic environment will support a modest appreciation of the Canadian dollar relative to its US counterpart.

Medium term

Two issues will dominate the Canadian outlook over the medium term—from 2005 to 2010. Governments are expected to ramp up spending so as to slow down the pace of debt pay-down over time. Consequently, government spending on investment and consumption is expected to outstrip overall GDP growth. As well, the past appreciation of the Canadian dollar combined with an expected decline in commodity prices will take the wind out of the trade sector. The growth rate in imports will exceed than in exports in both the volume and value terms. Canada will make a small, but significant, contribution to the narrowing of the US current account deficit.

Long term

Over the long term, from 2011 to 2025, Canada's economy will slow from just under 3% to slightly under 2%. The reason for the slowdown will be a deceleration of employment growth as the growth rate in working-age population falls to zero. We hope that labour productivity growth—defined as GDP growth less employment growth—will rebound from the recently disappointing performance to 1.7% per year. In 1990s, labour productivity growth averaged 1.7% so our long-term assumption is not without a precedent. The scarcity of labour is expected to drive up the participation rate higher. Also, because younger workers have a greater incidence of unemployment, the dearth of entrants into the workforce will drive down the sustainable unemployment rate to 6.7% over the long term from just above 7.0% over the medium term.

Economic Growth

Growth in Canada for 2003 was 2.0%. Now 2004 is expected to come in 2.7% and up a hair to 2.8% in 2005. The United States is in a strong recovery mode in 2004, stimulated by passage of tax reductions, strong government spending, a weaker US dollar and continuing low interest rates. This should bring its growth to 4.4% in 2004 and 3.5% in 2005.

With recovery in the United States, coupled with strong growth globally, exports in Canada will be a major driver of growth in 2004, in spite of the 80-cent Canadian dollar—a distinct improvement from the past three years. Residential construction is continuing strong, aided by historically low interest rates.

High prices of oil and natural gas are bringing unexpectedly strong profits to the energy sector and to the Alberta and Newfoundland economies. British Columbia, Nova Scotia, and Saskatchewan also benefit from the strong natural gas sector. For energy and many other commodities, in 2004 higher US dollar prices have compensated for the fall in the value of the Canadian dollar.

In the labor markets, the public sector, particularly healthcare and education, is showing strong employment and output gains. Employment growth is expected to be near 2% for the third consecutive year. In 2004, fuelled by energy growth, Alberta is expected to lead all other provinces. Growth in Saskatchewan is also expected to be well above other provinces, driven by its natural gas sector and a return to normal crop conditions. The B.C. economy is finally coming into its own. Economic growth in British Columbia exceeded the national average in 2003 for the first time since 1996, and is expected to do so again in 2004 and 2005.

Consumer Demand

Consumer spending is expected to grow a bit stronger than the economy overall. Relatively low interest rates are continuing as an important driver of consumer strength. Sales of autos are expected to be just short of last year's level. Consumer debt is at a high level by historical comparisons, but with interest rates so low, and employment growth remaining strong, debt charges are not expected to significantly hinder future spending. The housing sector has again been a driver of the economy, owing to continued low interest rates and healthy employment growth. With interest rates moving up, a cooling is likely just around the corner. The stronger Canadian dollar will cause a marginal shift from consumption of domestic production to imports. Over the medium term, consumer spending may lag economic growth overall, as consumers pay down debt and restore a reasonable level of savings. The personal saving rate will be close to zero this year, but move up steadily over the medium term. Over the longer term, consumer spending is expected to match the rate of growth in the economy overall.

Business Investment

Business investment has picked up. Continued low interest rates and a significantly lower cost of machinery imported from the United States were instrumental. Even though the Bank of Canada tightened monetary policy slightly in late 2004, interest rates will remain very low by historical standards well into 2005. Housing construction, which has been so strong for the past several years, will begin to move down to more sustainable levels. The rapid appreciation of the Canadian dollar in 2003 and 2004 has taken a large bite out of some exporters, particularly those non-commodity exporters selling in US dollars. As in recent years, the energy sector will continue to be robust, however. The information technology sector has begun its recovery, particularly computers, as opposed to telecom equipment. Federal and provincial governments have plans for strong infrastructure spending on airports, roads, subways, hospitals, and office buildings over the medium term. The federal government and some of the provinces have pledged reductions in the capital tax rate, which could act as a spur to business investment over the medium term.

Regionally, business investment has been particularly strong in Alberta, and investment is expected to remain strong as long as the price of oil stays above the $30 (WTI) level and natural gas follows this pattern. There are several large resource investments that have potential. Most notably, there is likely to be a boom in natural gas production in northeastern B.C. and the possibility of offshore oil drilling on the coast of British Columbia. With the Liberals replacing the PQ in the recent Quebec election, the province is more “business friendly” again. Quebec already has relatively low business taxes, but lower personal taxes and, importantly, much less intervention and regulation, are expected to improve business confidence and investment in Quebec over the medium term. Meanwhile, conditions for business have taken a sour turn in Ontario. Taxes are higher than otherwise anticipated, and there are more problems in power supply and energy pricing than earlier realized. The Ontario government deficit is significantly larger than earlier understood, fiscal policy is tighter than earlier anticipated. There is the appreciation of the Canadian dollar and oil prices, which hurt Ontario more than most other provinces. The new minority Liberals at the federal level promise more infrastructure spending, primarily through transfers to the provinces and cities.

Inflation

From just above 1.0% in early 2004, overall consumer price index (CPI) averaged 1.8% growth in 2004. In recent months, the overall CPI has been driven by high energy prices, while the higher Canadian dollar has put a damper on import prices.

The core rate has been moving up steadily but still remains at slightly less than the 2.0% level. The output gap, which was close to being closed at the end of the third quarter of 2004, opened considerably in the final quarter of 2004, and as growth moves along at slightly less than the 3.0% level during 2005, the output gap will gradually widen some more.

CPI inflation will likely fall to less than 2% level in 2006, however, as energy prices recede from their lofty levels of late 2004, and the strong Canadian dollar puts downward pressure on import prices. These readings indicate that inflation can be expected to move along near the 2% level in the medium term. The GDP deflator hit 3.0% in 2004, driven by surging commodity prices, particularly for oil, but will approach 2.0% in 2005. The Bank of Canada has made a significant investment in controlling its inflationary expectations, and it is not going to put that reputation at risk.

Labor Market and Demographics

Employment growth came in at 1.8% in 2004, but is expected to fall to a more sustainable pace (1.1%) in 2005. Public-sector employment—particularly in health and education—and private-sector residential construction were the strongest labor markets in 2004 and is a continuing trend in 2005. Alberta is expected to lead other provinces in job growth in 2005, driven by its energy sector. As the output gap narrows, and perhaps more importantly, as governments seem more vulnerable, some signs of labor strife are beginning to emerge. Federal public servants have been picketing, and, given increased funding in healthcare, we expect to hear from nurses and other hospital workers. In the labor markets, the public sector, particularly healthcare and education, show strong employment and output gains. In the medium term, Ontario, British Columbia, and Alberta will be the centers of job gains, against a medium-term employment growth rate of about 1.3% in Canada as a whole. The unemployment rate trended down as well, from 8.0% in mid-2003 to below 7.0% by mid-2005. Due to a peaking in the participation rate and continued reasonable employment growth, the unemployment rate is likely to keep near the 7% level for 2005 and 2006. Although the general trend in unemployment will continue to be stable or slide downward, the structure of unemployment geographically is not expected to change in the medium term. By far, Newfoundland and Labrador will continue to have the highest unemployment rate, followed by Prince Edward Island. The lowest jobless levels will continue to be seen in the Prairie Provinces.

Monetary Policy

The Bank of Canada is committed to keeping inflation close to the mid-point of the 1-3% target band. In 2004, consumer price index (CPI) inflation averaged 1.8% and is expected to average in the 1.5%-2.0% range in 2005. During the past year, there has been a struggle between the upward pressures from energy prices and the downward pressures from the stronger Canadian dollar.

The core rate, which excludes the most volatile components—specifically, oil prices—has generally held at less than the overall CPI. The GDP deflator, on the other hand, is even more influenced by energy prices than is the CPI, since Canada is a net energy exporter. In 2004, the GDP deflator increased 3.0%, driven primarily by strong oil prices. As oil prices recede, the GDP deflator is expected to increase at a slower pace than will the overall CPI.

After its 30% appreciation in 2003 and 2004, we anticipate modest but steady further appreciation in the value of the Canadian dollar over the medium term. In fact, falling commodity prices and a narrowing and negative Canada/US interest-rate gap will keep the Canadian dollar steady throughout most of 2005.

The policy rate fell to a historical low of 2.0% after the rate reduction of 13 April 2004. After several months of inaction, the Bank of Canada began its tightening cycle with a 25-basis-point increase in September, followed by another 25-point increase in October, and paused at each announcement date, December through May. Global Insight forecasts that the policy rate is likely to stay level until late 2005 as the Canadian economy fully digests the rapid rise in the Canadian dollar during 2003 and 2004. With the US Federal Reserve climbing to 3.0% in May, the Canada/US interest-rate gap turned to a negative 50 basis points.

The output gap was nearly closed in mid-2004, but opened again thanks to a weak, fourth-quarter performance. With the economy moving along at a pace slightly less than 3% during 2005, the output gap will continue to be reasonably open by late 2005.

Fiscal Policy and Public Finances

All levels of government have ramped up spending, particularly on healthcare, leaving little room for tax or debt reduction. In mid-September, a significant, long-term deal on federal-provincial healthcare transfers was negotiated, followed by an agreement on equalization in October.

The 2005 budget, which was delivered in late February, laid out a very ambitious spending program for the next five years. By May, further spending post-Budget 2005 had totaled 9 billion over the next five years. Some modest tax cuts are also planned for late in the five-year plan. These fiscal actions combined to exhaust nearly all the fiscal room that can be expected to arise during the next five years. The federal government will make steady but very modest reductions in its debt levels in the coming years. Alberta has now effectively eliminated its debt. British Columbia finally moved from deficit to surplus in 2004/05. Other provinces will be nearly in balance in the coming years, with the exceptions of Ontario and Newfoundland and Labrador, which will have significant deficits.

Only the Alberta government is in a position to consider significant tax reductions over the next year. At the federal level there will probably be some modest reductions on the business side over the next few years, but reductions on the personal side will be scarce. There are strong reasons for reductions in the capital tax rate at both federal and provincial levels.

In its 2005 budget, the federal government set plans to modestly reduce both personal and business taxation, primarily in the latter years of the five-year fiscal plan. Specifically, it plans to increase the Basic Personal Amount, eliminate the capital tax in the next five years, and provide more generous depreciation allowances on IT equipment.

This is a particularly fragile, minority government, which must seek issue-by-issue support. Given the numbers, however, coalitions will be difficult to come by. Progress must be made on significantly increasing transfers to the provinces for healthcare and equalization. The government's social spending agenda includes child care, the environment, and aboriginals. Little progress on substantive changes to economic policy can be expected from this precarious minority situation. Liberals and Conservatives will both be focused on preparing to win a majority in another election, undoubtedly only about a year or so away. The Liberals will be courting Quebec voters, the key to them regaining a majority.

Ontario and Newfoundland & Labrador will be struggling with significant deficits for the next several years. While the federal government has made great progress in reducing the debt burden since 1997, from 70% of GDP to 40%, this level should fall at least another 15 percentage points. In Budget 2005, the government re-affirmed plans to reach the 25% debt-to-GDP level by 2014, which is eminently attainable. At the provincial level, the debt burden is far too high in Newfoundland & Labrador and Nova Scotia. Alberta is the envy of all governments, with the debt burden effectively eliminated.

Exchange Rates

The Canadian dollar appreciated about 30% in 2003 and 2004, largely reflecting the fall in the US dollar relative to most currencies. Indeed, at the end of 2004, the euro costs roughly the same in Canadian dollars as it did at the beginning of 2003 (C$1.60).

In early 2005, the Canadian dollar was on a downward trend from a decade-high US$0.85 level seen in late November 2004. After this November peak, until early June, the dollar was in general decline, averaging about 80 cents in May. The Canadian dollar continues to be most heavily influenced by the combination of energy prices, the falling Canada/US interest-rate gap, and the general movement of international financial portfolios away from the US dollar.

Even though the US dollar depreciated considerably in 2003 and 2004, some further downward adjustment in the US current-account deficit is still necessary for a sustainable equilibrium. International financial markets are also becoming nervous about the federal and state deficits.

As a significant offset to these upward pressures on the Canadian dollar, however, the Bank of Canada narrowed the Canada/US interest-rate gap from 225 basis points to 100 basis points over July 2003–April 2004. The gap narrowed to zero in February 2005, and in May 2005 moved to 50 basis points negative as the US Federal Reserve moved its rates upward against a steady position by the Bank of Canada. All things considered, Global Insight forecasts the Canadian dollar will average about US$0.82 in 2005. The Canada/US interest-rate gap is expected to stabilize at about 90 basis points negative in 2006; energy prices will resume a downward trend, and the medium-term, downward pressures on the US dollar will dominate. This combination of forces will cause the Canadian dollar to stabilize at the 86-cent level over the medium term.

Trade and External Accounts

The current-account surplus strengthened to the C$29-billion level in 2004, up from the C$18 billion of 2003. The rapid appreciation of the Canadian dollar in 2003 and 2004 is a source of significant downward pressure, but this is being more than offset by the increasing strength of the global economy and stronger US dollar commodity prices on demand for our exports.

The nominal value of energy exports was strong in 2004, and should continue into early 2005. Interest payments to foreigners have fallen significantly in recent years, and will continue downward over the medium term.

As the United States moved into recovery in 2004, exports strengthened. The fact that so much of Canada’s imports are inputs to products, which are later exported, reduces the negative impact of a reduction in exports on Canada’s current-account surplus.

The auto sector and other sectors dominated by multi-national firms are examples of this phenomenon. Increasing imports of machinery and equipment, taking advantage of the stronger Canadian dollar, also reduce the current account. Overall, the current account is expected to hit the C$19-billion level in 2005, the C$28-billion level in 2006, and then remain in the C$25-30-billion level over the medium term. This erosion of Canada’s current-account surplus is a contribution to the necessary reduction of the US current-account deficit.

The performance of the trade surplus will mirror the current account. The C$54-billion trade surplus of 2004 probably represented a peak, and is likely to move down steadily over the medium term. This decline in Canada's trade surplus in the medium term is largely in response to the rise in the value of the Canadian dollar, in turn, resulting from a general decline in the value of the US dollar relative to industrial currencies generally.

CANADA

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	724.75	1,106.80	1,426.91	2,840.11	8.8	5.2	4.7
Nominal GDP per capita, US dollars	23,646	34,382	42,789	78,309	7.8	4.5	4.1
Real GDP, billion real 2000 US dollars	724.69	820.79	948.76	1,321.91	2.5	2.9	2.2
Real GDP per capita, real 2000 US dollars	23,644	25,498	28,451	36,448	1.5	2.2	1.7
Real private consumption, billion real 2000 US dollars	401.22	469.25	548.17	762.57	3.2	3.2	2.2
Real government consumption, billion real 2000 US dollars	134.69	157.19	187.20	260.07	3.1	3.6	2.2
Real fixed investment, billion real 2000 US dollars	138.86	175.68	217.70	302.06	4.8	4.4	2.2
Real exports, billion real 2000 US dollars	330.28	343.41	398.51	738.38	0.8	3.0	4.2
Real imports, billion real 2000 US dollars	288.64	332.28	400.83	722.24	2.9	3.8	4.0
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	15.33	15.97	18.65	24.40	0.8	3.2	1.8
Mining	40.48	45.18	52.92	71.78	2.2	3.2	2.1
Manufacturing	133.64	140.88	162.80	221.28	1.1	2.9	2.1
Utilities	18.59	18.31	21.36	31.74	-0.3	3.1	2.7
Construction	33.54	42.23	49.24	72.30	4.7	3.1	2.6
Wholesale & Retail Trade	89.62	113.93	133.18	194.76	4.9	3.2	2.6
Transport & Communication	45.53	52.77	62.70	104.99	3.0	3.5	3.5
FIRE	166.37	192.07	223.16	325.93	2.9	3.0	2.6
Other Services	129.57	145.39	166.99	239.84	2.3	2.8	2.4

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	55.4	55.8	58.1	59.2	0.5	2.3	1.1
Government consumption share of GDP	18.6	19.2	20.2	21.2	0.6	1.0	1.0
Fixed investment share of GDP	19.2	20.1	21.4	19.4	0.9	1.3	-2.0
Exports share of GDP	45.6	37.2	32.4	32.9	-8.4	-4.8	0.5
Imports share of GDP	39.8	33.0	33.2	33.8	-6.8	0.1	0.6
Net extports share of GDP	5.8	4.1	-0.8	-0.9	-1.6	-4.9	-0.1

II. Asia

Japan

Overview

The revised national income accounts—GDP and components are now measured on a chain-weighted basis with 2000 as the base year—showed the economy was extremely sluggish in the third quarter of 2004: GDP increased at an annual rate of only 0.3%. Moreover, the new figures show that output actually fell in the second quarter; in addition, growth during the export boom of late 2003 and early 2004 was revised downward. Although some of this bad performance was due to cuts in wasteful public works projects, it is clear that all sectors of the economy slowed substantially. Exports flattened, but this was expected, considering the disproportionately response of overseas demand relative to overseas domestic growth. In addition, the stronger yen had a moderate, negative effect on competitiveness. Capital expenditures and inventory investment, which move in tandem with exports, likewise slowed. But the slowing of consumption was unexpected. Incomes had been rising, thanks to the export boom, and monetary policy was aggressively expansionary, so the fundamentals appeared to favor increased household spending.

Rising commodity prices quickly translated into higher domestic prices. This was considered beneficial in Japan, where deflation has been the norm for years. However, by late last year, world commodity prices were easing, and weakness in consumer and corporate goods prices were beginning to return. Considering that the GDP deflator was still falling in the third quarter, there is little doubt that deflation will continue to show up in the national accounts for the next few quarters.

The labor market has done relatively well. The unemployment rate recently fell to 4.4%, an improvement that was made while the economy was barely growing. On the downside, some of this improvement reflects the fact that the discouraged unemployed have stopped looking for work. This decline in the labor force has been going on for years, a trend that appears largely independent of the strength or weakness of economic growth.

There has been little change on the policy front. Monetary policy has been surprisingly neutral for many months; this is in marked contrast to the expansionary policies prior to early last year. Fiscal policy has kept spending, taxes, and the deficit roughly in line with GDP growth.

Last, the long-anticipated strengthening of the yen finally took place in the fourth quarter—private capital outflows were not sufficient to offset the large current account surplus—but the yen eventually settled near 100 per dollar without any intervention by the Bank of Japan. This partly indicated the reputation of the BOJ, which was expected to intervene at any moment; which in turn discourage speculators from taking a long position on the yen. But, as in early 2004, it also indicates that many Japanese exporters are willing to hold dollars, at least temporarily. This began to change in early 2005; high commodity prices raised Japan's import bill, while a widening interest rate differential with the United States encouraged capital outflow, and thus led to a mild depreciation.

Short Term

Global Insight expects a gradual rebound in private consumption (and, to a lesser extent, government consumption). Capex and exports will grow together, albeit slowly; imports will also grow slowly, so the external surplus will decline only gradually. This assumes no upward surprises in commodity prices. The GDP deflator will initially be weak, continuing the downtrend of last year, but should level out by late 2005–early 2006; consumer price deflation should end sooner, while corporate goods deflation should continue well into 2006. Inflation rates of 1–2% are not expected until late 2007.

There is a good chance that the labor force, which has been trending downward for years, will level out soon, as job opportunities improve and people are willing to tolerate spells of unemployment. Nevertheless, the unemployment rate is expected to hover in the mid-4% range for many quarters.

Although the monetary aggregates continue to grow, the fact that deflation seems to be returning suggests that additional expansion will be coming. The one exception to this depends on whether bank lending continues to decline; if it levels out, the Bank of Japan will likely remain cautious to avoid overstimulating the financial sector. Regarding fiscal policy, little change is on the horizon: spending will be roughly constant in the upcoming fiscal year, as small increases in social spending are offset by declines in public works spending and subsidies for prefectural governments. Further into the future, some tax hikes—probably consumption taxes—will be needed to close the budget deficit; these will probably begin in 2007.

The recent weakness of the yen should prove temporary. As oil prices moderate, and multinationals begin to convert accumulated dollar holdings to yen, another round of yen appreciation appears likely. The BOJ will fight it, but by year-end the exchange rate should approach 100 per dollar.

Medium Term

Over the next several years, Japan's GDP should increase roughly 1.5% per year. This modest growth rate is partly due to stagnant population growth, though in fact the working-age population will increase slightly. More importantly is that restructuring has been slow: many unprofitable firms are not downsizing, and many unproductive workers continue to hold jobs. These impediments will gradually be corrected, but at the same slow pace that has been the norm for over ten years. Demand is unlikely to receive significant policy stimulus: the government will gradually reduce its fiscal deficit—with spending cuts and consumption tax increases—which will not be substantially offset by the Bank of Japan's cautious monetary policy. Net external demand should likewise hold steady, as imports recover to more normal levels (relative to GDP), thus keeping up with export growth and keeping the real trade balance constant.

The medium term should also see a return to positive price increases, i.e. inflation rather than deflation. In fact, the large money overhang created in recent years even raises the possibility of a surge in inflation; however, the Bank of Japan's reputation would keep such a price rise limited. Thus, consumer price inflation should gradually rise toward 2% over the next several years. Note that this low rate of inflation, compared to the US and other countries, will add to Japan's competitiveness, and keep demand for exports growing. This in turn will tend to appreciate the yen. A reduction in capital outflows, as investors become less interested in dollar-based assets, will add to the yen's strength. We expect the yen to appreciate past 90 per dollar before 2010.

Lastly, little change is expected in the labor market. The unemployment rate could creep up from the low- to high-4% range, reflecting the structural mismatch between workers' skills and the requirements of new jobs. Although the working-age population will increase slightly, employment should peak around 2008 then begin to decline, reflecting changing attitudes toward work and unemployment by both the young and older workers. This also reflects the high savings of most households, which allows most unemployed to get by despite Japan's relatively small welfare benefits.

Long Term

Looking beyond 2010, Japan's GDP growth rate should gradually decline from 1.5% to 1.0%. But this is entirely due to a falling population; in fact, the per capita growth rate should hold steady near 1.5% indefinitely. This productivity growth rate actually has the potential to be much higher, given Japan's highly-educated workforce and its strong work ethic. But it appears unlikely that Japan would ever fully accept, either legally or socially, the instability that would result from high labor turnover, corporate takeovers, and other free-market characteristics. In addition, there will be less output growth generated by net external demand, which will level off and eventually decline. This in turn stems from rising domestic demand and falling savings—due to an increasing share of the population retiring—which will pull in more imports. The falling savings rate will also reduce capital outflows, allowing the yen to remain strong indefinitely. Assuming inflation rates average 2% in the long term, the yen should stabilize near 85 per dollar. Lastly, the government's fiscal deficit should continue to the forecast horizon of 2025. But as a percent of GDP, the deficit will gradually decrease; as a result, the national debt as a share of GDP should level off at 180% of GDP.

Economic Growth

Japan's export-led growth surge in 2003 carried through to the first quarter of last year—GDP grew at an annualized rate of nearly 7% during the quarter—but then abruptly stalled. The new national income accounts show this clearly, with GDP essentially unchanged in the second and third quarters of 2004. A major reason were the cuts to public works spending; these cuts are necessary, since much of this "investment" is actually unnecessary, but it has the effect of lowering officially-measured output. More seriously, private consumption grew sluggishly; this was a surprise, since the rapid income growth of the previous year was expected to stimulate household spending. And recent monthly data verify that consumer spending remains relatively flat. Lastly, real exports also slowed last year; this in itself was not a problem, but the induced negative effects on capital expenditures and inventory investment did contribute to slower growth.

Only modest export growth is expected in the near term, with the negative impact of the stronger yen being offset by the high productivity growth of Japanese multinationals. Similarly, this will stimulate only slow growth in capital expenditures and inventories. In fact, in the medium to long term, capital investment is likely to decline as a share of GDP, reflecting the gradual decline in the national saving rate. Private consumption should stage a small rebound; it seems unusually low at the moment, considering that fundamentals—mainly income and unemployment—favor rising spending. This also means that import growth will gradually rise, but at such a slow rate that the external surplus will remain large for years to come. Lastly, it is likely that government consumption will trend upward, as a response to the slow economy. Although the budget deficit will constrain spending, cuts in public works will allow some small budgetary additions to social spending. For 2004, the annual growth rate should be approximately 2.9%, falling to roughly 1.5% this year and then rebounding slightly to 2.0% in 2006. Going into the medium term—assuming Japan can achieve sustainable growth and avoid further business cycles—GDP should increase at a roughly 1.5% pace, generated largely by domestic demand; net external demand could even trend downward. In the long run, GDP growth rates should gradually decline toward 1.0% at the end of the forecast horizon, composed of productivity growth of 1.5% combined with a population decline of 0.5% per year.

Consumer Demand

In early 2003, strong growth and a stable labor market appeared to be having a positive impact on household spending, and it was hoped that consumption would become the locomotive for the economy. But in the second and third quarters of last year, real consumption grew at a sluggish 1% annualized rate; and recent monthly data verify that consumer spending is not undergoing significant rebound. The shift to a new system of national income accounts late last year has added to the malaise: not only was real consumption growth revised downward, but nominal spending as well was lowered from 2% to a sub-1% growth rate. The reluctance of households to spend partly stems from ongoing restructuring and concerns about job security; although unemployment remains relatively low, this reflects the fact that many discouraged unemployed have stopped looking for work. On the positive side, saving remains high and is very liquid, with considerable household wealth in the form of easy-to-spend bank deposits. Given these conflicting pressures, Global Insight forecasts real consumer spending to gradually accelerate during 2005, until it is growing at an annual rate of slightly below 2%. Nominal consumption should follow a similar pattern, but should eventually reach a 3%+ growth rate next year as deflation finally gives way to positive price movements. Over the next several years, consumption should gradually increase past 57% of GDP, continuing in the long term to nearly 60% by 2025. This would still be somewhat low by developed-country standards, but we assume Japan's propensity to save will remain high, even as an increasing share of the population retires.

Business Investment

The export boom of a year ago greatly benefited large exporters and heavy manufacturers, who enjoyed rapid profit growth. But it also illustrated the structural inadequacies that remain: small manufacturers saw little benefit, and much of Japan's exports involved shifting production overseas, especially to China. Given Japan's high wages and strong currency, it is not clear that manufacturers can continue to generate sufficient productivity growth so as to keep their domestic production competitive on world markets. So the pattern of offshoring should continue. This will not necessarily hurt profits—in fact, Japanese auto companies have been reaping the benefits of their overseas production for years—but it does mean that production of capital goods will continue to trend downward as a share of GDP. At the same time, investment should shift toward new, growing sectors of the economy such as healthcare and consumer goods. But this will only happen if restructuring is successful, with capital markets becoming more focused on profitability. But note that Japan's high savings and investment rates result in low rates of return on most investments. This disincentive, in combination with a falling savings rate, means that investment as a share of GDP will decline in the medium and long term, from nearly 20% today to roughly 15% in 2025. This does not mean investment will decline in absolute terms, but rather that expenditures will grow at a slower pace than the overall economy.

Inflation

Deflation was on the wane in 2004: rising international commodity prices and strong demand from China for industrial goods resulted in both export and import prices rising in mid-2004. These prices for traded goods fed through the rest of the economy; as a result, the GDP deflator was virtually flat in the third quarter. But these effects ended in late 2004, as commodity prices weakened and the yen strengthened. Consequently, monthly price indexes for corporate goods and consumer prices were flattening out by the end of the year. Adding to this change was relatively weak domestic demand, as both consumption and capital expenditures decelerated rapidly in midyear.

In the near term, domestic spending is expected to remain sluggish, and will provide little upward pressure on prices. From the supply side, capital goods will maintain productivity growth, so the secular downtrend in capex prices will continue indefinitely. In fact, as capacity rises to catch up with last year's demand surge, a sharp drop in industrial prices is likely. Consumer prices are more problematic: although household spending will not grow quickly, the relatively slow pace of productivity gains could keep prices flat in the near term, or at least limit the rate of price decreases. Lastly, uncertainties in the financial markets have encouraged households to keep high levels of liquid savings; as concerns about the health and safety of banks begin to fade, some of those monies will be spent and thus provide suppliers with some pricing power. Overall, we expect the GDP deflator and consumer prices to flatten permanently by the end of this year, while corporate goods prices—as they correct from the demand surge and supply constraint of last year—actually decline for several quarters.

Even as prices begin to rise consistently in the medium term, inflation should remain low: the consumer price index should not exceed 2% until 2010. This results from slack in the labor market—the unemployment rate will remain in the high-4% range—which will prevent any supply-side shortages. In addition, demand should grow at a moderate pace, constrained by a high savings rate and the Bank of Japan's cautious monetary policy. Only in the long term, after the economy has had years to make necessary structural changes, will inflation rates rise into the mid-2% range. This will be followed by necessary policy adjustments that bring inflation back down below 2% by 2025.

Labor Market and Demographics

In early 2004, the unemployment rate fell below 5% thanks to the export-led recovery. Since then, the jobless rate has been volatile but has managed to trend downward slightly: in December 2004 it reached 4.4%, its lowest level since 1998. This improvement was noteworthy in that it took place even while the economy was slowing—GDP was essentially flat in the second and third quarters. To some extent, this indicates that the labor market has become more flexible, especially in utilizing part-time workers. Unfortunately, some of the fall in the unemployment rate stems from a drop in the overall labor force; because of the ongoing structural changes, as the Japanese economy shifts away from heavy industries, many discouraged unemployed people have stopped looking for work. In recent years, despite the fact that the working age population has not changed, the labor force has been falling by 200,000 per year.

The downtrend in the labor force should begin to decelerate. Labor has become more mobile, with people moving to large metro areas that have better job opportunities. There is also less stigma associated with part-time work, especially in the service sector. But this also implies workers will remain in the labor market when they are between jobs, thus the unemployment rate is unlikely to fall much further. Continued restructuring in heavy industries will add to the pool of unemployed, but this process should continue to be gradual, as it has been for the past several years. Although the embarrassment associated with unemployment has lessened in the past several years, it will remain an undesirable outcome: government-funded unemployment benefits will remain modest, due to both cultural attitudes and the need to reduce the budget deficit. In the near and medium term, the unemployment rate should remain in the mid-4% range; paradoxically, this could rise slightly if the economic recovery accelerates, since it would shorten the duration of periods of unemployment and thus encourage workers to remain in the labor market. This situation will continue in the medium term; Global Insight forecasts the unemployment rate peaking at 4.9% in 2008. But going into the long run, as society adjusts to the new labor environment, we expect some improvement. However, the falling population will make it more difficult for labor adjustments to occur. Consequently, the unemployment rate should fall only marginally to level off at 4.7%.

Monetary Policy

For several years, Japan's monetary policy has been judged on the basis of the monetary aggregates and exchange rate intervention, since short-term interest rates have been stuck at zero. Governor Fukui had been fairly expansionist—especially compared with his predecessor—during his first year at the Bank of Japan, rapidly increasing the monetary base and bank reserves, and engaging in considerable yen-selling in the forex market. But monetary policy shifted to neutral last year. This initially appeared to be the logical response to healthy first-quarter growth and the fact that the exchange rate stabilized following massive intervention. But by end-2004, after months of near-zero growth, there were no signs of monetary expansion. This could reflect simple caution: monetary policy has long and variable lags, so the BOJ may want to avoid creating another "bubble" in a year or two. In addition, inflation turned positive for several months, due to external demand and rising commodity prices, so the BOJ possibly wanted these effects to dissipate before further stimulating the economy. But with prices now flattening, and expected to resume falling, further stimulus is likely. Thus the monetary base, which has been flat for months, should begin to rise again, although probably not at the same rapid pace as when Fukui first joined the BOJ. Although this could be accomplished by normal open-market operations, it could take the form of exchange rate intervention: if the yen strengthens past 100 per dollar, the BOJ could again engage in large-scale yen-selling. In the medium term, as price inflation returns, short-term interest rates will quickly rise to 2%, followed by marginal increases in the long term. But real short-term rates will remain low indefinitely, reflecting the scarcity of investment opportunities in Japan.

Fiscal Policy and Public Finances

The budget for fiscal year 2004 (April 2004–March 2005) is 82.1 trillion yen. This is composed of increases in social spending, mainly for the elderly, and decreases in most other items, such as public works. Of the total 82.1 trillion yen of expenditures, taxes will finance 45.5 trillion yen; the remaining 36.6 trillion yen will be financed by borrowing. Large budget deficits have become common in Japan and have sent government debt above 160% of GDP; however, this debt has yet to become a burden, thanks to the high savings rate of the Japanese people and to the Bank of Japan's purchases of 1.2 trillion yen of government bonds every month.

Budgeted spending for fiscal year 2005, meanwhile, should increase marginally; the general budget (which is roughly half of the total budget) has initially been set at 48.2 trillion yen, compared with 47.6 trillion in the current fiscal year. This should result in a smaller budget deficit, as current strong growth and the end of deflation raise nominal incomes and, consequently, tax revenues. This will also allow the Bank of Japan to reduce its bond purchases, a necessary part of monetary tightening when deflation ends. Thus, the budget deficit should quickly move toward 20 trillion yen, and then improve gradually thereafter. Although Global Insight does not foresee and end to the deficits, the national debt should level off as a percent of GDP, peaking at 180% later this decade. Note that the Japanese government also does not see a quick end to deficits: it hopes to achieve a primary surplus (i.e. revenues greater than non-interest spending) sometime after 2010. From there to the forecast horizon, all major fiscal indicators—revenues, expenditures, and deficits—should remain relatively constant as a share of GDP.

Exchange Rates

The strengthening of the yen in late 2004 had been expected for some time, since it was unlikely that normal capital outflows from Japan could offset the large current account surplus indefinitely. But in the fourth quarter, the exchange rate leveled off slightly above 100 per dollar. Surprisingly, this happened without any intervention by the Bank of Japan; this suggests that speculators were loath to go long on the yen, out of fear that the BOJ would intervene and force the yen lower. But it also indicates that there are still large capital outflows from the private sector; this in turn is a result of the large amount of savings in Japan as well as the low return on capital for domestic investment. Looking into the near term, it is unlikely that capital outflows will increase; despite the better returns overseas, the risk associated with foreign investment will limit the outflows. In addition, a gradual increase in household spending will tend to reduce national savings, and thus reduce the amount of funds available for foreign investment. Lastly, Japan remains very competitive in world markets even at current exchange rates—years of deflation have reduced nominal prices, while productivity growth remains high in export industries—so exports will continue to grow, albeit slowly. Thus, continued demand for the yen and moderating supply will lead to further yen appreciation. This process will not be smooth, especially with intervention by the Bank of Japan likely, but by the end of this year the exchange rate will near 100 per dollar, with further strengthening next year. This process will continue for the next several years: as Japan remains competitive thanks to low inflation, foreign demand for exports will remain strong, thus raising the demand for yen on the foreign exchange markets. The nominal exchange rate should peak in roughly ten years, at approximately 83 yen per dollar, then be followed by a gradual weakening. The latter reflects the rising importance of domestic demand—itself partly due to the aging population—which will increase the demand for imports and thus increase yen-supply in the forex markets.

Trade and External Accounts

Exports have decelerated recently; this comes after a year-long export boom that was Japan's main source of growth. The slowdown was expected: the world recovery is maturing, and the stronger yen makes Japanese goods less competitive. Imports grew rapidly last year, after being relatively flat, due mainly to higher commodity prices; the subsequent cooling of these prices has in turn led to lower imports by year-end. As a result, the trade surplus remains rather high, above 2% of GDP. Adding the service deficit and the large income surplus yields the sizable current account surplus, at 3+% of GDP

Despite the current sluggishness, the prospects for Japanese exports are relatively good. The main sources of demand are North America and Asia (especially China), and these countries will continue to grow at a healthy pace. And Japanese goods are sufficiently differentiated from other countries' goods so that demand will decline only marginally due to the stronger yen. Imports will remain weak in the near term, reflecting the lack of domestic demand, and thus the external surpluses will remain very large; the current account balance is not expected to fall below 3% of GDP until late 2006. In the medium term, Japanese goods exports could be hurt by increased competition from industrializing Asian countries, but rising income earned from direct investment in those countries will keep prevent the current account surplus from declining rapidly. This process will continue in the long term; in addition, demographic changes will tend to increase import demand, further lowering the trade balance. But Japan's current account surplus will continue indefinitely, although it will decline as a share of GDP from its current 3.5% to roughly 2.7% in 2025.

JAPAN

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	4,750.28	5,123.40	6,873.83	10,937.28	1.5	6.1	3.1
Nominal GDP per capita, US dollars	37,449	40,044	53,699	89,579	1.3	6.0	3.5
Real GDP, billion real 2000 US dollars	4,745.85	5,013.45	5,509.90	6,771.06	1.1	1.9	1.4
Real GDP per capita, real 2000 US dollars	37,414	39,185	43,044	55,457	0.9	1.9	1.7
Real private consumption, billion real 2000 US dollars	2,651.47	2,795.91	3,117.50	3,930.94	1.1	2.2	1.6
Real government consumption, billion real 2000 US dollars	779.61	870.37	1,019.75	1,414.19	2.2	3.2	2.2
Real fixed investment, billion real 2000 US dollars	1,250.24	1,193.20	1,204.93	1,253.24	-0.9	0.2	0.3
Real exports, billion real 2000 US dollars	512.72	666.22	782.58	1,163.48	5.4	3.3	2.7
Real imports, billion real 2000 US dollars	444.84	525.12	644.33	1,029.57	3.4	4.2	3.2
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	65.97	63.34	64.49	65.28	-0.8	0.4	0.1
Mining	6.14	5.70	5.42	5.04	-1.5	-1.0	-0.5
Manufacturing	1,030.32	1,033.03	1,101.74	1,344.73	0.1	1.3	1.3
Utilities	175.30	187.74	210.99	284.25	1.4	2.4	2.0
Construction	352.01	291.94	310.37	380.06	-3.7	1.2	1.4
Wholesale & Retail Trade	756.00	791.94	857.90	1,051.28	0.9	1.6	1.4
Transport & Communication	302.68	316.98	357.95	500.87	0.9	2.5	2.3
FIRE	1,276.17	1,362.81	1,516.05	1,908.14	1.3	2.2	1.5
Other Services	1,047.49	1,187.11	1,295.35	1,625.30	2.5	1.8	1.5
					Share change, percentage points		
	2000	**2005**	**2010**	**2025**	**2000-05**	**2005-10**	**2010-25**
Private consumption share of GDP	55.9	57.0	58.8	61.7	1.2	1.7	3.0
Government consumption share of GDP	16.4	17.8	19.2	22.6	1.4	1.4	3.4
Fixed investment share of GDP	26.3	23.2	20.8	16.1	-3.1	-2.5	-4.7
Exports share of GDP	10.8	12.8	12.0	11.8	2.0	-0.8	-0.3
Imports share of GDP	9.4	11.3	11.5	12.9	1.9	0.2	1.4
Net extports share of GDP	1.4	1.6	0.6	-1.1	0.1	-1.0	-1.7

China

Overview

Short Term

The economy will maintain strong momentum into 2005, at least in the first half of the year. Economic growth regained momentum in the final quarter of 2004. Export growth is showing no signs of cooling, with external demand still healthy, particularly in the all-important US market. Consumer demand has remained steady. Most importantly, there are indications that the government has relaxed on the austerity measures—liquidity growth has picked up again in recent months after nearly a year of deceleration.

The oil-price resurgence is an important concern. High oil prices in 2004 did not have a significant impact on growth and inflation partly because the oil industry is still government run, which imposes price controls on the sector. Concerned about soaring oil prices' potential damage on the economy, the government has imposed only limited oil price hikes, hence essentially forcing the state oil companies to subsidize the economy's oil usage with their profit margins. If oil prices continue to stay at high levels, it would be difficult for the government to keep squeezing the state oil companies. Moreover, except for oil prices, true world market conditions will continue to encourage inefficient oil usage in China.

Despite the overheating, there remain substantial deflationary forces in the economy, reflected by consumer price inflation's sharp deceleration in recent months. The government therefore fears that too much tightening could revive deflation and damage domestic demand. As a consequence, Beijing will remain cautious in its economic policies on all fronts. Fiscal priming will continue, although at a more moderate pace. Monetary conditions will remain accommodative.

In sum, over the short term, growth will moderate, but remain strong. There will be no out of control inflation as in the past overheating cycles. Price increases are likely to be mild. The fixed exchange rate policy is here to stay, though the benefits of such a policy has been steadily eroding.

Medium Term

Economic growth will stabilize to a more moderate 7-8% range over the medium term. Though the absence of inflationary pressure has allowed the Chinese government to be measured and selective in their attempt to dampen growth, the government's tightening policies have been, nevertheless, effective. Fixed investment growth, the main source of the current overheating, has been steadily inching down, from first-quarter 2004's torrid 43% growth to 23% in the first quarter of 2005. This trend should continue, as the government is not showing signs of relenting.

Another factor for a medium-term growth trend-down is the reversal of the "hot economic growth-hot money inflow" vicious cycle. China's ongoing heated economic growth has made China's fixed exchange rate appear extremely undervalued, even though the renminbi has been re-based under a "package" scheme. This in turn exerts substantial upward pressure on China's money supply, which exacerbates overheated economic growth, which attracts more "hot money." But as Beijing continues to clamp down on investment growth and remains steadfast in the fixed exchange rate policy, renminbi speculation will eventually dissipate. Hence, the "hot economic growth-hot money inflow" vicious cycle will reverse.

Seemingly paradoxically, as speculative pressure on the fixed exchange rate disappears, Beijing is likely to switch to a more flexible exchange rate regime. The fixed exchange rate has become increasingly problematic for China. It has exacerbated the current overheating cycle. Moreover, it is inconsistent with China's long-term objective of liberalized control on cross-border capital movement. That is, as China's capital account has become increasingly porous, the fixed exchange rate has deteriorated the government's ability to set monetary policy. The government has refused to budge on the fixed exchange rate policy so far because of the legitimate fears that implementing a moderate revaluation would encourage even more speculation, and having a substantial revaluation would hurt exports. But once growth moderates, it will be much less risky for Beijing to change the exchange policy, most likely to a managed float system.

Long Term

Over the long run, China's continued success rests on whether the government can tackle the structural problems in the state-owned enterprises (SOE) and the financial sector. The massive and inefficient SOEs have been a major impediment to China's growth. The required large scale layoffs are also exerting a toll on social stability, in addition to depressing consumer demand. Moreover, the SOEs are the major source of the banking system's gigantic non-performing loans problem. The flawed financially sector in general, and banking sector in particular, has not only created massive inefficiencies in capital allocation, but also induced excess savings in the non-state sector. This has produced structural deflation and domestic demand weakness in the seemingly high flying economy.

Nevertheless, the government should be able to successfully tackle these structural problems. Beijing's decision to enter China into the WTO and subject its domestic producers to stiff foreign competition reflects the authorities' resolve in continuing the effort to move China to a fully market-based system.

Economic Growth

China saw real first-quarter GDP growth of 9.5% year-on-year (y/y), matching its fourth-quarter 2004 rate, according to the official National Bureau of Statistics. Nominal first-quarter GDP reached 3.136 trillion yuan (US$379 billion).

However, the rapid first-quarter growth is not as alarming as it seems. Although fixed-asset investment growth remained high in the first quarter, at 22.8%, it was much slower than the 43.0% expansion in the first quarter of 2004. Moreover, net exports were major contributors to the first quarter's high growth. Exports rose 34.9% to US$155.9 billion, while import growth moderated to 12.2%, down from 30.3% in the fourth quarter of 2004. The trade balance resulted in a substantial surplus of US$16.6 billion (5% of first-quarter 2004 nominal GDP), compared with an US$8.7 billion deficit for the same period in 2004.

We believe that recent developments still justify an economic soft landing as our baseline view. First, the "healthy" growth components (that is, demand components other than state investment) are still growing strong. Export growth, as mentioned above, has continued to sizzle, while foreign direct investment inflow remained strong, at US$13.4 billion in the first quarter, 9.5% higher than the year-earlier levels. Retail sales, which are a proxy for private investment, rose 13.7% in nominal terms and 11.9% in real terms.

Perhaps even more importantly, inflation continued to ease in the first quarter of 2005. Consumer prices rose 2.8% y/y, compared with 3.2% in the final quarter of 2004. Producer prices measured by the ex-factory price index advanced 5.6% in the first quarter, compared with 7.9% gains in the fourth quarter of 2004, which should give Beijing leeway in its efforts to impede growth; it does not need to choke off credit in order to combat high inflation, as it did during past overheating episodes. The government must therefore remain measured and selective over which macroeconomic control measures it implements.

Over the long run, we expect growth to trend down to around 6%. China can still benefit from "catch-up" effect, as its per-capita income is still extremely low. The government is likely to successfully tackle the structural problems in the state-owned enterprise sector and the financial system. Beijing's decision to enter China into the WTO and subject its domestic producers to stiff foreign competition reflects the authorities' resolve in continuing the effort to move China to a fully market-based system.

Consumer Demand

Consumer demand has continued its steady climb in 2005. Retail sales in April totaled 466.3 billion yuan ($56.3 billion), 12.2% more than a year ago. The April growth rate marked a deceleration from the March rate of 13.9% and the January-February rate of 13.7%.

Sales in clothing rose 16.8% year-on-year (y/y) in April, compared with 18.9% y/y in March. Athletic and entertainment goods sales jumped 29.8% y/y in April, up from 24.8% y/y in March. Jewelry sales in April rose 12.1% y/y, sharply lower than 19.2% y/y in March. Automobile sales increased 13.0% y/y in April, 2.8% higher than the April rate. Petroleum and petrol-related goods sales surged 44.5% y/y in April, up from 37.5% y/y in March.

It is quite remarkable that China's consumer demand has been able to remain so steady, getting almost no spillover effects from the torrid growth other demand components have been enjoying in the last couple of years. In 2004, fixed investment and exports surged 25.8% and 35.4%, respectively, and retail sales rose 13.3% in nominal terms and 10.2% in real terms. This trend has continued in 2005. Fixed investment and exports in the first four months of this year shot up 25.7% y/y and 34.0% y/y, respectively, while retail sales growth continued to hover around 10%.

The causes for this relative weakness in consumer demand are structural. The first is the inefficient state-owned enterprises (SOE). Although the government has not fundamentally altered the SOE managerial incentive structure, massive layoffs were still implemented. SOE employment between 1995 and 2002 was cut by 36.9 million, to 39.5 million. Given that the SOE problem remains unresolved, the prospect of additional layoffs persists. Furthermore, as China rapidly industrializes, its agricultural sector, which still employs about half of China's labor force, has become increasingly uncompetitive. Nevertheless, the country's strict labor-movement restrictions have prevented the agricultural labor force from migrating to industrial urban areas, thus producing a huge surplus of labor in rural areas, estimated at 150 million. Unemployment pressure is further heightened as a result, and has weighed on China's consumer demand.

Another cause of China's insufficient demand lies in the country's inadequate financial intermediation system. China's financial system is still dominated by banks. In the first half of 2003, for instance, bank loans provided nearly 90% of the non-financial sector's funding. Moreover, the banking system is still dominated by state banks. In 2002, state-owned commercial banks and state policy banks held nearly 80% of the Chinese banking sector's assets. Except for foreign banks (which hold just 1% of the banking sector's assets), Chinese banking institutions are nearly all under state control. And the state-controlled banks, especially the state-owned commercial banks and state policy banks, have a bias against lending to private firms.

The small size of the stock market and bond market and their inability, or unwillingness, to act as funding sources force the private firms to resort to saving, as well as borrowing on the black market at very high interest rates. Moreover, because China is in the third decade of market reform, many private firms are ready to climb the value-added chain, from very labor-intensive production that requires low-level investment, to the more capital-intensive activities that require much higher level investment.

As the private sector's investment demand soars, the lack of financing options naturally leads to excess saving in the sector. Consequently, China's consumer demand has received virtually no positive spillover from exports' and fixed investment's sizzling performance in the last couple years.

Therefore, we maintain our view that sales growth will continue this trend in the coming quarters as a result. In fact, in recent years, retail sales growth has remained extremely stable in spite of wild swings in investment and export growth during the period. Since 1998, export growth has oscillated between -20% and 50%, and fixed investment growth of state-owned firms has swung between 10% and 60%, but real retail sales growth has hovered around 10%.

Inflation

Consumer prices rose 1.8% year-on-year (y/y) in April, the National Bureau of Statistics reported. The gain marked a deceleration from the March rate of 2.7%, and the lowest rate of inflation in 19 months. The April deceleration was mainly driven by food price inflation, which eased from 5.6% y/y in March to 3.1% in April. Non-food prices, on the other hand, advanced only 1.2% in April, the same as March.

Producer price inflation has continued to remain significantly above CPI inflation. Chinese producer prices measured by ex-factory price index rose by 5.8% y/y in April, up from 5.6% in March and 5.4% in February. Upward pressure in April was exerted by a 36.9% surge in crude oil prices, which was even higher than the 32% rate of increase posted in March. The inflation of coal prices by 26.2% in April also provided upward pressure, though it was 0.4% lower than March's rate. During January–April, ex-factory price index rose 5.7% y/y, with energy prices rising 10%.

It seems counterintuitive that inflation could swiftly decelerate while the economy maintains extremely fast growth. Indeed, despite such intense upstream price pressures—producer price inflation's rapid acceleration last year, as well as surging world oil prices—inflation has failed to move downstream and show up in consumer prices. There are several reasons for these phenomena. First, the oil sector is still run by the government, which imposes price controls on the sector. Concerned that soaring oil prices could damage economic growth, the government has imposed only limited oil price hikes, essentially forcing the state oil companies to subsidize the economy's oil usage with their profit margins. More fundamentally, the Chinese economy's disinflationary fast growth suggests that this cycle is a supply-led boom. Indeed, with the current up-cycle mainly driven by investment, China's production capacity has greatly expanded. Consequently, despite fast-rising costs for the producers, the oversupply conditions have left them with very little pricing power, and they simply have not been able to pass producer price inflation on to the consumers.

Most importantly, there is also structural weakness in China's non-state demand. This is caused by massive layoffs in state-owned enterprises and insufficient financing for non-state-sector investments (which has forced the sector to save excessively or obtain funding on the black market at very high interest rates). This structural weakness in China's domestic demand has manifested itself not only in persistent deflation, but also in its protracted current-account surplus.

The central government actually recognizes this problem, and in the March National Peoples' Congress meetings issued a circular that set guidelines to promote the non-state sector, including discouraging banking-sector discrimination against non-state firms in its lending practice, as well as allowing private firms to enter state-controlled sectors. However, given the massive vested interests in the state-owned sector, it will take a long time before the guidelines in the circular are fully realized. In the short-to-medium term, we expect China to continue to operate in a low inflationary environment.

Monetary Policy

On 17 March 2005, the central People's Bank of China (PBoC) raised its minimum interest rate for mortgage loans of more than five years from 5.31% to 5.51%. In addition, commercial banks are being pushed to increase minimum down payments to 30.0% of the property's value, from the current 20%.

Although the increase in the mortgage lending rate is marginal, it sends a clear sign of the authorities' intent to constrict investment in potentially overheating sectors. Urban fixed-asset investment rose 24.5% year-on-year (y/y) in January and February to 422.2 billion renminbi (US$50.9 billion), with investment in real estate alone soaring 27.0% on the year, to 120 billion renminbi (US$14.5 billion). The property boom is being magnified by inflows of "hot money" speculation in renminbi assets on the expectation of a future revaluation of the currency. The primary risk of the recent investment-led growth cycle is that in the medium term the credit position of domestic banks already encumbered with huge volumes of non-performing loans will be impaired.

Despite concerns about overheating in select sectors, the monetary policy's general direction is cautiously accommodative. China's central bank, the People's Bank of China (PBoC), has set a target of 15% for broad money growth (M2) in 2005. So far, money-supply growth has met its target. M2 expanded 13.9% in February and 14.1% in January, lower than the December rate of 14.6%. It remains to be seen whether January-February's M2 growth dip will be sustained. Interestingly, money-supply growth actually accelerated once more after the October 2004 rate hike. Revived money-growth acceleration could indicate that the central government has begun to relax tightening measures implemented earlier to rein in overheating. Meanwhile, continued "hot money" inflow, reflected in surging foreign-exchange reserves, has also pressured money supply.

The October rate hike came after nearly a year of using administrative measures to tighten money-supply growth. The magnitude of the rate hike was fairly modest: 0.27 percentage points were added to one-year benchmark lending and deposit rates, reaching 5.58% and 2.25%, respectively. This modest rate hike suggests that the move was more of a complement to Beijing's non-market-based tightening measures; indeed, historically, interest rates have never been the Chinese government's main policy tool.

Yet it suggests that the government is still seriously concerned about the structural problems in the Chinese economy. In fact, there has been much debate in Chinese policy circles about the use of market-based measures such as interest-rate hikes instead of administrative measures to rein in growth. There has also been much resistance to raising rates, however, due to the fear that the added financial burden would be too much for the financially troubled, state-owned firms to bear. There have also been concerns that higher interest rates could lead to excessive saving, and hence weaker consumer demand.

The more significant policy move has been the central bank's further liberalization of interest rates by eliminating caps on all commercial bank lending rates. A floor for these lending rates will remain at 90% of benchmark rates, however. For example, commercial banks can now float one-year lending rates of more than 5.02%. Lending rates of the less financially viable rural credit cooperatives, on the other hand, will continue to have a ceiling of 230% of benchmark rates. The People's Bank of China has also allowed deposit rates to float below the benchmark deposit rates, although deposit rates are still banned from exceeding benchmark rates.

This interest-rate liberalization will lead to more efficient financial intermediation in China. Specifically, banks will be allowed to price in the risk premium associated with lending to non-state firms, the government backing and accounting reporting quality of which are highly uneven. Yet, this improved efficiency will take some time to materialize, as the Chinese banks will need time to experiment with servicing a non-state sector with which they have had very little history.

Fiscal Policy and Public Finances

The central government will be cautious and selective in tightening investment spending to steer the economy to a soft landing. Despite high-flying growth, deflationary forces abound in China's economy. Nonfood consumer prices' zero inflation through this "overheating" cycle is a prime example. As a consequence, the central government fears that excessive brakes on the economy could revive deflation and further weaken domestic demand. And there are signs that the government has relaxed the austerity measures in the fourth quarter. Indeed, since October 2004, money supply growth re-accelerated after nearly a year of easing.

The official fiscal balance for the central government shows a deficit around 3% of GDP. But since state-owned enterprise investment is not included in the government account (they are financed by state bank lending), the actual fiscal deficit is much larger. Similarly, official public debt is around 19% of GDP, but the actual level is much higher. According to estimates by a Citigroup study, for example, China’s overall public debt is around 70% of GDP (including social security funds, central and local government debt, 1998 bank bailout bonds, and external debt). With the Chinese bank sector in dire need of another massive bailout, fiscal strain is even more serious. These concerns should lead the government to eventually ease up on state investment.

Exchange Rates

It is interesting that amid all the heightened rhetoric and speculation, real pressure on the renminbi, however substantial, has actually subsided. Foreign exchange reserves increased US$49.2 billion in the first quarter of 2005, as compared with the US$95.4 billion increase in the fourth quarter of 2004. Merchandise trade surplus and foreign direct investment (FDI) inflow—the two dominant sources of China's foreign-exchange earnings—stood at US$13.4 billion and US$16.8 billion in the first quarter, respectively. This suggests that the hot money inflow to China in the first quarter was roughly US$19 billion, which, while astounding, was actually much more moderate than the US$55.4 billion seen in the fourth quarter of 2004 (when the trade surplus and FDI were US$28.1 billion and US$11.9 billion, respectively).

It was widely believed that the renminbi was substantially undervalued, with various estimates of undervaluation ranging from 10% to 40% (we think these are over-blown).

So, if Beijing were to revalue, they would need to implement a substantial revaluation to be credible. But a large revaluation hurts exports, which China needs to cushion the government's attempt to steer down investment growth. If Beijing were to implement a small revaluation, the market would not believe it would be the final move. As a result, speculative capital could flood into China ever more intensely, exerting even greater pressure on Chinese money-supply growth, and hence exacerbating investment overheating.

The following news item of 20 July 2005 was inserted into this report when it occurred, in order to be up to date in the discussion of how the Chinese may adjust their currency relative to the dollar and other currencies.

Update –China's change in setting its exchange rate, July 20 2005

The People's Bank of China (PBOC) announced that China has abandoned its fixed exchange rate with the US dollar and moved to a managed float.

This means that, each trading day, the PBOC will set the value of the Chinese renminbi, with a basket of major trading-partner currencies as a guide (including the US dollar, yen, and euro at a minimum).

Beijing has not revealed—nor is it likely to anytime soon—the composition of this basket.

China has given itself a little more flexibility on its currency than before.

Why Did They Do It Now?

China's currency move was in reaction to both external and internal pressures.

Part of the government's motive was to head off protectionist moves by the US Congress. But Chinese authorities are also trying to stem the flow of hot money, which has produced a boom in capital investment and pushed its share of the economy from 40% three years ago to 51% last year.

Impacts: Very Small, Unless the Chinese Currency Continues to Appreciate

So far, the renminbi has appreciated 2%. This will have almost no impact on the US and Chinese economies.

Global Insight's best guess is that Beijing will allow the currency to appreciate by no more than 10% over the next two years. This should be seen in the context of estimates suggesting that the renminbi is undervalued by 30–40%.

Assuming that all other Asian economies (including Japan) allow their currencies to appreciate by roughly the same amount, this will translate into a 4% drop in the US dollar on a trade-weighted basis. This is relatively small compared with its 17% drop since early 2002.

Another factor to consider is that China's chronic current-account surplus is mainly driven by structural, excess saving in its private sector, rather than a undervalued currency.

Bottom line: unless the renminbi appreciates a lot, the overall impact on the US and Chinese economies will be small.

A larger, underlying factor in Beijing's exchange-rate policy calculation is the issue of stability. Indeed, this desire for stability was the chief reason for China to adopt a gradualist approach to market reform in 1978. In this context, it is easier to understand why Beijing has refused to budge on the exchange-rate policy during turbulent times, as well as in the aftermath of the Asian financial crisis. The fixed renminbi policy, despite all its shortcomings, is a known quantity to Chinese policymakers. All other policy alternatives, despite their theoretical attractiveness, are unknown and untried in China, and are therefore deemed too risky, especially during chaotic times.

Beijing has repeatedly indicated that its long-term objective is a more flexible exchange-rate regime,. This is credible, since China's financial intermediation system, and especially the foreign exchange market, is still severely underdeveloped. This could cause excess exchange-rate volatility if the renminbi were allowed to float. The Chinese government recognizes these inadequacies of its financial system, and has been steadily implementing market reforms, like those discussed above.

The government also realizes that to become more fully integrated into the global economy, China needs to loosen controls on cross-border capital movement, and has been doing so in a stepwise fashion. Given China's need and desire to retain monetary policy independence, Beijing will likely abandon the fixed exchange rate long before capital-control liberalizations would compromise its monetary policy autonomy.

Therefore, one should view China's exchange-rate liberalization as one small stride in a very long march towards a full market-based system. Given that the government directing this march is willing to sacrifice speed for a stable ride, the renminbi adjustment to a basket of currencies is a cautious way to move ahead.

Over the long-run, costs of the peg will inevitably surpass its benefits, and the government should move to a managed float system, as this system can both ensure some exchange rate stability and allow monetary independence.

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Trade and External Accounts

Strong performance in external accounts has continued in 2005. In the first four months of 2005, exports totaled US$218.1 billion, which is 34% higher than a year earlier, while imports rose 13.3% y/y to US$197.9 billion. Trade balance resulted in a surplus of US$21.2 billion in January-April, compared to a US$10.9 billion deficit in the same period last year. Processing trade continued to dominate. In January-April, processing exports stood at US$117.7 billion, 29.7% higher than a year ago, while processing imports totaled US$78.9 billion, or 22.6%. This implies that the growth of imports for domestic purchase was extremely weak in 2005. This weakness is partly due to the moderation of fixed investment growth, as well as importers delaying purchases because of raging speculation about a renminbi revaluation in recent months.

Foreign direct investment (FDI) in China rose by just 2.2% in the period January-April, from the same period a year ago, to US$17.5 billion, according to data released by the Ministry of Commerce. Contracted investment, which is a gauge of future FDI flows, rose by 8.0%, to US$50.2 billion. In the first three months of 2005, FDI rose by 9.5% on the year, to US$13.40 billion, while contracted FDI increased by 4.5%, to US$35.22 billion. Although the rate of growth in FDI flows is slowing, the economy is sustaining the extremely high base of FDI established in 2004, during which FDI flows totaled US$60.63 billion.

The hot streak China's external accounts have been riding is extremely impressive—the last time Chinese external trade posted single-digit growth was June 2002. Contracted FDI amounted to $153.5 billion in 2004, 33.4% more than it had in 2003, thus suggesting that the sizzled FDI growth should continue in 2005. This strong export and FDI performance should give the government some breathing room in its efforts to slow overheated, domestic-investment growth, and mitigate the risk of an economic hard landing.

In 2004, China performed impressively in its external accounts. Foreign direct investment inflow totaled $60.6 billion, 13.3% higher than the year before. Exports rose 35.4% to $593.4 billion, while imports surged 36.0% to $561.4 billion. The trade balance remained in surplus, at $32.0 billion, $6.5 billion more than 2003.

The capital and financial account balance recorded a US$122 billion surplus in 2004, according to official data reported by state press. The total almost doubled that accrued in 2003 (US$52 billion). The current account surplus was posited at US$70 billion; rising from US$45 billion in 2003. Undisclosed net errors and omissions on the balance of payments stood at positive US$20 billion. Total external debt was reported at US$228.6 billion; an 18.1% increase on the year-earlier figures. Short-term liabilities accounted for US$104.3 billion of that total; up from US$77 billion in 2003. Growth in external surpluses will continue to exert sustained pressure on China's domestic money supply, as the central bank intervenes to alleviate upward pressure on the fixed exchange rate of the renminbi. Relaxation of monetary controls therefore remains unlikely in the near term despite the re-emergence of disinflationary trends.

An interesting development is China's strong outbound FDI, which rose 27% year on year (y/y) in 2004 to total US$3.62 billion. Contracted investment, a gauge of future investment, rose 78% to US$3.71 billion. Of the total, US$2.51 billion was spent acquiring stakes in foreign companies; the remainder reflected reinvestment of profits from ongoing concerns. The total number of off-shore units of Chinese-invested companies rose 63% annually, to 829. The lion's share of investment (some 53%) was directed into the mining sector, reflecting the resource-hungry state of the economy; 26.5% was sunk into the business and service sector. Foreign manufacturing attracted 13.5% of Chinese FDI. The strong growth of outbound direct investment, albeit dwarfed by the US$60.6 billion in foreign inward investment, is a portent of China's future potential weight in the global economy. The government has actively encouraged large, domestic companies to increase overseas investment to offset huge surpluses on external balances. By the end of 2004, China's accumulated overseas investment stood at almost US$37 billion, according to Ministry of Commerce data.

Strong growth exports and foreign direct investment inflows are likely to continue. The country's WTO membership has attracted much foreign direct investment that is eyeing the soon-to-be-open domestic markets. Moreover, the elimination of the Multi-Fiber Agreement (MFA) should boost exports. China's textile exports are extremely competitive in the global market, but growth had been restricted by the quotas imposed by the MFA. Given that textiles account for nearly one-fifth of China's overall exports, an end to the artificial restriction on Chinese textile exports will no doubt be a huge boon to overall exports.

Yet there are substantial risks that the United States and the European Union will impose safeguards measures on exports of a number of Chinese textile products (that is, maintaining quotas on these Chinese exports). To preempt these restrictions, China in mid-December 2004 announced that it would unilaterally impose export duties in selected textile and clothing sectors in order to ensure a "smooth transition for textile integration" following the disbandment of the global quota system at the end of the year. An explosion of Chinese textile exports, therefore, is unlikely in the near term, but a healthy boom should be expected, nevertheless.

Over the longer term, as China's economy becomes more open due to the WTO membership, and Beijing is likely to allow the renminbi to appreciate, imports will rise as a result of the country's pent-up demand for foreign goods and services. Consequently, the current account is likely to dip into the negative territory.

CHINA

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	1,080.73	1,800.62	3,326.09	13,756.08	10.7	13.1	9.9
Nominal GDP per capita, US dollars	856	1,377	2,476	9,614	10.0	12.5	9.5
Real GDP, billion real 2000 US dollars	1,080.73	1,618.32	2,270.19	5,462.86	8.4	7.0	6.0
Real GDP per capita, real 2000 US dollars	856	1,237	1,690	3,818	7.7	6.4	5.6
Real private consumption, billion real 2000 US dollars	517.88	604.85	849.37	2,339.07	3.2	7.0	7.0
Real government consumption, billion real 2000 US dollars	141.39	221.06	337.97	977.24	9.4	8.9	7.3
Real fixed investment, billion real 2000 US dollars	394.08	834.98	1,263.13	3,386.79	16.2	8.6	6.8
Real exports, billion real 2000 US dollars	279.56	916.58	1,722.99	5,193.53	26.8	13.5	7.6
Real imports, billion real 2000 US dollars	250.69	904.73	1,773.51	5,956.13	29.3	14.4	8.4
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	176.70	193.52	208.00	307.29	1.8	1.5	2.6
Mining	66.41	88.59	99.81	144.74	5.9	2.4	2.5
Manufacturing	372.83	701.46	1,057.37	2,734.16	13.5	8.6	6.5
Utilities	32.43	57.55	76.14	169.58	12.2	5.8	5.5
Construction	71.12	105.73	145.41	361.76	8.3	6.6	6.3
Wholesale & Retail Trade	98.31	131.31	180.34	458.84	6.0	6.6	6.4
Transport & Communication	65.33	83.52	113.83	298.28	5.0	6.4	6.6
FIRE	100.34	139.15	186.71	452.31	6.8	6.1	6.1
Other Services	103.62	117.11	135.08	261.56	2.5	2.9	4.5

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	47.9	37.4	36.9	40.4	-10.5	-0.5	3.5
Government consumption share of GDP	13.1	15.2	12.5	17.9	2.1	-2.7	5.4
Fixed investment share of GDP	36.5	49.6	48.6	40.6	13.1	-0.9	-8.0
Exports share of GDP	25.9	48.4	62.6	63.5	22.5	14.2	0.9
Imports share of GDP	23.2	51.3	61.2	62.6	28.1	9.9	1.4
Net extports share of GDP	2.7	-2.9	1.4	0.9	-5.6	4.4	-0.5

South Korea

Overview

It appears that Korea is finally emerging from its slump. The most recent national income data for the fourth quarter of 2004 show that real consumption was growing at a 2.5% annual rate, its best performance since 2002. Inventory investment also increased, suggesting that firms have become more optimistic about future sales. Recent monthly data are mixed, but indicate that domestic demand is trending upward. Fiscal policy has been neutral—despite policymakers' pro-expansion talk—while monetary policy continues to be easy, with interest rates remaining low. In addition, there has been no further intervention to weaken the won, despite the recent strengthening of the currency. Note that the strong won has helped to restrain inflation. Prices have also been weakened by moderately high unemployment. The unemployment rate has averaged 3.5% for the past two years, compared with 3.0% prior to the recession. But the labor force has been rising over time; this indicates that there is sufficient mobility in the labor market to create jobs even when aggregate demand is weak.

Short Term

In the near term, consumption will be the leading growth sector, encouraged by expansionary fiscal and monetary policies. But the rebound will initially be gradual, since there is still considerable economic uncertainty, including a moderate consumer debt overhang and fluctuations in unemployment. Later this year, however, consumption will begin to accelerate as spending on big-ticket items such as cars begins to pick up. Fixed investment should also make substantial gains, both to support the growing consumer goods markets as well as to maintain the moderate growth in the export industries. In addition, investment will be supported by low interest rates, high savings, a pro-business government, and the fact that Korea's level of technology still allows for some significant gains in productivity. Overall, Global Insight forecasts a steadily rising quarter-on-quarter growth rate for 2005, mostly due to domestic demand, which then decelerates modestly next year. Thus we forecast GDP growth rates of 4.2% for 2005 and 6.0% for 2006.

Fiscal policies will allow for normal growth in expenditures and revenues, leaving a small surplus—less than 1% of GDP—in this and subsequent years. Monetary policy will remain slightly expansionary, holding interest rates down until the recovery is well under way. It appears that the currency has found a ceiling near 1,000 won per dollar, so the Bank of Korea is unlikely to find the need to sell won in the forex market. Moreover, we expect the won to slowly weaken over time, ending the year near 1,050 per dollar.

Inflation will not be a serious problem. Import prices should remain above-average in the near term, with the rise in world commodity prices outweighing the strength of the won. Export prices will have to decline, however, to compensate for the won's strength, although this could change if the economies of North America and Asia surge and dramatically increase purchases of Korean exports. The net effect will be a slight increase in the inflation rate this year. Consumer goods prices should begin to rise as household spending ramps up and capacity constraints take effect. These effects will be reinforced by the Bank of Korea's easy monetary policy, which continues to value growth over price stability. Thus, by the end of 2005, both the GDP deflator and the consumer price index should see annualized inflation rates nearing 4%, which will subside gradually thereafter.

Korea's exports have recently leveled off, and even fallen slightly in won terms; imports have followed a similar pattern. In real terms, however, the quantities of exports and imports have continued to increase, reflecting the rapid productivity growth of traded goods. With the overseas economies decelerating, the growth rate of exports will remain low. And with the current recovery being led by domestic demand, import growth should accelerate. Thus the external surpluses will narrow over time. This process could be slow, however, since the demand for Korean goods remains strong; moreover, Korean multinationals will be able to absorb much of the recent won appreciation through additional efforts to improve productivity. Global Insight forecasts that the trade and current-account surpluses will be roughly half their current values by late 2006 to early 2007.

No change is expected in the unemployment rate in the near term, despite the recovery, since hiring tends to lag the business cycle. But by year-end the accelerating growth trend should lead to the hiring of new workers. By next year, the unemployment rate should be declining to the low 3% range with the labor force passing 24 million by the end of 2006.

Medium Term

For the next several years, Korea still has considerable growth potential. The main growth driver will be productivity improvement in its industrial sector. As Korea continues to catch up with the technology frontier of the developed countries, its efficiency will continue to rise. At the same time, it still has the advantage of moderate wages compared to developed countries. Overall, Korea's comparative advantage in manufactured goods should last through the medium term; thereafter this advantage will decline as a result of increasing competition from China. In the meantime, exports of manufactured goods will be a primary source of growth, while domestic purchases of manufactured goods become increasingly important. The working age population will grow, albeit slowly, and improved labor flexibility will allow for a more efficient allocation of labor. Growth will be reinforced by relatively good policies. The Bank of Korea should be able to keep both inflation and short-term rates in the low single digits, while financial deregulation allows capital flows and rates of return to be more determined by the market. The government will preside over a modest budget surplus, which will slowly decline as social spending gradually increases. Thus, we forecast an average 5.6% growth rate over 2006–10. This will be accompanied by a modest depreciation of the won, suggesting that the recent won strength represents and overshoot of its equilibrium level, and a shrinking trade surplus. Inflation should average roughly 3%—slightly higher for the consumer price index, slightly lower for the producer price index, representing the combined effects of monetary policy, the exchange rate, and moderating prices for raw materials on world markets. Lastly, the unemployment rate will show little improvement: fast growth will be largely met by improved labor productivity, and the new jobs that are generated will be matched by new entrants into the growing labor force.

Long Term

After 2010, Korea's per capita income will be well over $20,000 per person. At this level, the industrial sector will be less competitive on world markets, mainly due to competition from low-wage Asian countries. Manufactured exports will still deliver some growth, as Korea's high savings rate and high level of capital expenditure will keep productivity rising, but we expect the trade surplus to peak in the middle of the forecast period then slowly decline. The main growth driver will be domestic demand. Consumption in particular will stimulate rising output, as households gain confidence from their accumulated assets and begin to exert their earning power. Thus, we expect consumption to rise as a share of GDP, to 58+% in 2025. Population, both total and working age, as well as employment will begin to trend downwards toward the end of the forecast period. This will not only lower the potential growth rate, but also make the labor market less flexible. The net result of these influences will be a GDP growth rate that declines rapidly in the early years after 2010, then more slowly in later years. The average growth rate over 2010–25 is 3.3%.

Economic Growth

It appears that Korea is finally emerging from its slump. The bursting of the credit bubble at end-2002 led to a drop in consumption that continued until late last year. As a result, aside from two quarters of export-led growth in late 2003, the economy has been sluggish for two years. The most recent national income data for fourth-quarter 2004 show that real consumption was growing at a 2.5% annual rate, its best performance since 2002. Inventory investment also increased, suggesting that firms have become more optimistic about future sales. Interestingly, there was little change in government consumption last year, despite policymakers' frequent pledges to stimulate the economy. Lastly, capital expenditures and net external demand posted marginal declines at end-2004. Recent monthly data are mixed, but indicate that domestic demand is trending upward.

Consumption will be the leading growth sector in the near term. Households have a lot of catching up to do, to make up for their unusually low spending of the past two years; in addition, expansionary fiscal and monetary policies will also encourage consumer expenditures. But the rebound will be gradual, since there is still considerable economic uncertainty, including a moderate consumer debt overhang and fluctuations in unemployment. So real consumption will accelerate throughout 2005, and be growing at a 7+% annual rate by year-end. Fixed investment should also make substantial gains, both to support the growing consumer goods markets as well as to maintain the moderate growth in the export industries. Overall, Global Insight forecasts a steadily rising quarter-on-quarter growth rate for 2005, mostly due to domestic demand, which then decelerates modestly next year. Thus we forecast GDP growth rates of 4.2% for 2005 and 6.0% for 2006. Over the medium term, with productivity growth still high and in the absence of business cycles, Korea grow at an average rate of 5.6%. In the long term, with the “easy” growth behind them, Korean producers will see decelerating productivity gains, yielding an average 3.3% growth rate over 2010–25.

Consumer Demand

After a two-year slump, consumer spending appears to be rebounding. The debt hangover from the bursting of the credit bubble in late 2002 restrained household spending despite low interest rates and moderate unemployment. It was hoped that the export surge in late 2003 and early 2004 would, by raising incomes and confidence, encourage consumers to begin spending again, but such was not the case. It was not until late last year that a substantial increase in real consumption was seen. Modest growth is expected again in the first quarter of this year, with monthly data showing the initial stages of broad household spending as well as rising consumer confidence. Later this year, consumption will begin to accelerate as spending on big-ticket items such as cars begins to pick up. By next year, consumer spending should be generating over half of Korea's 6% growth rate. In the medium-to-long term, consumption will make up a gradually increasing share of the economy, as the structure of the Korean economy shifts away from heavy industries and toward consumer goods.

Business Investment

Following the Asia crisis, fixed investment as a share of GDP fell several percentage points to roughly 30%. But even at this level, it continues to be a major output component. The last major surge in capital expenditures was in late 2003, when the export boom encouraged firms to increase capacity and improve productivity. Since then, capex has been essentially flat; even though operating rates were often above 80%, firms had little incentive to invest when the prospects for growth were so poor. But that situation is now changing. With the economy expected to recover from the low-consumption slump, capital expenditures should stage a mild rebound. In addition, investment will be supported by low interest rates, high savings, a pro-business government, and the fact that Korea's level of technology still allows for some significant gains in productivity. This implies an annualized growth rate of roughly 10% in the near term; one which will decline to the mid-single-digits in the next two years. Lastly, in the very long run, investment as a share of GDP will begin to trend down toward developed-country levels, reaching 25% of GDP at the end of our forecast horizon of 2040.

Inflation

With exports and imports amounting to 40% of GDP, Korea's price level is very sensitive to the exchange rate and to external prices and demand. The export boom of late 2003 drove up the prices of industrial goods, and rising oil prices last year generated further price increases. But the won appreciation in the fourth quarter offset much of this, causing both consumer and producer prices to decelerate sharply. The sluggishness of the economy also kept inflation in check, by preventing any supply-side constraints. In early 2005, inflation has been accelerating slightly due to another surge in oil prices and the rebound in domestic demand.

Import prices should remain above average in the near term, with the rise in world commodity prices outweighing the strength of the won. Export prices will have to decline, however, to compensate for the won's strength, though this could change if the economies of North America and Asia surge and dramatically increase purchases of Korean exports. The net effect will be a slight increase in the inflation rate this year. Consumer goods prices should begin to rise as household spending ramps up and capacity constraints take effect. These effects will be reinforced by the Bank of Korea's easy monetary policy, which continues to value growth over price stability. Thus, by the end of 2005, both the GDP deflator and the consumer price index should see annualized inflation rates nearing 4%, which will subside gradually thereafter. Producer prices, however, will continue to fall throughout 2005, due to rapid productivity growth. In the subsequent years, medium inflation rates will gradually decelerate toward their long-run levels: approximately 3.0% for consumer prices and 2.1% for producer prices; the GDP deflator will be in the mid-2% range.

Labor Markets and Demographics

The recession of early 2003, and the sluggishness thereafter, directly impacted the labor market: the unemployment rate has averaged 3.5% for the past two years, compared with 3.0% prior to the recession. Even the export-led growth surge in late 2003 had little effect on employment: that growth was biased toward industrial goods, which have higher productivity growth and consequently generate few jobs, as opposed to consumer goods, which are more labor-intensive. But a good sign is that the labor force has been rising over time. This indicates that there is sufficient mobility in the labor market to create jobs even when aggregate demand is weak.

No change is expected in the unemployment rate in the near term, despite the recovery, since hiring tends to lag the business cycle. Having said that, however, in fact the labor market has become much more responsive to changes in the overall economy, so by year-end the accelerating growth trend should lead to the hiring of new workers. This quicker response has been aided by the increased use of temporary workers, making Korea's labor force more flexible than it was just a few years ago. As the recovery proceeds, a "virtuous" circle should develop, in which falling unemployment encourages more consumer spending, in turn stimulating the economy and generating more jobs. In fact, in the medium term there will be a chance of overheating, but this would not pose a serious problem. By next year, the unemployment rate should be declining to the low 3% range, with the labor force passing 24 million by the end of 2006. In the medium term, the labor force will continue to grow at a steady pace; thus, despite healthy job creation, the unemployment rate should average 3.5%. Going into the long term, the structure of the economy will shift away from manufacturing towards jobs that require higher skills, and population and employment will peak and then trend downward, thus the unemployment rate will gradually climb past 4% by 2025.

Monetary Policy

The Bank of Korea cut the overnight call rate by one-quarter percentage point in both August and November of last year, and has kept it at 3.25% since then. Normally this would be considered a fairly expansionary policy, in light of the inflationary threats of rising oil prices as well as the fact that the United States has been raising rates. Adding to this has been the BOK's forex intervention, which injected large amounts of liquidity into the financial markets. But the Bank of Korea is clearly biased toward growth, so the sluggishness of the past two years outweighed concerns of inflation. In addition, high international commodity prices represented a one-time effect, which in turn would moderate when those prices decline later this year. These price effects were further reduced by the won's appreciation late last year, which ameliorated the price impact in local currency terms.

With consensus expectations looking for recovery this year, and commodity prices not expected to fall quickly, further rate cuts appear unlikely. Real short-term rates remain low, and the monetary base is growing steadily, so further stimulus could be seen as excessive. Given the long and variable lags in monetary policy, the BOK is now concerned with the impact its policies today will have on the much-stronger economy of a year from now. The one possible exception is forex intervention, which could occur if the won strengthens much more. Overall, interest rates should hold steady for several months, and then will slowly begin to rise toward the end of this year. Long-term rates are not expected to reach 6% until the middle of next year. In the medium term, interest rates will peak around 2008, as strong economic growth increases demand for capital. But going into the long term, slower growth—and decelerating capital investment—will lead to gradually declining interest rates. By 2025, short-term rates should be below 4% and long-term rates below 5%.

Fiscal Policy and Public Finances

Last year, the government boosted spending and cut taxes in an attempt to stimulate the weak economy. These measures actually proved to be rather timid; consequently, spending and revenues increased roughly 3% and 4%, respectively, leaving a small budget surplus of 0.8% of GDP. For 2005, the general account budget (which is smaller than the consolidated budget) is scheduled to increase by nearly 10%. Tax revenues are expected to increase by roughly 8%. This suggests that the consolidated budget—which includes transfer payments and other special accounts—will be approximately 190 trillion won; like last year, the fiscal balance should manage to generate a small surplus, forecast at 0.7% of GDP. Given the distaste most Korean policymakers have for debt, there will likely be a serious effort to keep the fiscal balance back in the black after 2005. But the large surpluses of several years ago are unlikely to be repeated; consequently, the budget balance should continue with small surpluses, less than 1% of GDP, for the next several years. In the medium term, small deficits are likely to appear as social spending receives higher priority. In the long term, budget deficits should stabilize at 0.5% of GDP.

Exchange Rates

The won has appeared undervalued for many years, ever since it collapsed during the Asia crisis. Since then, the resulting large external surpluses have been offset by capital outflows, so there was little upward pressure on the won. But for the past two years, there has been a slight strengthening trend. And late last year, the currency surged, with the won appreciating 10% in three months. This occurred despite heavy intervention by the Bank of Korea; and in fact additional strengthening occurred in 2005, with the exchange rate recently passing the 1,000 mark. Note this did not just reflect the weakness of the US dollar; the won strengthened relative to the euro and the yen as well. So the net capital outflows that have characterized post-Asia crisis Korea appear to be shrinking, sending the won back toward its long-run equilibrium level.

With the exchange rate now near the 1,000 won/dollar level, there is little chance of further significant appreciation. It is even possible that the won has overshot its final level—driven by speculation—and could suffer a correction in the near term. But it is more likely that the exchange rate will hold steady in the near term. There are still significant capital outflows—e.g., direct investment in China—that should be sufficient to prevent further appreciation. Moreover, the long-anticipated decline in the trade surplus should begin to take effect; this in turn will tend to reduce the upward pressure on the won as well as ease expectations about the unsustainability of the US current-account deficit. Thus Global Insight forecasts a mild weakening this year to put the exchange rate at roughly 1,050/dollar at year's end; subsequent gradual depreciation will eventually take the exchange rate to 1,100/dollar by the end of 2008. This process will continue to the middle of the long-term forecast period, followed by a slow appreciation, all reflecting the relative inflation rates between Korea and the United States.

Trade and External Accounts

Korea's exports have recently leveled off, and even fallen slightly in won terms; imports have followed a similar pattern. In real terms, however, the quantities of exports and imports have continued to increase, reflecting the rapid productivity growth of traded goods. Interestingly, the trade and current-account surpluses have held relatively steady near $2–3 billion per month, despite the rise in oil prices; this reflects the fact that strong global growth has caused the rise in oil prices but has also generated demand for Korean goods. In addition, the types of goods that Korea exports—high-value manufactured goods, such as autos, semiconductors, cell phones, and ships—have demand that is relatively firm and less sensitive to price.

With the overseas economies decelerating, the growth rate of exports will remain low. And with the current recovery being led by domestic demand, import growth should accelerate. Thus the external surpluses will narrow over time. This process could be slow, however, since the demand for Korean goods remains strong; moreover, Korean multinationals will be able to absorb much of the recent won appreciation through additional efforts to improve productivity. Global Insight forecasts that the trade and current-account surpluses will be roughly half their current values by late 2006 to early 2007. As a share of GDP, the trade surplus will continue to decline in the medium and long term; the current account, however, rises in the later long-term years due to high income inflows from Korea's overseas investments.

KOREA

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	511.96	766.68	1,132.93	2,455.77	8.4	8.1	5.3
Nominal GDP per capita, US dollars	10,861	15,773	22,817	48,483	7.7	7.7	5.2
Real GDP, billion real 2000 US dollars	511.87	641.55	842.45	1,360.11	4.6	5.6	3.2
Real GDP per capita, real 2000 US dollars	10,859	13,198	16,967	26,852	4.0	5.2	3.1
Real private consumption, billion real 2000 US dollars	275.99	320.45	431.69	708.46	3.0	6.1	3.4
Real government consumption, billion real 2000 US dollars	61.89	75.85	93.75	134.29	4.2	4.3	2.4
Real fixed investment, billion real 2000 US dollars	159.05	190.66	253.02	376.14	3.7	5.8	2.7
Real exports, billion real 2000 US dollars	209.11	338.74	472.43	813.93	10.1	6.9	3.7
Real imports, billion real 2000 US dollars	192.84	285.89	408.37	677.12	8.2	7.4	3.4
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	21.68	22.16	25.10	31.24	0.4	2.5	1.5
Mining	1.59	2.19	2.35	2.48	6.5	1.5	0.4
Manufacturing	144.38	191.18	252.09	424.38	5.8	5.7	3.5
Utilities	12.71	17.22	23.61	44.33	6.3	6.5	4.3
Construction	36.95	46.11	60.96	105.22	4.5	5.7	3.7
Wholesale & Retail Trade	55.89	60.10	77.98	130.26	1.5	5.3	3.5
Transport & Communication	30.86	43.77	57.24	97.81	7.2	5.5	3.6
FIRE	87.41	108.24	142.07	238.33	4.4	5.6	3.5
Other Services	69.70	84.79	105.89	150.65	4.0	4.5	2.4
					Share change, percentage points		
	2000	**2005**	**2010**	**2025**	**2000-05**	**2005-10**	**2010-25**
Private consumption share of GDP	53.9	52.5	54.5	56.4	-1.5	2.0	2.0
Government consumption share of GDP	12.1	13.6	14.0	14.3	1.6	0.4	0.3
Fixed investment share of GDP	31.1	29.9	29.7	27.0	-1.1	-0.3	-2.7
Exports share of GDP	40.9	42.0	36.4	32.5	1.2	-5.6	-3.9
Imports share of GDP	37.7	38.4	34.6	30.6	0.7	-3.9	-3.9
Net extports share of GDP	3.2	3.6	1.8	1.8	0.4	-1.8	0.0

Hong Kong

Overview

Hong Kong's economy enjoyed a great year in 2004, with a broad-based recovery supporting the 8.1% year-over-year increase in real GDP. Exports of goods and services climbed 15.2%, benefiting from China's strong growth and the vibrant regional trade, as well as the influx of tourist arrivals. This remained a big help to Hong Kong's small, open economy. The most positive sign, though, came from a 6.7% pickup in consumer spending, while a 4.5% increase in fixed investment was also a turnaround from the previous year's mere 0.1% growth. As 2004's broader recovery should provide solid footing for 2005, it should help the economy weather the softening global economy that is threatened by high global oil prices. That said, Hong Kong is projected to post a more moderate growth rate, as slower exports feed into its export-dependent economy.

Two concerns dominate Hong Kong's export prospects: the outlook of the world's economic leader—the United States—and the Chinese economy, on which the Hong Kong economy is increasingly dependent. These two markets accounted for 61% of Hong Kong's exports during January–November 2004. While above-trend growth is expected to continue, the US economy could deliver a lower 3.5% growth rate in 2005, down from last year's 4.4% pace. This is because the previous drivers of the US expansion—consumer, residential, and government spending—are losing steam on the back of tightening monetary and fiscal conditions. With the US economy slowing down, the world economic prospects are also trending down—which will inevitably drag down Hong Kong's trade performance in the short-to-medium term.

China's continued tightening measures to cool down its economy pose another threat to Hong Kong's overall prospects. China remains Hong Kong's largest trading partner, absorbing more than 40% of its exports during January–November 2004. More than 90% of Hong Kong's exports are re-exports of goods made in other markets, especially China (which accounted for 45% of these goods). Because Beijing is keen to manage a soft landing for the Chinese economy, growth is projected to moderate to a still-strong 7–8% in 2005–06, down from a 9.5% in 2004. This, plus moderating US-led global growth, should bring Hong Kong's 16%-plus merchandise export gain last year down into high single digits in 2005, and lower 2006.

One positive note came from Hong Kong's currency, though. While the Hong Kong dollar has exhibited a slight upward bias against the US dollar, it actually weakened against other major currencies, due to the US dollar's slide. Indeed, the Hong Kong dollar's trade-weighted, effective exchange rate has been weakening over the last three years, by some 15%. With the US dollar's weakness expected to persist due to the worsening US current-account deficit, Hong Kong could maintain its export competitiveness through its currency's relative weakness.

In addition, Hong Kong could continue to benefit from Beijing's stimulus measures to accelerate the integration between the two economies. Such measures have already boosted local business and consumer sentiment, along with investment and tourism from the mainland. Indeed, visitors from mainland China—which accounted for 56% of all Hong Kong visitors—surged nearly 50% during January–November 2004. This, coupled with broad recoveries elsewhere, has brought more than 20 million tourists to visit Hong Kong. The influx of tourist arrivals not only fueled the tourism sector, which accounted for 3% of GDP, but also bolstered exports of services, boosted retail sales, and helped lift consumer sentiment. The indirect contributions from tourism could top 11% of GDP, according to Hong Kong's tourism board. Moreover, the sector's outlook remains bright, as the opening of Hong Kong Disneyland is expected to attract more visitors in 2005 and beyond.

Nevertheless, in tandem with slower exports, domestic demand should also moderate. While improving, the labor market continues its painful structural adjustments. Furthermore, still-cautious hiring by companies and subdued wage growth could undermine consumer confidence, and thus spending, when the economy slows. While local banks have delayed hikes in their interest rates due to sluggish loan growth and still-ample liquidity, further tightening by the US Federal Reserve and the HKMA could put pressure on these banks to follow suit. Therefore, the Hong Kong economy is projected to grow by a slower but sustainable 4–5% in the short-to-medium term, before growing around 3% by 2025 when the economy matures.

Short Term

Hong Kong's economy posted a strong 8.1% year-over-year growth rate in 2004, after three consecutive years of lackluster performance. Above-6% growth was actually seen in each quarter, with, in particular, a sharp 12.1% in the second quarter, although this was driven primarily by a low comparison base a year earlier. Judging by 2004's performance, the most impressive was stronger-than-expected consumer spending, rising 6.7% in 2004, after falling 0.3% in 2003. The upturn in the property market and the continued influx of tourist arrivals were the main contributors helping boost consumer sentiment, and these have carried their momentum entering 2005. Consumer spending therefore should remain one driving force for the economy in the short term.

In addition, after returning in July 2004, inflation has remained mild and should stay so in the near future, indicating positive consumer demand and still not alarming to consumer confidence. Nonetheless, moderation in economic growth is still expected in the short term, stemming primarily from the softness in the global economy, as Hong Kong's exports have shown signs of weakening, which is a worry indicator to its export-dependent economy. Moreover, despite still ample liquidity in the banking system, the local banks have been picking up their pace in raising interest rates in early 2005, in particular following the Hong Kong Monetary Authority's refinements to its fixed exchange rate policy in May. A more-than-expected rate hike could have an adverse impact on the property and consumer sectors

Medium Term

Hong Kong's economic growth could be sustained at 4-5% in the next five years. While exports should remain as the economy's growth engine, domestic demand should pick up and gain the importance of driving growth. On the external front, foreign demand should be boosted by sustained economic expansion in the world economy. In particular, following a 'soft patch' in 2005--06, the US economy is projected to continue its above-trend growth in the medium term. In addition, while the Chinese government's effort to cool down its economy would gradually take effect, its economic growth is expected to achieve a soft landing with growth rate of 7% in the medium term. Combined with the pickup in other major trading partners, Hong Kong's export growth could be well maintained at around 6-8% in the next five years.

Private consumption and total fixed investment are expected to grow at an average rate of 4.3% and 6% in 2005-2010, respectively. It would be supported by a further recovery in the tourism sector and property sector, as the stimulus measures by the Chinese government continue to take effect. Nonetheless, as the highly accommodative monetary environment has come to an end following rising interest rates and higher inflation, tightening monetary condition could somewhat have a dampening impact on domestic demand, albeit would not derail the economy. In addition, while the fiscal deficit is narrowing and would turn into surplus in the medium term, the government still seems keen to resolve the structural problem with a widening tax base. A tightening fiscal policy could also induce adverse impact on domestic demand. Although rising, inflation should remain modest, restrained by heightened competition in the market and imported deflationary pressure from the neighboring China provinces.

Long Term

Over the long term, Hong Kong's economic growth would ease to 3-4%. The economy will transform to a service-based one during the long run, with the tourism sector remaining the major source for revenue receipt, while the sound financial sector attracts foreign and mainland companies. It, however, would gradually loose its edge as the gateway to China, as the main Chinese cities develop. More goods would be shipped out of mainland ports directly without taking the rout through Hong Kong,; more foreign firms would choose to set up the headquarters in the mainland cities rather than costly Hong Kong with high rent and other operational costs; mainland tourists would choose to visit other cities and countries than Hong Kong as the Chinese government relax restrictions of its residents visiting overseas. While a service-based economy implies Hong Kong would endure less impact from the world business cycles than an export-dependent one, higher structural unemployment during the transformation to a service-based economy could remain the obstacle to the economic development. In addition, an aging society would raise the challenge to the economic progress, as the burden to the society increase with the need for healthcare program and pension payments, which in turn would raise the risk to fiscal position, along with lower overall saving rate.

Economic Growth

Following an upbeat 9.5% increase in the first half of 2004, Hong Kong's economy slowed in the third quarter, as the base effect from the 2003 SARS outbreak waned. Real GDP advanced a still-impressive 7.2% year over year (y/y), compared with 12.1% and 7.0% in the second and first quarters, respectively. On a seasonally adjusted basis, GDP growth came in at 1.9% quarter over quarter (q/q), lower than 2.6% in the second quarter.

The external sectors remained the key drivers of economic growth in the third quarter, as Hong Kong continued to benefit from robust demand from regional economies, in particular, mainland China. It was also the first time in four quarters that export growth outpaced imports. Total exports of goods climbed 15.3%, outperforming a 14.2% increase in goods imports. Meanwhile, thanks to a continued upswing in tourism sector, exports of services rose 10.3% and imports of services 5.8%.

On the domestic front, supported by positive consumer sentiment, private consumption grew a still-healthy 5.1%, albeit much weaker than the 11.2% posted in the second quarter. On the quarter-over-quarter (q/q) base, however, the moderation was more pronounced, with private consumption falling 2.2% q/q, after gaining a remarkable 3.7% in the second quarter. Similarly, total fixed investment rose by a lower 4.9% y/y, from 12.7% in the previous quarter. This came on the back of a significant decrease in building and construction investment (8.4%), with the completion of several private projects, the cutback of state housing scheme, and fewer railway projects.

Hong Kong's economy should remain fairly robust in the short term, despite a further moderation in growth that is expected in the quarters ahead, compared with the upbeat first half of 2004. The still-positive outlook is supported by several factors, which include stimulus measures from the Chinese government that should help boost domestic demand and tourist arrivals further. The measures include the second phase of Closer Economic Partnership Agreement, the permission for the convertibility of the yuan in the territory, and the relaxation of restrictions over mainland visitors to Hong Kong. The visa relaxation was further expanded to 32 cities in July 2004, while the benefit of zero tariffs under CEPA (Closer Economic Cooperation Agreement) will be expanded to more than 1,000 products beginning 2005. Coupled with the improvement in the property market and the opening of the Hong Kong Disneyland, these factors will likely continue to sustain the tourism boom, help lift consumer and business sentiment, and support economic progress.

The pace of economic expansion, however, could moderate, offset by a less-positive external environment. For one thing, the US-led world economies have shown signs of slowing down and the prospects are less optimistic coming into 2005, on the back of lingering worries over global monetary tightening and the volatile outlook on world oil prices. In addition, due to Hong Kong's close ties with the mainland, the likely moderation in China's economy could have adverse effects on Hong Kong's economy. The Hong Kong dollar's peg, on the other hand, should help maintain export competitiveness. We therefore expect the economy to grow by a slower but sustainable 4.7% in 2005 and 4.4% in 2006, after rising 8.1% in 2004. As the economy is transferring itself to become more service-based, growth rate would moderate to around 3% by 2025.

Consumer Demand

Consumer demand has rebounded well in the first half of 2004: private consumption expenditures climbed 8.5% year over year (y/y) and retail sales in value jumped by 13.4%. While rising consumer sentiment had helped boost the rebound, a low year-earlier base due to the SARS outbreak in 2003 also contributed to the revival. As the base effect diminishes, consumer demand should moderate somewhat in the months ahead. Already, retail sales slowed in recent months, albeit they remain in the high end of single digits. Sales in value rose by 8.4% y/y in July–December, after rising 14.6% in June. In terms of volume, retail sales expanded by 7.0% in the second half of the year, easing from an upbeat 11.3% increase in the first. Meanwhile, the value of restaurant receipts and purchases also posted a slower 8.2% growth in the third quarter, compared with the second quarter's 21.4%.

Looking ahead, we expect retail sales and consumer demand to advance further in coming months, but at a slower pace, compared with the first half. Strong tourist arrivals should continue to help lift spending on local goods. Local consumers, though, have shown sings of cautiousness, with sentiment undermined by uncertainty on the global economic outlook, in particular, the US and Chinese economies. In addition, higher inflationary pressure, albeit mild, could lead consumers to be more cautious on spending. While the jobless rate has been improving since the second half of 2003, the pace in 2004 has been glacial. These factors, coupled with the subdued increases in wages (if any), could drag down consumer confidence and spending. Real private consumption, therefore, is expected to grow by a slower 4.2% in 2005, after 6.6% in 2004, while the value of retail sales is projected to increase by 5.1% in 2005, compared with 10.8% in 2004.

Inflation

The composite consumer price index (CPI) rose by a modest 0.9% year over year (y/y) in July 2004, the first increase in 69 months, and good news for the deflation-troubled territory. It also reflected that confidence has returned to the territory and consumers were buying. With more than five years of deflation ended, however, mild inflation has remained the theme since then. Indeed, the CPI actually eased to a 0.7% increase in September, and further to 0.2% during the last three months of the year. The modest increases in late 2004 were due to the facts that higher costs on clothing and utility were partly offset by continued falls in private housing rents and consumer durable goods. Private housing rentals were down by 4.1% in December, while costs of consumer durable goods dropped by 1.8% during the month. As the declines in early 2004 offset mild increases in the second half, the CPI posted a 0.4% decrease for 2004 overall.

The inflationary trend should continue going forward, but it should remain rather mild. The upward pressure should come from still strong oil and other raw material prices. In addition, due to the Hong Kong dollar's peg, a weaker US dollar has pushed up retained import prices. The influx of tourist arrivals and improving consumer sentiment have also enhanced retailers' and producers' pricing power. The upward pressure, however, could be limited by heightened competition and the expected moderating in economic activities.

While improving slowly, the labor market continues to suffer painful structural adjustment. In addition, higher external uncertainty, from oil prices to the global economic prospect, would further keep companies cautious on hiring and other employment plans. These, in turn, have reduced workers' negotiating margins on wages. Meanwhile, private housing rentals have continued to post year-over-year declines, and remained the drag to consumer prices, as housing rentals account for more than 20% of the CPI. This, though, should be removed gradually along with the improving property market. Overall, we expect the CPI to rise by 0.7% in 2005, before accelerating to 1.2% in 2006.

Monetary Policy

Hong Kong's monetary policy depends mostly on that of the U.S, Federal Reserve, due to the Hong Kong's peg to the US dollar. Therefore, the Hong Kong Monetary Authority (HKMA) has raised its key interest rate six times since early July 2004, each by 25 basis points—matching the moves of the US Federal Reserve. As a result, the HKMA's base rate discount window was brought to 4% in early February 2005, with the latest increase on February 3. Before the tightening cycle began, it had stayed at 2.5% for a year, after the cut in June 2003. The Fed is expected to be on track for further "measured" tightening of monetary policy, as suggested by the US economy's above-trend growth and a gradual increase in core inflation. It is also consistent with the Fed's goal of reaching a "neutral" or "normal" level of the funds rate by early 2006. With the Fed not in the business of defending the US currency, a weaker dollar could lift both economic growth and inflation. This implies that the Fed need not be so loose with interest rates. Indeed, it has reiterated that policy accommodation can be removed at a measured pace. The federal funds rate is therefore expected to undergo five 25-basis-point hikes in 2005, reaching 3.5% by year-end. The HKMA should follow course.

Fiscal Policy and Public Finances

The economic rebound since the second half of 2003 has helped lift the government's tax collection and improved the fiscal balance. With higher revenues than expenditures seen in the later months of fiscal 2003–04, the government actually posted a smaller deficit than expected. Boosted by additional revenues from profits tax and stamp duties, the provisional deficit totaled just HK$40.1 billion, or 3.3% of GDP, lower than the initial estimate of HK$49 billion.

The improvement has extended into the current fiscal year. While the government continued to record a budget deficit, it has received a boost from its better-than-expected land auctions in early October, as well as an HK$20 billion bond issue in the summer. The budget deficit was fast narrowing to just HK$2.8 billion during the first nine months of fiscal 2004–05. Monthly surpluses were actually posted in November and December, at HK$22.3 billion and HK$0.25 billion, respectively, due mainly to proceeds from land sales and profits tax revenue. Government revenue amounted to HK$176.2 billion, and spending totaled HK$179 billion. With the help of a strong land auction, which has taken in HK$18.6 billion so far in 2004, the budget deficit could come in below the government's earlier estimate of HK$42.6 for the fiscal year 2004-05 (estimate after taking into account of bond issuance).

To widen the tax base, stabilize the government's income sources, and reduce the burden on the middle class, Financial Secretary Henry Tang proposed seven tax measures at the Legislative Council financial affairs panel in early November. In consultation for next fiscal year's budget, Tang proposed to introduce a capital gain tax, a goods and services (GST) tax, a tax on offshore income, and “green” taxes on shopping bags and vehicle tires. He also proposed to raise tunnel tolls, and proposing to abolish the estate duty and modify the duty on alcoholic beverages.

A study on the GST tax implementation is currently underway and will be concluded by the end of 2004. The tax is expected to generate around HK$20-30 billion in revenues per year, with a GST of 5%. However, Secretary Tang has said the decision to introduce GST will be based on public consultation, which is planned to be launched in 2005, and will take at least three years to fully implement. Indeed, Chief Executive Tung Chee-hwa has pledged that no goods and services tax will be implemented during the remainder of his term, through June 2007.

While it is necessary to broaden the tax base, a tax on capital gains could be controversial. A government advisory committee was not supportive of such a tax when it investigated ways to broaden the tax base in 2002. It noted in a report that a capital gains tax would be complex to administer and vulnerable to the business cycle, which would be a volatile revenue source. In addition, the tax is also against Hong Kong's well-known simple tax system, which has long been the major support to the territory's status as a regional financial center.

Exchange Rates

On 18 May this year, the Hong Kong Monetary Authority (HKMA) introduced three refinements to its linked exchange rate system: a new strong-side Convertibility Undertaking set at HK$7.75 against the US dollar, effective immediately; extending the existing weak-side Convertibility Undertaking to HK$7.85, from the previous HK$7.80; and operating its policy under the new 'Convertibility Zone' in according with the currency board principles. Meanwhile, the weak-side Convertibility Undertaking would be achieved gradually with weekly adjustment of 100 pips, beginning on 23 May, until reaching HK$7.85 by 20 June.

Under the linked exchange rate system, the Hong Kong dollar is pegged to the US dollar at HK$7.80/dollar, and the operation is maintained through a rule-based currency board system. In fact, the HKMA has enforced the floor (weak-side Convertibility Undertaking) of HK$7.80, at which it is obligated to defend the currency from weakening below the threshold. It has never set up an upper limit, however, although it would maintain the currency near the peg, by intervening to keep the currency from strengthening sharply. The linked exchange rate system was imposed in 1983, when the currency was threatened by mounting uncertainty during the talks between the British and Chinese authorities over the return of Hong Kong to Chinese sovereignty in 1997. The linked system was therefore set up to curb heavy depreciation pressure at the time. The floor, however, was initially set up at HK$7.75, and was adjusted in September 1998, with the gradual movement to HK$7.80 during 1999–2000, amid another round of depreciation pressure during the Asian crisis. During the whole operation, the system has not encountered strong upward pressure until recent years due to the mounting speculation on the Chinese renminbi.

Global investors have been raising their bets on the revaluation of the renminbi, on the back of the worsening global imbalance. However, it is rather difficult to invest in the renminbi directly, as the government has heavy restrictions on the money flowing into the country. Instead, investors find the Hong Kong dollar as the 'proxy' for the renminbi due to Hong Kong's close economic ties with the mainland China. Rising speculation has therefore brought a flood of hot money into the territory, raising upward pressure on the Hong Kong dollar and keeping the financial market awash with ample liquidity. This, in turn, has also kept the local banks' interest rates low, despite the fact that the HKMA has followed the US Fed and raised its base rates eight times since mid-last year. Excessively low interest rates have prompted the government's concerns of potential inflationary pressure and asset bubble.

The introduction of the convertibility zone is aiming to "reduce the usage of the Hong Kong dollar as a vehicle for speculation on a revaluation of the renminbi." Another goal is to narrow the gap between Hong Kong and US interest rates. Following its announcement, initial reports indicated that the move seemed working: the Hong Kong dollar fell below HK$7.80 after the announcement, which enforced the HKMA to buy HK$3.12 billion to defend the peg, pointing to the sign of capital outflows. In addition, the overnight interbank rate rose to around 2%, above 1.25–1.5% on the previous day. These have prompted major local banks to raised their lending rates by 50 basis points.

Trade and External Accounts

Hong Kong's trade sector enjoyed a great year in 2004, as robust external and domestic demand produced a solid trade performance. The value of merchandise exports gained 15.9% in 2004, while imports surged 16.9%. Despite the strong full-year growth, however, the pace of expansion in both exports and imports has been moderating. This was particularly noticeable in December, when exports rose by a slower 12.9%, and imports increased by an even weaker 10.5%.

The further moderating in export and import growth is expected in the short to medium term. External demand would be easing, as the Chinese economy shows slower growth due to tightening measures, along with a more profound downturn in the US-led global economy. The Hong Kong dollar's peg, on the other hand, could help maintain export competitiveness, as the currency weakens against trading partners. In tandem with slower exports and expected moderation in domestic demand, import growth would decelerate as well. The continued growth of imports at a rate faster than that of exports had resulted in a wider trade deficit; it amounted to HK$92 billion in 2004, up significantly from the 2003 HK$63.3-billion deficit. This, in turn, would lead to a narrowing current account surplus in the short term; however, rising tourism receipts could help elevate the service balance, and restrain some of the narrowing.

HONG KONG

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	165.34	169.91	227.71	519.74	0.5	6.0	5.7
Nominal GDP per capita, US dollars	24,807	24,797	32,394	68,516	0.0	5.5	5.1
Real GDP, billion real 2000 US dollars	165.34	197.01	249.50	420.90	3.6	4.8	3.5
Real GDP per capita, real 2000 US dollars	24,807	28,751	35,495	55,485	3.0	4.3	3.0
Real private consumption, billion real 2000 US dollars	97.56	108.05	133.62	213.77	2.1	4.3	3.2
Real government consumption, billion real 2000 US dollars	15.42	17.22	18.06	20.73	2.2	1.0	0.9
Real fixed investment, billion real 2000 US dollars	44.58	49.05	65.74	138.39	1.9	6.0	5.1
Real exports, billion real 2000 US dollars	240.57	360.65	513.27	1,164.45	8.4	7.3	5.6
Real imports, billion real 2000 US dollars	234.63	339.34	483.35	1,120.79	7.7	7.3	5.8
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	0.12	0.12	0.13	0.14	0.6	0.5	0.8
Mining	0.03	0.02	0.03	0.03	-4.8	3.5	0.7
Manufacturing	9.20	7.31	7.75	8.17	-4.5	1.2	0.4
Utilities	4.99	5.64	7.09	10.90	2.5	4.7	2.9
Construction	8.22	7.34	9.25	14.57	-2.2	4.7	3.1
Wholesale & Retail Trade	41.66	49.54	64.61	106.33	3.5	5.5	3.4
Transport & Communication	16.14	22.26	29.18	50.16	6.6	5.6	3.7
FIRE	37.35	42.56	53.87	85.06	2.6	4.8	3.1
Other Services	52.33	59.09	72.85	118.37	2.5	4.3	3.3

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	59.0	59.1	59.2	59.8	0.1	0.2	0.6
Government consumption share of GDP	9.3	9.5	7.9	5.0	0.2	-1.6	-3.0
Fixed investment share of GDP	27.0	23.7	25.3	28.0	-3.2	1.5	2.8
Exports share of GDP	145.5	200.2	228.4	286.4	54.7	28.3	58.0
Imports share of GDP	141.9	193.2	221.7	280.2	51.3	28.5	58.5
Net extports share of GDP	3.6	7.0	6.7	6.2	3.4	-0.2	-0.5

Taiwan

Overview

Taiwan's economy has headed south ever since achieving its 7.9% growth rate in the second quarter of 2004. The faltering global environment has been largely to blame for this economic downswing, as it is still heavily dependent on exports despite the recent pickup in domestic demand. Real GDP came in just 3.3% year-over-year in the final quarter of 2004, down from the third quarter's 5.3%. Nonetheless, thanks to strong expansion in the first half of the year, the economy still rose a robust 5.7% in 2004 as a whole, its strongest increase since 2000, when it reached 5.8%. With the global economic outlook remaining weak since the second half 2004 (threatened by soaring oil prices), however, the island's economic downturn is expected to extend into 2005, and even 2006.

Recent releases of major economic indicators have confirmed our view: the leading economic indicators have been falling since May 2004, barring September 2004. The index fell 0.4% month-on-month in March, to 106.3, as compared with 106.7 in February and 108.5 in January. March's reading marked the lowest since June 2003, when the economy was hurt by the SARS outbreak, and was also the 10th such decrease in the past 11 months. Exports through customs clearance have been slowing as well, with growth down to 6.9% in March, as compared with an impressive 20.7% growth posted in 2004 as a whole. Although export growth picked up to 11.2% in April, further downturn cannot be ruled out amid the current, more pessimistic, global environment. The most worrisome sign pointing to the economy's slowdown, however, was the index of industrial production, which has been weakening fast since mid-2004, even with its first year-on-year contraction in December since May 2003 (barring its January 2004 fall, which was caused by base effects). It fell 0.5% in the first two months of 2005 and further 0.8% in March, led by the downswings in tech and consumer products, indicating that weakening external and domestic demand could be greater than was initially expected.

Overall, we see further moderation in both external and domestic demand in the short term. Surging global oil prices have taken their toll worldwide, with the projection of the US economy being revised down to 3.4% and 2.9% in 2005 and 2006, respectively. The recent spike of oil prices has prompted an increase of about $5/barrel in our average price projection of crude oil, to $50/barrel in 2005. This could lead to a further downgrade in the global growth, while rising inflationary risk would prompt tighter monetary policy worldwide. Indeed, we expect Taiwan's central bank to continue raising its key interest rates, as the bank has iterated that real interest rates remain low and would not jeopardize economic progress. It should keep the rate hikes at a measured, gradual pace, amid concerns about slowing economic expansion. In addition, due to the US current account imbalance, pressure for appreciation of the major currencies has increased. The Taiwan dollar is therefore expected to strengthen further, although the central bank's intervention and the widening interest rate gap with US would keep the pace gradual. Higher interest rates and lacklustre improvement in the job market would keep domestic demand from rising, while lower external demand and a stronger currency would reduce export growth.

On the fiscal front, the budget deficit increased in 2004, after having fallen in 2003, due to a drop-off in the government's capital revenue, while government spending continued to increase. Deficit amounted to NT$344.9 billion in 2004, up from 2003's NT$287.2 billion. There is little room for fiscal stimulation in the short term, amid an enlarged budget deficit. In fact, to widen the tax base, the Ministry of Finance in late February has proposed a series of tax reforms, including the imposition of an alternative minimum tax scheme, an increase in the corporate value-added tax, rising business taxes, levying taxes on insurance payment, and repealing income tax exemption for military servicemen and schoolteachers. Among them, the minimum tax scheme sparked greatly controversial views, as it is aimed largely at high-tech companies that were criticized for paying too-little tax. At the time when the tech industry already sees weakening sales, the proposal could further dampen business sentiment, undermining private investment, and speeding up companies' outsourcing to China.

Short Term

The downswing in Taiwan's economy deepened in the first quarter of 2005, with real GDP growth decelerating to 2.5% year-on-year (y/y), down from 3.3% and 5.3% in the fourth and third quarter of 2004, respectively. The slowdown in the all-important export sector was primarily responsible for the downturn, while domestic demand was holding up. The short-term outlook is gloomier, as dampening factors continue to cloud the economy; including high global oil prices, slowing external demand, as well as uncertainty in the high-tech sector, which has been the backbone of the island's exports.

Fuelled by higher energy costs, consumer price inflation is projected to edge up, but should remain under control. The central bank will continue raising its key interest rates, as it sees the need to pre-empt inflationary risk amid sky-rocketing oil prices, yet its pace should be measured and gradual, concerning slowing global demand and weaker economic expansion. The New Taiwan dollar should continue strengthening, as the imbalance of the US current accounts drags down the US dollar, while speculation on the Chinese renminbi brings in hot money and adds upward pressure to neighboring currencies, including the Taiwan dollar. Despite allowing the currency's appreciation, the central bank should keep this pace steady amid falling trade surpluses, intervening in the foreign exchange market to maintain Taiwan's export competitiveness.

Medium Term

Following slower economic growth in 2005–06, Taiwan’s economy should be able to enjoy a stronger expansion in the medium term, with the growth rate of 4-5%. The economy should remain highly export-oriented over the next five year, in particular with the high-tech sector dominating the export receipt. This implies that the economy would continue to progress along with the ups and downs of the global business cycle, which is expected to come to an up-cycle after the slowdown in 2005 and 2006. In particular, exports to China and Hong Kong should gain further importance to Taiwan’s economic expansion, benefiting from the Chinese economy’s rapid development and the rising integration between the two sides. In tandem with the pickup in exports, growth in total fixed investment should return to 6-7% range, as the private sector expands their business and upgrade their facilities. Supported by higher personal income, consumers should be more willing to spend, but would keep cautious due to higher inflation and tighter monetary environment.

Inflation should gradually pick up, but would be kept under 2%. Recent inflationary pressure is driven largely by the volatile energy and transportation costs. As the world oil prices are expected to moderate in the medium term, it would impose less inflationary pressure as a result. While stronger domestic demand results in higher demand-pull inflation, the tightened monetary policy and heightened competition should help keep the inflation under control. Fiscal policy, on the other hand, could impose a higher risk to the economy's medium term development. While the government's fiscal position could improve along with the economic recovery, the government's lack of fiscal discipline and heavy election-oriented spending would remain the obstacle to the state budget, despite the government's plan to raise tax to help reduce the deficit. Higher tax rate, in turn, could impede consumer spending and business investment in the medium term.

Long Term

Taiwan's economy is projected to expand at a rate of 3.5% in 2010–25. The major challenge to this estimate comes from the government's economic policy. In particular, its lack of prudent industry policy, as well as short of long-term economic development plan, become major obstacles when the economy progresses. The high-tech industry has been the major contributor to the economic expansion in recent years, thanks to the considered policy in the 1980s. With the industry growing and global competition rising, however, signs of losing competitive edge in the island's tech industry have emerged. The government seems unable to identify the problem or offer needed policy support. Rather, it has planned to trim down the investment incentive to the overall industry in an attempt to reduce fiscal deficit. The major source of the fiscal burden comes from its reckless spending rather than being short of tax revenue. The decision to reduce tax incentive to the island's industry results in not only falling business investment, but shrinking industry competitiveness.

In addition, facing China's rapid development and rising competition, Taiwan could position itself and incorporate its cultural and geopolitical advantage to access the massive Chinese market, or exclude itself from the business opportunity provided with China's progress. The latter has seemed to be the government's choice in recent years. With China's rising economic and political power in the region, the choice would not only allow Taiwan itself to be marginalized and excluded from the regional cooperation, but also reduce the chance for utilizing the Chinese market and upgrading itself for a more service-based economy. Despite the government's discouragement, the economic integration between China and Taiwan has nonetheless tightened in the private sector. It implies that the economy would continue to be subjected under the political tensions cross the strait, with the direct transportation and business links with China remaining unclear in the foreseeable future. Should this be the case, Taiwan would gradually loose its competitive edge, as evidenced by the reported lost cargo freight through its major ports in recent years. With the lack of direct links with China, higher transportation costs and longer traveling rout imply companies, as well as tourists, would eventually move their business and interest to the Chinese cities.

Economic Growth

Taiwan's GDP growth came in at 3.3% year-over-ear (y/y) in the fourth quarter of 2004, decelerating from 5.3% and 7.9% in the third and second quarter, respectively, according to the data released by the Directorate-General of Budget, Accounting and Statistics. It marked the lowest rate since the second quarter of 2003 when the economy was shaken by the SARS outbreak. On a seasonally adjusted base calculated by Global Insight, GDP inched up by just 0.1% in the fourth quarter from the previous quarter, after rising 2.2% in the third quarter. For 2004 as a whole, real GDP registered a 5.7% increase, compared with 2003's 3.3%, and was also the strongest since 2000's 5.8%.

Gross fixed capital formation climbed 14.9% in the fourth quarter, slightly up from the third quarter's 13.7%, but still below the second quarter's 19.4%. Investment in civilian air crafts pushed up private investment by 30.4% and was largely responsible for the improvement, but a 20.5% decrease in public investment remained the drag. Private consumption advanced 3.3% in the fourth quarter, up from the third quarter's just 1.4% but still lower than the second quarter's 4.3%. It was led by an 8.5% in household operation and a 6.1% increase in spending on clothing and footwear.

While remained in surplus, trade balance on goods and services narrowed rapidly, down by a sharp 27.8%. As a result, next exports became a big drag to GDP growth in the fourth quarter, subtracting as high as 3.2 percentage points from the growth. Due to the global economic downturn, in particular demand for high-tech products, exports rose by just 3.4% in the fourth quarter, decelerating sharply from the third quarter's 15.1%. Imports, on the other hand, continued to register double-digit growth, at 10.3%, albeit lower than the third quarter's 17.4%.

With export growth easing markedly, Taiwan's exports-dependent economy unsurprisingly slowed in the fourth quarter. What surprised us, though, was the slowdown in external demand, which was more profound than we initial thought. Indeed, export growth in the fourth quarter was the lowest in three years, even lower than the rate of 3.7% posted in 2003Q2 when the shipment was disrupted by the SARS outbreak. With the continued appreciation in the New Taiwan dollar adding into the problem, further moderation in exports are expected in the short term. Import growth, on the other hand, outpaced exports, thanks to strong demand for capital equipment, while surging crude oil and other raw material prices also helped. As a result, next exports' contribution to GDP growth turned negative for the first time since 1998.

In tandem with easing external demand, manufacturing production and business fixed investment has been moderating as well, but at lesser extent. With exports weakening further, however, private investment could see more pronounced moderation in quarters ahead, as has been reported by some companies in early this year. Consumer spending, on the other hand, held unexpectedly strong. While spending on clothing and footwear and household operation provided major support, more encouraging was higher spending on durable goods, including vehicles. Despite the improvement, the strength in spending was still below those seen in the first half of 2004, and further easing could be expected alongside with weakening consumer confidence due to less favorable economic condition. We expect GDP growth to ease to 4% in 2005 and further to 3.7% in 2006, while could be maintained at 4-5% in the medium term. However, the long-term economic prospect is less clear. The high-tech sector has been the main support to Taiwan's economy in the past decades, but its competitive edge has been declining, while those in China are catching up. Although the government claims it would support the industry to upgrade, while promoting the service sector as the same time, its policies have shown lack of long-term direction. Long-term growth therefore could moderate below 3% by 2025.

Consumer Demand

Following a strong upturn in the first half of 2004, consumer demand has moderated in the second half. Real private consumption rose just 1.4% in the third quarter, decelerating from the second quarter's 4.3% rate; the lowest since the second quarter of 2003, when sentiment was spooked by the SARS outbreak. Although a fading base effect could be the blamed for the third quarter's lower growth, falling consumer confidence certainly contributed to weaker demand.

Consumer sentiment has been weakening throughout most of 2004 and into 2005, despite a few pickups in between. Indeed, the consumer confidence index fell to 75.85 in January 2005; a 1.7% decline from the previous month, and compared with as high as 83.70 posted in February 2004. This was according to a survey conducted by the Research Center for Taiwan Economic Development of the National Central University. January marked the second month of falling confidence after its strong pickup in November, which was attributable to rising concerns over the job market, inflationary pressure, and the condition of the household income, which offset a strong rebound in sentiment to the local stock market. A figure below 100 is classified as “pessimistic.”

In the second half of 2004, surging oil prices, accelerating inflation, and a tighter monetary environment kept consumer sentiment blue and created a more discouraging atmosphere for consumer spending. Although pressure from these factors, particularly oil prices and domestic inflation, was winding down in early 2005, they could still pose threats to sentiment and demand. For one, oil prices are still exceeding $40 dollar/barrel, and the outlook remains volatile. In addition, despite January's significant ease in CPI inflation, pressure on food, clothing, transportation, and other costs of consumption goods and services have remained high. Further pickups are likely, as costs on several items are reported to likely be raised after the Lunar New Year holiday.

Meanwhile, the labor market has been improving, but a large part of jobs created were in technology companies. Yet excluding high-tech firms, other traditional, more labor-intensive companies have seemed cautious on hiring and other employment plans. In addition, with inflation picking up, growth in real wages has even slipped into negative territory in the first seven months of 2004. We therefore expect real private consumption to moderate, growing 2.4% in 2005 and 2.3% in 2006, after having risen 2.8% in 2004.

Inflation

After hovering below 1% in the first half of 2004, inflationary pressures have been building up quickly in mid-year, hitting a near-six-year-high in July, in particular. The consumer price index (CPI) climbed by 3.3% in July, followed by 2.6% in August and 2.8% in September. Judging from the major components, the increases in July–September were primarily due to seasonal factors, with a typhoon and heavy rains damaging crops and pushing up food costs. Rising energy and transportation costs, caused by surging world oil prices, also played a major role in fanning consumer prices.

Upward pressure has since eased, however, as volatile food costs stabilized. CPI inflation stood at 1.6% in December, compared with November's 1.5% and October's 2.4% inflation rates. Increases in food costs have moderated to around 3.5% in November–December, retreating from heights of 9.8% in July. Fuel costs, however, continued to surge despite the retreat in global oil prices. After surging 12.2% in July, fuel prices soared to 16–17% in November–December. For the full year of 2004, the CPI rose 1.6% after having fallen 0.28% in 2003.

In January 2005, inflationary pressure eased further, due mainly to the timing of the Lunar New Year celebration, which fell in January in 2004 but was in February during 2005. This created a higher year-earlier comparison base, and resulted in only a 0.48% increase in January's CPI. Among the components responsible for January's substantial ease in CPI, a reduction in bonuses to house-helpers and a 2.5% decrease in grooming costs were the factors caused by the different timing, and the impact of these should fade in months to come. The drop-offs in housing rentals, however, (despite easing to 0.4% in recent months) have continued to drag down overall price levels, and the impact of that should persist longer.

Barring January's substantial easing of inflation, the inflationary trend should remain rather stable in the short-to-medium term, with slight, upward risks. Volatile global oil prices should remain the major risk to the island's inflation outlook, along with planned hikes in utility costs, such as electricity and water rates. In addition, the strong increase in the wholesale prices in the second half of 2004 could pressure producers to pass on some of their costs to consumers. Heightened competition and advances in technology, however, should help limit producer pricing power, and restrain some of this upward pressure. In addition, pressure from housing rents and wages has remained subdued, with continued falls in residential rents, in particular. The central bank's tighter monetary policy, from higher interest rates to gradual adjustments for a stronger exchange rate, could also help stem some inflationary pressures. CPI inflation is therefore projected to hit 1.5% in 2005 before accelerating to 1.6% in 2006.

Monetary Policy

Taiwan's central bank raised its key interest rates twice in 2004; first in September, and again in December. The moves marked the end of its highly accommodative monetary policy for more than three years, and signaled the bank's firm stance towards a more neutral policy. Following September's 25 basis-point rate hikes, the bank raised its key interest rates just 12.5 basis points in December, with the rediscount rate hiking to 1.75%.

The accommodations with and without collateral rates were raised to 2.125% and 4%, respectively. Despite easing inflationary pressure towards the end of 2004, the bank viewed its rate hikes as necessary to curb inflation expectations, which could result from the likely increases in utility fees, such as the planned electricity and water rate hikes.

Going forward, inflation is expected to be rather stable, but volatile oil prices could continue to add upward bias. In addition, the bank has reiterated that real interest rates have remained at negative territories, which could affect funds allocation and undermine the long-term stability of the financial market. Despite noting possible slower global and domestic economic growth in the coming quarters, the bank still seems confident of its economic performance. A growth rate of 4–5% in the coming quarters appears acceptable to the bank, provided that it comes on the back of high oil prices and global slowdowns. We therefore expect that more rate hikes could be possible, but they should take a more measured pace, as inflationary pressure has eased and concerns over the external and domestic economic condition have risen.

Fiscal Policy and Public Finances

The 2005 general budget draft of the central government was finalized in November 2004, with government revenues rising 3.9% to NT$1.402 trillion, from 2004's NT$1.349 trillion. Meanwhile, government spending was estimated at NT$1.636 trillion, a 2.4% increase from 2004's NT$1.597 trillion. The resulting budget shortfall was thus narrowed to NT$232.9 billion; down from 2004's NT$247.8 billion. Among total spending, those on education, science, and culture topped other spending to account for 19.4% of the total. This was followed by spending on social welfare (17.7%), economic development (15.7%), and national defense (15.4%). The budget, however, was slashed by parliament in January 2005. Spending was cut to NT$1.61 trillion, while revenue was slashed to NT$1.33 trillion. It resulted in a widened budget deficit of NT$277.3 billion compared with both the draft and the previous year's shortfall. Although some spending and revenue was seen as unnecessary and could be subjected to a cut, many slashed were viewed as imperative for economic development and reform, as well as administrative operations, including spending on special, high-tech development projects, science development funds, and the privatization of state-owned enterprises. Due to Parliament's lack of thorough consideration and planning for the budget, it would take some time to fix the damage done to the budget and economic development.

Exchange Rates

The New Taiwan dollar has been strengthening for six straight months since September 2004. Upward pressure was particularly strong during the last two months of the year and into early 2005, as rising speculation on the upward movement or even revaluation of the Chinese renminbi has attracted an inflow of hot money. This, in turn, has cast higher pressure on the neighboring currencies, including the New Taiwan dollar. The rallying US dollar, on the other hand, delivered some downward pressure early in January 2005, as the US Fed continued its measured interest-rate hikes, while the Bush administration indicated that it supported a strong dollar and would lower the budget deficit. Fed chairman Greenspan's less-alarming tack on the trade and current account imbalance also supported the US dollar. With these two forces (speculation on the renminbi and the US dollar's rally) counteracting each other, they have resulted in greater volatility for the local currency. The New Taiwan dollar averaged 31.86/dollar in January 2005, strengthening from 32.18 in December, and compared with August's 34.00 before this round of strengthening began.

In February, the New Taiwan dollar came in even stronger, to a four-and-a-half year high, as investors continued to speculate on greater appreciation in the regional currencies, as well as betting that the central banks, including South Korea and Taiwan, would allow their currencies to strengthen. Taiwan's central bank, however, has been reported to be constantly intervening in the foreign exchange market, in particular after the sharp appreciation in late February. The bank's move was an attempt to erase strong volatility in the local currency and to maintain exports' competitiveness. It also called in major foreign investors and issued concerns against speculation, as investors were urged to either invest in the stock market or leave. The New Taiwan dollar averaged 31.51 in February.

In spite of the US dollar's rally in early 2005, however, the ballooning trade and current account deficit should continue to weigh down the dollar. In addition, despite the US authority's verbal support for a stronger dollar, no real action was taken on that matter, and doubt remains that it would let the dollar weaken to restore the current account imbalance. This, in turn, implies that further upward pressure should remain on the major world currencies, in particular the yen, the renminbi, and regional currencies. While maintaining the currency's general stability, Taiwan's central bank should allow for further strengthening of the Taiwanese dollar, which could not only help curb imported inflationary pressure, but could also reduce the need for more interest-rate hikes, in light of slowing domestic demand. It would restrain the currency's movement, however, keeping it in line with other regional currencies and stronger than no others, in an attempt to maintain export competitiveness.

Trade and External Accounts

Following a strong performance in the first half of 2004, the momentum of export growth has been cooling in the second half, on the back of slowing external demand, in particular those for Taiwan's all–important, high-tech products. In addition, a higher year-earlier comparison base and the rapid appreciation in the New Taiwan dollar were also the cause of the slowdown. Exports rose by 16.5% year-over-year in the second half of 2004; down from 25.6% in the first half. The slowdown was more profound towards the end of year, with just a 6.2% growth posted in December, the lowest since July 2003. That said, exports rebounded strongly in January 2005, climbing as strong as 29.7%. It, however, was distorted by the timing of the Lunar New Year holidays, which fell in January in 2004 but was in February during 2005. Lesser working days last year created a lower year-earlier comparison base.

Imports, on the other hand, have continued to grow strongly through the year, albeit at a slower rate in later months than earlier in the year. Strong import bills were pushed up by the continued surge in oil payments, while rising investment demand also helped. Imports climbed 28.8% in the second half, compared with a 35.6% increase in the first half.

Strong import growth has extended into early 2005, with a surge of 46.7%, due to the distortion by the timing of holidays and the imports of civilian aircraft and high-speed-rail train. Higher import growth than exports has resulted in narrowing trade surplus, standing at US$6.1 billion in 2004 as a whole, which was more than halved from 2003's US$16.9 billion. Indeed, the trade balance posted two straight months of deficit in December and January, with December's deficit mounting to a record US$1.1 billion.

Despite January's strong rebound (that was distorted by the holidays), further moderation in export growth is expected in the short to medium term, stemming largely from the slowing global economies and the strength in the New Taiwan dollar. One major threat comes from the volatile outlook of world oil prices, which have been clouding the global economic prospects, as the US and Japanese economies, among others, have shown softness in recent economic reports. In addition, a continued surge in oil prices could further erode the island's terms of trade and result in a persistent narrowing in the trade surplus. Strong demand from China has become one major support to regional exports, particularly Taiwan. China's growth is projected to moderate to 8.2% in 2005, from 2004's 9.5%, as the government's effort to cool down its economy takes effect. This could have great adverse impact on Taiwan's export sectors. With export growth decelerating, trade and current account surpluses could narrow further.

TAIWAN

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	307.84	346.79	523.32	1,438.53	2.4	8.6	7.0
Nominal GDP per capita, US dollars	13,913	15,306	22,543	58,433	1.9	8.1	6.6
Real GDP, billion real 2000 US dollars	307.84	355.73	440.42	740.83	2.9	4.4	3.5
Real GDP per capita, real 2000 US dollars	13,913	15,701	18,972	30,092	2.4	3.9	3.1
Real private consumption, billion real 2000 US dollars	190.72	208.72	248.99	426.10	1.8	3.6	3.6
Real government consumption, billion real 2000 US dollars	39.76	40.32	41.68	46.21	0.3	0.7	0.7
Real fixed investment, billion real 2000 US dollars	72.26	66.56	92.35	207.66	-1.6	6.8	5.6
Real exports, billion real 2000 US dollars	168.34	236.59	328.08	572.51	7.0	6.8	3.8
Real imports, billion real 2000 US dollars	161.31	196.38	272.11	518.13	4.0	6.7	4.4
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	6.46	5.95	5.64	6.52	-1.6	-1.1	1.0
Mining	1.30	1.31	1.30	1.09	0.3	-0.2	-1.2
Manufacturing	81.68	108.70	149.72	250.51	5.9	6.6	3.5
Utilities	6.67	7.83	10.21	16.32	3.3	5.4	3.2
Construction	10.55	7.56	8.54	11.53	-6.5	2.5	2.0
Wholesale & Retail Trade	60.84	67.80	81.52	138.94	2.2	3.8	3.6
Transport & Communication	20.77	26.02	31.88	54.76	4.6	4.1	3.7
FIRE	70.44	82.17	96.43	152.50	3.1	3.3	3.1
Other Services	62.93	72.80	83.96	134.35	3.0	2.9	3.2

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	62.0	62.2	60.2	59.7	0.2	-2.0	-0.5
Government consumption share of GDP	12.9	12.0	9.9	5.8	-1.0	-2.0	-4.1
Fixed investment share of GDP	23.5	20.6	23.8	33.2	-2.9	3.2	9.4
Exports share of GDP	54.7	68.0	74.8	73.5	13.3	6.8	-1.3
Imports share of GDP	52.4	62.7	69.2	73.5	10.3	6.4	4.4
Net extports share of GDP	2.3	5.3	5.7	0.0	3.0	0.4	-5.6

III. Europe

United Kingdom

Overview

Short-Term

We expect GDP growth to moderate from 3.1% in 2004 to a still-respectable 2.6% in 2005. The growth drivers are expected to be broadly based this year. Consumer spending is projected to hold up reasonably well, benefiting from still-healthy employment and modestly rising earnings. Even so, personal expenditure will be more moderate overall in 2005 than in 2004, as it is constrained to some extent by the higher interest rates, a further slowdown in the housing market and increased debt levels.

Fiscal policy will remain a significant growth driver in the near term given the already-announced government investment and spending plans for fiscal 2005/06, while gross fixed capital investment is projected to extend the overall improvement seen in the second half of 2003 and first three quarters of 2004. Finally, exports should largely benefit over the coming months from still relatively healthy global growth, although it is expected to be softer in 2005 than in 2004. U.K. exports should gain to some extent from an anticipated, very modest pickup in domestic demand in the Eurozone as 2005 progresses. The overall easing back of sterling on a trade-weighted basis since the middle of 2004 should also help exports.

We expect inflation to remain relatively benign, although annual consumer/retail price inflation has been trending up, since bottoming out in September. Consumer price inflation was up to 1.9% in March and April, compared with 1.1% in September, while underlying retail price inflation rose from 1.9% to 2.3% in April. Underlying retail price inflation is projected to rise to a peak of 2.7% in the summer of 2005, before easing back amid gradually softening oil prices and more moderate growth.

Monetary policy now seems unlikely to be tightened any further, although there is still a small chance that the Bank of England could raise interest rates again later this year. Specifically, we currently forecast the Bank of England key interest rate to remain at 4.75% through the rest of 2005.

Meanwhile, public finances are expected to remain under pressure in the near term, at least. Government spending will continue to be pushed up by the commitment to improve public finances. However, the government will clearly be reluctant to tighten fiscal policy in the budget for 2005/06, given a general election is certain this year - probably in May.

Medium Term

Growth is seen stabilizing at 2.4% in 2006, which is considered to be modestly below trend growth. UK fiscal policy is likely to be tightened in 2006, as the re-elected Labour government sets about correcting the weakened public finances, in the knowledge that the next general election is probably at least four years away.

In addition, consumer spending is projected to be pressurized to some extent by a still soft housing market in the first half of the year, as well as a less robust jobs situation during the early months. This is likely to be partly compensated for by the central bank cutting interest rates, as its concerns over medium-term inflationary pressures abate. Tighter fiscal policy is also likely to encourage the central bank to relax monetary policy. Specifically, we see the central bank's key interest rate falling to 4.25% during the first half of the year. In addition, softer oil prices should provide some support to growth in 2006, while global growth is expected to stabilize after softening overall in 2005 compared with 2004.

Growth is actually forecasted to be weakest in the first quarter of 2006, and then pick up gradually as the year progresses. It is expected to gain further momentum in 2007, when GDP is projected to expand by 2.9%. Stabilization and then gradual improvement in the housing market, rising employment, and a modest softening in oil prices should also help growth to strengthen. Consumer spending is projected to regain some upward momentum, to once again become a key growth driver. Meanwhile, business investment should also make a significant contribution to growth. However, net trade is likely to remain a modest drag on growth, as imports largely grow modestly faster than exports. Growth is then expected to remain around trend (seen at 2.5-2.75%) during 2008–10.

The anticipated tightening of fiscal policy in 2006/07 should see public finances start to improve modestly. Fiscal policy is likely to see further modest tightening thereafter, but this should be partly compensated at least by the Bank of England keeping monetary policy relatively relaxed. Meanwhile, consumer price inflation is projected to average 1.8% in 2006, with underlying retail price inflation averaging 2.4%. Consumer price inflation is forecast to average around 1.8% over the next five years, with underlying retail price inflation largely staying around 2.2-2.3%.

Regarding UK membership in the Eurozone, it is clear that a referendum on the matter remains a long way off, given the continuing lack of progress on fulfilling the Treasury's economic tests for UK membership. The current political crisis within Europe following the May/June 2005 rejection of the new European Union constitution by the French and the Dutch—as well as the persistent disappointing growth performance of the Eurozone—makes UK membership even more unlikely. We also remain sceptical that a positive vote in any referendum can be achieved for many years to come. Consequently, Global Insight's view is that the United Kingdom will not join the Eurozone until at least 2011, and even this currently seems extremely unlikely.

Long Term

The longer term economic outlook for the United Kingdom remains relatively upbeat, particularly compared with the other large Western European economies. This partly reflects the UK's more favorable demographics. The population is forecast to keep growing through to 2025, although the working age population (16-65) is projected to start declining from 2023. Trend growth is forecasted to be around 2.5%. This is actually below the Treasury's current estimate of 2.75% trend growth, as we are skeptical about how successful the Chancellor will be in achieving his long-term objective of closing the United Kingdom's productivity gap with the United States and Europe.

Determined to achieve the government's objective of raising U.K. productivity growth over the economic cycle, the chancellor declared that he would demonstrate progress on this objective by 2006. To that end, he announced a £12-billion boost to education over three years (an average increase of 6% per year in real terms). The government will not reap the full benefit (in terms of higher productivity) from higher investment in education for several years yet, implying that growth may well not live up to the Treasury's expectations in 2005–10. However, the chancellor has already committed to higher spending as far out as 2007–08, suggesting that taxes will have to rise to fund the increased spending if growth persistently falls short of these projections.

In May 2003, The Department of Trade and Industry released an assessment of U.K. competitiveness, stating that Britain needs to raise skill levels and change management behavior in order to move up the value chain and make the transition from competing on relatively low costs to competing on unique value and innovation. The report showed U.K. total factor productivity lagging behind France and Germany by around 20% and the United States by about 40%.

One longer term problem is expected to come from the rapidly aging population. Lower population growth will reduce the scope for labor-force gains and increase the ratio between people economically inactive and active. This will only be partly compensated for by an anticipated increase in the labor participation ratio, as the government increase its efforts aimed at getting more people to work. Furthermore, it has recently become clear that there is a looming pensions' crisis in the United Kingdom, despite earlier confidence that the situation was less severe than in most other EU countries. Various ways of tackling this are currently being examined by the government, including raising the retirement age. An aging population will present other problems for future governments; most notably, the burden on the national health service will become ever greater.

Economic Growth

GDP growth amounted to 3.1% in 2004. This was up from expansion of 2.2% in 2003 and was the best performance since 2000, when GDP surged 3.9%. Domestic demand grew 3.8% overall in 2004, as consumer spending expanded 3.3%. Gross fixed capital formation rose by 5.6%, helped by a healthy recovery in business investment. This grew 5.5% last year, having contracted 1.2% in 2003. Investment was further boosted by significant government capital expenditure as it sought to improve public services. Also reflecting the focus on improving public services, government spending rose 4.7% in 2004. Meanwhile, net trade reduced overall GDP growth by 0.7 percentage point last year, as import growth of 5.2% was getting on for double export growth of 3.0%. On the output side, industrial production rose just 0.4% in 2004, with manufacturing expanding 1.4%. In contrast, service sector output surged 4.0%.

Growth regained limited upward momentum in the final quarter of last year, after slowing in the third quarter following a robust first-half performance. Specifically, GDP growth slowed significantly to 0.6% quarter-on-quarter (q/q) in the third quarter of 2004—the weakest performance since the first half of 2003—before picking up modestly to 0.7% q/q in the fourth quarter. This compared to growth of 1.0% q/q in the second quarter and 0.7% q/q in the first. Meanwhile, the year-on-year (y/y) growth rate fell back to 2.9% in the fourth quarter, from 3.1% in the third quarter and a near four-year high of 3.6% in the second quarter.

On the output side, growth in the fourth quarter continued to be driven by the services sector. Indeed, service sector output was up by 0.9% q/q and 4.0% y/y. This followed broadly similar levels of expansion in each of the previous three quarters. In marked contrast, the industrial sector continued to struggle in the fourth quarter. In fact, it disappointingly returned to technical recession, after showing strong signs of recovery in the second quarter. The sector has clearly been hit by higher interest rates, strong oil prices, and at least a temporary moderation in global growth. The overall strength of sterling in 2004 was also a problem for industry. Industrial production fell by 0.1% q/q and 0.5% y/y in the fourth quarter, after a decline of 1.1% q/q and 0.1% y/y in the third quarter. These renewed declines in industrial production followed robust expansion of 1.2% q/q in the second quarter, which boosted hopes that the sector was finally seeing a significant upturn after sustained weakness.

On the expenditure side, consumer spending moderated for a third successive quarter in October-December and at a more pronounced rate, having surged in the first quarter. This suggests that higher interest rates and the marked slowdown in the housing market since the middle of 2004 had an increasing dampening impact. The Bank of England raised its key interest rate five times between November 2003 and August 2004, taking it from a 48-year low of 3.50% to the current level of 4.75%. Even so, consumer spending still gained some support from record-high employment and very attractive prices on the high street amid intense competition.

Encouragingly, fixed capital formation expanded for a seventh successive quarter in the fourth quarter of 2004, and at a still relatively healthy rate. Business investment expanded for a sixth quarter in seven, although at a reduced rate. The central bank, in particular, is looking for continuing healthy business investment to underpin future growth, while the government is hoping that further strong investment will play a key role in improving UK productivity.

Government spending continued to make a strong contribution to growth in the fourth quarter, as it has repeatedly in recent times. This reflects the Labour Party's ongoing commitment to improving public services, particularly health and education. Despite recent concerns about softening global growth compared with the first half of 2004 and the strength of sterling during much of 2004, UK exports of goods and services picked up to grow 1.6% q/q in the fourth quarter, having stagnated in the third quarter. With imports rising 2.2% q/q, net trade reduced the quarterly growth rate by 0.2 percentage point in the fourth quarter.

A "flash" estimate from the National Statistics Office indicates that GDP growth moderated to 0.6% q/q and 2.8% y/y in the first quarter of 2005. However, it is likely that that first quarter growth will be revised down to at least 0.5% q/q, as more recent data have shown that industrial production contracted to a significantly greater extent in the first quarter than was originally estimated (0.7% q/q and 0.8% y/y compared to 0.1% q/q and 0.2% y/y). In contrast, the service sector remained relatively healthy, although it expanded at a reduced rate of 0.8% q/q and 3.6% y/y. Details are unavailable on the first-quarter GDP expenditure components, but it appears likely that consumer spending was relatively subdued.

We expect GDP growth to moderate to 2.6% in 2005. Expansion in domestic demand is seen easing back to 2.7% in 2005 from an estimated 3.8% in 2004. This is largely due to an anticipated significant slowdown in consumer spending growth (which has been the long-term growth driver) to 2.3% from 3.3% in 2004, as higher interest rates further weigh down, particularly on indebted families, and the housing market continues to slow.

While interest rates are unlikely to go much higher, and may well have peaked at the current level of 4.75% (up from 3.50% in late 2003), they seem unlikely to start falling until at least near the end of 2005. Higher interest rates and softer house prices will also lessen the scope for mortgage equity withdrawal, which helped to fuel consumer spending in 2003 and the early part of 2004. Even so, a still-healthy labor market and reasonable earnings growth should ensure that consumer spending does not slow sharply. In addition, continuing intense competition on the high street should limit any pick-up in inflation and provide further support to consumption.

Meanwhile, gross fixed investment is forecasted to see further healthy growth in 2005, largely due to companies seeking to further upgrade and boost capacity following the very weak capital spending of 2001–2003. Relatively strong business profitability, still-low interest rates by past norms, and a reasonably healthy equity market should support investment. It is also assumed that the manufacturing sector will see recovery, despite its disappointing performance since mid-2004. Overall, gross fixed capital expenditure is expected to climb 3.5%, with business investment expanding by a further 4.4%. Public spending and investment growth will continue to grow relatively strongly in 2005, as the government has already committed further significant resources to boosting public services this year.

Export growth is expected to accelerate to 3.9% in 2005 from an estimated 1.9% in 2004. Although global growth is forecasted to moderate from 4.1% in 2004 to 3.3% in 2005, U.K. exports should benefit to some extent from an anticipated modest pickup in domestic demand in the Eurozone as the year progresses. In addition, sterling is projected to be generally weaker against the euro in 2005. This should largely offset a likely appreciation in sterling against the dollar and help protect U.K. competitiveness. Imports are forecast to grow 4.4% this year. As a result, net trade is expected to cut overall GDP growth by just 0.1 percentage point in 2005 compared to an estimated 0.7 percentage point reduction in 2004.

GDP growth is seen slipping further to 2.4% in 2006, before rebounding to 2.9% in 2007. It is likely that fiscal policy will be tightened in 2006, as the re-elected Labor government seeks to rein in weakened public finances. This will not only curtail the boost to growth from public investment and spending, but will likely weigh down on consumer spending if taxes or national insurance contributions are raised. In addition, the weakness of the housing market is expected to limit the upside for consumer spending early in the year. Lower interest rates and stabilization in the housing market are projected to lead to a renewed pickup in consumer spending later on in 2006 and in 2007, however, while exports should benefit from accelerating growth in the United States, and, to a lesser extent, in the Eurozone.

Trend GDP growth is considered to be around 2.5-2.7% over the next five years, with domestic demand slightly higher. Over the longer term, we believe that trend growth will be slightly lower at 2.5%, primarily due to the aging population. We assume that investment will rise as a proportion of GDP, as companies seek to boost their productivity and compensate for an aging labor force.

Consumer Demand

Consumer spending has clearly moderated since the middle of 2004, having been the major growth driver through most of 2003 and the first half of last year. Indeed, the Bank of England currently regards soft consumer spending as a major downside risk to the growth and inflation outlooks.

National accounts data show that consumer spending growth weakened to 0.2% quarter-on-quarter (q/q) in the fourth quarter, which was the weakest level since the first quarter of 2003. It had previously eased back to 0.7% q/q in the third quarter, from 0.8% q/q in the second and 1.2% q/q in the first. Furthermore, latest data show that seasonally adjusted retail sales volumes edged down 0.1% month-on-month (m/m) in March. This represented continuation of the recent, markedly softer tone in retail sales, as the rebound in sales had been limited to 0.3% m/m in February and 0.7% m/m in January, after falling 1.2% m/m in December. Meanwhile, the year-on-year (y/y) increase in retail sales volumes fell to a 19-month low of 2.7% in March. It had peaked at 7.5% y/y in July 2004.

Despite the recent softness of consumer spending, a GfK Martin Hamblin survey (carried out on behalf of the European Commission) showed that consumer confidence rebounded strongly from an 18-month low in September 2004 to a 28-month high in March 2005. It was only marginally below this level in April. Although the index for consumers' perceptions of whether it is a good time to make major purchases has slipped back recently, it was still above the five-year average in April.

We expect the downside for consumer spending over the coming months to be limited by the strong labor market, modestly increasing earnings, a still-relatively healthy domestic economic environment, and widespread belief that interest rates will not go much higher and may even have peaked. In addition, consumers continue to benefit from attractive prices, resulting from strong competition (although the retail sales price deflator fell at a reduced rate of 0.7% year-on-year in March).

Nevertheless, higher interest rates and the softer housing market will undoubtedly continue to have some dampening impact. Consumers took advantage for an extended period of low interest rates and house price gains to borrow more to finance their spending habits, with borrowing rising fastest among low-income families. Consequently, with consumer debt levels at a record high in nominal terms, it is only to be expected that higher interest rates have caused some sustained retrenchment by the consumer sector. Meanwhile, the housing market has also clearly weakened markedly overall since the middle of 2004, and we expect it to remain soft for an extended period (although we do not anticipate a crash). These developments have lessened the scope for mortgage equity withdrawal, which helped to fuel consumer spending during much of 2003 and 2004. In addition, lower housing market turnover has reduced demand for such products as furnishings and household appliances.

Spending could also be restrained to some extent by the belief that taxes will rise in some form or another in the near future, given the need to rein in the public finances. Consequently, we expect consumer spending growth to moderate from 3.3% in 2004 to a still respectable 2.3% in 2005.

Consumer spending growth is projected to slow further to 2.1% in 2006. Even so, it is expected to accelerate as the year progresses, helped by lower interest rates and a more stable housing market. Fiscal policy is almost certain to be tighter though.

Over the medium term, we expect consumer spending growth to average around 2.7% a year, supported by generally high employment, a healthier housing market and reasonable real earnings growth. Nevertheless, private consumption's share of total GDP is projected to ease back from 64.3% in 2005, to 62.4% in 2010, and 59.9% in 2025.

Business Investment

Business investment increased at a significantly reduced rate of 0.2% quarter-on-quarter (q/q) in the fourth quarter of last year. At least, though, this marked a fifth successive quarter of expansion in business investment and it followed healthy growth of 1.6% q/q in the third quarter, 1.3% in the second, and 1.3% in the first. Meanwhile, the year-on-year (y/y) increase in business investment moderated to a still very respectable 4.4% in the fourth quarter from 6.4% in the third. Overall, business investment rose by 5.5% in 2004.

The overall improvement in business investment has been driven by the strongly performing services sector. Indeed, private service-sector investment rose 8.1% in 2004. It was up 0.7% q/q and 5.6% y/y in the fourth quarter, having risen 3.1% q/q and 7.5% y/y in the third quarter. Service-sector investment had actually suffered a temporary relapse in the second quarter, when it eased back 0.8% q/q, after surging 2.6% q/q in the first.

Meanwhile, investment by manufacturing companies recovered to grow 2.9% q/q in the fourth quarter, after dropping 2.6% q/q in the third. This means that it essentially stabilized overall in the second half. It had shown significant improvement in the second quarter, when it had jumped 5.6% q/q following extended weakness. The reluctance of manufacturing companies to increase their investment overall in the second half of last year was hardly surprising, given the sector's loss of momentum. Manufacturing investment was up 4.7% y/y in the fourth quarter. It increased 3.2% overall in 2004, after plummeting 7.6% in 2003 and 11.5% in 2002. Investment in construction and other production fell a further 1.2% q/q in the fourth quarter, after dropping 3.2% q/q in the third quarter. This followed reasonably healthy expansion overall in the first half of last year. It was down 1.8% y/y in the fourth quarter.

A key question for the health of the economy going forward is whether firms will be prepared to keep on investing amid the many uncertainties that face both the domestic and global outlook at the moment. For sustainable, balanced economic expansion to occur, it is vital that robust business investment compensate for likely more moderate consumer spending. The latest survey evidence on investment intentions from the Confederation of British Industry, British Chambers of Commerce, and Engineering Employers Federation has been somewhat mixed.

On the positive side, firms' capability to finance investment will benefit from the four-and-a-half-year high of corporate profitability in the second quarter of 2004, and its essential stability at this level in the third quarter.. Furthermore, the generally stronger equity market compared with 2003 should improve their ability to raise finance. In addition, interest rates are projected to remain low by past norms. The government is particularly keen to see stronger investment, aimed at boosting productivity.

The manufacturing sector is forecasted to contribute to investment growth, assuming that its upturn continues, after apparently suffering a serious relapse since the middle of 2004 (we think the official data overstates the sector's current weakness, although it undeniably has lost momentum). Particularly in the manufacturing sector, there is likely to be a need among some firms to replace or upgrade equipment following very weak investment in recent years.

We expect business investment to expand at a very healthy rate of 4.4% in 2005 before moderating to a still respectable 2.5% in 2006 as overall economic activity moderates. Total fixed capital formation is projected to grow 3.5% in 2005 and 2.8% in 2006, following estimated expansion of 6.1% in 2006.

Business investment is expected to be an important growth driver over the medium and long term, as companies look to boost their productivity and upgrade their capacity to keep as competitive as possible. Indeed, fixed investment is projected to rise from 17.3% of GDP in 2005, to 18.4% of GDP in 2010, and 21.7% of GDP in 2025.

Inflation

Annual consumer price index (CPI) inflation spiked to 1.9% in March, after having stood at 1.6% in each of the previous three months. This was its highest level since May 1998, and took it further up from the equal two-year low of 1.1% last September. Indeed, annual consumer price inflation had been contained in a relatively tight 1.1–1.6% range from the first quarter of 2003 through to February 2005. Furthermore, annual consumer price inflation is now very nearly up to the Bank of England's 2.0% targeted rate. However, it is still below the Eurozone average rate—which was 2.1% in March. The strength of oil prices has been a major contributory factor to the leap in consumer price inflation since last September. This has particularly pushed up utility and transport prices. Upward pressure on inflation is also currently stemming from some supply shortages of seasonal food items.

Meanwhile, annual underlying retail price index (RPIX) inflation also accelerated in March. It rebounded to 2.4% after having dipped from a 12-month high of 2.5% in December to 2.1% in both February and January. This is up from last September's 25-month low of 1.9%. Thus, it is only fractionally below the 2.5% target level that the central bank used to focus on. The housing element in the RPIX index had exerted a downward influence in January.

Annual consumer/retail price inflation seems likely to trend up modestly further over the coming months. GDP growth is still very near to trend, and any pickup in activity is liable to exert some inflationary pressures, given the lack of an output gap. Furthermore, earnings growth is expected to pickup to a limited extent, amid a tight labour market. In addition, oil prices are forecasted to remain relatively high through 2005, although the impact of high oil prices is likely to be diluted to some extent by the continuing strength of sterling against the US dollar.

Worryingly, annual producer output price inflation rose back up to 3.2% in April, close to last November's near-nine-year high of 3.5%, as producers tried to push through some of their sharply higher input costs resulting from high oil and commodity prices. Furthermore, there is a danger that it will rise further, as producer input prices increased at their fastest rate over 20 years in February and were still rising at annual rate in excess of 10% in April. This seems likely to exert upward pressure on consumer/retail prices in the next few months at least—even allowing for the fact that further strong competition is expected to limit the extent to which producers and retailers can pass on their higher costs.

Consequently, underlying retail price inflation is forecasted to trend up to reach a peak of 2.7% around mid-2005. It is then expected to ease to 2.5% by the end of 2005, in reaction to a moderation in oil prices and slower growth. Consequently, underlying retail price inflation should average 2.6% throughout 2005. A further easing in oil prices in 2006 (Brent oil is projected to average US$34.6/barrel) and softer growth should see underlying RPI inflation back at 2.2% by the end of 2006.

Underlying retail price inflation is projected to average around 2.25% over the medium term, with consumer price inflation averaging around 1.8%. A low-inflation mentality has now largely developed within the United Kingdom, and consumers have become very price conscious. Even at times of strong consumer demand, retailers have found it difficult to pass on marked price increases. In addition, strong competition from low cost importers is likely to continue to keep prices down in the traded goods sectors.

Labor Markets

The number of claimant-count unemployed increased by 11,000 in March, having grown 3,900 in February. This was the biggest increase since May 2003. Consequently, the number of jobless rose back up to 828,700 in March, having fallen to a near-30-year low of 813,800 in January. Indeed, apart from a modest combined increase of 1,600 in September-October 2004, unemployment had trended consistently down between June 2003 and January 2005.

Overall, the number of claimant-count jobless fell by 80,100 in 2004. This was more than double the 30,100 drop in 2003. The number of unemployed rose from 935,200 at the end of 2002 to a peak of 949,600 in June 2003, before dropping back to 905,100 at the end of 2003 and 825,000 at the end of 2004. Meanwhile, the national claimant-count unemployment rate edged back up to 2.7% in March, from a near 30-year low of 2.6% in February. It had originally fallen to 2.6% in December, from 2.7% in June-November 2004, 2.8% in February-May, and 2.9% in January of last year. The jobless rate had ended 2003 at 2.9%, after having been at 3.1% in the middle of that year.

Unemployment also rose on the International Labour Organization (ILO) measure. It was up 29,000 in the three months to February, compared with the three months to November. This took the average number of unemployed during December-February back up to 1.430 million from an average 1.400 million in September-November and 1.387 million in June-August (the lowest level since comparable results were recorded in 1984). The ILO count includes those out-of-work and not drawing unemployment benefits, and is the primary measure by which international comparisons are drawn. The December-February ILO unemployment rate edged up to 4.8%, from 4.7% in both September-November, and June-August.

However, average employment on the ILO measure increased 148,000 in the three months to February, hitting a record 28.639 million. This was up 231,000 y/y. Consequently, the employment rate for people of working age was 75.0%, up from 74.8% in September-November and 74.9% a year earlier. The number of employed has been significantly boosted by increased demand for public-sector workers, as the government attempts to improve its national health and education services.

The outlook for employment appears to be broadly favorable in the near term at least. Public sector employment should continue to grow as the government seeks to improve services through higher investment, while the manufacturing sector will hopefully see a turnaround in employment assuming that it can regain some upward momentum over the coming months, after faltering badly in the second half of 2004 and early in 2005. Even so, manufacturers are expected to retain an extremely cautious approach to employment, given the sector's frequent relapses. Meanwhile, the service sector should continue to generate new jobs, albeit at a reduced rate.

Overall, we expect employment to rise by 0.3% over 2005, with most of the improvement coming in the first half of the year. The labor market is seen broadly stabilizing in the second half of this year, as growth moderates. Unemployment on the ILO measure is projected to fall to an average of 1.363 million in the third quarter, before edging back up to 1.374 million in the fourth. The unemployment rate is forecasted to fall to 4.5% in the second and third quarters of this year, and then move back up to 4.6% in the fourth quarter.

The labor market is forecasted to weaken modestly in the first half of 2006, as growth remains below trend. The number of jobless is projected to rise to 1.403 million by mid-2006 with the unemployment rate up to 4.7%. However, an acceleration in growth in the second half of next year is expected to result in a renewed improvement in the labor market, sending the number of jobless down to 1.379 million in the fourth quarter and the unemployment rate back to 4.6%. Overall, employment is expected to edge up by 0.1% over 2006.

Over the longer term, we expect the labor force participation rate to gradually edge up as the government steps up its efforts to at least partly compensate for the aging population. In addition, it is highly likely that the retirement age will eventually be raised. Latest population estimates from the Office for National Statistics show that the population is forecast to keep growing through to 2025, although the working age population (16-65) is projected to start declining from 2023.

Monetary Policy

The Bank of England kept its key interest rate unchanged at 4.75% for a ninth month running at the conclusion of the May meeting of its Monetary Policy Committee (MPC). The central bank had previously raised its key interest rate by 25 basis points, from 4.50% to 4.75% in August. In total, the central bank has raised its key interest rate by 125 basis points since November 2003, taking it to the current level of 4.75%, from the 48-year low of 3.50% in July–November 2003.

The MPC's decision to leave interest rates unchanged again in May was widely expected in view of the current continuing uncertainty about the inflation and growth outlook. The MPC's uncertainties relate, in particular, to the strength of consumer spending, the evolution of wages, productivity growth, import prices, the global economy, and the housing market. These uncertainties had again been evident in the minutes of the April meeting. In particular, those members preferring to leave interest rates unchanged highlighted the recent weakness of consumer spending, and expressed uncertainty about whether this would continue or whether it would pick up again. In addition, these committee members were unsure to what extent other sectors of the economy would offset any sustained slowdown in consumption. In addition, they remained uncertain about how "rapidly consumer prices would respond to demand and cost pressures."

Data and survey evidence since then have continued to give conflicting signals. The case for an interest rate hike appeared to be reinforced by consumer price inflation spiking to 1.9% in March from 1.6% in February. However, the downside risks to the growth and inflation forecast identified by the MPC appear to be currently materializing, with latest retail sales data and survey evidence in particular magnifying concern about the consumer sector. In addition, the manufacturing sector is clearly struggling very markedly at the moment, while global growth appears to be moderating. Although the dominant service sector appears to be holding up relatively well, the April purchasing managers' survey nevertheless showed some slowdown in incoming new business and a clear falling back in companies' expectations.

We now expect the Bank of England's key interest rate to remain at 4.75% through the rest of this year, before it is cut early in 2006. However, it must be acknowledged that there is still a case for a further interest rate hike and it certainly cannot be ruled out completely yet. Although first-quarter 2005 GDP growth of 0.6% quarter-on-quarter (q/q) was modestly below trend, and could be revised down, there is still little, if any, output gap. Consequently, any renewed pickup in activity could exert some inflationary pressures. In addition, earnings growth seems likely to move a little further upwards in the near term, given the tight labor market.

Worryingly, annual consumer price inflation has trended up from a low of 1.1% in September to 1.9% in March, and it seems highly possible that it could rise above the 2.0% target level in the near term. Significantly, annual producer output price inflation rose back up to 3.2% in April, close to last November's near-nine-year high of 3.5%, as producers tried to push through some of their sharply higher input costs resulting from high oil and commodity prices. Furthermore, there is a danger that it will rise further, as producer input prices increased at their fastest rate over 20 years in February and were still rising at annual rate in excess of 10% in April. In addition, oil prices spiked up to new nominal record highs in March and early April.

Finally, the monetary policy stance is still probably only neutral, despite the 125-basis-point rate-tightening that has been enacted since November 2003. Meanwhile, latest data suggest overall that house prices are slowing steadily rather than sharply, while tentative signs are emerging that housing activity may be picking up modestly, albeit from a low level, after slowing markedly overall in the second half of 2004. Thus, fears of a housing market crash have eased, at least for now, meaning that the sector need not stand in the way of a modest further hiking of interest rates.

However, we believe that inflationary pressures will be largely contained by modestly below-trend expansion over the next few quarters, and intense competition amid softer growth in consumer spending. Furthermore, the labor market is likely to start easing a little later this year, thereby reducing the upward pressure on wages. Indeed, we project that these factors will cause inflation to ease back modestly in the latter months of this year. We also forecast that the housing market will eventually settle into an extended period of essentially flat or very modest year-on-year price increases from the second half of 2005.

We expect the central bank to start cutting interest rates early in 2006, in reaction to the softer growth, a loosening labor market, easing of inflation and still soft housing market. The key interest rate is forecasted to stand at 4.75% at the end of 2005, and then to fall to 4.25% in the first half of 2006. Lower interest rates in 2006 will also be influenced by a likely tightening of fiscal policy, as the government seeks to rein in the budget deficit. Obviously, the central bank has the scope to cut interest rates more rapidly and extensively, should the housing market undergo a sharp correction.

Fiscal Policy and Public Finances

Public finances have deteriorated markedly overall in recent years, as the government has placed priority on improving public services through increased investment and spending. Indeed, the budget moved back into deficit in 2001–02, then rose substantially.

Specifically, the Public Sector Net Borrowing Requirement (PSNBR) rose from £0.4 billion in fiscal 2001/02 to a nine-year high of £35.7 billion in 2003/04, before edging back to £34.5 billion in 2004/05. Meanwhile, having been in surplus by more than £20 billion in both 1999/2000 and 2000/01, the current budget moved into deficit (by £13.5 billion) in 2002/03. The current budget deficit widened to £21.1 billion in 2003/04, before narrowing to £16.6 billion in 2004/05. As a result of these trends, net debt rose from 30.2% of GDP at the end of fiscal 2001/02 to 32.8% of GDP at the end of fiscal 2003/04 and to 34.5% of GDP at the end of fiscal 2004/05.

The current budget deficit of £16.6 billion in 2004/05 meant that Chancellor Gordon Brown only just missed out on his target for limiting the current budget deficit to £16.1 billion over the fiscal year (this was raised from a previous target of £12.5 billion in the March budget for 2005/06). Central government current receipts rose 7.1% in fiscal 2004/05, to £419.2 billion, helped by a 12.1% increase in income and wealth tax receipts, to £163.3 billion. In addition, receipts from taxes on production were up 4.9% y/y, at £155.4 billion. Meanwhile, central government current expenditures were up 5.8% y/y, to £428.9 billion in fiscal 2004/05, as the government maintained its efforts to improve public services, particularly health and education. Originally, in the 2004/05 budget, the Treasury had expected current expenditures to rise 5.1% during the fiscal year, and current receipts to rise 7.9%.

With net investment amounting to £17.8 in fiscal 2004/05 (up 21.8% from £14.6 billion in 2003/04), the PSNBR totalled £34.46 billion. This meant that the chancellor again only fractionally missed his (revised) PSNBR target of £34.4 billion over fiscal 2004/05.

Consequently, the chancellor now appears to have a good chance of satisfying his "Golden Rule" for this cycle. Under the "Golden Rule," the current budget (expressed as a percentage of GDP) must be balanced during the economic cycle, with borrowing only allowed to finance capital investment; it is not allowed to fund current expenditures. In his budget for 2005/06 (delivered in March), Chancellor Brown forecasted that the current budget deficit would fall from £16.1 billion in 2004/05 to just £6.0 billion in 2005/06, meaning that he would satisfy the "Golden Rule" by about £6 billion in this economic cycle (which he assumes will end with fiscal 2005/06). This projection is based on growth forecasts of 3.0-3.5% for 2005 and 2.5-3.0% for 2006.

Given the tightness of government finances, Chancellor Gordon Brown avoided the temptation in his March budget for 2005/06 to embark on a major giveaway ahead of the imminent general election. Instead, he preferred to enact a number of relatively modest concessions aimed primarily at helping the low-paid, families with young children, pensioners, and first-time house buyers. No changes were made to income or corporation tax rates, or to the existing overall spending plans. He forecast that the PSNBR would fall to £31.9 billion in 2005/06 and £28.8 billion in 2006/07. This was based on expected GDP growth of 3.0-3.5% in 2005, 2.5-3.0% in 2006, and 2.25-2.75% in 2007. The PSNBR is projected to be down to £22 billion by 2009/10.

Current government expenditure was projected to rise by 5.7%, to £476.9 billion, in 2005/06, and by 5.6%, to £503.4 billion, in 2006/07. Within this amount, spending is to be heavily orientated to education and health services. Some savings are to be made through cutting civil service jobs and reducing government departments' administration budgets. Meanwhile, current government receipts were expected to grow 8.2% to £486.7 billion in 2005/06, and 6.9% to £520.4 billion, in 2006/07. The overall deficit on the current budget was projected to decline to just £6.0 billion in 2005/06. The current budget was seen moving into surplus by £1.0 billion in 2006/07, before rising to £12.0 billion by 2009/10.

We currently forecast the PSNBR to be £36.2 billion (2.9% of GDP) in 2005/06. This is higher than the chancellor's projection, and primarily reflects our belief that growth will be 2.6% rather than the 3.0-3.5% expected by Brown. Nevertheless, we believe that the chancellor may just succeed in achieving his "Golden Rule" in this economic cycle.

Even if he does though, he still faces a major problem further out. This is because Brown will be starting the next cycle from a deficit position. Consequently, corrective action will almost certainly be needed to bring down the public borrowing requirement. What form this action takes is open to question, but it is probable that significant tax hikes will occur in some form or another, and/or national insurance contributions will be raised. Although Labour's election manifesto pledged to not raise income taxes in the next parliament, it notably did not refer to other taxes or national insurance. There may also have to be some reduction in the rate of growth in public spending.

Although we expect some corrective measures will be taken in next year's budget, we believe the government will struggle to get the PSNBR down to the targeted £28.8 billion in 2006/07. Indeed, we forecast the PSNBR to still be as high as £32.2 billion (2.5% of GDP) in fiscal 2006/07 due to more moderate growth than the government is forecasting.

Exchange Rate

Although the pound set a 12-year high of US$1.9552 on December 16, this was largely due to general dollar softness, which was primarily a consequence of the unsustainable US current-account deficit. Indeed, the pound fell to a 12-month low of 0.707/euro (1.415 euro/pound) at the end of December, and it remained around that level for the first half of January. Sterling also sank to a ten-month low of 99.2 on the Bank of England's trade-weighted index in November, and was still trading down near this low in late December and the first half of January. In addition, the pound retreated to a low as US$1.853 in mid-January, as the dollar enjoyed some respite from its recent weakness. Sterling was under pressure during this period by further soft housing market data and increased market expectations that UK interest rates had peaked. In addition, news of a sharp widening in the UK current-account deficit in the third quarter weighed down on the pound.

Sterling then trended up overall from these lows to reach an eight-month high of £0.673/euro (1.485 euro/pound) at the beginning of May. The pound also reached a seven-month high of 102.8 on its trade-weighted index, although its peak against the US dollar was constrained to US$1.915. This was because the US dollar generally traded significantly above its late-December troughs, as it gained some support from higher American interest rates and some healthier capital flows into the US. The pound's overall strengthening between January and May largely reflected renewed expectations that UK interest rates would rise further. This was influenced by a rise in consumer price inflation from 1.1% in September to 1.9% in April. In addition, it was revealed that two of the nine

MPC members actually voted for an interest-rate hike in March and April. Finally, the UK current-account deficit narrowed in the fourth quarter of 2004.

However, the upside of the pound was limited after weak retail sales data for March and some other softer data effectively ended speculation that interest rates could rise as early as May. Indeed, speculation re-emerged that the next move in interest rates could be down. Sterling was little affected by the 5 May general election result, which saw the Labour party retain power, albeit with a reduced majority.

We expect sterling to benefit in the near term from still relatively favourable UK economic fundamentals compared to the Eurozone. While UK economic expansion is forecast to moderate, we still expect it to come in at 2.4% in 2005. This is well above the 1.4% expansion expected in the Eurozone. Meanwhile, the US dollar is projected to come under renewed downward pressure over the medium term from the huge American current-account deficit. Furthermore, while we no longer expect the central bank to raise interest rates again in this cycle, we do not believe it will relax monetary policy this year.

Consequently, interest rate differentials are projected to remain in sterling's favor during 2005, although the margin is expected to become less positive as the year progresses. The ECB is projected to keep its key interest rate at the current level of 2.0% through the whole of 2005, before eventually cutting it by 25 basis points around spring 2006 in reaction to the strength of the euro. Meanwhile, although the Federal Reserve is forecast to raise US interest rates steadily over the coming months, following its eight 25-basis-point hikes enacted between June 2004 and May 2005, they are likely to remain well below UK levels for some time.

Against this backdrop, sterling is expected to see some recovery against the euro in the near term, before resuming a downward trend in the second half of 2005. Meanwhile, both sterling and the euro are forecast to make significant overall gains against the dollar this year. Specifically, we project the euro to reach US$1.45/euro at the end of this year. Meanwhile, sterling is expected to trade around 1.420 (£0.704/euro) at the end of this year. As a result, sterling is expected to appreciate to US$2.06 at the end of 2005.

Over the medium term, sterling is expected to largely be driven by movements in the dollar-euro rate. Thus, we see the pound making further substantial gains against the dollar in 2006, before easing back to a limited extent over the next few years (although the pound will remain relatively high against the dollar).

Regarding UK membership in the Eurozone, it is clear that a referendum remains a long way off, given the continuing lack of progress on fulfilling the Treasury's economic tests for UK membership. The current political crisis within Europe following the May/June 2005 rejection of the new European Union constitution by the French and the Dutch—as well as the persistent disappointing growth performance of the Eurozone—makes UK membership even more unlikely. We also remain sceptical that a positive vote in any referendum can be achieved for many years to come. Consequently, Global Insight's view is that the United Kingdom will not join the Eurozone until at least 2011, and even this currently seems extremely unlikely.

Trade and External Accounts

The current-account deficit amounted to £25.7 billion (2.2% of GDP) in 2004. This was up markedly from £18.7 billion (1.7% of GDP) in 2003. The main reason for this was the increase in the traded goods deficit to a record £57.9 billion from £47.7 billion in 2003. Exports of goods rose by a mere 1.1% in 2004 to £190.7 billion, while imports surged 5.2% to £248.6 billion.

Exports were handicapped by the overall strength of sterling during much of last year, particularly against the dollar, as well as persistently weak domestic demand in many important Eurozone markets. The UK's traded goods deficit with EU countries widened to £28.5 billion last year from £25.6 billion in 2003. In addition, the traded goods deficit with non-EU countries rose to £29.5 billion in 2004 from £22.0 billion in 2003.

In addition, the net deficit on transfers widened to £10.9 billion in 2004 from £9.9 billion in 2003. However, the current-account deficit was limited by the surplus in services trade rising to £19.1 billion in 2004 from £15.6 billion in 2003 and the surplus in the income account rising to £24.0 billion from £23.2 billion.

Although we believe that global growth peaked in the first half of 2004, it should remain relatively healthy over the coming months, and provide some support for UK exports. In particular, domestic demand is projected to improve gradually in key Western European markets later on in 2005.Indeed, in our April detailed quarterly forecast, we assumed that the trade-weighted index of global demand for UK exports will rise by 8.1% in 2005 and 6.8% in 2006, down from 12.2% in 2004. Trade to other EU countries should also benefit from a generally softer pound against the euro, compared with recent norms. High oil prices will also boost the value of UK exports.

Yet the continuing strength of the pound against the dollar will clearly impact on UK companies' competitiveness in dollar-denominated markets. Meanwhile, UK imports are expected to soften in volume terms in 2005, in line with some moderation in domestic demand. However, high oil prices will push them up in value terms. Import growth is seen slowing in 2006, when domestic demand is projected to soften further and oil prices are projected to be marginally weaker.

Against this backdrop, we expect the traded goods deficit to be £57.9 billion in 2005 and £54.3 billion in 2006. The deficit in goods and services is projected at £39.1 billion and £32.5 billion, respectively. The current account deficit is projected to be essentially stable at £28.0 billion (2.3% of GDP) in 2004, before narrowing to £22.6 billion (1.8% of GDP) in 2005.

UNITED KINGDOM

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	1,441.01	2,457.51	3,119.00	5,995.84	11.3	4.9	4.5
Nominal GDP per capita, US dollars	24,280	40,919	51,007	92,723	11.0	4.5	4.1
Real GDP, billion real 2000 US dollars	1,439.22	1,619.09	1,842.79	2,627.60	2.4	2.6	2.4
Real GDP per capita, real 2000 US dollars	24,249	26,959	30,136	40,635	2.1	2.3	2.0
Real private consumption, billion real 2000 US dollars	948.63	1,090.16	1,238.66	1,778.03	2.8	2.6	2.4
Real government consumption, billion real 2000 US dollars	268.12	319.57	364.79	530.12	3.6	2.7	2.5
Real fixed investment, billion real 2000 US dollars	244.11	288.80	335.76	522.61	3.4	3.1	3.0
Real exports, billion real 2000 US dollars	404.17	444.36	568.99	1,204.46	1.9	5.1	5.1
Real imports, billion real 2000 US dollars	433.69	524.63	669.05	1,415.74	3.9	5.0	5.1
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	13.50	13.62	14.18	16.19	0.2	0.8	0.9
Mining	38.22	28.71	29.44	30.87	-5.6	0.5	0.3
Manufacturing	234.67	239.00	267.25	354.15	0.4	2.3	1.9
Utilities	24.40	26.65	30.11	42.52	1.8	2.5	2.3
Construction	68.85	83.52	91.25	113.92	3.9	1.8	1.5
Wholesale & Retail Trade	199.11	235.66	269.33	386.92	3.4	2.7	2.4
Transport & Communication	106.07	120.72	141.87	226.92	2.6	3.3	3.2
FIRE	360.52	439.88	515.00	780.26	4.1	3.2	2.8
Other Services	287.05	324.07	361.53	484.46	2.5	2.2	2.0

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	65.9	64.3	62.4	59.9	-1.6	-1.9	-2.5
Government consumption share of GDP	18.6	21.5	21.3	21.9	2.8	-0.1	0.5
Fixed investment share of GDP	17.0	17.3	18.4	21.7	0.4	1.1	3.3
Exports share of GDP	28.1	24.6	26.7	37.1	-3.5	2.1	10.4
Imports share of GDP	30.1	27.8	29.1	40.6	-2.3	1.2	11.5
Net extports share of GDP	-2.1	-3.2	-2.3	-3.5	-1.2	0.9	-1.1

Germany

Overview

Short-Term

Although GDP growth in the first two quarters of 2004 was 0.3% quarter-on-quarter, on average, and growth for 2004 as a whole was 1.6% y/y (although only 1.0% adjusted for additional working days), the recovery that was begun in the second half of 2003 continues to be erratic. This was highlighted by the disappointingly flat, third-quarter growth performance and even more so by the 0.1% q/q contraction in the final quarter of 2004, which raised fears that sustained recovery had failed before it had begun. In recent years, very weak economic activity has been seen in Germany because of an accumulation of global (September 11, Iraq war, high oil prices, euro appreciation) and domestic issues (structural problems, perceived inability of the government to effectively deal with these problems, restrictive fiscal policy to rein in budget deficits). This experience has led to a pervading sense of uncertainty among consumers and investors that harbours the risk of becoming self-perpetuating, all the more so because the relatively encouraging reforms passed in 2003 and 2004 have so far produced only unsatisfactory results.

To an extent, the mid-May release of unexpectedly strong first-quarter 2005 GDP growth of 1.0% q/q has signalled that risks are not one-way anymore, however. Supportive factors, such as the January 2005 income tax cuts, the ongoing, robust global economic growth, low interest rates, and subdued inflation have had some effect. The same holds for the gradual, but by now, quite significant improvement in wage and price competitiveness, especially relative to other Eurozone members. Finally, the government's less forceful efforts since 2004 to contain budget deficits and a somewhat more flexible labor market in the wake of the 2003/2004 Hartz reforms are leaving an impact.

To be fair, roughly half the first-quarter growth jump can be attributed to statistical over-adjustment of contrasting calendar effects in the two quarters saddling the turn of the year 2004/2005. Nevertheless, although this means that some of the growth now measured for early 2005 actually belonged to late 2004, average growth in those two quarters is still above 0.4% q/q. Even Easter taking place in March in 2005 may have additionally brought some growth forward into the first quarter (second-quarter growth may easily show stagnation again), an underlying growth pace close to 0.3% between October 2004 and June 2005 seems likely.

We expect the upturn to develop gradually, as 2005 unfolds. This is based on the assumptions that global growth remains generally robust and that oil prices eventually ease to some degree in the spring of 2005. Furthermore, the strength of the euro has led us to expect the ECB to not only hold its key interest rate steady at 2.00% through the first half of 2005 but to make another 50 basis–point, key rate cut in the third quarter. Businesses are forecasted to raise investment in reaction to the increase in orders in 2004, particularly given the low fixed capital spending that has taken place in recent years, and the need to invest in new technology to boost competitiveness. Consumer spending is projected to pick up more gradually, but is limited by the continuing softness of the labor market. Indeed, there is a clear risk that net employment creation (which was indeed observed already in 2004) will remain largely restricted to small, part-time, or publicly funded employment until well into 2005, and in any case will lag a rising supply of labor.

In the January detailed forecasting round, we trimmed our growth forecast for 2005 to 1.3% (1.1% unadjusted), which compares to the forecast of 1.7% (1.5% unadjusted) at the time of the October quarterly forecasts. The main reasons for lowering growth expectations during the final quarter of 2004 were the higher profile for oil prices, lower global demand forecasts, and a much-stronger euro outlook than previously expected. These risks appear to be largely priced in now, and for instance consumer spending may in fact surprise on the upside as a result of the January 2005 income tax cuts, higher purchasing power due to falling inflation and euro strengthening, and possibly lower contributions to the public health system in mid-2005, as these insurance companies have accumulated considerable surpluses in 2004 due to the impact of last year's reforms.

Consumer price inflation stayed relatively high at almost 2% in the second half of 2004; in fact, it reached a peak of 2.1% y/y in December. In relation to the weakness of domestic demand, these elevated levels are due to the strength of oil and commodity prices, an upward impact of 0.7% by the early 2004 healthcare reforms (making patients pay more for treatment and drugs), and two tobacco tax hikes in March and December (raising CPI a further 0.4%). Core inflation at the end of 2004 was close to 0.5%. Accordingly, we expect inflation to remain subdued in the longer term, despite persistently high oil prices. Wage moderation is continuing. Therefore, base effects related to the administered price hikes of 2004 should play out in full, and we expect average annual consumer price inflation to ease from 1.6% in 2004 (1.7% based on seasonally adjusted data) to 1.2% in 2005 despite slightly stronger growth.

Public finances will remain problematical, even though the budget deficit of 2004 fell to 3.6% of GDP, down from 3.9% in 2003. It is expected to improve only modestly, to 3.5%, in 2005. Consequently, we believe that the budget deficit will exceed the 3.0%-of-GDP ceiling allowed under the Stability and Growth Pact for a fourth successive year in 2005. It could fall below this level in 2006, at 2.8% of GDP.

Medium Term

The cyclical upturn is expected to gain some additional strength in 2006. Thus, GDP growth could now reach 1.7% (1.5% calendar unadjusted) in 2006, as global growth is expected to remain reasonably robust, and as some structural improvement become apparent in the labor market due to the 2003–05 Hartz reforms. The latter should also underpin domestic growth at a little less than 2% in the following years through to the end of the decade. Businesses are expected to further increase their investments in 2006 and eventually also to step up regular, full-time employment on a sustained basis in reaction to a lasting improvement in orders. Consumer spending is expected to strengthen, helped foremost by the anticipated improvement in the labor market but also, for instance, by the boosts to take-home pay from the January 2005 income tax cuts, and likely also from greater-than-expected declines of health system contributions in mid-2005.

Finally, two key events in 2006 argue for some additional expansionary impetus; namely the Soccer World Cup hosted by Germany in June/July, and the federal elections due in September. Meanwhile, exports will remain quite competitive despite the further euro appreciation that we foresee until 2007, given declining, relative unit labor costs in the last few years, particularly against other Eurozone countries. In addition, the ECB is now expected to tighten monetary policy much later than at the time of the October forecast round, namely in early 2008 rather than in the second half of 2005. This largely reflects the perceived dampening impact of euro appreciation on the Eurozone economy.

Growth is expected to peak at 1.8% in 2007, before easing back marginally over the next three years. Overall, GDP growth is projected to average 1.7% through to 2010. Consumer spending is forecast to rise by 1.7%, reflecting generally higher employment as the Hartz reforms have some positive impact. There is also likely to be some pent up consumer demand following the very weak overall expenditure in recent years. However, the upside for consumer spending is likely to be limited by continuing consumer concerns and uncertainties about structural reform. Unemployment is also expected to remain relatively high, despite the expected improvement during the period. Meanwhile, fiscal policy is likely to remain restrictive overall due to the need to improve the weakened public finances.

Real fixed investment is expected to be the main growth driver over the next five years, rising by an average annual rate of 2.3% over 2005–10. This largely reflects the ongoing need for many companies to upgrade or replace capacity following a sharp overall decline in investment in recent years. Investment should also be supported by relatively low interest rates and improved profitability. However, net trade is forecast to be modestly reduced overall GDP growth over the period 2005–10. Exports are expected to grow by an average 4.4% during this period. While exports should benefit from reasonably healthy global growth during much of this period, they are likely to be held down to some extent by the relative strength of the euro. The euro is projected to appreciate to a peak of US$1.50 in late 2006 and early 2007, as the US dollar continues to be pressurized by the large American current account deficit. Although the euro is projected to then ease back, it is expected to continue to largely trade above US1.40. The strength of the euro will also make imports more competitive, contributing to forecast annual average import growth of 4.9% during 2005–10.

Consumer price inflation should edge up marginally, from 1.2% in 2005 to 1.4% in 2006; largely reflecting the lack of base effects that depress measured inflation in 2005, and, to some extent, perhaps also thanks to the cautious recovery of domestic demand. The wage moderation observed in the last few years will only come to an end in 2006 at the earliest, and continuing strong competition should limit price pressures in any case. Inflation should remain generally subdued in the medium term. This partly reflects the expected firmness of the euro and a continuing, relatively large output gap, but also the view that the ECB's monetary policy course will remain more restrictive for Germany than for the Eurozone average. Inflation is seen averaging 1.4% in the period 2006–10; well below the 2.0% ceiling targeted by the ECB.

Public finances will remain in bad shape initially, particularly as the government becomes unwilling to take strong, corrective action with the next general election looming in September/October 2006. Accordingly, no significant, further structural reform initiative should be expected until that time; apart maybe from limited modifications to the Hartz labor market laws in the light of experiences made in the meantime. Recent talk of a major corporate tax reform is unlikely to lead to results ahead of the next legislative period starting in late 2006. Nevertheless, any improvement on the domestic demand front, which we expect will begin in the second quarter of 2005 and gradually gain momentum in 2006, should also provide relief for the finance minister. Overall, we expect the budget deficit to still hit 3.5% of GDP in 2005, thereby exceeding the Stability and Growth Pact's 3.0%-of-GDP ceiling for a fourth year before this level can finally be undershot at 2.9% in 2006 again. Further progress in the following years will be slow, however, with a deficit near 2% expected from 2008 onwards.

Long Term

We believe that German growth will continue to under-perform that of the Eurozone as a whole in the next decade and beyond. Overall GDP growth is projected to edge back from an annual average of 1.7% during 2005–10 to 1.6% during 2010–25. This reflects our belief that structural reforms—relating to the labor market, product markets, pensions, social benefits system—will occur only very slowly for some time to come, despite the widespread acknowledgement on both sides of the political spectrum that is needed. The best hope for faster progress on reform is that one of the major political parties (almost certainly with a coalition partner) gains effective control of both houses of parliament after the 2006 elections.

Furthermore, Germany’s aging population and shrinking workforce will also become an increasing factor. The population has been projected to decline to 60–75 million inhabitants by 2050, compared with the current 82 million, and it is also expected that labor shortages could become acute around 2010. Note that the population decline will only set in from about 2020 onwards, however. Also, on the positive side, productivity should gradually benefit from “new economy” developments. As a result, GDP growth is now forecasted to average around 1.5–1.7% in 2007–30. This is modestly below the average of 1.8% during the 1990s.

Adverse demographics will not only dampen long-term growth potential, but will increasingly impose a burden on the economy. A Federal Statistics Office report has concluded that because of demographic developments, there would be a need to raise the retirement age and import millions of immigrant workers. The report also stressed that increasing life expectancy will put even greater burdens on the costly pensions system. Consequently, additional pension reform will have to take place in addition to that enacted in May 2001. The Finance Ministry expects there to be 80 people aged 60 or over for every 100 “active” members of the population by 2050. Indeed, in May 2003, the European Commission warned that public debt could rise from just over 60% of GDP to 384% of GDP by 2050 primarily due to the aging population, unless strong action is taken, and assuming welfare cuts do not go far enough.

In our long-term forecast, we assume that the labor participation rate will rise gradually over the next two decades, as the need to counter the aging and falling population provides an added stimulus to undertake much-needed labor market reforms. While such reforms have traditionally proved controversial and difficult, we believe that over time, necessity will eventually provide the spur for greater action. Specifically, we see the labor participation rate rising from around 75% currently to just over 79% by 2025.

Much-needed product market reforms are also expected to increasingly occur over the longer term, and Germany should benefit over time from a more efficient functioning of the European single market, and its extension to include new members from Central and Eastern Europe (although Germany could be adversely affected by some companies re-locating to lower labor cost countries unless significant progress occurs in reducing non-wage costs). We also assume that German firms will step up their investment in order to try and boost productivity and get over potential labor shortages.

The Eastern German economy will continue to lag the western part for some considerable time, reflecting its persistent, serious structural problems. Even so, its relative performance is expected to improve over time, as restructuring measures take effect and its competitiveness progresses. This will help the overall performance of the country, although it must be borne in mind that the eastern part accounts for only about one-tenth of the whole German economy.

In March 2003, a Bundesbank report, compiled for the government, concluded that the economy's potential growth rate will decline further, from around 1.5% now to 1.0%, unless fundamental structural reforms are made to increase competitiveness. The report, entitled "Ways out of the Crisis," called for action to reduce the high tax and social security burdens, reform the systems of social protection, and make the labor market more flexible. It highlighted the need to consolidate public finances and undertake further pension reform. Failure to tackle these problems will weigh down on confidence and limit companies' willingness to invest and employ. Deteriorating demographics make the need for action even more urgent. The government's Agenda 2010 program announced by Chancellor Schroeder also in March 2003 was only a starting point in this, as confirmed by the fact that until early 2005 very few positive effects on employment and growth have been discernable.

Economic Growth

The economy emerged from recession in the third quarter of 2003, with average growth for 2002 and 2003 being virtually non-existent. Growth accelerated to 1.6% y/y in 2004 (1.0% when adjusted for additional working days). Two factors were mainly responsible—net exports provided a GDP growth contribution of 1.0% y/y (in 2003, they had subtracted 0.6% from GDP growth), and an unusually large working-day effect contributed slightly more than 0.5% to the headline (unadjusted) result. Domestic demand was flat, weaker even than the 0.6% y/y in 2003.

Based on data not corrected for working-day effects, real exports of goods and services increased by a substantial 8.2% in 2004, yet imports at 5.7% lagged considerably, thus enabling the large GDP growth contribution. Export growth was strong yet far from record levels of the past—in 1990 and in 2000, exports grew by 13.3% and 14.2%, respectively. Meanwhile, private consumption fell by 0.3% (it had stagnated in 2003) and government consumption was also weak at 0.4%.

Real fixed investment was also negative at -0.7%, despite investment in equipment posting 1.2% growth and other investment (mainly computer software and licensing rights) growth of 2.4%. The reason is investment in construction, which declined by 2.5% against 2003. Nevertheless, the construction sector has slowed its structural decline—it contracted at almost double that rate on average in the three preceding years. Similarly, fixed investment of -0.7% in 2004 compares favourably with rates of -2.2% in 2003, -6.3% in 2002, and -4.0% in 2001. Finally, inventories still declined in 2004 but at a much slower pace than in 2003. This means that the change in inventories actually provided a 0.7% positive contribution to overall GDP growth in 2004 (in 2003, this had been even larger at 0.9% because de-stocking in 2002 had been more rapid still).

In terms of growth contributions, the swing of net exports in 2004 relative to 2003 accounts for all of the improvement in Germany's growth performance last year. Otherwise, a small further deterioration of private consumption (from 0.0% in 2003 to -0.2% in 2004) was broadly offset by a smaller negative contribution from real fixed investment (only -0.1% instead of -0.4%), driven mainly by the first increase of investment in equipment since 2000.

Looking at quarterly developments since late 2003, the economic recovery had appeared to gather momentum in the final quarter of 2003 and in early 2004 before encountering a setback in the second half of last year and then accelerating sharply in the first quarter of 2005. The latest swing from -0.1% q/q in the fourth quarter of 2004, to 1.0% q/q in the first quarter of 2005 was clearly overstated by extreme calendar effects and the impact of the calendar adjustment method on the published data. This statistical effect accounts for about half a percentage point of first-quarter growth, as such partly being a technical correction for the unexpected degree of weakness in the fourth quarter.

Aside from these technical considerations, growth in the first quarter of 2005 was driven almost exclusively by the contribution of net exports, as seen in most quarters since mid-2003. The boost from net exports even exceeded the 1.0% gain of overall GDP, implying that domestic demand as a whole, as in the final quarter of 2004, actually contracted. The boost from the external sector stemmed from both strong export growth and modestly contracting imports. Export momentum, at least in early 2005, was only slightly hurt by the sharp euro acceleration in late 2004 and the dampening impact on global growth of record oil prices in October 2004 and again in March 2005.

Domestic demand components mostly posted negative growth in early 2005, with the exception of moderate increases of investment in equipment and "other investment" (mainly computer software and licenses). The relative strength of investment—which did not match the pace of the third quarter of 2004—had been indicated by monthly data on orders and production of investment goods at the very beginning of 2005. The main dampening influence came from investment in construction, as an unusually prolonged and severe winter (until mid-March) delayed some construction work into the second quarter.

Private consumption also slipped slightly from fourth-quarter levels. This was a disappointment, given the income tax cuts in January and relatively encouraging retail sales data in early 2005 compared with late 2004. The high level of job uncertainty seemed to continue to be a major deterrent to spending, with the unemployment numbers spiking to a statistically induced above-five-million mark because of the Hartz IV labor market reform. Meanwhile, the ongoing weakness of public consumption was expected, given continuing pressure for budgetary consolidation as tax revenues stay below plan. Finally, inventories had only a slight dampening effect on GDP growth in early 2005, whereas they had depressed quarterly growth by 0.8% in the final quarter of 2004 when firms ran down precautionary stocks they had built up in the third quarter in reaction to sharply rising commodity prices.

As long as global demand follows our assumption of not weakening anymore than has been seen during the second half of 2004, German exports will not suffer unduly even if the euro does appreciate toward US$1.40/45, as Global Insight expects for 2005. Net exports will provide much less of a growth contribution in 2005 than in 2004, but they will probably not deduct from growth, as they did in 2003. This view does require that oil prices refrain from approaching or even surpassing the October 2004 record highs, however. Growth in exports of goods and services is expected to post a still-solid 5.8% y/y, as the ongoing boost from robust global growth largely outweighs the dampening impact of the relatively strong euro. Meanwhile, imports of goods and services are also projected to rise 5.8%, helped by the improved competitiveness of foreign goods resulting from the euro’s strength as well as gradually improving domestic demand.

As for domestic demand, signs for a strengthening remained somewhat patchy in late 2004, but on balance still suggested that 2005 will see stronger, domestically induced growth. On balance, we expect an increase to 1.1%. The impact of such factors as the January 2005 income tax cuts and the Hartz IV labor market reform should be critical in this respect.

It is indeed the consumer sector that is key for the growth outlook in 2005. We expect growth of 1.2%. Although consumer confidence had strengthened significantly in the second half of 2003, it struggled to build on this improvement during 2004, and was still at a relatively low level by past norms at the end of 2004. This largely reflected continuing worries over unemployment, the strength and sustainability of the economic recovery, and the potentially adverse impact of welfare reforms on personal finances. In particular, the experience of early 2004, when significant income tax cuts were offset by increases in welfare contributions, reduced subsidies, and higher indirect taxes, is still on consumers’ minds, even if no major further reform steps are allegedly tackled by the government ahead of the autumn 2006 elections. In addition, pensions will once again hold steady at best in 2005.

The earliest conceivable timing of underlying improvement of the unemployment situation is the autumn of 2005. Although employment growth should pick up from 0.3% in 2004 to 0.7% in 2005, this will be almost exclusively due to the sector of lowly-paid and part-time jobs as well as small-scale self-employment. Thus, consumers are expected to continue to save a significant proportion of their extra income from the tax cuts offered due to ongoing job insecurity. Fortunately, concerns about the inflationary (and thus negative) purchasing-power impact of high oil prices receded in November and

December, leading to fairly significant improvements of the GfK sub-index measuring consumers' willingness to buy between November and January. In January, the income expectations sub-index rose sharply after the January income tax cuts, which helped to drive the GfK headline index up strongly in early 2005. On balance, we believe that the improvement in consumer spending will remain gradual.

At the same time, government investment and spending will remain soft, reflecting the need to contain expenditure amid very weak public finances. Public consumption growth should hit only 0.2% y/y in 2005.

Investment will probably pick up at an earlier stage than will private consumption. There are good reasons for expecting another rebound of investment in equipment in early 2005. Business confidence as measured by the Ifo index and manufacturing PMI had remained broadly steady in the spring and summer of 2004, but slipped thereafter, showing a particularly pronounced dip in November. This reflected a slowdown in the inflow of new orders, and subsequently, of production, and probably also of work disruptions in this period linked to announced restructuring plans at major firms (Opel, Volkswagen, retail chain Karstadt).

A strong rebound in December and January surveys, was led by new orders (both domestic and foreign). In addition, firms should now be heartened by recent equity market advances, and should be fairly confident that the European Central Bank will leave its monetary policy unchanged throughout 2005 (Global Insight even sees a 50 basis-point cut in the third quarter due to euro appreciation). Also, the pressure to upgrade capacity, even if only to maintain competitiveness via modernized equipment, is increasing steadily the longer the period of weak capital expenditure lasts. Therefore, Global Insight looks for a fairly sharp bounce of total fixed investment in 2005 to 2.3% y/y; after four consecutive years of declining investment). In fact, this hides an even stronger improvement of investment in equipment (from -1.0% to 4.2%) because the long-suffering construction sector should only just end a decade of structural decline, its investment forecast at 0.6% y/y from -2.4% in 2004.

Overall, we expect working-day adjusted GDP growth toreach 1.3% in adjusted terms in 2005. The more encouraging survey indications in December and January suggest that forecasts risks are more balanced at this level now..

The cyclical upturn is expected to gain some additional strength in 2006. Thus, GDP growth is now seen at 1.7% (1.5% calendar unadjusted) in 2006, as global growth is expected to remain reasonably robust, and as some structural improvement should become apparent in the labor market due to the 2003–05 Hartz reforms. Businesses are expected to further increase their investment in 2006 (Global insight forecasts 3.2% y/y for total fixed investment, from 2.3% in 2005) and eventually should also step up regular, fulltime employment (forecast 0.8% y/y) on a sustained basis in reaction to a lasting improvement in orders. Consumer spending is expected to strengthen to growth of 2.0%, aided foremost by the anticipated improvement in the labor market, but also by greater-than-expected declines of health system contributions in mid-2005 (for which initial indications yield improved finances of the public health system). Meanwhile, exports will remain quite competitive despite the further euro appreciation that we foresee until 2007 (forecast growth of 4.7%), given declining, relative unit labor costs in the last few years, particularly against other Eurozone countries. Finally, two key events in 2006 suggest that the foreseen expansion may even be on the conservative side. The Soccer World Cup hosted by Germany in June/July and the federal elections due in September may well exert some additional impetus via private and public consumption, respectively.

Overall, GDP growth is projected to average 1.7% through to 2010. Consumer spending is forecast to rise by 1.7%, reflecting generally higher employment as the Hartz reforms have some positive impact. There is also likely to be some pent up consumer demand following the very weak overall expenditure in recent years. However, the upside for consumer spending is likely to be limited by continuing consumer concerns and uncertainties about structural reform. Unemployment is also expected to remain relatively high, despite the expected improvement during the period. Meanwhile, fiscal policy is likely to remain restrictive overall due to the need to improve the weakened public finances.

Real fixed investment is expected to be the main growth driver over the next five years, rising by an average annual rate of 2.3% over 2005-2010. This largely reflects the ongoing need for many companies to upgrade or replace capacity following a sharp overall decline in investment in recent years. Investment should also be supported by relatively low interest rates and improved profitability. However, net trade is forecast to be modestly reduce overall GDP growth over the period 2005-2010. Exports are expected to grow by an average 4.4% during this period. While exports should benefit from reasonably healthy global growth during much of this period, they are likely to be held down to some extent by the relative strength of the euro. The euro is projected to appreciate to a peak of US$1.50 in late 2006 and early 2007, as the US dollar continues to be pressurized by the large American current account deficit. Although the euro is projected to then ease back, it is expected to continue to largely trade above US1.40. The strength of the euro will also make imports more competitive, contributing to forecast annual average import growth of 4.9% during 2005-2010.

Consumer Demand

The consumer sector remains a source of concern, although survey evidence and retail sales data for the first few months of 2005 have offered some modest encouragement compared with the outlook a quarter earlier. The May GfK consumer climate indicator—based on the survey conducted in April—posted the first small dip after seven consecutive months of improvement since an interim low in September 2004. It should be noted that the majority of the reasons for the low level last autumn were still in place in the spring of 2005—ongoing job cuts at major firms, fears about being affected by the financial consequences of the Hartz IV labor market reform, the risks of euro strength for exports, sharply rising oil prices, and gloomier 2005 growth prospects. In addition, the government has announced in the meantime that pensions would be frozen again this year, as in 2004 (adjustment is always in mid-year). Therefore, it is all the more remarkable that consumer confidence continued to rise during the first quarter. Supportive factors were the temporarily lower oil prices in late 2004 and the general drop in inflation in early 2005, slightly larger take-home pay due to the January 2005 income tax cuts, and perhaps also a positive psychological impact from euro strength and the purchasing power abroad that this entails (cheaper package tours).

The main factor boosting the GfK consumer confidence indicator in recent months was a sharply higher willingness to buy durable goods, but this was indeed the element experiencing the greatest setback in April, almost returning to the low levels seen in mid-2004. A modestly declining propensity to save had also supported consumer spending prospects in the first three months of 2005, but it rose again in April, weighing on consumer confidence anew. Income expectations have been zigzagging lately at levels slightly below the long-term average. The sub-index on views about the country's economic outlook—which does not impact headline confidence directly—has also failed to embark on a clear upward trend as yet, oscillating around sub-average levels.

The European Commission data on German consumer confidence has in fact been more disappointing than the GfK indicator. While the EU index rose from an eight-month low of -18 in May 2004, to -12 in January 2005, it reverted to -18 in March and only recovered to -15 in April.

Meanwhile, real retail sales (excluding auto and petrol station sales) improved in the first quarter, having posted -2.3% in 2004 and shown particular weakness in November and December. On a seasonally and calendar-adjusted basis, they posted a 2.1% month-on-month in January and were flat in February and March. Accordingly, year-on-year rates have broadly stabilized around zero in the first three months. That being said, the retail sales data available for 2005 so far have to be treated with some caution, as an ongoing change to a new sample of contributing firms has narrowed the statistical basis for now to large department stores. Revised data on the new basis will likely only be provided in July.

Over the medium term, we expect private consumption's share of GDP to edge up from 58.5% of GDP in 2005 to 58.7% of GDP in 2010. Consumer spending is expected to benefit to a limited extent from rising employment and an increasing labour participation rate, resulting from structural reforms. However, the savings rate is likely to remain relatively high, reflecting consumers' continuing uncertainty about how they will be affected by the much-needed reforms.

Business Investment

The influential Ifo business climate index, which measures conditions in manufacturing, wholesale and retail trade, and construction, retreated further to 93.3 in April 2005, from 94.0 in March and an interim peak of 96.4 in January. This takes us back to levels last seen in September 2003 and confirms that the sharp bounce in December 2004 was yet another false dawn. Not only the sub-index for current business conditions but also that signalling expectations for the next six months declined, not auguring well for any near-term improvement of economic prospects. The driving force for the recent decline in overall business confidence has been the manufacturing sector, although the manufacturing sector's export expectations have remained close to their high levels of late 2004. The latter shows that euro strength and even some weakening of global growth forces have left companies operating in the exporting sector relatively unscathed. These can cope much better with the cost squeeze created by the high oil prices because—unlike their counterparts who are fixated on the weak domestic market—they can pass on higher costs to their customers.

Aside from oil prices, the fragility of Germany's economic growth outlook is also due to the pervading pessimism about the ability of German politicians to introduce reforms that markedly reduce investor uncertainty and thereby boost investment. This discrepancy between the perceived need to invest to master the structural and demographic challenges of the future, and the unwillingness on the part of firms to engage in associated risks because of the unfavourable political climate, is what makes economic growth rates above 2% an unlikely prospect even in the medium term.

With this in mind, the modest improvement for investment plans registered in the latest DIHK (Federation of Chambers of Industry and Commerce) survey of some 25,000 companies conducted in January 2005 should not be overstated. Compared with September 2004, that indicator rose to -7, from -11, and most other categories improved too. Nevertheless, sentiment in the period of the previous survey had been depressed by sharply rising oil prices, and the January improvement probably owes a lot to the temporary softening of energy prices in the interim. Also, the DIHK stressed that most of those improved investment plans stemmed from export-oriented companies, and concentrated on replacement of old equipment and on cutting costs (as opposed to expanding activity).

Based on these results, the DIHK concluded that signs of increasing domestic demand were emerging at the start of 2005, mainly from the investment side (the DIHK forecast equipment investment growth at 5% y/y). Even given this fairly optimistic outlook, the DIHK emphasized that, as in October 2004, investment growth at this stage of the cycle (notably, after 18 months of strong exports) had been even stronger in the past. The DIHK blames this, in part, on export companies that prefer to expand their foreign production locations, and thus increase the internationalization of their value-added chain, rather than investing within Germany. Therefore, imports of intermediate goods, rather than of investment, are boosted by these activities. Accordingly, this factor dampens consumption and employment-growth prospects when compared with historical business cycles.

In sum, German companies will remain relatively cautious in significantly stepping up their investment in 2005, likely waiting to see a sustained improvement in domestic demand first. On the other hand, political uncertainty about future developments in economic and social system reforms beyond the "Agenda 2010" program may now diminish earlier than expected given the planned early elections in September 2005, and the high chances of the conservative opposition coming to power (which could then act more swiftly given majorities in both houses of parliament). Unlike consumers, businesses may be more willing to give such a new government the benefit of the doubt even before it is installed. Furthermore, continuing low interest rates, a healthier equity market, and various agreements in 2004 between management and unions over working hours, pay, and job security, which have introduced greater labor market flexibility, support investment intentions.

Over the next 5-10 years , we expect investment to play a modestly increased role as a growth driver, reflecting the desire of firms to upgrade and replace capacity following extended weakness in capital expenditure, as well as an ongoing desire to boost productivity. Relatively low interest rate should help to support investment. Fixed investment's share of total GDP growth is expected to trend gradually up from 17.5% of GDP in 2005 to 17.7% of GDP in 2010 and 18.0% in 2025.

Inflation

Annual consumer price inflation averaged 1.6% in 2004, up from just 1.1% in 2003 and 1.3% in 2002, but softer than the 1.9% in 2001. Excluding fuels and heating oil, consumer price inflation averaged 1.4% in 2004, up from 1.0% in 2003. Meanwhile, wholesale price inflation averaged 2.9% in 2004, well above the 0.5% in 2003, and import prices have similarly swung higher, rebounding 1.0% in 2004, following a 2.2% contraction in 2003. In contrast, average producer price inflation was 1.6% in 2004; hardly changed from 1.7% the year before. In 2003, intense competition amid very weak economic activity, the strong euro, and wage moderation were all major contributors to the low inflation environment. In 2004, the only significant change was accelerating upward pressure from high oil prices, which climbed to all-time highs in late October 2004 due to the persistent strength of global demand amid a lack of significant spare supply capacity. There was some offsetting, dampening influence from base effects among food prices, related to the long, hot summer in 2003 that had pushed up some fresh produce and grain prices sharply.

Data for 2004 as a whole show that consumer price inflation at 1.6% was boosted by energy prices, although this was limited by corrective declines toward the end of the year—excluding prices of mineral oil products, 2004 inflation would have been 1.4%. Of even greater significance was the health reform at the start of 2004. This triggered higher prices for pharmaceutical products and other health services that had to be paid by patients directly, which impacted overall inflation by about 0.7%. This base effect will depress measured inflation in the first quarter of 2005 by roughly that amount. Finally, the two tobacco tax hikes in March and December added another 0.4% that will fall out of the comparison in those months in 2005 (although in September 2005 the third leg of the tax hike will add 0.2% again). Subtracting those administered price increases as well as the energy price spike (the latter on the assumption that oil prices will either hold average January 2005 levels around US$42 (Brent) in 2005 or even slip modestly), the underlying momentum of inflation is only in the area of 0.4%.

Despite some adverse developments on the oil price and euro fronts in January, as well as signs of improving domestic demand, Global Insight in its January quarterly forecast saw little reason to revise its expectations for an inflation rate in excess of 1.0% in the second quarter of 2005 (aided by base effects from a tobacco tax hike and surging oil prices last spring) and a 1.2% average inflation rate for 2005.

The optimism that the 2005 inflation forecast does not have to be lifted again is supported by the observation that the very strong, upward trend observed for many other commodities, particularly for that of metals, seems to have tapered off at the turn of the year 2004/2005. There was a small month-on-month price decline for metals in the wholesale, producer, and import price series in December, following very steep increases throughout most of 2004 that have led to y/y rates around 40% at the end of last year. It therefore appears as if global demand for raw materials has weakened a little from the pace still seen in mid-2004.

Furthermore, it can be expected that the strong further euro appreciation of late 2004 will only dampen prices of imported finished goods with a delay of a few months—given customary lags as delivery contracts are renewed—so that a downward impact on consumer price inflation is still in the pipeline. In any case, Global Insight's expectation that oil prices will broadly maintain levels around US$40–45/barrel in 2005, while the euro appreciates towards US$1.45 at the end of 2005 (and even US$1.50 in 2006), should ensure that there will be further disinflationary impact from import prices in 2005 and 2006. In addition, although economic growth is projected to be stronger in 2005, a significant output gap will persist, and competition seems certain to remain strong. Thus companies' weak pricing power amid relatively subdued domestic demand will hardly change before the second half of 2005 at the earliest, and wage growth will fail to pick up given an only-slowly-improving labor market.

On the other hand, the return to economic growth (albeit modest) since the middle of 2003, evidence that the government is becoming more prepared to take stimulative action to boost the economy rather than stick to the straight-jacket of the Stability and Growth Pact, the pickup in equity prices from their March 2003, multi-year lows, and the rise in annual consumer price inflation that has taken place notably in 2004 have collectively led to the current disappearance of the deflation fears that were particularly evident during the first half of 2003. At this stage, a temporary return of consumer price inflation to the 1.0% area is conceivable in the third quarter of 2005, but it would require a massive, further oil price decline or euro appreciation from November 2004 levels to re-ignite those concerns.

Over the long term, we expect German inflation to remain broadly muted. The country has a long-established, low-inflation reputation; and, with a large output gap having developed, it seems unlikely that growth will be strong enough over the medium and long-term to lead to any sustained, strong surge in price pressures. Wage moderation is also projected to continue over the long term, particularly as many companies are increasingly using the threat of relocating parts of their operations to cheaper-cost locations abroad to wring out concessions from their employees.

Labor Markets

The labor market remained weak during 2004 and the first few months of 2005, and the fact that economic growth slowed sharply in the second half of last year obviously did not help. This softness will continue to exert downward pressure on consumer confidence and spending at least until the third quarter of 2005, in turn limiting the pace of recovery, and thus employment prospects. This vicious cycle highlights the desperate need for further, major labor market reforms in addition to those made so far under "Agenda 2010" (the Hartz I–IV laws).

It remains to be seen whether the Hartz IV law enacted in January 2005 (including employable former recipients of welfare payments among the official pool of unemployed persons) eventually also leads to greater mobilization of all parties concerned (the unemployed themselves, the placement efforts of the Labor Agency, and private and public employers). The preoccupation of the personnel at the Labor Agency in the initial months of 2005 to manage the technical transition linked to the reform—including correct classification of the unemployed and correct payments for those with new unemployment status—will hardly allow greater placement successes before the final quarter of 2005.

The impact of the changes in legislation brought about by the Hartz laws since the spring of 2003 have made it increasingly difficult to interpret the data. In fact, both unemployment and employment have been moving broadly in parallel since about the middle of 2003; a fairly unusual constellation caused by changes in statistics and reform steps that are increasing the measured labor force. Initially, between May and December 2003, there was a moderate decline of measured joblessness (of about 60,000 or 0.15 percentage point of the unemployment rate), as the unemployed suddenly faced stricter regulations as to when cuts or the suspension of benefit payments would be applied. During this period, employment also continued to drop modestly due to the dampening effects of the recession of late 2002 and the first half of 2003.The statistics for January 2004 showed a misleading decline in the seasonally adjusted unemployment figures of 90,000 versus December 2003, entirely due to a new method of calculation by the Labor Office that excluded people on training programs from the register (unemployment would have risen around 20,000 m/m without the change).

Coincidentally, measured employment also bottomed out at the beginning of 2004, and began to trend higher. This was exclusively the result of the various Hartz laws that encouraged numerous forms of lowly paid or part-time employment, and such is still largely the case in the spring of 2005. Until the autumn of 2004, this included (mainly) the so-called "mini-jobs"—those paying no more than 400 euros/month, and which are hardly burdened by taxes or social security contributions—and small-time, self-employment (“Ich-AG’s”) of formerly unemployed persons enabled by Labor Office subsidies in the start-up phase. From October 2004 onward, “1-euro” jobs gave added impetus to employment numbers. These are mostly low-qualification, service-sector jobs offered by public entities for around one euro per hour to recipients of unemployment benefits, which are only attractive because such earnings are not deducted from the benefits.

In contrast, the number of regular, full-time jobs paying full social security contributions has still been declining in early 2005, albeit seemingly at a slowing pace (the picture is complicated by a two-month delay of such data compared to unemployment statistics, and the lack of seasonally adjusted numbers). Note that those people doing one-euro jobs of fewer than 15 hours/week continue to be counted as unemployed, thus raising both employment and unemployment numbers at the same time, and contributing to the parallel movement of both statistics. Similarly, rising employment attributed to mini-jobs hardly lowers joblessness because most people taking such jobs were not formerly registered as unemployed: they are students, housewives, or pensioners.

Turning to the latest evidence on unemployment, seasonally adjusted unemployment in April 2005 fell 79,000 month-on-month (m/m); the first drop-off after fourteen consecutive months of increases. Unemployment increases had been particularly strong in January (239,000), February (154,000), and March (up 94,000), thanks to the Hartz IV reform. The adjusted April level is 4.889 million, down from March's all-time peak of 4.968 million. The adjusted unemployment rate fell from 12.0% in March to 11.8% in April, but exceeded the end-2004 level of 10.8%. It should be noted that unemployment unadjusted for seasonal variations retreated below the politically sensitive level of 5.000 million, to 4.968 million (down 208,000 m/m).

Meanwhile, the unusual April decline in seasonally adjusted terms is largely explained by the delay to the normal spring recovery in the labor market because of an unusually prolonged winter (50,000 of the 79,000 m/m drop). Another 20,000 can be put down to a statistical effect of the Hartz IV reforms—these dropped out of the statistics when failing to renew their registration after three months, upon being told they were ineligible to the new ALG II unemployment benefits. The labor agency said that the buildup in unemployment that occurred during the first quarter of 2005 because of the addition of employable former recipients of welfare payments is now completed (total net impact: 360,000, raising the unemployment rate by almost 0.9%). Leaving statistical and weather distortions aside, underlying joblessness on cyclical grounds thus declined marginally in April 2005, in contrast with the monthly buildup of about 10,000-20,000 during 2004 and up until March 2005.

Overall, the pressure in the labor market will not diminish before mid-2005 at the earliest. In our January quarterly forecasting round, Global Insight has projected that the seasonally adjusted unemployment rate will rise to 11.1% on average in 2005 from 10.5% in 2004. This included an estimate of the impact of the Hartz IV reform on measured unemployment that was probably too low when compared with the January unemployment data (rate jumping to 11.4% from 10.8% in December 2004). On the other hand, the forecast for employment growth of 0.7% y/y in 2005 is probably on the conservative side, although, once again, this should not be equated with the predicted rise in total hours worked in the economy. Also, the labor force is seen to have increased 1.3% in 2005 (following 0.3% in 2004). In conjunction with the relapse of economic growth in the second half of 2004, this suggests that unemployment will not decline on an underlying basis before the autumn. Accordingly, our January forecast for the average unemployment rate in 2006 is only at 10.6%; roughly where it was in 2004. Employment should increase steadily further in 2006, however, growing 0.8% y/y on average. The labor force should not increase that much anymore, however (only 0.3%), which partly explains the unemployment improvement that we do not expect for 2005. Finally, although per-employee compensation in 2005 will not repeat the extreme softness of 2004 (estimate of -0.3%), the predicted rise of 0.9% seems modest by historical comparison, and actually risks being on the high side when judged against the latest, Hartz IV-related developments that argue against any rapid tightening-up of the German labor market.

Monetary Policy

The European Central Bank (ECB) kept its key interest rate unchanged at 2.00% for the 23rd successive month at its regular policy meeting in May. The ECB last acted in June 2003, when it cut its key rate by 50 basis points. Its only other move that year occurred in March, when it made a 25-basis-point cut. The ECB's total easing in monetary policy between May 2001 and June 2003 amounted to 275 basis points, taking its key interest rate down from a peak of 4.75%. The key rate is currently at its lowest level since the ECB assumed responsibility for the Eurozone, when it came into being in January 1999.

We expect the ECB to leave monetary policy unchanged for several more months to come. However, we believe that the sustained strengthening of the euro against the dollar will eventually force the ECB to cut interest rates. The euro is projected to trend further upwards against the dollar through 2005 and beyond. This is primarily due to the sustained downward pressure on the dollar stemming from a need to correct the huge US current account deficit. Specifically, the euro is projected to move towards $1.40 during the first half of this year, and then to appreciate further to trade around $1.45 by end-2005. The euro is projected to peak at $1.50 in 2006.

The ECB is expected to continue to respond to the euro's strength in the near term by trying to talk the currency down. But this is unlikely to have much impact, and the ECB may well intervene directly in the foreign exchange markets—most probably in tandem with other central banks, such as the Bank of Japan. This too is unlikely to dampen the euro significantly on a sustained basis, unless the US Federal Reserve participates in the intervention as well (which Global Insight feels is unlikely).

Therefore, the ECB will ultimately have little option but to cut its key interest rate to try and stem the euro's rise. This could well occur in the form of two 25-basis-point cuts, say in July and October. But we think there is a strong chance that the ECB will attempt a greater impact through a single 50-basis-point cut in the third quarter, taking the key rate down to 1.50%.

We believe that economic fundamentals would fully justify such ECB action. In addition to the dampening impact of the strong euro, Eurozone growth should remain pressurized by slower global growth and still-high oil prices (which are forecasted to stay relatively high through 2005, although we think they peaked last October). Furthermore, we believe that Eurozone domestic demand will remain persistently subdued against this backdrop. There is currently clear evidence that the Eurozone's recovery is struggling to develop sustainable, significant upward momentum.

Meanwhile, we believe that the second-round effects from high oil prices will be muted, even though Brent oil rose to a record high near $52/barrel in October. This caused Eurozone consumer price inflation to rise to 2.4% in October—only just below May's 26-month high of 2.5%. But inflation was stable at this level in December, helped by a moderation in oil prices. Furthermore, latest data show that core inflation was 2.1% in December, still firmly in the narrow 1.9–2.2% range that existed during 2004. Intense competition amid subdued domestic demand in many Eurozone countries, large output gaps throughout the region, the general strength of the euro, and further wage moderation due to still-soft labor markets should all help to limit the upside for Eurozone inflation over the medium term, which is what the ECB is mandated to focus on.

This view seems to be largely shared by the ECB. In its January 13 policy statement, for example, the ECB concluded that annual Eurozone consumer price inflation in excess of 2.0% is likely to persist over the coming months, but the central bank considered that inflation should fall back below 2.0% if no further adverse shocks occur. The ECB noted that the information available so far does not suggest any buildup in underlying inflationary pressures at the moment, and it expressed confidence that the medium-term outlook for price stability are favorable.

Nevertheless, the ECB has recently indicated increasing concern about the strength of money-supply growth in the Eurozone, even though it effectively downgraded the importance of this indicator in its May 2003 adjustments to its monetary policy strategy. In addition, the ECB has voiced concern about an overall pickup in the growth of loans to the private sector since May.

Assuming that the ECB does cut its key interest rate by 50 basis points (to 1.50%) around July in an attempt to rein in the euro, the rate should then stay at this level for an extended period. This reflects our belief that the euro will appreciate further, albeit at a slowing rate.

Fiscal Policy and Public Finances

The total public sector deficit amounted to 80.3 billion euro (3.6% of GDP) in 2004. Although down from 82.5 billion euro (3.9% of GDP) in 2003, it nevertheless meant that Germany had exceeded the 3.0% of GDP ceiling allowed under the Growth and Stability Pact for a third successive year. The deficit had been 3.2% of GDP in 2002.

In spite of these excessive total public deficits, Finance Minister Hans Eichel has made only half-hearted efforts to take corrective action, arguing that to do so would undermine the recovery and worsen the deficit situation even further. Although the European Commission launched its excessive deficit procedure against Germany in 2003, Germany (along with France) has avoided being disciplined. Eurozone finance members agreed in November of that year to a deal, which asked Germany and France to give a political commitment to reduce their budget deficits, in return for the suspension of disciplinary action. This was effectively an emasculation of the Stability and Growth Pact, which subsequently led to its reform in March 2005.

Under the reforms, Eurozone finance ministers' leeway was raised by allowing variation in the medium-term goals (depending on a country's levels of debt and potential growth), by allowing modifications to the relevant deficit in the case of structural and pension reforms or suspending sanctions if one of a number of specific circumstances are met, and finally by giving countries more time to correct deficits and introducing more flexibility into the application of the pact in the event of extended economic slowdowns. Notably the latter seems tailored to Germany's fiscal situation of the last few years.

In 2003 and 2004, the dictates of the pre-reform Stability and Growth Pact, and the fact that Germany's deficits in recent years were rooted more in revenue shortfalls than in excessive spending, have meant that fiscal policy remained slightly restrictive. Despite the persistent weakness of the (domestic) economy and a subdued outlook, even the 2005 budget remained significantly oriented towards lowering the deficit. Nevertheless, overly optimistic government assumptions about economic growth and unemployment trends, as well as on revenues from key product taxes (notably fuel and tobacco, where high prices depressed demand), seem most likely to lead to a renewed major deficit overshoot in the current year.

With regard to the federal budget alone, the original deficit target in 2004 was 29.3 billion euro, compared with an eventual outcome of 39.5 billion euro. It should be noted that this can partly be blamed on the CDU/CSU opposition having blocked several deficit-reducing measures planned by Eichel via the party's Upper House majority—an ongoing problem related to Germany's federal structure. Even more importantly, the only very limited efforts at structural reform to decouple tax revenues and contributions into the social security system from employee wages—amid an ongoing downward trend in full-time, regular employment—have maintained upward pressure on deficits. Accordingly, the latest (mid-2004) medium-term federal deficit projections—22.0 billion euro in 2005, 21.7 billion euro in 2006, 21.2 billion euro in 2007, and 19.5 billion euro in 2008—must be taken with more than a pinch of salt.

The only significant, pro-active government measures to loosen the fiscal grip in the last two years have been the income tax cuts in January 2004 and 2005. The top rate of personal income tax has fallen in stages from 48.5% in 2003, to 42.0% in 2005, and the basic rate has fallen from 19.9%, to 15.0% in 2005. These cuts, worth some 0.7% of private consumption just between 2004 and 2005, have not led to any significant expansionary impulse on the economy, however. Consumers, unsettled by growth stagnation and reforms that lowered job security, have saved most of those increases in net income.

The draft 2005 federal budget published in July 2004 aimed to cut net new government borrowing from a planned 29.3 billion euro in 2004 (actual outcome 39.5 billion), to 22 billion euro in 2005. The bulk of the intended reduction in borrowing was due to plans to raise 15.45 billion euro in proceeds from the privatization of state assets. The budget, when finally passed by parliament in late November 2004, foresaw total spending edging up by just 1.1%. Tax income was expected to rise 2.0%, from 187.0 billion euro to 190.8 billion euro. In the meantime, the mid-May 2005 tax revenue estimates (by the working group meeting twice a year that is comprised of finance ministry officials from federal and Laender authorities) have revealed a shortfall of 3.5 billion for the federal budget, resulting in effective stagnation of tax revenues between 2004 and 2005. Other key elements of the 2005 budget include a surge of 38% in non-tax revenues (this includes privatization proceeds) from 30.3 billion euro in 2004, to 41.2 billion euro in 2005, and a marginal rise of planned government investment from 22.4 billion euro in 2004, to 22.7 billion euro in 2005.

Indications given by Eichel in May 2005 point to a revised government expectation for the deficit in 2005 of around 33 billion instead of 22 billion, mainly as additional spending on unemployment of six-to-ten billion euros is feared on top of the tax revenue shortfalls.

Meanwhile, the latest official government projections for the total public sector deficit—still valid in May 2005—stem from August 2004. At that time, Eichel expected a decline from 3.5% of GDP in 2004, to 3.0% in 2005, 2.0% in 2006, 1.5% in 2007, and 1.0% of GDP in 2008. When the next finance plan for the whole public sector is published in July/August 2005 (assuming this will happen despite the early elections planned for September 2005), these deficit figures will need to be revised up heavily. First, the budget-gap projections for 2006-08 have already been raised for the federal budget, after the November 2004 tax revenue estimates, to show almost steady deficits in the medium term. Second, the May 2005 tax revenue estimates imply total public sector deficit projections based on revenue shortfalls alone that are in the vicinity of 2.8% in 2006, 2.5% in 2007, and 2.1% in 2008. Since expenditures on unemployment will also have to be raised, given higher levels of joblessness than previously assumed, Global Insight in its second-quarter detailed forecast predicts that the total public-sector deficit will exceed the 3.0%-of-GDP level allowed under the Stability and Growth Pact once more in 2005 (3.3%) and not fall very far below in the following years (2.9% in 2006, 2.6% in 2007, 2.3% in 2008).

Exchange Rate

The euro has retreated overall against the dollar so far in 2005, having traded at a lifetime high of US$1.367 in late December. Indeed, the euro has dipped below US$1.30 at times during each of the first five months of this year, although it did briefly spike back up near US$1.35 in mid-March.

The euro's moderately softer tone in recent months is a reflection of a widespread but limited recovery by the dollar. This is largely due to the increased support that the dollar has gained from higher US interest rates. In addition, the dollar has benefited from some recent stronger capital inflows data that have—temporarily at least—alleviated concern about US ability to finance its huge current-account deficit.

Nevertheless, the euro is still relatively strong as the dollar's upside continues to be limited by the huge US current-account deficit. The shortfall increased to a record US$665.9 billion in 2004, with the trade deficit amounting to an all-time high of US$617.7 billion. This was up from US$530.7 billion and US$496.5 billion respectively in 2003. Indeed, the American current-account deficit widened to a record US$665.9 billion in the fourth quarter of last year, up from US$165.9 billion in the third quarter. Furthermore, the trade deficit was a record US$60.6 billion in February, although it narrowed to US$55.0 billion in March. The dollar has also been pressured on occasions by a periodic focusing of market attention on the possibility that a growing number of central banks could decide to switch some of their reserves out of dollars in the future, or at least buy fewer dollars.

Senior Eurozone politicians and European Central Bank (ECB) officials have voiced serious concerns at the euro's strength, and they were particularly concerned at the rate of appreciation late in 2004. In early December, the ECB and Eurozone finance ministers released a joint statement saying that "excessive volatility and disorderly movements in exchange rates are undesirable for economic growth…we will monitor the situation closely."

Early in 2005, ECB chief economist Otmar Issing observed that Europe had accounted for an excessive share of the dollar's adjustment. He called on Asia, and particularly China, to play an increasing role in solving the problem. These sentiments were later repeated by ECB president Jean-Claude Trichet. Nevertheless, the G-7 meeting at the beginning of February contained no new initiatives on currencies, with the statement exactly matching that contained in the February 2004 communiqué. Indeed, the overall perception remains that the Bush administration is largely happy to see the dollar soften, and that there is little prospect of coordinated efforts by the major economies to counter the dollar's weakness.

We still believe that the euro will trend higher against the US currency over the course of this year as the markets largely focus on the unsustainable American current account deficit. There is concern that America will increasingly struggle to attract, on a sustained basis, the capital inflows needed to finance its current account deficit, as well as the very real possibility that several countries could switch a proportion of their foreign currency reserves out of dollars. Total foreign currency reserves were US$3.36 trillion at the end of March 2004. The dollar accounted for some 64% of global forex reserves at the end of 2003, with the euro representing about 20% and the yen around 5%.

Meanwhile, the euro will still account for a disproportionate share of the dollar’s adjustment due to Asian policymakers' continuing inflexibility over their currency regimes. Specifically, Global Insight currently believes that it is likely that the Chinese government will maintain its fixed exchange rate policy for another couple of years.

The dollar is likely to enjoy some periods of respite, though, when the market particularly focuses on the increasing US interest rates. The dollar is also likely to benefit periodically from particularly strong US data that highlight the relevant strength of the American economy vis-à-vis the Eurozone. Furthermore, the dollar could gain some significant support from US multinational companies taking advantage of the Homeland Investment Act, which allows them to repatriate earnings from their foreign subsidiaries at a significantly reduced tax rate for a year from January 1.

Nevertheless, we still now expect the euro to reach $1.45 toward end-2005, and then peak around $1.50 during 2006.

The ECB will almost certainly respond by trying to talk the euro down. Indeed, there has already been evidence of this in 2005, with Trichet and Issing both observing that the euro has taken too much of the burden of the dollar's adjustment and calling on Asian currencies to take more of the share. Since this verbal intervention is unlikely to work on a sustained basis, the ECB is eventually expected to intervene in the foreign exchange markets—very possibly in tandem with other central banks, such as the Bank of Japan. Yet again, though, this should have little sustained dampening impact on the euro, unless the Federal Reserve also participates (which Global Insight sees as unlikely).

Therefore, the ECB will ultimately have little option but to cut its key interest rate to try and stem the euro's rise. This could well occur in the form of two 25-basis-point cuts, say in July and October. But there is a strong chance that the ECB could attempt a greater impact by enacting a single 50-basis-point cut in July, taking the key rate down to 1.50%.

Further out, we see the euro trending modestly down against the dollar, reflecting the US' stronger long-term economic fundamentals and growth potential. However, the American trade deficit will continue to have some dampening effect on the dollar.

Trade and External Accounts

The overall current-account surplus in 2004 was 77.9 billion euro (3.6% of GDP); a 70% increase compared with the 45.8-billion-euro surplus in 2003 and a return to the record levels of the late 1980s. This was driven by a sharply higher trade surplus of 156.7 billion euro, compared with 129.9 billion in 2003 (a rise by more than 20% and a new historical record). Exports of goods rose very strongly by 10.0% year-on-year (y/y) (8.8% based on calendar adjusted data) to 731.8 billion euro, versus growth of just 2.0% in 2003 (1.9% adjusted). Export growth had accelerated in late 2003 and was buoyant throughout the first half of 2004, boosted by improving global economic growth and initially defying marked further euro strengthening, before slowing down under the unsettling impact of skyrocketing oil prices and slightly weaker global demand in the second half of last year. Imports also accelerated to growth of 7.8% y/y (6.4% adjusted) to 575.2 billion euro in 2004, compared with just 3.4% y/y in 2003. This occurred despite ongoing domestic demand weakness, which was affected by higher oil and metal prices.

The so-called invisible components of the current account (everything apart from goods trade) remained in deficit throughout but also improved modestly in 2004, from 2003. A significantly reduced deficit for wage and property income (-4.2 billion euro) and a slightly smaller deficit in transfers (-26.9 billion) offset modestly higher deficits for supplementary trade (-10.1 billion) and for services (-37.7 billion).

Trade developments deteriorated moderately towards the very end of 2004 and in January/February 2005, before showing a tentative improvement in March. The narrowing of the merchandise trade surplus in those months can be attributed to the double impact of the sharp oil price spike last autumn and euro appreciation to new life-time highs during the fourth quarter of 2004. Nevertheless, the dampening effects on exports have been limited by the fact that the bulk of German export products (notably investment goods such as plants and machinery) are considered not very price sensitive, relying on quality and service to compete. In addition, hedging is quite widespread.

Furthermore, a January 2005 European Central Bank (ECB) report revealed that the factorization in euro of German goods exports to non-Eurozone countries already rose sharply to 63% in 2003, from 49% in 2002. Given that around 45% of German exports go to the Eurozone and are thus not exposed to currency risk at all (only to competition risk from dollar-based competitors), this leaves little more than 20% of overall exports immediately exposed to currency risk. The ECB study also showed that factorization of imports in euro has lagged (reaching 55.2% in 2003), reinforcing the so-called "J-curve" effect—euro strengthening of late 2004 will on its own have initially dampened imports via the price effect, boosting the trade surplus. Once volume effects come more to the fore after half a year or so, increased purchasing power from a stronger euro will boost imported volumes, and export competitiveness will suffer to a degree, thus weighing on the trade balance again.

The latest indications on foreign orders—either from surveys such as the December–April PMI and Ifo or from the hard data on manufacturing orders available through March—argue for only moderate and short-lived weakening of export growth having taken place in the second half of 2004 and in early 2005. In addition, any dampening impact on exports otherwise foreseen for mid-2005 on currency grounds will be mitigated by the partial downward correction of the euro in the first few months of 2005. On the negative side, West European markets are growing markedly less quickly than the US and many other dollar-bloc markets lately, although Eastern and Central European economies are out-performing their western counterparts.

In our January quarterly forecast, on the assumption that the euro will trend up during 2005 to end the year at US$1.45, we expect that nominal exports will grow 6.3% in 2005 (slowing down from 10.0% in 2004). Meanwhile, imports of goods are projected to grow by 7.5%, almost matching the 2004 pace. These forecasts are slightly softer for exports and more clearly so for imports compared with our October 2004 detailed forecast round. We now forecast a merchandise trade surplus of 158 billion euro (7.1% of GDP). The current account surplus is seen at 73 billion euro (3.3% of GDP).

As we do not expect any serious slowdown of global and Eurozone growth in 2006 either, we forecast export and import growth of 5.2% and 5.6%, respectively, in 2006. The modest slowdown of exports does have to do with the anticipated further appreciation of the euro to US$1.50 next year. The merchandise trade surplus is nevertheless forecast to rise slightly to 163 billion euro (7.1% of GDP). The current account surplus is projected at 74 billion euro (3.4% of GDP) in 2006.

GERMANY

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	1,872.92	3,128.28	3,765.18	5,400.16	10.8	3.8	2.4
Nominal GDP per capita, US dollars	22,789	37,895	45,502	65,951	10.7	3.7	2.5
Real GDP, billion real 2000 US dollars	1,869.30	1,934.02	2,107.74	2,658.43	0.7	1.7	1.6
Real GDP per capita, real 2000 US dollars	22,744	23,428	25,472	32,467	0.6	1.7	1.6
Real private consumption, billion real 2000 US dollars	1,102.69	1,120.41	1,221.74	1,551.35	0.3	1.7	1.6
Real government consumption, billion real 2000 US dollars	355.46	367.86	386.58	471.90	0.7	1.0	1.3
Real fixed investment, billion real 2000 US dollars	404.76	358.00	401.45	513.29	-2.4	2.3	1.7
Real exports, billion real 2000 US dollars	630.73	811.44	1,005.69	1,895.93	5.2	4.4	4.3
Real imports, billion real 2000 US dollars	623.12	730.59	926.45	1,808.92	3.2	4.9	4.6
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	20.77	21.17	23.14	28.29	0.4	1.8	1.3
Mining	4.84	4.38	4.39	4.59	-2.0	0.0	0.3
Manufacturing	390.24	422.34	464.75	591.07	1.6	1.9	1.6
Utilities	31.77	32.92	36.73	48.16	0.7	2.2	1.8
Construction	89.88	74.01	76.93	87.60	-3.8	0.8	0.9
Wholesale & Retail Trade	204.61	211.12	232.94	310.77	0.6	2.0	1.9
Transport & Communication	102.61	127.31	145.71	215.07	4.4	2.7	2.6
FIRE	517.99	566.37	631.19	850.94	1.8	2.2	2.0
Other Services	374.28	387.39	423.31	549.66	0.7	1.8	1.8

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	59.0	58.5	58.7	62.2	-0.5	0.3	3.4
Government consumption share of GDP	19.0	18.5	18.0	18.3	-0.5	-0.6	0.3
Fixed investment share of GDP	21.7	17.4	17.7	18.0	-4.3	0.3	0.2
Exports share of GDP	33.8	39.5	44.1	67.0	5.8	4.6	22.9
Imports share of GDP	33.4	34.4	39.2	65.5	1.0	4.8	26.3
Net extports share of GDP	0.4	5.1	4.9	1.5	4.7	-0.2	-3.4

France

Overview

Short Term

The economy grew by 2.1% overall in 2004. This was up from growth of just 0.9% in 2003 and was the equal strongest performance (with 2001) since 2000. The overall performance last year benefited from a marked rebound in activity in the fourth quarter, after economic activity had slowed substantially in the third quarter. Furthermore, growth was encouragingly well balanced in the fourth quarter of 2004, with consumer spending and business investment both picking up significantly and exports strengthening anew. Meanwhile, stocks were run back down to some extent.

Disappointingly, though, growth appears to be currently faltering again, after a reasonable start to 2005. Indeed, growth currently faces a number of handicaps. High oil prices are a particular concern, with Brent oil moving strongly back up recently to set new record highs of more than US$55/barrel in March and April. Global Insight expects them to remain relatively high through 2005. In addition, businesses are still facing a significant threat to their competitiveness from the strength of the euro against the dollar. Although the euro has softened from last December's lifetime peak of US$1.367, it has nevertheless largely continued to trade around US$1.30 this year and we believe it is likely to make renewed significant gains in the coming months, as the huge US current account weighs down on the dollar. Global Insight forecasts the euro to appreciate to US$1.45 by the end of 2005. These gains are anticipated to eventually lead the European Central Bank to cut interest rates in the second half of this year.

On top of this is the fact that global growth has slowed compared with the first half of 2004. Specifically, Global Insight currently forecasts global growth to moderate from an estimated 4.1% in 2004 to 3.2% in 2005 and 3.1% in 2006. The strong euro and slower global growth seems certain to limit the upside for French exports and is liable to weigh down on business confidence. Unsurprisingly, confidence has softened markedly since hitting a 43-month high in October. Indeed, it was at a 15-month low in March, when the personal business outlook was at a 17-month low. Meanwhile, businesses and consumers still have significant concerns about future government fiscal policy, given the weakness of public finances. Additionally, consumers still have concerns over unemployment and their financial situations.

Consequently, consumption seems likely to struggle to sustain its recent role as a major growth driver. Consumer spending over the next few months at least is expected to be restrained overall by a still relatively soft labor market. Indeed, for consumer spending to see renewed and sustained strong growth, it is critical that employment starts to grow, thereby boosting overall purchasing power as well as still vulnerable consumer confidence (which has been softer overall so far in 2005, at its lowest level since the end of 2003). Worryingly, though, unemployment rose back up by 46,000 in the first quarter of 2005, after falling modestly in the fourth quarter of 2004. In addition, latest data show that payrolls were essentially flat in the first quarter of 2005.

Meanwhile, the government has confirmed that it will not cut income tax further in 2005, despite President Chirac's 2002 election pledge to reduce this by 30% during this legislature. This reflects the poor state of public finances, which will also limit the government's scope to take any action to give the recovery a renewed boost. Indeed, fiscal policy will be restrictive overall in 2005, despite the fact that the government has made it clear that it is not prepared to bring down the budget deficit at the cost of throttling growth. Consequently, we expect GDP growth to moderate to 1.7% in 2005.

Meanwhile, consumer price inflation is forecast to only moderate from 2.1% in 2004 to 1.7% in 2005 despite softer growth, as oil prices remain relatively high. Stronger growth in 2004 helped bring the budget deficit down to 3.7% of GDP from 4.2% of GDP in 2003. Nevertheless, it still exceeded the 3.0%-of-GDP ceiling allowed under the Stability and Growth Pact for a third successive year. Furthermore, we still expect the budget deficit to be as high as 3.2% of GDP in 2005.

Medium Term

GDP growth is projected to strengthen to 1.8% in 2006 and 2.3% in 2007. It is then expected to ease back to 2.0% during 2008-2010, which we consider to be around its trend level. The modest upturn in growth starting in 2006 is expected to be supported by a modest overall easing back of oil prices, low interest rates, and income tax cuts (the government has already pledged the resumption of income tax cuts next year). In addition, the labor market is projected to see modest improvement from late-2005, while inflation should remain relatively muted amid intense competition.

Growth is projected to be relatively balanced over the next five years, with real fixed investment leading the way, as companies seek to upgrade their capacity and boost productivity. Specifically, real fixed investment is projected to grow at an annual average rate of 3.1% over the period 2005-2010. Meanwhile, consumer spending growth is expected to be limited to an average of 2.0%, partly due to only modest employment growth. Wage moderation is also expected to largely continue, holding down growth in real disposable incomes. Consumers are also expected to be relatively cautious in their spending, given some uncertainty about how they will be affected by much needed government structural reforms e.g. on pensions.

Monetary and fiscal policy is unlikely to provide much overall help to growth during 2005-2010. The European Central Bank seems unlikely to abandon its overly conservative monetary policy posture any time soon, while France will still face pressure to bring down its budget deficit over the next few years, despite some much-needed flexibility being brought into the Stability and Growth pact via the March 2005 reforms. For this reason, we assume that real government spending growth will be limited to 2.0% a year during 2005-2010.

Meanwhile, net trade is projected to be modestly reduce overall GDP growth over the period 2005-2010. Exports are expected to grow by an average 4.3% during this period. While exports should benefit from reasonably healthy global growth during much of this period, they are likely to be held down to some extent by the relative strength of the euro. The euro is projected to appreciate to a peak of US$1.50 in late 2006 and early 2007, as the US dollar continues to be pressurized by the large American current account deficit. Although the euro is projected to then ease back, it is expected to continue to largely trade above US1.40. The strength of the euro will also make imports more competitive, contributing to forecast annual average import growth of 4.8% during 2005-2010.

Inflation is expected to remain largely contained in France over the medium term, averaging just below 2.0%. It is projected to be limited by relatively subdued domestic demand, intense competition, wage moderation and the general strength of the euro.

Long Term

France's long-term prospects are reasonably good, compared with the other major Eurozone economies, but its aging population will pose an impediment to growth and a threat to public finances. The population has been growing steadily in recent years, and the projection from the national statistics institute (INSEE) shows this trend continuing until the end of the decade. A major demographic shift will then take place because of an aging population. While the annual increase in total population will fall below 0.3% by the end of 2010–20, the working-age population will start contracting in 2011, decreasing at an annual 0.3% by 2020. Such a demographic shift has two major implications. First, it slows the economy's potential growth for a given rate of labor-productivity gains. Second, the aging population will lift the burden of pension payments in a pay-as-you-go system. A report commissioned by the government showed that, in the absence of pension reform, the total pension payments should rise from the present 12% to run around 15-17% of GDP in 2040.

Consequently, in July 2003, parliament passed pension reform plans. As a result, over 2004–08, civil servants will extend their contributory period to the pension scheme from 37.5 years to 40 years. The private sector made this change in 1993. From 2008 onwards, there will be further gradual increases in the contribution period for all workers, taking it up to 42 years.

Turning to the labor market, we remain somewhat cautious about the country's ability to cope with its high structural unemployment, which we still see as being around 8%. Bringing down structural unemployment—the level under which inflationary pressures systematically stop any further progress in the labor market—would require consistent and extensive reforms. Among other things, the government would need to implement policies to promote the willingness to work. In particular, it should enable a widening gap between the lowest end of the wage scale and the income you live on when you are unemployed. Such measures currently appear extremely radical to many French politicians.

Even so, over the longer term, we expect some positive steps ranging from a reduction of taxes on the lowest income brackets, further active labor market policies, and improved training schemes. This should bring down structural unemployment somewhat, but the experience in other European countries indicates that bolder measures would be required to return to the low unemployment levels of the 1960s. Overall, we foresee the unemployment rate falling below 8% around 2010 and then trending down towards 5% by 2025.

Given our baseline assumptions of trend productivity gains, and working-age population and participation rates, long-term growth should be just under 2.00% during 2010–25.

Economic Growth

GDP growth amounted to 2.1% in 2004, with domestic demand expanding by an impressive 3.1%. However, 0.8 percentage point of this growth was due to an inventory build-up. Excluding this contribution, domestic demand expanded by 2.4%. Consumer spending grew 2.3% in 2004, up from 1.6% expansion in 2003. Meanwhile, total investment was up by 2.2% in 2004, as business investment recovered to grow by 2.4% after being flat in 2003 and contracting significantly in 2002. However, public investment growth slowed substantially to 3.0% in 2004, from 8.6% in 2003. Public spending growth accelerated modestly to 2.7% in 2004 from 2.1% in 2003.

Net trade reduced the overall GDP expansion by a substantial 1.0 percentage point last year, even larger than the 0.9-percentage-point reduction in 2003. This was because import growth surged to 6.1% in 2004, from just 1.3% in 2003. Meanwhile, exports grew by 2.4% in 2004, having contracted by 1.7% in 2003.

Economic activity has been disappointingly weak so far in 2005. Indeed, real GDP growth slowed to just 0.2% quarter on quarter (q/q) in the first quarter of this year, from 0.7% q/q in the fourth quarter of 2004. The breakdown of the first-quarter 2005 GDP data showed that growth was significantly hit by a weakened export performance. Specifically, exports edged down by 0.1% q/q, following growth of 0.9% q/q in the fourth quarter of last year. This was clearly a consequence of a slowdown in global growth as well as the strength of the euro. The euro had hit a lifetime high of US$1.367 in December 2004, and it remained relatively strong through the first quarter of this year despite trading back below US$1.30 on occasions. Meanwhile, imports growth slowed to 0.6% q/q from 1.0% q/q in the fourth quarter of 2004, reflecting a moderation in domestic demand. Consequently, net trade reduced overall GDP growth by 0.2 percentage point in the first quarter of 2005.

Domestic demand growth moderated to 0.4% q/q in the first quarter of 2005, from 0.7% q/q in the fourth quarter of 2004. This was dragged down by public consumption falling by 0.5% q/q, as the government sought to rein in expenditure to improve the weakened public finances. In addition, stocks were run down for a second successive quarter, reducing domestic demand by 0.1 percentage point.

Consumer spending growth slowed to a still robust 0.7% q/q in the first quarter, from 1.1% q/q in the fourth quarter of 2004. Consumption was boosted late in 2004 and early in 2005 by a number of one-off measures introduced by the government, as well as by the strong housing market. In particular, employees were allowed to spend part of their company savings schemes early. Indeed, consumer spending still seems to be highly reliant on consumers dipping into their savings, as the labor market has remained persistently soft, thereby failing to provide a much needed boost to consumer purchasing power.

The most encouraging element of the first-quarter GDP data was a 1.3% q/q increase in total investment. This matched the fourth-quarter 2004 performance. Business investment held up well in the first quarter, despite a marked falling back in confidence and concern that companies would start to scale back their capital expenditures because of the more difficult conditions stemming from softer global growth, high oil prices, and a strong euro. Indeed, companies' margins have been significantly squeezed under these conditions. Business investment rose by a further 1.6% q/q, after a 1.9% q/q increase in the fourth quarter of 2004. Meanwhile, public investment grew by 1.1% q/q in January-March and household investment expanded by 0.8% q/q.

We expect GDP growth to be softer overall at 1.8% in 2005. The lower growth this year is expected to be a consequence of a markedly stronger euro, softer global growth compared with 2004, and still-relatively high oil prices. Specifically, we expect oil prices to trend only gradually lower in 2005, while the euro is projected to reach US$1.40 around the middle of this year and to reach US$1.45 by the end of the year. Meanwhile, we expect global growth to moderate to 3.3% in both 2005 and 2006 from an estimated 4.1% in 2004.

French domestic demand is forecast to grow 2.2% in 2005. Consumer spending is projected to rise 1.7%, supported to some extent by a modest increase in employment during the year as a whole, as well as by a gradual easing-back in inflation. In addition, the ECB is now expected to eventually cut interest rates in the second half of the year in an attempt to rein in the euro. No further income tax cuts are planned by the government because of the poor state of public finances, however, and consumers may be uncertain about how they will be affected by future government reform and revenue raising measures. Meanwhile, total fixed investment growth is forecast to pickup modestly, to 3.4% in 2005, with business investment again being the main factor behind the improvement.

Net trade is projected to reduce overall GDP growth by 0.4 percentage point in 2005. Softer global growth and the stronger euro will obviously weigh down on French exports, although they should benefit to some extent from modestly healthier domestic demand elsewhere in Western Europe. In addition, expansion in Central and Eastern Europe is projected to be relatively robust. Consequently, exports of goods and services are projected to rise by 4.0% in 2005. Meanwhile, import growth is projected to ease back to 5.4%, in line with softer domestic demand.

GDP growth is forecasted to accelerate modestly to 2.0% in 2006, with domestic demand expanding by 2.1%. Consumer spending is projected to improve to 2.3% next year, benefiting from modestly stronger employment growth, lower inflation, and income tax cuts as the government resumes its tax-cutting agenda with the next presidential and national assembly elections, due in 2007. Meanwhile, total fixed investment is forecasted to grow by 3.4%, with business investment up 4.5%. Public spending growth is expected to be limited to 2.0%. Net trade is seen reducing overall GDP expansion by 0.1 percentage point in 2006, as export growth of 4.0% is modestly outstripped by import growth of 4.3%.

Further out, GDP growth is seen averaging 2.0% over the next ten years or so, easing back to just below 2.0% from 2015 onwards as the population ages markedly. We assume that this will only be partly compensated for by an increase in the labor force participation rate. In addition, we assume that investment will increasingly become a growth driver over the longer-term, as companies seek to boost productivity and increase the capital content of their production process to compensate for the declining workforce. We also assume that consumer spending will be supported to some extent over the longer term by a reduction in the currently very high savings rate.

Consumer Demand

The consumer sector performed surprisingly well during the first half of 2004, despite relatively low consumer confidence during much of this period. Spending lost significant momentum in the third quarter, but it then rebounded strongly in the final months of last year. It also held up relatively well in the first quarter of 2005. This is despite the fact that consumer confidence fell back late in 2004 and has since fallen further in 2005.

Consumer confidence edged up in April, but nevertheless remained very close to its weakest level since the end of 2003. This is worrying, given the importance of the consumer to the overall economy. Indeed, it is vital for the strength and sustainability of the upturn that consumer spending hold up well. Ominously, though, the latest data suggest that consumers are beginning to tighten their belts after spending relatively heavily in the fourth quarter of 2004 and the start of 2005.

The INSEE consumer optimism index edged up from -25 in March to -24 in April. The index has been locked in a range of -23 to -25 (which is the lowest level since December 2003) since November, which is significantly down from the 23-month high of -17 that was seen in September 2004.

Unemployment remains a significant concern for consumers, and these fears actually worsened further in April. Specifically, the breakdown of the April confidence survey showed that the index for future unemployment rose to 58 in April, from 57 in March and 42 in February. This index is now back near the June-2004 high of 63. Meanwhile, consumers remained largely pessimistic about their past and future personal finances and living standards in April. Indeed, they were more pessimistic about their future ability to save, even though more of them thought it was a good time to save.

After trending down late in 2004, consumers' concerns over future inflation rose in March and then stabilized in April. This reflected the move back up in oil prices, which reached record nominal highs late in March and early in April. Indeed, annual consumer price inflation spiked up from 1.6% in February to 1.9% in March, although it subsequently edged back to 1.8% in April.

Modestly encouraging, the balance of consumers who think it is a good time to spend edged up in April. The index stood at -10, compared with -11 in March, -10 in February, -12 in January, and the 2004 low of -15 in December. Last year's peak was -8, which occurred in September. It should be noted, however, that there is not always a close link between this index and actual consumption.

Latest data show that consumer spending on manufactured goods (which accounts for some 30% of overall consumption) retreated a further 0.8% month-on-month (m/m) in

March after a fall of 1.1% m/m in February. Although spending was still up 4.0% year-on-year (y/y), it suggests that consumers may now be starting to economize. Consumer spending on manufactured goods had surged 2.1% m/m in January. It has been evident that consumers are very price conscious, and they have tended to significantly concentrate their spending at times of dramatic and extended discounting. Clearly, January's strong spending was significantly boosted by the winter sales, while it was also still benefiting from the one-off measures introduced by the government in the latter months of 2004. The impact of these measures will gradually fade in the coming months.

Over the long term, consumer spending will increasingly be hit by adverse demographics. We expect consumer spending to fall from 54.2% of GDP in 2005 to 53.6% of GDP in 2010 and 51.6% of GDP in 2025. Even this assumes that there is a significant decline in the currently high savings rate.

Business Investment

The national accounts data show that business investment grew by 1.6% q/q in the fourth quarter of 2004. It had fallen 1.1% q/q in the third quarter, after rising 1.3% in the second quarter and 0.3% in the first. The fourth-quarter rebound was particularly welcome, given concern that companies were scaling back their capital expenditures, because of more difficult conditions from softer global growth, high oil prices, and a strong euro. Indeed, companies' margins have been significantly squeezed under these conditions.

INSEE’s April survey of industry’s investment intentions showed that investment is expected to rise 3% over 2005. While still subdued, this at least marks a modest upward revision from the 2% increase that had been anticipated in the January survey. In the manufacturing sector alone, investment is now expected to rise by 4% this year, compared with a 3% increase that had been anticipated in October. INSEE indicated that investment is being increasingly targeted at boosting capacity.

The survey also indicated that industrial and manufacturing investment were both flat in 2004. This was a somewhat disappointing final outcome, as in July 2004 industrial companies had indicated that their investment was likely to rise by 8% over the year, while manufacturing companies put the likely increase at 6%. Nevertheless, it was still the strongest investment performance since 2000, as the survey indicated that investment fell in both industry and manufacturing by 6% in 2003 and by 13% in 2002. It was essentially flat in 2001.INSEE's April survey of industry investment suggests that companies are still relatively cautious in their investment plans. This is only to be expected, given that business confidence has retreated markedly overall in recent months to be at a 17-month low in April. Indeed, the personal business outlook was at a near two-year low.

Companies have serious concerns about persistent high oil prices and the strength of the euro. These factors have resulted—and continue to do so—in a significant squeezing of many companies' margins, which is clearly contributing to the modest investment plans. In addition, companies are facing a somewhat uncertain domestic economic outlook and some moderation in global growth. Furthermore, there is some uncertainty regarding government policy over the medium term regarding reforms and the need to bring down the budget deficit.

Nevertheless, capital expenditure should gain some support from the fact that many firms will likely feel a need to replace and upgrade capacity following the extended weakness in investment between 2001 and the first three quarters of 2003. Sustained low interest rates should also support investment. We forecast business investment to increase 3.9% in 2005 and 4.0% in 2006.

Over the longer term, we expect investment to increasingly become a growth driver, as companies seek to boost productivity and increase the capital content of their production process to compensate for the declining workforce. Specifically, we project fixed investment to rise from 19.8% of GDP in 2005 to 20.9% of GDP in 2010 and 24.8% of GDP in 2025.

Inflation

Consumer price inflation averaged 2.1% in 2004, as it had done in 2003. This was the highest rate since 1993 (when it was also 2.1%). It exactly matched the average consumer price inflation rate across the Eurozone.

Having ended 2003 at 2.2%, annual consumer price inflation trended down during the first quarter of 2004. It stood at 1.7% in March, the lowest level since July 2002, and down from 2.2% at the end of 2003; however, it then spiked to 2.6% in May to equal its highest level (first achieved March and February 2003) since 1992. Annual consumer price inflation subsequently trended gradually back down to 2.0% in November, before rising modestly in December to end the year at 2.1%.

Core inflation (which excludes public tariffs and food and energy prices) rose by 0.1% m/m in December. As a result, the annual rate of increase retreated to 1.4%, having spiked up to 1.5% in November from 1.3% in October. With the exception of August (when it was 2.0%), core inflation was locked in a fairly narrow range around 1.5% during 2004.

Going forward, annual consumer price inflation should benefit from the easing of oil prices from October's record highs. Even so, oil prices firmed again at the beginning of 2005 and they are forecasted to remain relatively high during the coming months, thereby limiting the downside for inflation. On a positive note, the strength of the euro against the dollar should help to contain oil prices, and also have some dampening impact on raw materials and other dollar-denominated, imported products. We expect the euro to reach US$1.45 by the end of the year. The euro is expected to peak at US$1.50 in 2006. In addition, strong competition should help to contain inflation at the consumer price level, particularly as recent buying patterns show that consumers are very price-conscious. Indeed, anticipated slower growth overall in 2005 should ensure that competitive pressure remains intense.

Furthermore, the continuing softness of the labor market is projected to ensure further wage moderation. Growth in hourly wages eased back from 4.3% in 2001 to 3.8% in

2002 and 2.8% in 2003. We expect the 2004 increase to have been little changed from 2003, and wage growth is projected to be limited to 3.1% in 2005 and 2.9% in 2006.

Consequently, consumer price inflation is projected to ease back from an average 2.1% in 2004 to 1.7% in 2005. It is seen standing at 1.4% at the end of 2005, and then stabilizing around this level in 2006. Going forward, inflation is forecast to fluctuate around the 1.4–1.8% mark over the medium and long terms.

Labor Markets

The number of jobless persons, seasonally adjusted, rose by a further 7,000 (0.3%) in March to reach 2.775 million on the International Labor Organization measure, according to the Labor Ministry. This followed rises of 4,000 (0.1%) in February and 35,000 (1.3%) in January. Consequently, the number of jobless rose by 46,000 in the first quarter of 2005.

This marks a worrying new downward turn in the labor market, which had seen little significant improvement in 2004, even though the economy grew by 2.1%. Specifically, the number of unemployed edged down by 6,000 overall in the fourth quarter of last year, after having risen by 5,000 in the third quarter and 12,000 in the second. While unemployment had fallen by 6,000 in the first quarter of 2004, the data had been distorted by people struck off the jobless registers due to changes in the requirements for claiming benefits.

Meanwhile, the ILO unemployment rate rose to a five-year high of 10.2% in March, from 10.1% in both February and January and 10.0% in December. The unemployment rate had previously been stable at 10.0% since October 2003.

On the government measure, the number of jobless rose by 8,100 in March, to 2.9391 million, after increases of 3,700 in February and 18,000 in January. Thus, there was an overall increase of 29,800 in the first quarter. Unemployment had edged down by 5,600 in the fourth quarter on this measure, having risen by an identical amount in the third quarter. The government measure comprises all registered unemployed persons, including those who worked fewer than 78 hours per month.

Meanwhile, latest data show that non-farm payrolls edged up by just 0.1% q/q and 0.4% y/y in the first quarter of 2005. Payrolls had also risen by 0.1% q/q in both the fourth and third quarters of 2004. The number of employed stood at 15.44 million in the first quarter of 2005, having previously risen to 15.43 million in the fourth quarter of 2004 from 15.41 million in the third, 15.40 million in the second, and 15.38 million in the first.

The prospects for the labor market are looking increasingly worrying at the moment, particularly in the near term. GDP growth of 2.1% in 2004 was insufficient to significantly boost the job market, and growth currently looks unlikely to reach 2.0% this year.

Overall business sentiment has retreated markedly in recent months. Indeed, it was at a 17-month low in April, with the personal business outlook deteriorating to a near-two-year low. Companies' margins are being squeezed, and they have significant uncertainties and concerns relating to the strong euro, softer global growth compared with the first half of 2004, and still relatively high oil prices. Indeed, the latest survey and anecdotal evidence generally indicate that businesses are cautious about taking on more staff, and are trying to boost productivity by squeezing as much output as possible out of their existing labor forces.

The right-of-centre government is clearly looking to encourage firms and unions to adopt a much more flexible approach to the 35-hour week than the previous administration, which will likely reduce the need to hire more workers as activity strengthens. In the first quarter of 2005, parliament approved government proposals under which employees will be able to work up to an EU-imposed maximum of 48 hours a week, if they reach a collective agreement with their employers.

We believe that the labor market will remain under pressure through the first half of this year, before starting to see modest improvement later on. In our April detailed quarterly forecast, we projected the unemployment rate to edge up to a peak of 10.3% in the second quarter, before edging back down to 10.1% by the end of the year. Employment was expected to be broadly flat over the year as a whole. The labor market was forecasted to see slightly stronger improvement in 2006, as growth picks up modestly. Employment is projected to increase by 0.8% next year, allowing the unemployment rate to fall back to 9.7% by the end of 2006.

Over the long term, the aging population means that it is critical that the government can push up the labor force participation rate. We assume that this will happen, but only relatively gradually.

Monetary Policy

(See discussion of monetary policy under Germany, Monetary Policy)

Fiscal Policy and Public Finances

The Finance Ministry indicated in late January that the budget deficit had been limited to 43.9 billion euro in 2004. This was significantly below the 55.1 billion euro deficit initially expected, and down from the 2003 shortfall of 56.96 billion euro. This improved performance was primarily due to tax receipts being 9.2 billion euro higher than originally projected.

The 2005 budget, which was unveiled last September, targeted the public-sector deficit to fall from 3.6% of GDP in 2004 to 2.9% of GDP in 2005. Thereafter, it was projected to decline to 2.2% of GDP in 2006, 1.6% of GDP in 2007, and 0.9% of GDP in 2008. This was based on the assumption that GDP growth will be 2.5% in both 2004 and 2005. Significantly, the government suspended a further income tax cut, and it now seems unlikely to be able to meet its pledge to bring income tax down by 30% during this parliament's lifetime. This is despite the fact that President Chirac in his 2005 New Year policy initiatives committed the government to resuming its income tax-cutting strategy in 2006.

Nevertheless, tax breaks worth around 2 billion euro were announced (1.07 billion for companies and 885 million euro for households) in the 2005 budget. In total, government expenditure is projected to rise by 1.8% in 2005 to 288.8 billion euro. As a result, state spending is expected to decline to 53.6% of GDP in 2005, down from an estimated 54.0% in 2004, and 54.7% of GDP in 2003. Meanwhile, government revenues are expected to amount to 272.1 billion euro in 2005. The budget deficit is seen at 44.9 billion euro in 2005 (2.9% of GDP).

In our January full quarterly forecasting round, we estimated that the budget deficit was 3.5% of GDP in 2004, down from 4.1% of GDP in 2003. Thus, we believe that the government slightly surpassed its target of lowering the deficit to 3.6% of GDP in 2004. Even so, this still means that France exceeded the 3.0%-of-GDP ceiling allowed under the Stability and Growth pact for a third successive year in 2004, and by a significant margin.

Furthermore, we are highly skeptical that the government will achieve its target of lowering the public deficit to 2.9% of GDP in 2005; particularly as we believe its growth forecast of 2.5% this year is optimistic. Indeed, we expect an "excessive" budget deficit to occur again in 2005, as the deficit is forecasted to only edge down further to 3.2% of GDP amid softer overall economic growth compared to 2004. The budget deficit is projected to fall to 2.9% of GDP in 2006, finally taking it below the 3.0% of GDP allowed under the Stability and Growth Pact.

Exchange Rate

(See discussion of the Euro under Germany, Exchange Rate)

Trade and External Accounts

France had a current account deficit of 4.4 billion euro in 2004, according to the Finance Ministry and Bank of France. This was the first deficit since 1991, although the surplus had previously narrowed to 4.4 billion euro in 2003 from 15.4 billion euro in 2002 and 24.0 billion euro in 2001. In 2004, France saw deficits of 6.1 billion euro in merchandise trade and 16.5 billion euro in net transfers. These outweighed surpluses of 7.7 billion euro in the net income account, 10.4 billion euro in the travel account, and 0.2 billion euro in services.

The merchandise trade balance suffered increasingly in the latter months of 2004, as French exports were pressurized by softening global growth and the strength of the euro (which achieved a lifetime high of US$1.367 in late December). Overall, exports of goods rose by 6.5% in 2004 to 340.2 billion euro. Meanwhile, high oil prices and relatively healthy domestic demand pushed up imports. In addition, the strong euro also made many imports more competitive. Consequently, imports grew by 9.0% last year, reaching 346.3 billion euro.

Latest data from the Bank of France and the Finance Ministry show that there was a current-account deficit of 4.1 billion euro in the first quarter of 2005. Deficits in merchandise trade (4.3 billion euro) and net transfers (5.2 billion euro) outweighed surpluses in the travel account (2.8 billion euro), net income (2.6 billion euro) and services (56 million euro). There had been a current-account deficit of just 224 million euro in January-March 2004.

The seasonally adjusted current-account deficit widened from 298 million euro in February to 1.7 billion euro in March, according to the Finance Ministry and Bank of France. This was primarily due to the merchandise trade deficit almost doubling from 1.1 billion euro in February to 2.1 billion euro in March, as exports fell by 2.9% month-on-month (m/m) to 28.3 billion euro, while imports edged up by 0.5% m/m to 30.4 billion euro. Exports were up by 4.0% year-on-year (y/y), and imports soared by 12.8% y/y. Clearly, the strength of the euro and some moderation in global growth compared with the first half of 2004 continues to handicap French exporters. Meanwhile, higher energy prices pushed up the import bill.

Global GDP growth is projected to remain relatively healthy, but is nevertheless forecast to moderate from an estimated 4.1% in 2004 to 3.2% in 2005 and 3.1% in 2006. This will obviously have some dampening impact on French exports, although they should benefit from a modest pickup in domestic demand later in the year elsewhere in the Eurozone. In addition, domestic demand is expected to be largely healthy in Central and Eastern Europe. This is significant, as around 70% of French exports go to other European countries. These markets will also be less affected by the strength of the euro against the US dollar, although exports from dollar-bloc countries will be competitive.

On balance, we expect French exports of goods in value terms to grow by 7.5% in 2005 and 7.1% in 2006. Meanwhile, imports are projected to expand by 9.3% in 2005, before easing back to growth of 5.8% in 2006, partly reflecting lower oil prices. As a result, the merchandise trade deficit is seen rising to 12.4 billion euro in 2005, before falling back to 8.7 billion euro in 2006. The current account deficit is forecast to be 4.5 billion euro (0.3% of GDP) in 2005, held down by an improvement in the net income account. It is seen back in surplus in 2006, by 3.4 billion euro (0.2% of GDP).

Exports are expected to grow by an average 6.0% in nominal terms over the next five years or so. While exports should benefit from reasonably healthy global growth during much of this period, they are likely to be held down to some extent by the relative strength of the euro. The euro is projected to appreciate to a peak of US$1.50 in late 2006 and early 2007, as the US dollar continues to be pressurized by the large American current account deficit. Although the euro is projected to then ease back, it is expected to continue to largely trade above US$1.40. The strength of the euro will also make imports more competitive, contributing to forecast annual average nominal import growth of 6.0% during 2005–10.

FRANCE

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	1,311.87	2,375.55	2,966.48	4,990.09	12.6	4.5	3.5
Nominal GDP per capita, US dollars	22,266	39,385	48,454	79,481	12.1	4.2	3.4
Real GDP, billion real 2000 US dollars	1,309.75	1,412.51	1,561.93	2,086.23	1.5	2.0	1.9
Real GDP per capita, real 2000 US dollars	22,228	23,419	25,513	33,229	1.0	1.7	1.8
Real private consumption, billion real 2000 US dollars	705.08	777.79	857.48	1,119.96	2.0	2.0	1.8
Real government consumption, billion real 2000 US dollars	304.24	350.64	387.42	521.39	2.9	2.0	2.0
Real fixed investment, billion real 2000 US dollars	264.62	282.65	330.04	536.83	1.3	3.1	3.3
Real exports, billion real 2000 US dollars	374.09	405.20	499.08	935.12	1.6	4.3	4.3
Real imports, billion real 2000 US dollars	356.87	426.73	539.02	1,097.86	3.6	4.8	4.9
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	32.74	33.76	35.23	38.75	0.6	0.9	0.6
Mining	2.37	2.45	2.52	2.63	0.7	0.6	0.3
Manufacturing	215.94	233.98	260.22	345.30	1.6	2.1	1.9
Utilities	23.64	25.24	28.36	39.19	1.3	2.4	2.2
Construction	55.90	65.83	71.84	88.46	3.3	1.8	1.4
Wholesale & Retail Trade	153.86	160.81	179.47	247.74	0.9	2.2	2.2
Transport & Communication	75.74	86.49	100.14	153.44	2.7	3.0	2.9
FIRE	365.18	401.16	454.48	635.89	1.9	2.5	2.3
Other Services	277.67	315.02	350.44	475.28	2.6	2.2	2.1

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	53.8	54.2	53.6	51.6	0.4	-0.6	-2.0
Government consumption share of GDP	23.2	24.0	23.5	22.3	0.8	-0.5	-1.2
Fixed investment share of GDP	20.2	19.8	20.9	24.8	-0.4	1.1	3.9
Exports share of GDP	28.6	26.3	29.3	40.7	-2.2	2.9	11.4
Imports share of GDP	27.3	26.0	28.8	41.6	-1.3	2.9	12.7
Net extports share of GDP	1.3	0.4	0.4	-0.9	-0.9	0.0	-1.3

Italy

Overview

Short Term

Italy slid into a technical recession in the first quarter of 2005, and the economy is now set to remain in the doldrums this year. Real GDP contracted 0.5% quarter-on-quarter (q/q) in the first quarter of 2005, after a 0.4% fall in the final quarter of 2004, according to the "flash" estimate from ISTAT (Italian statistics office). Recent leading and confidence indicators suggest that the economy will continue to struggle in the near term at least. Consumer confidence is still low, while retail sales and new car registrations data remain sluggish. Furthermore, business confidence slumped to a 21-month low in April.

This, coupled with the significant threats stemming from high oil prices and the strong euro, suggests that companies will be fairly cautious in the near term at least over investment and employment. In addition, the industrial sector is struggling, according to latest production and orders data, with even recent survey evidence showing sustained weakness.

Medium Term

The economy is expected to perform adequately at best next year, with growth accelerating to just over 1.5%, before peaking at around 2.0% in 2007.Again, the scale of the upturn will be restricted by the impact of still relatively high oil prices and our anticipation of the euro making further gains against the dollar. Nevertheless, growth will be stronger next year, helped by anticipated improvement in private spending, low interest rates, and reasonable income gains (due to tax cuts and the resumption of modest employment growth). Total fixed business investment began to contract in the second half of last year and should shrink further this year because of plunging business confidence, falling industrial output, and squeezed profit margins, which in turn were impaired by persistently high oil prices and the strong euro. More encouragingly, business investment should begin to recover in mid-2006, helped by low interest rates and an improved economic outlook in Italy and across the Eurozone. In addition, firms will need to renew their machinery and equipment after a prolonged period of depressed capital spending.

Growth is projected to remain moderate over the next five years, held back by a lackluster recovery in export sales. Real fixed investment will lead the way as companies attempt to upgrade their capacity and boost productivity after several years of weak spending on machinery and other equipment. Specifically, real fixed investment is projected to grow at an annual average rate of 2.1% over the period 2005–10. Meanwhile, consumer spending growth is expected to be limited to an average of 1.8%, partly due to only modest employment growth. Wage moderation is also expected to largely continue, holding down growth in real disposable incomes. Consumers are also expected to be relatively cautious in their spending, given some uncertainty about how they will be affected by much needed government structural reforms e.g. on pensions.

Monetary and fiscal policy is unlikely to provide much overall help to growth during 2005–10. The European Central Bank seems unlikely to abandon its overly conservative monetary policy posture any time soon, while Italy will still face pressure to bring down its budget deficit over the next few years, despite some much-needed flexibility being brought into the Stability and Growth pact via the March 2005 reforms. For this reason, we assume that real government spending growth will be limited to below 2.0% a year during 2005–10.

Inflation is expected to remain largely contained in Italy over the medium term, averaging just below 2.0%. It is projected to be limited by relatively subdued domestic demand, intense competition, wage moderation and the general strength of the euro.

Long Term

We project real GDP growth will be stuck below 2.0% in the outer years of our forecast horizon, well below the 3.0% target rate that Berlusconi's government is hoping to achieve. The lower long-term growth projections reflect our current view of a stronger euro in the outer years of the forecast period than in previous forecasts, which has implications for export growth. The other assumptions remain the same. The aging population will start claiming its toll on the labor force, and will impose increasing pressures on public finances, intensifying the need for major pension reform. Growth in the labor supply is expected to slow; low birth rates over the last 10–15 years will offset the impact of a projected rise in participation rates. However, productivity is expected to benefit modestly over the coming decade from greater benefits accruing form the "new economy." It is important that wage moderation continues over the long term, or Italy risks a sustained damaging loss of competitiveness against its Eurozone fellow members, given that currency devaluation is no longer an option.

Achieving faster growth also depends on further significant progress in the process of structural reform, which was started in the mid-1990s. Privatization is not complete, and greater liberalization is still needed in sectors such as telecommunication and energy. Much also needs to be done to improve the operation of the labor market—particularly with regard to wage negotiations, where the system remains too centralized. The efficiency of the public administration and civil justice system must also be improved significantly. Finally, the reform of the pension scheme needs to be extended to maintain its long-term viability, reduce employer costs, and encourage private saving and investment through pension funds. It remains to be seen how much the new center-right Berlusconi government can—or, indeed, wants—to achieve, given its recent political wobble.

Economic Growth

Italy slid into a technical recession in the first quarter of 2005, and the economy is now unlikely to register any growth this year. Real GDP contracted 0.5% quarter-on-quarter (q/q) in the first quarter of 2005, after a 0.4% fall in the final quarter of 2004, according to the "flash" estimate from ISTAT. This was considerably weaker than expected, and was the worst performance since the fourth quarter of 1998. In addition, the annual rate of growth slumped to -0.2%, down from 0.8% in the fourth quarter and 1.0% in the third.

ISTAT indicated that the depressed industrial sector was the main drag on first-quarter activity, while service sector activity was flat. It did not reveal any details on the expenditure side. We suspect that exports retreated, hurt by the strong euro and softer global demand, while business investment and consumer spending were likely to have been soft.

The economy also shrunk in the final quarter of 2004, when seasonally and working day adjusted real GDP declined 0.4% quarter on quarter (q/q), compared with rises of 0.4% in both the third and second quarters. Consequently, the year-on-year growth slowed to 0.8% in the final quarter of 2004, after having hovered above 1% in the preceding quarters of 2004. This implies that the economy grew 1.0% last year; a moderate improvement from its 0.3% increase in 2003.

The expenditure breakdown of the GDP data showed that domestic demand continued to edge up in the fourth quarter. Indeed, it raised overall, quarter-on-quarter growth 0.2 percentage point in the fourth quarter, as compared with a positive contribution of 0.1 in the third quarter. Worryingly, the only component of domestic demand to make a significant contribution to growth in the fourth quarter growth was inventories, which lifted overall, quarter-on-quarter GDP expansion 1.2 percentage points, after having seen a negative contribution of 0.6 percentage point in the third. Meanwhile, net exports were a significant drag on growth, in contrast with the third and second quarters. They lowered fourth-quarter growth 1.4 percentage points, compared with a 1.1 percentage-point lift in the third quarter.

Consumer spending continued to grow very gradually in the fourth quarter, rising 0.2% q/q again. Consequently, the year-on-year increase accelerated to 1.1% in the fourth quarter, after having slowed to just 0.3% in the third quarter. Nevertheless, spending still remains weak, with depressed household sentiment offsetting the positive backdrop of historically low interest rates and continuous employment growth.

Worryingly, gross fixed capital formation contracted sharply in the latter half of 2004; down 1.7% q/q and 1.2% q/q in the fourth and third quarters, respectively. In addition, the year-on-year growth slowed from 2.5% y/y to 0.5% y/y in the fourth quarter. Within this segment, construction investment declined 0.7% q/q, but was still 3.2% higher than it had been a year ago. Meanwhile, equipment investment shrunk sharply for the second successive quarter, down 1.5% q/q in the fourth quarter of 2004. Clearly, industrial investment intentions have taken a tumble as business confidence and industrial output continue to weaken.

The large drag on growth from net trade was due to a steep decline in exports of goods and services, which fell 4.7% q/q after having risen 4.8% in the third quarter. In addition, year-on-year export increases slowed to 1.7% in the fourth quarter, after gains of 5.6% y/y in the third quarter and 6.1% in the second. Italian exports appeared to be hurt by softer global growth and a strengthening euro, appreciating from slightly more than US$1.27 to US$1.36 in the fourth quarter. Imports of goods and services were flat during the quarter, but were still up 2.5% y/y.

Industrial production edged up in February, but the sector continues to struggle, as it did during much of last year. Output (seasonally and workday-adjusted) rose 0.1% month-on-month (m/m) in February, after being flat in January. Nevertheless, working-day-adjusted output contracted by 2.5% year-on-year (y/y) in February, which was the seventh successive month to post a decline. In addition, industrial production declined by 0.7% in 2004, following falls of 0.6% in 2003, 1.6% in 2002, and 0.9% in 2001. Activity in the sector last expanded in 2000, when it grew by 4.3%.

Industrial activity stagnated across some key sectors. The production of consumer goods faltered in February, declining by 0.9% m/m after expanding for two successive months. In addition, it fell by 5.9% y/y, compared with a 3.8% y/y fall in January. Meanwhile, investment goods output was unchanged between January and February, but still contracted by 4.9% y/y, the sixth consecutive month to post an annual decline. Finally, the output of intermediate goods rose by 0.2% m/m but still fell 1.2% y/y.

Recent leading and confidence indicators suggest that the economy will continue to struggle in the near term, at least. Household and corporate confidence will likely remain shaky over the next few months in the wake of recent political instability. Consumer confidence is still low and is set for further decline after the collapse of Berlusconi's original coalition government. In addition, retail sales and new car registrations remain poor. Business confidence slumped to a 21-month low in April. This, coupled with the significant threats stemming from high oil prices and the strong euro, suggests that companies will be fairly cautious in the near term at least over investment and employment. In addition, the industrial sector is struggling, according to latest production and orders data, with even recent survey evidence showing sustained weakness.

Economic activity is set to remain weak this year, before gathering some momentum from mid-2006. We believe activity has been hurt by expensive crude oil, loss of some momentum in the global economy, particularly the stuttering recovery across the Eurozone, the strong euro, and a restrictive fiscal policy. We are concerned about the implications on growth and confidence of the prime minister's plan to introduce a fiscal tightening package for 2004–05 in attempt to drag the national budget deficit below 3.0% of GDP. In addition, we now expect oil prices to remain persistently high, while the euro will remain strong.

Domestic demand will continue to struggle this year, probably expanding by a mere 0.6%, down from a 0.8% rise in 2004. Household consumption is projected to expand by just 0.7% this year, with demand not responding to tax cuts, easy monetary stance, and some real wage growth. A key factor is very low consumer confidence due to deep-rooted concerns over the political situation, labor market and the economy. Meanwhile, the growth in total fixed investment is likely to contract by 1.4% this year, after a 1.9% rise in 2004. Already fragile industrial sentiment is weakening in the face of persistently high oil prices and the stronger euro. In particular, profit margins are under increasing pressure from rising energy costs and the firmer euro.

Meanwhile, exports of goods and services are set to slow sharply this year, hurt by the strong euro, intense competition from low-cost producers in the Far-East, and softer global economic growth, particularly the stuttering recovery across the Eurozone. Consequently, exports of goods and services are projected to struggle this year. Weak domestic spending will suppress import demand this year, but net trade should still be a drag on activity.

The economy is expected to perform adequately at best next year, with growth recovering to over 1.5%, before peaking at around 2% in 2007. Again, the scale of the upturn will be restricted by the impact of still relatively high oil prices and our anticipation of the euro making further gains against the dollar. Nevertheless, growth will be stronger in 2006, helped by anticipated improvement in private spending, low interest rates, and reasonable income gains (due to tax cuts and the resumption of modest employment growth). Total fixed business investment began to contract in the second half of last year and should shrink further this year because of plunging business confidence, falling industrial output, and squeezed profit margins, which in turn were impaired by persistently high oil prices and the strong euro. More encouragingly, business investment should begin to recover in mid-2006, helped by low interest rates and an improved economic outlook in Italy and across the Eurozone. In addition, firms will need to renew their machinery and equipment after a prolonged period of depressed capital spending.

Softer global growth and the stronger euro will obviously weigh down Italian exports this year and in 2006, but should accelerate in 2007 as domestic spending across the Eurozone fortifies. Consequently, exports of goods and services are projected to disappoint in 2005, but are expected to improve gradually from 2006.

Further out, GDP growth is set to remain below 2.0% over the next ten years or so, as the population ages markedly. We assume that this will only be partly compensated for by an increase in the labor force participation rate. In addition, we assume that investment will increasingly become a growth driver over the longer-term, as companies seek to boost productivity and increase the capital content of their production process to compensate for the declining workforce. In addition, Italian exporters will struggle to overcome intense competition from low-cost producers from Far East and Eastern Europe. We also assume that consumer spending will be propped up to some extent over the longer term by a reduction in the currently high savings rate.

Consumer Demand

Consumer spending continued to grow very gradually in the fourth quarter, rising 0.2% q/q again. Consequently, the year-on-year increase accelerated to 1.1% in the fourth quarter, after having slowed to just 0.3% in the third quarter. Nevertheless, spending still remains weak, with depressed household sentiment offsetting the positive backdrop of historical low interest rates and continuous employment growth.

Other spending indicators also suggest that consumer spending failed to gain any momentum at end-2004. The value of retail sales rose a seasonally-adjusted 0.3% quarter on quarter (q/q) in the fourth quarter, according to ISTAT. Meanwhile, unadjusted data show that retail sales were down 1.1% year on year (y/y) during the quarter. In volume terms, retail sales are likely to have declined fairly substantially in the final quarter, given that annual consumer price inflation was 2.0%. In addition, the demand for new car sales remained weak, down by 1.3% y/y in the final quarter of 2004.

The latest indicators point very weak consumer spending at the start of this year. The value of retail sales rose a seasonally adjusted 0.1% month-on-month (m/m) in February, after a 0.2% fall in January. Meanwhile, unadjusted data show that retail sales were up 0.6% year-on-year (y/y) in February; the first month to register an annual decline since June 2004. Nevertheless, in volume terms, retail sales are likely to have declined fairly substantially in February, given that annual consumer price inflation was 1.9% that month. In addition, the average level of new car registrations in the first quarter of this year fell 5.7% year-on-year.

Consumer confidence improved to its highest level since October 2004, as stronger sentiment about the outlook offset greater pessimism about current conditions, according to ISAE's latest household survey. The seasonally adjusted consumer confidence index rose to 104.8 in April, up from 104.1 in March and 104.4 in February, although still less than its 12-month high of 105.5 in last October. Despite the improvement in April, the index remains relatively subdued by past norms and when compared to the long-run average of 114.0. The index had been as low as 97.3 in May 2004.

Meanwhile, the core consumer confidence index (which excludes seasonal and erratic components) rose to 104.6, up from a revised 104.4 in March and 103.7 in both January 2005 and December 2004. It has trended up slowly from a 10-year low of 99.4 in May 2004. This index also has a long-term average of around 114.0, so it too remains relatively low by past norms.

Although overall confidence improved in April, we still expect spending to remain weak in the next few months. Worryingly, the survey was conducted before Berlusconi's 20 April resignation, which could trigger a renewed slump in confidence in May, as confidence is already under pressure from the growing impact of soaring crude oil prices and the stagnant Italian economy. In this current climate of uncertainty, households are choosing to save rather than spend the additional, disposable income generated from the moderate tax cuts at the start of 2005, which does not bode well for overall growth prospects, given the importance of the consumer sector to the overall economy.

Assuming the current political crisis is resolved quickly, we expect a sustainable turnaround in confidence in the latter months of 2005, which, coupled with low interest rates, should help to lift consumer spending growth from the final quarter of 2005 from its current sluggish level. Consequently, household consumption is projected to grow 1.6% in 2006, up from a projected 0.7% in 2005 and 1.0% in 2004.

Over the long term, consumer spending will increasingly be hit by adverse demographics. We expect consumer spending to fall from 59.3% of GDP in 2005 to 58.9% of GDP in 2010 and 57.8% of GDP in 2025. Even this assumes that there is a decline in the currently high savings rate

Business Investment

According to ISTAT, gross fixed capital formation contracted sharply in the latter half of 2004; down 1.7% q/q and 1.2% q/q in the fourth and third quarters, respectively. In addition, the year-on-year growth slowed from 2.5% y/y to 0.5% y/y in the fourth quarter.

Within this segment, construction investment declined 0.7% q/q, but was still 3.2% higher than it had been a year ago. Meanwhile, equipment investment shrunk sharply for the second successive quarter, down 1.5% q/q in the fourth quarter of 2004. Clearly, industrial investment intentions have taken a tumble as business confidence and industrial output continue to weaken.

Business confidence fell for a third successive month in April, to its lowest level since July 2003. Apart from briefly stabilizing in January, business confidence has been trending steadily downwards since reaching a near-two-year high last August. The seasonally adjusted ISAE business confidence index weakened to 84.6 in April, down from 85.0 in March, 86.6 in February, and a peak of 91.1 in August.

The decline in business confidence has been significantly influenced by companies' pessimism about their order levels. Indeed, this sub-index deteriorated to an 18-month low of -25 in April, from -21 in March and -14 at the end of 2004. Although companies were modestly more comfortable about their inventory levels, with the sub-index for this edging down to +10 in April from +11 in March, they still remain at historically high levels. Surprisingly, the production outlook improved slightly to +12 from +10 in March, its lowest level since November 2001.

The weakness of business confidence does not bode well for investment and employment in the near term, at least. Furthermore, with political instability, high oil prices, a strong euro, and the fourth-quarter contraction in Italian GDP—all major sources of concern—it is hard to see business confidence improving markedly any time soon.

The fact that business confidence deteriorated again in March reinforces our view that sentiment will be fragile and prone to relapses for some time to come, given significant domestic economic problems, the strength of the euro, persistently strong oil prices, and concerns that global growth is slowing. Consequently, we believe that businesses will remain cautious about employment and investment for most of this year.

We expect to witness a sustainable improvement in confidence next year, which will encourage companies to step up their investment, encouraged by relatively low interest rates and firmer demand across the Eurozone. Consequently, corporate capital spending is now forecasted to resume modest growth from the final quarter of this year, before gathering momentum from next year. In addition, firms will need to renew their machinery and equipment after a prolonged period of depressed capital spending.

Over the longer term, we expect investment to increasingly become a growth driver, as companies seek to boost productivity and increase the capital content of their production process to compensate for the declining workforce and their ability to compete with low-cost producers in the Far-East and Eastern Europe. Specifically, we project fixed investment to rise from 19.5% of GDP in 2005 to 19.9% of GDP in 2010 and 22.2% of GDP in 2025.

Inflation

Consumer prices rose for the third successive month in April, rising by 0.2% month-on-month (m/m), after increases of 0.2% in March and 0.3% in February, according to final

ISTAT (Italian statistics office) data. Nevertheless, the annual rate of inflation was unchanged at 1.9% in April and remained well below its 2004 peak of 2.4% in June.

In addition, consumer price inflation averaged 2.2% in 2004, its lowest annual average since 1999 (when it was 1.7%) and down from 2.5% in 2003.

The inflation performance has been remarkably subdued in recent months, given the persistent strength of crude oil prices. A key factor has been falling communications costs, which dropped by 0.6% m/m in April and were 4.7% lower than a year earlier.

Higher oil prices resulted in a steep surge of transportation costs, which rose 0.4% m/m and 4.2% year-on-year (y/y). In addition, housing, electricity, and fuel costs expanded by 1.1% m/m and 4.8% y/y. Crude oil prices rose to new nominal record highs in March and early April. For example, having eased from its previous peak near US$52.0/barrel in October 2004 to trade under US$40.0/barrel at times in December, Brent oil rallied to average US$52.9/barrel in March. It eased marginally to US$51.9/barrel in April.

The strength of the euro against the US dollar has partly diluted the effect of high crude oil prices in euro terms, although the Eurozone currency actually eased back from its lifetime high of US$1.367 in late December to trade back under US$1.300 at times in January-May. Consequently, Brent oil prices in euro terms fell from a peak monthly average of 39.8 euro/barrel in October to 29.8 euro/barrel in December, before rejuvenating to a new peak of 40.1 euro/barrel in April.

Service sector inflation edged up in April, with hotels and restaurant prices rising by 0.6% m/m and 2.9% y/y. In addition, prices in the other goods and services category were flat over the month but still 3.1% higher than a year ago.

On the EU-harmonized measure, consumer prices increased 0.8% m/m in April after a 1.2% advance in the previous month. The annual rate of inflation edged up to 2.2% in April, from 2.1% in March. The Italian inflation rate was slightly higher than the Eurozone average inflation rate (estimated at 2.1% in April by Eurostat) and just breached the European Central Bank's targeted ceiling of 2.0%.

The inflation performance remains largely encouraging, given the backdrop of high crude oil prices. We had expected the steep climb in oil and several other commodity prices to lift the headline rate above 2.5% during summer, but the headline inflation rate actually fell to a five-year low of 1.9% in November, and was 1.9% in March 2005.

Inflation is likely to be pressurized for some time to come by high oil prices. Indeed, oil prices set new record nominal highs in March and early April, with Brent trading above US$55/barrel on occasions, and they are forecasted to remain relatively high during the coming months. We currently expect Brent oil to average US$47.7/barrel in 2005 and US$46.6/barrel in 2006. In addition, several commodity prices remain relatively strong.

On a positive note, the strength of the euro against the dollar should help to contain oil prices, and also have some dampening impact on raw materials and other dollar-denominated imported products. We expect the euro to trend up, and is expected to peak at US$1.50 in 2006. In addition, strong competition should help to contain inflation at the consumer price level, particularly as recent buying patterns show that consumers are very price-conscious. Indeed, moderate growth overall in 2005 should ensure that households continue to enjoy heavy price discounting.

The inflation profile over the next 12 months is encouraging. We expect high crude oil prices to keep feeding through over the next few months, and the headline inflation rate is likely to edge up slightly in the next few months. Nevertheless, the current strength of the euro, falling communication and food prices, and relatively gradual economic recovery should help to offset some of the inflationary impact of persistently high crude oil prices. In the latter months of this year, the headline inflation rate is set to fall, from around 2.0% during the summer months to 1.8% by the end of the 2005, amid softer oil prices and weak domestic spending.

Labor Markets

The labor market held up relatively well in the fourth quarter of 2004, despite economic activity having suffered a renewed relapse. Total employment grew 0.2% quarter-on-quarter and 0.5% year on year, to stand at 22.54 million at end-2004. This implied that employment rose 0.8% in 2004 as a whole; down from a 1.5% increase in 2003.

The seasonally adjusted number of unemployed only edged up to 1.959 million in the fourth quarter from 1.949 million in the third quarter. Meanwhile, the unemployment rate remained at 8.0% in the fourth quarter, its lowest level in more than a decade, according to ISTAT. The unemployment rate had been as high as 8.7% in the first quarter of 2003.

Yet ISTAT indicated that the low unemployment rate was significantly influenced in the second half of 2004 by fewer people looking for work. The employment rate was 57.8% in the fourth quarter. The seasonally-adjusted number of employed stood at 22.450 million in the fourth quarter, as compared with 22.408 million in the third. Consequently, the labor force increased to 24.409 million in the fourth quarter, up from 24.357 million in the third.

There continued to be a huge difference in the strength of the labor market across the country. In the north, the employment rate was 65.2%, but it was just 46.5% in the south.

We do not expect to witness any significant improvements in the labor market until 2006.Total employment growth is projected at 0.2% this year, before accelerating to 0.6% in 2006. We anticipate that public-sector employment at both the central and local government levels will face pressure as a result of the restrictive public-spending ceilings announced in the 2005 budget. Meanwhile, an uncertain business climate and uneven industrial production will continue to squeeze industrial employment this year, as companies continue to prune their workforces, given the uncertain economic picture. A continued source of employment opportunities will be the private services sector.

The unemployment rate is forecasted to edge up slightly, to 8.2% this year from an estimated 8.1% in 2004. A more vigorous development in the labor market is expected to resume from early 2006 as economic growth picks up. Consequently, the unemployment rate is projected to start to trend down again, falling to average 8.0% in 2006 and 7.7% in 2007.

Monetary Policy

(See discussion of monetary policy under Germany, Monetary Policy)

Fiscal Policy and Public Finances

The government presented its 2005 budget, which proposes a package of fiscal corrective measures worth 24 billion euro intended to keep the budget deficit below the European Union's ceiling of 3.0% of GDP. The overall fiscal package will consist of 7 billion euro in one-off measures, such as the sale of government real estate; 7.5 billion euro from other revenue-raising measures, including further moves to reduce tax evasion; and 9.5 billion euro from new limits on government departmental spending. This implies that ministerial spending will rise by 2% in nominal terms, which translates to a spending freeze in real terms. Pensions and other welfare payments will be excluded from the cap, and are projected to rise by 3.9% in 2005. Overall, government spending, excluding debt servicing and investments, will increase by 2.6%, lagging behind the projected 2.8% rise in revenues. Economy Minister Domenico Siniscalco hopes the measures will lower Italy's public-sector budget deficit from around 2.9% of GDP in 2004 to 2.7% in 2005.

The government has won final parliamentary approval for modest tax cuts beginning in January 2005, reversing a previous statement not to cut income taxes until 2006 (a general election year). Prime Minister Berlusconi had pledged to lower taxes during his election campaign in 2001, and insisted during last summer that he planned to lower income taxes some 12 billion euro throughout 2005–06. Initially, he was forced to cancel the tax cuts for this year because of significant concerns over the country's deficit and debt figures. After threatening to call an early general election, Berlusconi was able to win agreement from his government coalition partners to accept his tax-cutting agenda after all. The approved tax cuts for the beginning of this year total 6.0 billion euro, or around 0.5% of Italy's GDP, and are likely to have a modest impact on growth in 2005, but could help to improve persistently low consumer confidence. In the current climate of uncertainty, however, a significant risk is that households could decide to save rather than spend additional disposable income. An immediate concern is that the agreed tax cuts will place additional pressure on Italy's already soaring public-sector budget deficit, which is set to exceed 3.0% of nominal GPP, both last year and in 2005. The government has so far outlined funding for just 4.0 billion euro of the tax cuts, primarily from an amnesty on illegal building, raising other minor taxes, increased tax receipts from stronger growth (0.4 billion euro), and 0.6 billion euro from further ministerial spending cuts.

The government introduced cost-cutting measures and tax increases from July 2004, raising 7.5 billion euro last year. The plan will consist of 2 billion euro from one-off measures, such as the sale of real estate, 4.2 billion euro from spending cuts, and 1.3 billion euro from increased tax receipts through reduced tax breaks for the insurance and finance sector. The spending cuts include trimming the budget of incentives and subsidies to firms and national/regional funds by 1.25 billion euro, coupled with a 2.6-billion-euro reduction in transfers to government ministers. The total package is worth around 0.7% of GDP, exceeding the European Union's demand for fiscal tightening by 0.5% of GDP, to ensure the budget deficit does not slip over the 3%-of-GDP limit.

As expected, public finances deteriorated markedly in 2004. The general government budget deficit amounted to 3% of GDP last year, compared with an upwardly revised 2.6% of GDP in 2003. Nevertheless, Italy did not exceed the 3.0%-of-GDP ceiling allowed under the Growth and Stability Pact, which we had expected. However, the deficit is expected to widen to 3.6% of GDP this year, breaching the ceiling for the first time and overshooting the government's current estimate of 2.7%. The difference is due to our more conservative 2005 growth forecast, with the economy now expected to contract by 0.1%. More generally, the public accounts have to absorb some 5.8 billion euro of tax cuts this year, while the government has curtailed the popular use of one-off measures to raise revenue after sharp criticism from the European Commission.

The government won a confidence vote in parliament on its bill to reform the country's pension system at the end of July 2004. The government argued that low birth rates and an ageing population make the current pension system unsustainable. The official retirement age for men is 65 years, but Italy has a pension, called the *anzianita*, which allows a man to retire with pension at the age of 57 if he has made 35 years of contributions. The pension reform bill will raise the minimum age of male retirement with pension from 57 to 60, or after 40 years of contributions, up from the current 35 years. From 2010, the retirement age is set to rise to 61 and may be upped again to 62 in 2013. Women can continue to retire at 57 as long as they have paid in 35 years of contributions. The bill also introduces an incentive to keep individuals from retiring with the anzianita pension between 2004 and 2007 by allowing them to remain at work, exempt from paying pensions contributions. In addition, the current earnings-related system, where pensions are calculated from a person's earnings in the last few years of employment, is being gradually replaced by a contributions-based system. The bill states that the pensions of those joining the labor force from 1996 will be calculated purely on the basis of contributions. Finally, the government expects the reform to generate savings of around 0.7% of GDP each year from 2012 to 2018, and 0.6 percentage point of GDP between 2018 and 2030.

The government presented its 2004 National Budget in late September 2003. The main focus is to raise 16 billion euro from spending cuts and revenue-raising measures in attempt to keep the public sector budget deficit below the 3.0%-of-GDP ceiling allowed under the Stability and Growth Pact. The Treasury hopes to raise 10 billion euro in one-off measures, which include the continuation of the tax amnesty program and further securitization of state real estate assets. In addition, they hope to save around 1.8 billion euro from a cut in spending on social services and healthcare as well as lower central grants to the regional authorities. On the plus side, the 2004 budget aims to spend 5 billion euro to boost the economy, with around 2 billion euro allocated for infrastructure and research projects. Meanwhile, the government will now pay 1,000 euro to Italians on the birth of their second-born child, with this scheme running until August 31, 2005. There will be a six-month extension of the amnesty on disputed income tax claims until March 16, 2004. Finally, newly listed companies will be awarded 20% tax breaks. The 2004 National Budget was underpinned by a relatively upbeat view of the economy. The government expected the economy to grow by 0.5% in 2003 and 1.9% in 2004. The general government budget deficit was forecast to fall from 2.5% of GDP in 2003 to 2.2% of GDP in 2004. As was indicated well in advance, the government is aiming to save 16 billion euro in 2004 through deficit cutting measures, while it expects to raise 10 billion euro through one-off measures, including a tax amnesty. Global Insight believes both the growth forecasts and the projected budget deficits are very optimistic.

The government introduced tax cuts in January 2003, thus attempting to satisfy a key election pledge. Prime Minister Berlusconi lowered income tax by 7.5 billion euro ($19.6 billion), with some 5.5 billion euro targeted at employees earning below 25,000 euro a year. He estimated that approximately 28 million Italians enjoyed a lower income tax burden last year. Berlusconi also announced 20 billion euro of deficit reduction measures in order to pay for the tax cuts and to improve general government finances. The package to boost the government's fiscal position comprised of 8 billion euro of public spending cuts, and one-off revenue boosts from the continuation of the tax amnesty program and further securitization of state real estate assets.

Exchange Rate

(See discussion of the Euro under Germany, Exchange Rate)

Trade and External Accounts

According to ISAT, net exports were a significant drag on growth in the fourth quarter, in contrast to its gains in the third and second quarters. They lowered fourth-quarter growth 1.4 percentage points, as compared with a 1.1 percentage point lift in the third. The large drag on growth from net trade was due to a steep decline in exports of goods and services, which fell 4.7% q/q in the fourth quarter after having risen 4.8% in the third. In addition, year-on-year increase in exports slowed to 1.7% in the fourth quarter, down from rises of 5.6% y/y in the third quarter and 6.1% in the second. Italian exports appeared to be hurt by softer global growth and a strengthening euro, appreciating from slightly more than US$1.27 to US$1.36 in the fourth quarter. Imports of goods and services were flat during the quarter, but were still up 2.5% y/y.

In 2004, the current-account deficit was 11.0 billion euro, a marked improvement from the 16.9-billion-euro deficit recorded in 2003. This was due to a surplus posted on the services accounts, reversing the deficit in the corresponding period in 2003. The services balance posted a 2.3-billion-euro surplus in 2004, a significant turnaround from the 2.7-billion-euro deficit in the year-earlier period. Meanwhile, the trade balance generated an 8.0-billion-euro surplus, down from the 9.9-billion-euro surplus in 2003. The current-account deficit narrowed from 1.4% of GDP in 2003 to less than 0.8% of GDP in 2004.

The recent surge in global crude oil prices to over US$50 per barrel this year presents a considerable threat to the current deficit in the next few months. Worryingly, the current-account deficit widened significantly in the first month of this year, by 1.9 billion euro to 4.4 billion euro.

Exports of goods and services are set to struggle this year, hurt by the dampening impact of the strong euro, strong competition from the Far-East and softer global economic growth, particularly the stuttering recovery across the Eurozone. Consequently, exports of goods and services are projected to remain weak in 2005, struggling to exploit some reasonable growth in the trade-weighted index of world demand for Italian products, which suggests Italian exporters continue to suffer from the euro's relative strength in conjunction with intense competition from low-cost producers from the Far-East and

Eastern Europe. Weak domestic spending will suppress import demand this year, but net trade is still expected to be a drag on growth.

Softer global growth and the stronger euro will obviously weigh down Italian exports this year and in 2006, but we expect stronger export figures in 2007. The main factor behind the improvement in 2007 is the prospect of a stronger Eurozone economy bolstered by real GDP growth accelerating to over 2.0% during the year. This is significant because around 70% of Italian exports go to other European countries.

A downside risk is that the euro is projected to strengthen significantly to US$1.50 by end-2006, harming Italian competitiveness in non-Eurozone markets and thus restricting export growth to around 3.0% in 2006. Given that we expect the euro to fall moderately in 2007, Italian export growth is forecasted to quicken to just over 4.0% in 2007.

ITALY

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	1,077.29	1,978.75	2,502.87	4,322.61	12.9	4.8	3.7
Nominal GDP per capita, US dollars	18,742	34,321	43,130	73,378	12.9	4.7	3.6
Real GDP, billion real 2000 US dollars	1,075.49	1,130.48	1,241.53	1,647.25	1.0	1.9	1.9
Real GDP per capita, real 2000 US dollars	18,711	19,608	21,394	27,963	0.9	1.8	1.8
Real private consumption, billion real 2000 US dollars	645.83	678.93	745.66	990.31	1.0	1.9	1.9
Real government consumption, billion real 2000 US dollars	201.35	217.96	236.97	304.20	1.6	1.7	1.7
Real fixed investment, billion real 2000 US dollars	213.18	223.80	249.48	350.20	1.0	2.2	2.3
Real exports, billion real 2000 US dollars	303.95	309.22	369.37	623.31	0.3	3.6	3.6
Real imports, billion real 2000 US dollars	293.45	306.74	367.40	633.37	0.9	3.7	3.7
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	27.51	26.63	28.44	33.36	-0.6	1.3	1.1
Mining	5.23	5.93	6.12	7.01	2.5	0.6	0.9
Manufacturing	203.25	208.05	233.74	315.71	0.5	2.4	2.0
Utilities	21.58	24.73	27.92	38.37	2.8	2.5	2.1
Construction	47.88	54.21	58.21	68.73	2.5	1.4	1.1
Wholesale & Retail Trade	165.91	170.24	191.33	266.55	0.5	2.4	2.2
Transport & Communication	73.58	82.08	93.86	137.09	2.2	2.7	2.6
FIRE	259.43	292.50	329.50	465.44	2.4	2.4	2.3
Other Services	192.63	205.68	225.81	286.24	1.3	1.9	1.6

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	60.1	59.3	58.9	57.8	-0.7	-0.4	-1.1
Government consumption share of GDP	18.7	19.4	19.2	18.8	0.7	-0.2	-0.4
Fixed investment share of GDP	19.8	19.5	19.9	22.2	-0.3	0.4	2.3
Exports share of GDP	28.3	27.0	28.7	34.3	-1.3	1.7	5.6
Imports share of GDP	27.3	25.7	27.1	33.2	-1.6	1.4	6.1
Net extports share of GDP	1.0	1.3	1.6	1.1	0.3	0.3	-0.6

IV. South America

Venezuela

Overview

Short Term

First-quarter 2005 GDP figures did not show any big surprise. Overall, they repeated the same growth pattern of 2004; that is, strong domestic demand and sluggish oil and export sector. We do not expect this pattern to change during the remainder of 2005 or in 2006, as current conditions prevail. The government will continue to struggle with increasing oil output capacity, which could even decline in the short term amid new problems at Venezuela's state-owned oil company, PDVSA. Furthermore, the government's recent statement that private oil companies must pay back-taxes could jeopardize the permanence of some of these firms in the country. Such a scenario would be devastating for the oil sector as it has been the expansion of oil output by private companies that has kept the overall oil sector afloat in recent quarters.

On the other hand, stubbornly high oil prices will allow the government to sustain its current public spending levels for the rest of 2005 and likely for most of 2006. Such an impressive fiscal stimulus will continue to be the main growth driver of the economy in the short term. Yet, the government will find it increasingly difficult to keep the economy growing without the help from the private sector. Yet, increasing government intervention in the economy will do little to attract much-needed private investment. Thus, we expect economic growth to decelerate progressively from 2004's pace and to reach about 4% in average over the 2005–06 period. The long-term sustainability of the current expansion will depend heavily on the government's ability to boost oil output capacity and upon oil prices.

Medium Term

Over the medium term (2007-11), we expect the economy to keep growing around 4% annually on average. Such a rate is similar to that of the 2005-06 period, but the downside risk to our baseline scenario increases considerable over the medium term. Indeed, many assumptions would have to hold in order for the economy to grow at this rate in the medium term. As mentioned before, the government must find a way to boost oil output capacity over the medium term. This is perhaps the biggest assumption of our baseline scenario forecast—along with oil prices.

After 2006, the government will find it impossible to keep sustaining the economy by itself through a very expansive fiscal policy. Even if oil prices remain relatively high over this period the government's fiscal stimulus will tend to lose effectiveness and its impact on the economy will fade a bit. One of the reasons for this will be the inflationary impact of such expansive fiscal policy. Thus, the government's expansive fiscal policy will not longer be the main growth driver of the economy in the medium term. Our baseline scenario anticipates the oil sector being the main growth driver of the economy. A massive investment plan to increase oil output capacity will come to effect in the medium term. Such investment effort will have a cascade positive effect on other key sectors of the economy such as construction and manufacturing. Meanwhile, real oil exports will start growing at the fastest pace since the mid-1990s, thus boosting the economy's overall growth rate. For this investment plan to realize, the political elite in the country must reach some sort of consensus regarding the oil industry and the participation of the private sector in its development. Without private capital, the government will continue to struggle to increase oil output capacity.

On the other hand, increased government intervention, still-high-inflation levels, and an unstable political climate will prevent economic growth from reaching its potential over this period. Indeed, we expect the political climate to remain heated in the medium term, thus preventing the economy from reaching its full potential (growth rates of over 5%). In fact the political variable remains one of the main risk factors to the economy in the medium term. Under a risk scenario, the current political crisis worsens in the medium term, thus preventing the government from pushing forward much-needed reforms—especially in the oil sector.

Long Term

In the long term (2012–25), we expect economic growth to average 3.4%. Regardless of any possible political shock, the economy will remain oil-depended in the foreseeable future. This, of course, means that the economy will remain very vulnerable to oil prices movements and, therefore, is likely to experience deep expansion-recession cycles, as in the recent past.

Of course, for the economy to reach such a long-term growth rate, the country would need to make strides on multiple fronts. We can identify two big areas where Venezuela needs to advance to achieve its growth potential in the long term: the political/institutional and the economic/oil policy. Lack of political stability and weak democratic institutions have been a constant drag for growth during the last few years—specially since the mid-1990s. Such volatility on the political front has prevented any government from implementing sound economic policies amid fears of failing and facing turmoil. Venezuela's political system has suffered important changes since the mid-1990s that resulted in weak institutions and power vacuums, such as the practical disappearance of mainstream political parties. This situation has slowed economic growth considerably.

A dramatic turnaround in the country's oil policy during the mid-1990s—more specifically, after 1997—had an equally important negative impact on the economy. During the early 1990s, Venezuela initiated the opening of the oil sector, which allowed limited private investment into this key sector and helped the country to increase its oil output at an impressive pace. Such increase in oil output had an important multiplicative effect over the rest of the economy and fueled growth during the early 1990s. With the assumption of Chavez to power in 1998, the government abandons this policy and cuts oil output significantly in order to maximize fiscal revenues—lower output by Venezuela and the other OPEC members gave a boost to prices. In our view, for Venezuela to achieve its trend growth rate, the country must come back to an oil-output expansion program that would give a definite boost to the economy. In order for this to happen, the political system must develop and stabilize—the only possibility of reaching a political consensus on oil policy. We believe that this could happen in the long term, though the risk of the contrary seems to increase day by day.

On the economic policy front, Venezuela needs to become more fiscally responsible and decrease its dependence on oil revenues. Only an oil output expanding program and an increase in non-oil tax revenues will prevent the country from facing frequent financial crisis every time prices plummet. Furthermore, the public sector has to become significantly smaller and more efficient. Meanwhile, the country needs to allow further private investment in oil-related activities and privatize its remaining non-oil productive assets—e.g., aluminum sector.

Economic Growth

The economy continued to grow vigorously in the last quarter of 2004 amid high oil prices and booming public spending. According to preliminary figures from the central bank, the economy expanded 11.2% year on year (y/y) during the fourth quarter of 2004; down from 14.1% in the previous quarter. Most industries performed very well in the last quarter of the year, with the notable exception of the oil sector. Indeed, oil GDP contracted 5.9% y/y in the last quarter of 2004, thus confirming the fact that the oil industry has failed to recover completely from its 2002/2003 oil strike. This comes a bit as a surprise given the current level of oil prices. Yet, it also speaks of the difficulties the government is having in putting PDVSA (Venezuela's state-owned oil company) back on track after having fired half its employees in the aftermath of the 2003 strike. Curiously, PDVSA has refuted the central bank's GDP figures, saying it actually increased output in the last quarter of 2004. This conflict only brings more uncertainty regarding the actual level of oil output in the country—not even PDVSA seems to know how much it is producing.

Yet, the performance of the non-oil sector in the fourth quarter (14.2% growth) easily offset the contraction in the oil industry in this period. Indeed, the non-oil sector grew faster than had been expected in the fourth quarter, amid a very expansive fiscal policy and improved macroeconomic stability. The sectors that showed above-average growth in this period were banking and insurance (19.8%), construction (18.1%), commerce (23.1%), transport (23.8%), manufacturing (15.6%), and government services (15.4%). The performance of the manufacturing sector in particular brings hopes of a sustainable recovery. All these sectors benefited from a solid expansion in aggregated domestic demand in the fourth quarter, while the exporting sector added little to the performance of the economy in this period, due to declining oil export volumes.

Thus, the economy grew 17.3% in 2004; the highest pace ever recorded. This impressive figure partially reflects a very low comparison base; bear in mind that the economy contracted 16% in the previous two years. Yet, 2004's recovery has been stronger than initially anticipated even after considering the “statistical rebound” effect. Such impressive recovery has been possible thanks to the current oil windfall, which the government has poured into the economy without any restraint. The impressive expansion in public spending had a positive impact in both private and government consumption as well as in total investment. Thus, private consumption grew 16.6% in 2004 followed by government consumption, which expanded 13.9%. Meanwhile, total fixed gross investment expanded 43% in 2004. Private consumption benefited from a more stable macroeconomic environment and lower unemployment as well as a greater availability of imported items, thanks to the easing of foreign exchange controls.

Our latest forecast calls for the economy to grow 4% in 2005. Our latest GDP growth forecast represents an upward revision from the previous 3.5%, and comes after higher-than-expected GDP growth figures for the last quarter of 2004 and stubbornly high oil prices. Indeed, the ongoing oil windfall has allowed the government to boost public spending while keeping inflation and the exchange rate under control. Yet, some macroeconomic unbalances keep accumulating, and could start taking their toll on the economy as soon as the second half of 2005. Similarly, an unexpected drop in oil prices could seriously jeopardize the sustainability of the ongoing economic recovery.

Yet, the likelihood of this negative scenario—lower oil prices and huge macroeconomic unbalances—has somewhat diminished in recent months. Indeed, we expect the economy to keep growing at around 3.8% in 2006, thanks largely to stubbornly high oil prices. As mentioned before, high oil prices allow the government to boost its public spending, which, in the case of Venezuela, is enough to keep the economy growing in the short to medium term. Thus, as in 2004 and 2005, government spending will continue to be the country’s main growth driver in 2006. On the negative side, increasing government intervention in the economy and a still-uncertain political climate will prevent the economy from reaching its full potential in 2005 and 2006.

In the long term, the country’s main growth driver will be the oil sector. Venezuela has the biggest oil reserves in the Western Hemisphere and must tap these huge resources to drive its economic development. In order for this to happen, the country must open its oil sector, at least partially, to the private sector as huge investment amounts are required to tap the tap the country’s huge oil potential. Our baseline scenario assumes that the country will effectively increase its oil output capacity progressively over the long term. Such oil expansion will, in turn, have a positive cascade effect over the rest of the economy though the country will remain mostly oil centered over the foreseeable future.

Consumer Demand

The central bank’s real retail sales index increased 28.9% year-on-year (y/y) in February, up from 25.3% in the previous month. Thus, real retail sales expanded 27.1% y/y in the first two months of 2005. All but two of the 12 subcategories in the real retail sales index showed double-digit gains in the first two months of 2005. The leading sectors were motor vehicles (121.0%), appliances (74.9%), and drugs and other pharmaceutical products (52.3%). Car sales, in particular, remained very strong in early 2005 amid more favourable financing conditions and relative price stability. Meanwhile, the only subcategories that did not expand at double-digit rates in this period were sales of food and beverages (3.2%) and gasoline (4.0%).

Retail sales remained very strong in January and February, which indicates that domestic demand continued leading the economy in early 2005. Declining unemployment and rising average income—both due to the ongoing oil windfall—have stimulated retail sales since early 2004. Meanwhile, negative, real interest rates and slowing inflation have also prompted an increase in consumers' purchasing power.

We expect the real retail sales index to continue showing positive, year-on-year growth rates in the next few months, although we anticipate a progressive deceleration will start by mid-2005. Furthermore, a potential decline in oil prices and renewed political uncertainty could threaten the sustainability of the current expansion going into the last quarter of 2005. These risks will increase in 2006, as the country prepares to elect (or re-elect) a new president by the end of the year.

Auto sales reached 19,263 units in April, up 114% from a year earlier. Of that total, 6,645 units (36%) belonged to the family car category. The family car program allows low/median-income families to buy affordable automobiles that are tax-exempt. This program has been a huge success since its introduction in 1999 and currently accounts for about 40% of the overall auto market. Cumulative auto sales reached 61,905 units over the first four months of 2005, up 91% from the same period a year earlier. Family car sales reached 22,828 units over the same period. Meanwhile, domestically assembled vehicles reached 41,508 units over the first four months of 2005, up 47% from a year earlier. This means that sales of imported vehicles have easily outpaced nationals so far in 2005. Indeed, imported car sales grew 384% over the first four months of 2005—about half of those imports come from the Andean region and thus have a special tax regime.

Booming auto sales over the first four months of 2005 suggests still-strong domestic demand. Consumption of durable goods, in particular, has remained quite strong in recent months amid decelerating inflation, negative real interest rates and a strong currency. We expect auto sales to keep growing at double-digit annual rates over the next few months as the aforementioned conditions remain mostly in place. Nevertheless, do not expect April's impressive results (114%) to repeat in the next few months because the government has just announced the end of the family car program, and it will not introduce a substitute program at least until the third quarter of 2005.

Inflation

Venezuela's central bank said that its consumer price index grew 2.5% in May; up from 1.3% in the previous month and 1.2% a year earlier. May's inflation figure came as a result of a 3.8% increase in the average price of non-regulated goods and services—mostly due to higher food prices. Meanwhile, the average price for regulated items increased just 1.1% in the same period. Looking at the different subgroups, we find that the price index for food and beverages, household goods and services, and restaurant and hotels registered the largest increases in May, at 5.4%, 4.8%, and 3.3%, respectively.

The central bank also reported that the core inflation index, which excludes highly volatile items, increased 1.9% in May, as compared with 2.5% for the overall price index. A lower core inflation figure usually indicates that overall inflation is set to decelerate in the immediate figure. Indeed, when looking at May figures, we observe that the biggest factor behind the acceleration in inflation was a higher-than-normal increase in food prices—probably due to climate-related factors. Such abnormal price increase in food prices is unlikely to repeat in upcoming months, which would help curbing overall inflation down.

Annual inflation reached 17.4% by end-May, up from 15.8% in the previous month, but still down from 21.8% a year earlier. May's annual inflation figure represents the highest level since January, and breaks an eight-month declining trend. While May inflation figures certainly came higher-than-expected, we do not believe that they anticipate a drastic acceleration in inflation over the next few months. As we mentioned before, abnormal (one-time) price increases in some food items explain most of May's acceleration in inflation. Nevertheless, inflation will not decelerate in the next few months either, despite the stability of the exchange rate (both official and black market) and the upholding of wide spread price controls.

Thus, we expect inflation to accelerate a bit in 2005 as the government makes overdue price adjustments on some goods and services and devalues the official exchange rate. The size of those adjustments will depend in part on the behavior of oil prices. Similarly, strong domestic demand and lax fiscal and monetary policies will also put some pressure on prices over the next few months. Thus, Global Insight expects inflation to end 2005 at 26.1%, up from 19.2% at the end of 2004. In the longer term, we expect inflation to continue at double-digit levels until at least 2010, keeping Venezuela as one of the countries with higher inflation in Latin America.

Labor Markets

Unemployment in Venezuela averaged 12.1% in April, down from 16.3% a year earlier. According to the government's statistics office (INE), 1.451 million people were out of work in April, down from 1.972 million a year earlier. Unemployment averaged 13.98% in the 12-month period ending in April, down from 17.21% in the year-earlier period. April's 12-month average figure represents the lowest unemployment level since May 2002. We expect joblessness to continue dropping on a year-on-year basis through mid-2005, as the economy continues to rebound. Yet, we also expect unemployment to remain above 10% in the medium term.

The ongoing expansion of the economy and the government's aggressive increase in public spending continue to benefit the creation of new jobs—at least temporarily. Indeed, the unemployment rate has dropped consistently since the second half of 2003, although it still remains high by international standards. The main factor behind the ongoing rebound in the job market has been the impressive expansion of government spending. Such a boost in public spending has been possible thanks to the country's current oil windfall.

On the negative side, the quality of the new jobs being created is not the best, as many of them are in the public sector—and thus subject to instability—rather than the private sector. Furthermore, a drop in the rate of "informal" employment has not accompanied the decline in unemployment. Indeed, the number of informal workers—mostly street vendors and the self-employed—remains close to 50% of those counted as employed. These figures are among the highest rates in Latin America.

Over the long term, Venezuela's demographic situation will continue to represent a positive factor for growth. Indeed, Venezuela has a very young population and still enjoys one of the highest population growth rates in Latin America, which warranties that the country will remain "young" in the long term. On the negative side, this rapidly growing population will also impose an increasing burden on the country's public finances as social-related expenses grow exponentially. In the long term, the country will not suffer shortage of labour, but could face a severe fiscal crisis as a result of ever-growing social-related expenses—health and education in particular.

Monetary Policy

The central bank announced the imposition of limits for all interest rates starting 1 May. All loan activity rates will have a top limit equal to the central bank's benchmark discount rate minus 0.5 percentage point. Thus, as of 1 May, all loan rates must be under 28%. Similarly, the central bank has also imposed lower limits for all deposit rates. So, as of 1 May, saving rates must be higher than 6.5%; this rate is tied to a different central bank reference rate. Clearly, the central bank wants to see the spread between loan and deposit rates reduced. Meanwhile, the central bank also imposed limits to fees banks may charge for their services.

The imposition of interest rates controls comes as no surprise, as President Chavez has mentioned them several times over the last year. The recent appointment of a close Chavez ally as head of the central bank assures that the government wishes on monetary policy matters will become reality. Meanwhile, the short-term impact of the new measures on actual interest rates levels will be moderate. Indeed, by late April, most loan activity rates were well below the 28% limit—the average rate stood around 16%. If anything, the new controls could push the average loan rate upward, as market forces become secondary. The only notable exception is with credit card rates, which by late April averaged 37.2%. Meanwhile, the average saving rate by late April stood around 5.2%, a bit below the new lower limit of 6.5%. This rate will probably stay close to such limits. In the longer term, the new controls will certainly hurt profitability in the banking sector, thus scaring potential new investors. As with other price controls, putting limits on interest rates also creates market unbalances that, if maintained over time, could prompt a serious crisis.

Meanwhile, the government appointed Gaston Parra as the new head of its central bank. Parra has been serving as first vice president for the central bank since 2000, and replaces President Diego Castellanos, who was originally appointed by Chavez in the same year.

The government also expects to renew the bank's Board of Directors in 2005, thus completing the reshuffling of the institution's top rank. Castellanos and most of the board members have had repeated clashes with government officials in the last two years, as they tried to restrain the booming fiscal spending somewhat—especially regarding the handling of foreign-exchange accounting profits. The two sides have also clashed over other issues, such as the implementation of foreign exchange and interest-rate controls.

In effect, the appointment of Parras is just another blow to the central bank's independence, and will surely have a negative impact on the country's macroeconomic stability. Although we do not expect a radical change in the central bank's monetary policy—at least in the short term—the fight against inflation will surely lose some steam as a result of the bank's reshuffle.

The central bank last cut its market intervention rate—or discount rate—on August 1, 2003. This rate has stayed at 28.5% since then, down from 42.0% at the beginning of 2003. With no legal foreign exchange market, the central bank does not need to maintain a high intervention rate in order to slow capital flight, as it did in 2001–02. Furthermore, with imposed capital controls, changes in the central bank market intervention rate have little effect on other interest rates or liquidity levels.

We expect the discount rate to remain low while foreign exchange controls last, probably until at least the second half of 2005. The lack of an active foreign exchange market has allowed the central bank to push interest rates to negative levels in real terms. Once the government lifts current foreign exchange controls—at least partially—we should see a steady rise in nominal and real interest rates. Thus, the main focus of the central bank in the first half of 2005 will remain on controlling the ever-growing monetary liquidity, a result of the excessive public spending. In order to do so, the central bank will likely continue offering attractive short-term financial instruments—mostly short-term certificates of deposits—to the banking system.

Fiscal Policy and Public Finances

The government's tax collection agency (Seniat) said that non-oil tax collection grew 67% year-on-year (y/y) in the first four months of 2005. According to Seniat, tax collections reached 11.87 billion bolivars (US$5.53 million) in this period, which surpasses the agency's target by 48%. Non-oil income tax collections grew 85.1% y/y over the first four months of 2005, while value-added tax (VAT) receipts increased by 57%. VAT collections made up 44% of total non-oil tax revenues over the first two months of 2005. Meanwhile, customs' tax collections grew 97% over this period thanks to the ongoing imports boom.

These positive tax collection figures come thanks to the ongoing boom in domestic consumption. VAT tax collections, in particular, benefit tremendously from strong economic growth and soaring domestic consumption. Aside from the obvious positive impact of domestic consumption on tax revenues, recent figures may also indicate an improvement in Seniat's collection rate and a decline in tax evasion. Yet, such improvement is hard to quantify under current circumstances. The evolution of non-oil tax collections over the next few months—when we expect domestic consumption to soften slightly—should give us a clearer picture of Seniat's supposedly improved efficiency.

Meanwhile, the head of Venezuela's tax collection agency (Seniat), has said that his institution will propose a reduction in the value-added tax (VAT) rate. Currently VAT stands at 15%, but the Seniat is mulling dropping it by two percentage points by the end of the year. Such a reduction would come in two parts: a one-percentage-point drop in August and a matching cut in November. On the other hand, the Seniat official said that some current exemptions could be eliminated, thus partially offsetting the fiscal effect of the tax rate reduction. The Seniat will pass the proposal on to the minister of finance, who in turn will present it before the full economic cabinet for consideration. Only after gaining approval from the economic cabinet would the tax reform head to Congress for its approval.

The proposed tax cut comes after the Seniat has consistently over-achieved on its tax collection targets in the first few months of 2005. The collection of VAT, in particular, has reached higher-than-expected levels thanks to the ongoing boom in domestic consumption. Meanwhile, other tax revenues such as oil remain strong, thus reducing the need for extra fiscal receipts. We believe that this situation is only temporary, however, and that a cut in VAT could be premature. Indeed, we expect tax collection to start declining in upcoming months as domestic consumption softens. Furthermore, the government will likely need every extra resource available in order to keep the current public spending expansion going. In the end, the economic cabinet might reject the Seniat's proposal because of that.

The risk of major fiscal deficits in the future has risen since Chavez took power in 1999, despite record high oil prices. Although his administration has shown some fiscal constrain at times, it has worsened the structure of fiscal accounts while raising the country’s domestic public debt. Indeed, the reliance of the fiscal sector on oil revenues has increased in recent years, as the government implemented a series of important changes in the way oil activities are taxed. Such changes made the public sector even more dependent on oil revenues than before. This has not been a big problem in recent years because oil prices have remained surprisingly strong. Yet, when oil prices come down—as they always do—we expect the fiscal deficit to reach unmanageable levels. Furthermore, the domestic public debt has increased exponentially over the last five years to reach worrisome levels by end-2004. The servicing of this debt will make future fiscal budgets even more difficult to manage in the face of declining oil revenues.

Thus, the risk for sizeable fiscal deficits in Venezuela will remain high into the medium term, as the public sector’s dependency on oil revenues increases and budgets become less flexible. Only the implementation of deep structural reforms—regarding oil taxes and the size of the public sector—will diminish the country’s fiscal risk in the future. Yet, we do not expect these reforms to take place anytime soon

In the longer term, Venezuela’s fiscal sector will remain subject to oil price volatility unless much-needed reforms come along. These reforms should focus on reducing the non-oil fiscal deficit to about 5.0% of GDP; it currently stands at over 15%. To do this, the government must increase non-oil taxes and reduce the size of the central government. We do not expect any of these reforms to appear anytime soon, so the country's fiscal performance will follow the behavior of oil prices in the foreseeable future.

Exchange Rates

The government announced 10.7% devaluation of the official exchange rate on 3 March, from 1,920 bolivars/US dollar to 2,150. The much-anticipated devaluation came a bit later than had been initially expected amid increasing opposition within the government and pro-Chavez forces. The government was also able to delay the devaluation thanks to very high oil prices in the first two months of 2005. Nevertheless, this measure was unavoidable by the government, as it had planned the 2005 budget using the adjusted rate as the average for the year. If the government does not make any further adjustment this year, the actual average for 2005 will be less than 2,150 bolivars/US dollar, thus creating some revenue shortages. Keep in mind that the main beneficiary of any devaluation is the same government, which sees its oil revenues (in bolivars) jump by the same amount of the adjustment (12% in this case). Even with oil prices keeping close to record-high levels, the government still needed to devalue the official exchange rate to finance its ever-increasing fiscal spending.

After the devaluation, government officials assured the public that there will not be any further adjustment (top the official exchange rate) in 2005. In our opinion, this will depend heavily on the evolution of oil prices in upcoming months. Even a small (and sustained) drop in oil prices could prompt the government to make a new devaluation. We do not expect this to happen in the near future, but the risk of such a scenario will increase as the year progresses.

Meanwhile, the black market rate has barely moved since last August, hovering around 2,600 bolivars/US dollar. Even March's devaluation of the official exchange rate failed to have a significant impact on the black market rate—in part because the market had already priced in such measure. Record-high international reserves and a calmer political climate have been the main factors behind this behaviour. At the same time, the government has continually increased the dollar amount it gives to the private sector at the official exchange rate which has also reduced demand in the black market.

The closing gap between the official exchange rate and the black market rate represents a good indicator going forward. The narrower this gap, the easier the potential transition to a floating foreign exchange system will be, as will lowering the needed adjustment (devaluation). Yet, we do not expect this gap to keep closing or even remain close to its current levels. Once oil prices start declining and the government tightens controls again, this gap will soar to previous levels or even higher.In the longer term, we do not expect foreign exchange controls to last beyond 2006. The longer they last, the more difficult it will become to dismantle them. Our baseline scenario anticipates a gradual dismantling of the current system over a short period; perhaps six months. After such a period, we expect the government to go return to a managed float system similar to what it had been before 2003.

Trade and External Accounts

The National Statistics Institute (INE) said that non-traditional exports—which exclude crude oil sales from PDVSA, the state-owned oil company, and iron ore—reached US$1.02 billion in the first two months of 2005, down from US$1.25 billion a year earlier. Minerals (including oil sales by the private sector) and common metals (mainly steel and aluminium) generated more than 67% of non-traditional export receipts through the first two months of 2005. The United States and Colombia remained Venezuela's main trade partners over this period, accounting for 38.2% and 13.9% of total export revenues, respectively.

The decline of non-traditional exports over the first two months of 2005 comes as no surprise given the high comparison base—these exports grew 29% in 2004—and the softening of the US economy. Strong domestic demand for some items such as steel and aluminium has also hurt export revenues, as manufacturers dedicate a larger share of their output to the local market. On the other hand, commodity prices for most of Venezuela's non-traditional exports remained quiet strong in the first two months of 2005 thus preventing a larger decline. We expect non-traditional exports growth to rebound a bit in upcoming months as some commodity prices continue strong.

Meanwhile, INE said that imports, on a CIF (cost, insurance, and freight) basis, increased 62.4% year-on-year in the first two months of 2005. Such growth rate looks even more impressive when considering that it comes on top of an 82% increase in 2004, which establishes a high comparison base for this year—keep in mind that INE imports figures do not match those of the central bank, as they represent different concepts. The United States remained Venezuela's main source of imports over this period with a 35.0% share, followed by Colombia and Brazil with 10.3% and 7.7%, respectively.

The current imports boom comes amid strong economic activity and increasing access to foreign exchange at the official rate. Indeed, since the last quarter of 2004, the government has made the foreign exchange control more flexible, and sped the processing time, thus allowing the private sector more access to foreign exchange at the official rate. This has stimulated imports, as the official rate now seems overvalued, which makes imports relatively cheap. We expect imports to remain strong throughout most of 2005 as the economy keeps growing and the exchange rate remains overvalued in real terms.

Meanwhile, preliminary figures from the central bank indicate that total exports increased 35.4% in the first quarter of 2005. Oil receipts jumped 39.3% in this period, as oil prices reached record-high levels. Meanwhile, non-oil exports increased 16.5% in the first quarter, thanks to favourable prices. Keep in mind that these figures do not match those reported by INE, as they obey different methodologies. Oil receipts represented 85% of total exports in this period, up from 83% a year earlier.

Meanwhile, the central bank reported that imports (on a free on board basis) increased 56% in the first quarter of 2005—these figures also differ from those reported by INE. Such an impressive performance comes amid strong domestic demand and an overvalued currency. Similarly, the government has eased foreign-exchange controls considerably since the second half of 2004, thus effectively cheapening the cost of imported goods.

Despite booming imports, Venezuela's trade surplus widened in the first quarter of 2005 in comparison with year-earlier results. Indeed, the country's trade surplus reached US$6.36 billion in this period; up from US$5.19 billion a year earlier.

Import growth will start decelerating in the second half of 2005, in part due to a higher comparison base. Nevertheless, imports will remain strong for most of 2005 and grow 29% over the entire year. Still-strong domestic demand and a slightly overvalued currency will keep imports growing at double-digit rates in 2005. Meanwhile export's growth will also remain strong in 2005, amid higher oil prices. Indeed, we now expect average oil prices to increase about 20.0% in 2005. Even as oil-export volumes do not increase much in 2005, total export revenues will increase by 19.8% in 2005.

We expect Venezuela's trade surplus to reach $24.8 billion in 2005, up from $22.1 billion in 2004. As always, oil prices dictate the size of Venezuela's trade surplus (or deficit). Over the longer term, we expect Venezuela's trade surplus to average between 10% and 12% of GDP, down from 20% of GDP in 2004. Venezuela's impressive oil reserves will keep the country's trade balance positive in the foreseeable future, although they could turn into a temporary deficit if oil prices were to unexpectedly crash.

Venezuela's current account surplus reached US$4.62 billion in the first quarter of 2005, up from US$3.52 billion a year earlier. The sharp increase in exports during this period is the main factor behind this improvement in the current account. Indeed, record-high oil prices are the main factors behind the impressive trade and current account surpluses in recent quarters. As mentioned previously, the size of Venezuela's current-account surplus (or deficit) depends mostly on the behaviour of oil prices. Thus, in years of high oil prices, Venezuela reaches impressive surpluses, while sharp, downward swings in oil prices can send the current account into deficit, as happened in 1998.

VENEZUELA

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	121.25	117.79	128.33	206.65	-0.6	1.7	3.2
Nominal GDP per capita, US dollars	5,016	4,453	4,530	6,299	-2.4	0.3	2.2
Real GDP, billion real 2000 US dollars	121.25	124.69	151.82	251.14	0.6	4.0	3.4
Real GDP per capita, real 2000 US dollars	5,016	4,715	5,359	7,655	-1.2	2.6	2.4
Real private consumption, billion real 2000 US dollars	65.31	73.82	89.34	145.95	2.5	3.9	3.3
Real government consumption, billion real 2000 US dollars	12.21	14.80	17.57	25.41	3.9	3.5	2.5
Real fixed investment, billion real 2000 US dollars	16.17	14.36	19.71	41.82	-2.3	6.5	5.1
Real exports, billion real 2000 US dollars	34.49	31.41	39.49	68.19	-1.9	4.7	3.7
Real imports, billion real 2000 US dollars	19.79	16.97	22.96	44.88	-3.0	6.2	4.6
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	4.79	4.48	4.78	6.08	-1.3	1.3	1.6
Mining	23.41	24.46	28.66	49.08	0.9	3.2	3.7
Manufacturing	15.62	17.22	23.09	43.73	2.0	6.0	4.4
Utilities	1.67	1.91	2.27	3.51	2.7	3.5	2.9
Construction	5.65	4.62	5.67	10.21	-3.9	4.2	4.0
Wholesale & Retail Trade	17.19	17.27	20.24	34.08	0.1	3.2	3.5
Transport & Communication	10.18	12.66	15.58	29.68	4.5	4.2	4.4
FIRE	16.18	16.93	22.06	50.04	0.9	5.4	5.6
Other Services	22.58	22.46	26.45	42.95	-0.1	3.3	3.3

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	53.9	59.2	58.8	58.1	5.3	-0.4	-0.7
Government consumption share of GDP	10.1	11.9	11.6	10.1	1.8	-0.3	-1.5
Fixed investment share of GDP	13.3	11.5	13.0	16.7	-1.8	1.5	3.7
Exports share of GDP	28.5	27.7	24.0	25.7	-0.7	-3.8	1.7
Imports share of GDP	16.3	14.6	14.0	16.8	-1.7	-0.5	2.8
Net extports share of GDP	12.1	13.1	9.9	8.9	1.0	-3.2	-1.1

Ecuador

Overview

Ecuador's economic performance during 2004 was extremely positive. Total GDP growth hit a comfortable 6.95%, thanks to the continued strength of the oil sector and the recovery of domestic demand. Still-favourable external conditions and the continued stability of most macroeconomic variables supported the 2004 expansion; however, we expect a slower pace (3.2%) for 2005.

In a convergence toward international levels, the disinflation process continued in Ecuador during 2004 and the first five months of 2005. Monthly inflation reached 0.25% in May, while annual inflation hit 1.57%, a small rebound from the figure observed in April, when annual inflation reached 1.22%, its lowest point in Ecuadorian history.

Ecuador has a new president after opposition parties finally won enough support to oust Lucio Gutiérrez—the third consecutive leader to leave office early in the struggling South American country—amidst a swath of anti-government protests. In accordance with the democratic process, congressional members swiftly voted in favour of installing Vice President Alfredo Palacio as the country's next president. Palacio, an apolitical figure and cardiologist by profession, celebrated the end of the Gutiérrez government. His preliminary promises include a referendum on institutional reforms and the diversion of oil funds traditionally used for debt servicing to treat Ecuador's social ills.

The Ecuadorian Congress started debating in early June reformation of the Transparency, Stabilization and Fiscal Responsibility Law. The project, submitted by Finance Minister Rafael Correa, wants to eliminate the Social Investment and Public Debt Reduction Fund (FEIREP), and transfer its balance and future resources directly to the fiscal budget. Minister Correa's reform is gaining wide population support, since it completely departs from previous orthodox policy-making; however, different business groups and conservative political parties oppose the initiative, considering it populist and irresponsible in the use of oil rents. The position abroad is not better. Authorities have distanced from the International Monetary Fund and its surveillance program, under which Ecuador's economic performance was revised on a quarterly basis without any IMF disbursement. This in turn will affect Ecuador's ability to obtain loans from other multilateral organizations, which previously waited for IMF go-ahead before disbursing funds.

No further investments in the mining sector are expected during President Palacio's tenure, limiting the growth potential of the oil industry, which has been the country's source of growth since 2003. The new administration announced that no state-owned oil fields will be sold or lease for private production during its short mandate. It remains to be seen how the new administration faces the challenges of Petroecuador's decaying production.

On the external sector, the current-account deficit reached $122 million (0.4% of GDP) in 2004, a significant decline from $445 million (1.7% of GDP) a year earlier. Strong exports—especially oil, which jumped 62.4% in 2004—and an increase in the amount of remittances are among the main factors contributing to the improvement in the current account. Meanwhile, imports grew 19.4% in 2004 due to strong domestic demand. As a result, the trade balance improved from a $71 million deficit in 2003 to a $261 million surplus in 2004.

Short Term

The nature of the ongoing recovery, based on an oil boom, and current external circumstances, in particular high oil prices, shield the economy in the short term. We expect private investment to stay contained for the rest of 2005, in particular after last April political events, and the difficulties to appoint a new Supreme Court that maintain the legal system partially paralyzed. Government investment will also be contained to maintain fiscal discipline, unless recently appointed Finance Minister Rafael Correa manages to get congressional approval to reform the Fiscal Responsibility Law and eliminate the Social Investment and Public Debt Reduction Fund (FEIREP). His economic program wants to use high oil rents from FEIREP, which otherwise would have reduced public debt, and saved for precautionary purposes in a stabilization fund, to finance this year's budget and to promote public investment and expenditure.

The elimination of the FEIREP could also impose some pressure on inflation. So far, the dollarization system has brought Ecuador a great deal of price stability and the risk of a significant surge in inflation in the short term is low. Higher inflation rates abroad will impose some pressure in prices during the coming months, making domestic inflation to align those of Ecuador's main trade partners.

The labor market will continue weakening due to the sluggishness of the non-oil economy. Indeed, the ongoing oil boom has failed to stimulate the non-oil economy—which is capable of creating new jobs at a fast pace. Ecuadorian labor market also faces the risk from the increasing workers migration from Peru and Colombia, who attracted by a dollarized economy, are replacing domestic workers, enlarging unemployment figures.

Medium Term

On the external sector, it would be worrisome the small trade surplus observed in 2004 if it were unaccompanied by foreign direct investment and substantial unilateral transfers from abroad. So far, the flow of capital has been positive, and immigrants keep sending money to their families from abroad; however, the authorities will have to make major efforts to develop and implement a plan to promote exports so dollarization becomes sustainable. The US-Andean Free Trade Agreement might be a good alternative to promote Ecuadorian exports, but the negotiations continue on new rounds, and its first effects will not be seen until well into 2006 if it is ratified this year, which remains unlikely considering the gridlock of the Central American Free Trade Agreement (CAFTA) in United States' Congress.

The country's debt payment schedule is extremely heavy for both domestic and external debt in the short and medium term. Internal debt has an average maturity of 5.5 years, and costs an average 8.5%. The main holder is the Ecuadorian Social Security System, which, in turn, has announced it will not increase its government holdings during 2005.

External debt reached $11.16 billion, has an average maturity of 17.5 years, and is less expensive, at 7.3% on average. The most expensive part is denominated in the Global12 bonds that pay 12%. The previous government apparently decided to issue new sovereign debt and to buy back part or all these bonds; however, the process stopped, and the country lost another good opportunity to partially reduce its external debt service and balance, just after recent ratings upgrade of Ecuadorian debt announced by Fitch Ratings and Standard and Poor's, and before the political chaos that scared foreign investors in April.

Long Term

In the long run, perhaps the biggest risk facing the economy is the lack of reforms needed to increase the competitiveness of the non-oil sector. Such reforms in labor and taxes are critical for the sustainability of the dollarization system. The non-oil economy has lost competitiveness in recent years with respect to its main trading partners, a sector that traditionally produces its profit from the devaluation of the local currency. As a result, the non-oil economy has stagnated since 2002—and even the ongoing oil boom has failed to revive it. This risk is also on the rise, given that only a strong government can push forward such important structural reforms.

The labor market will suffer due to the lack of structural reforms that would create the right conditions for job creation. More flexible and simpler labor laws are needed in order for business to speed up the creation of new jobs. The increasing difficulties Ecuadorian migrants are facing when trying to enter to Spain (the latest destination for more than 300,000 citizens trying to legalize their permanence) and the United States will also generate some additional pressure in the domestic labor market.

Economic Growth

Total GDP growth hit a comfortable 6.95% in 2004, thanks to the continued strength of the oil sector and the recovery of domestic demand. Still-favourable external conditions and the continued stability of most macroeconomic variables supported the 2004 expansion; however, we expect a slower pace (3.2% rate of growth) for 2005.

The first three quarters' figures were revised, while the fourth quarter showed GDP growth of 4.5% with respect to the fourth quarter of 2003. As expected, this number is substantially lower than that which was seen in the first part of the year, but still gives a strong, 6.95% growth rate for 2004. Total GDP from the oil sector grew 33.2% in 2004, while the non-oil sector grew a weak 3.0%. Total oil production during the first two months of 2005 posted a 2.1% growth rate with respect to the year–earlier period.

It is clear from the results observed during the last quarter—and in particular from oil production numbers for the first four months of 2005—that the oil industry will not be a growth engine in 2005. Oil production in 2004 reached 192.4 million barrels, a 26.1% increase over year-earlier levels. Average daily production reached 525,500 barrels; 25.8% higher than a year earlier, with Petroecuador producing 37.4% and private companies adding 62.6%. After reaching its lowest participation level in total oil production (34.5%) in March 2004, Petroecuador has since shown some signs of recovery, ending the year with a total production of 203,300 barrels/day. On the other hand, private-sector monthly production appeared to have reached a ceiling of 10.4 million barrels, and no further increases are expected in the coming months. Oil production during the first quarter of 2005 increased 3.9% y/y, with Petroecuador production increasing 6.9% y/y, while private companies grew a weak 2.2% y/y.

Other 2004 results were also positive, led by construction (7.3% contribution to GDP), manufacture (12.5% of GDP), commerce (15% of GDP), and transportation (7.8% of GDP), which expanded 3.0%, 2.8%, and 4.1%, and 3.6% y/y, respectively. Only agriculture (8.4% of GDP) contracted 0.04%, the first decrease in output since 1998.

Gross fixed investment posted poor results during the first half of 2004 amid increasing political uncertainty and low business confidence, but grew during the second half of the year, for a 3.5% growth rate for the whole year. We expect private investment to stay contained for the first half of 2005, in particular after the recent political events and difficulties in the judiciary system.

Consumer Demand

Ecuador is experiencing a consumption recovery that started months after the dollarization was adopted as a monetary framework in 2000. At least three factors are clear sources of this recovery. Although unemployment has rebounded back lately, a high level of unemployment and the recovery of real wages are supporting this consumption rebound. In addition, family remittances also increased during 2004 and the first quarter of 2005, although at a lower pace than in 2003. Finally, consumers are able to obtain lower interest rates and long-term financing for their durable and non-durable demands. Consumer-loan portfolios of the Ecuadorian banking system increased 40.4% year-on-year (y/y) during the first quarter of 2005, while total loan portfolios increased only 22.8% y/y. Unfortunately, there is no information on retail sales to support our point with respect to this rebound in consumer demand; however, we are using three indicators: mobile phones sales, car sales, and VAT collection.

This recovery is evident among the families with mid-to-high levels of income. For this group, it is interesting to see the evolution of mobile phone sales, which have increased 60% on average during the last four years. Also for the same group, it is stimulating to see that the rate of growth for car sales during the first quarter of 2005 reached 33.6% with respect to the same period a year earlier. Last November, the car sales growth rate turned positive for the first time in 23 months, since former President Gutiérrez started his mandate. It is clear that there was an unusual boom in car sales in 2001 and 2002, but the increase in sales expected for this year is a clear sign that consumer confidence is recovering. The political crisis observed during April will surely affect consumer confidence, and lower sales are expected for the rest of 2005.

Total value-added tax (VAT) increased strongly during 2004 and the first four months of 2005, thanks to higher domestic demand for Ecuadorian and foreign goods. Total VAT accumulated during January–April 2005 reached $702 million, up 12.8% y/y. VAT collected from sales of domestically produced goods reached 59.7% of total VAT, while the difference should come from the sales of goods produced abroad. The increase in the VAT collected in the latter category shows the problem the country is facing with the balance of trade. VAT collected from consumption of domestically produced goods has increased 4.4% y/y from March 2004 to March 2005, while the consumption of goods produced abroad increased 17.9%. Domestic production cannot compete with lower prices of imported goods, particularly those from Colombia and China. Part of this increase responds to an improvement of tax-collection mechanisms, but its real figure is hard to determine.

Unfortunately, low-income families have not experienced this consumption recovery. Their real wages, mostly those of non-skilled workers, have not increased at the same pace as the wages of their skilled workers, and their limited access to credit from the financial system has also contained their recovery.

Inflation

In a convergence toward international levels, the disinflation process continued in Ecuador during 2004 and the first five months of 2005. Monthly inflation reached 0.25% in May, according to information released by the Ecuadorian Statistical Office (INEC). Annual inflation hit 1.57%, a small rebound from the figure observed in April, when annual inflation reached 1.22%, its lowest point in Ecuadorian history. Contributed to last month price increase the raise in utility prices (+0.18%), food and beverages (+0.03%) and transportation costs (+0.03%). The other nine categories part of the index contributed to the price increase by 0.01%.

The producer price index (PPI) increased 10.8% on an annual basis by the end of April. The average price of electricity and oil derivatives, which has the second-highest weight in the overall index, at 17.30%, increased 27.8% y/y. Producer prices have shown very volatile behavior in the last three years. Although a clear-cut trend in producer prices remains difficult to observe, we expect producers to transfer higher production costs to consumers, which will, in turn, create some inflationary pressure.

Labor Markets

The unemployment rate reached 10.6% in April 2005, up from 12.1% in the year-earlier period. Although the economy rebounded strongly during 2004, most of the increase in GDP comes from the capital-intensive oil industry. As growth spills over into other sectors—a slow process, considering that foreign oil companies hold a high share of total production, with their profits sent to their headquarters and lower GDP growth in 2005—the unemployment rate should decline. Underemployment also increased, from 46.2% in April 2004 to 47.3% a year later. Ecuador's real salary index grew 3.8% year-on-year (y/y) in March 2004. Inflation decelerations continue creating a good environment for real salaries to grow; their levels are currently equivalent to those seen in 1997.

The construction sector in Quito and Guayaquil has shown an impressive recovery due to improved economic conditions and the availability of long-term financing, particularly in the construction of residential units for high-income families. Because of its high labor intensity, this fact has reduced the unemployment rate among construction workers as well as the underemployment rate. However, an excess of housing supply and the limited increase in demand (there are just a few housing projects for low- and middle-income households) will limit the employment opportunities in this industry.

Fiscal Policy and Public Finances

According to the latest government figures, the non-financial public sector recorded a \$613-million fiscal surplus in 2004, equivalent to 2.0% of GDP, compared with a 1.2% surplus a year earlier. Total revenues reached \$8.80 billion, for a 16.9% increase, while total expenditures increased to \$7.46 billion, 13.4% higher than in 2003. The primary surplus (which excludes public-debt interest payments) reached \$1.41 billion—4.7% of Ecuador's GDP.

Total oil revenues reached \$2.11 billion in 2004, 27.1% higher than a year earlier. The increase came as a result of higher oil prices and higher volume exported. Total oil exports reached 129.4 million barrels, a 40.0% increase over 2003. State exports increased from 17.0 million to 24.3 million barrels, while private companies jumped from 75.34 to 105.0 million barrels.

The Ecuadorian Congress started debating in early June reformation of the Transparency, Stabilization and Fiscal Responsibility Law. The project, submitted by Finance Minister Rafael Correa, wants to eliminate the Social Investment and Public Debt Reduction Fund (FEIREP), and transfer its balance and future resources directly to the fiscal budget. In addition, it wants to remove the limit on maximum real growth rate in public investment, currently at 3.5%, while maintaining this limit for wages, salaries and other government expenditure. Currently, FEIREP funds are part of a trust fund under Central Bank management, theoretically out of direct government control, and are supposed to be used according to the following distribution: as much as 70% for debt buybacks, 20% for precautionary reasons (including natural disasters), and 10% for investment in social and health projects. If the reform is passed, funds previously feeding the FEIREP will enter in the fiscal budget, and will be used differently: as much as 40% in debt buyback or investment in the productive sector, 30% in social investment (divided in equal proportions between education and health projects), 20% for precautionary reasons, and 10% for investment in technology, research and development.

After the reform, authorities expect the 2005 central government primary surplus to increase from 0.9% to 2.6% of total GDP, while reducing the government deficit from 1.8% to 0.1% of GDP. Including FEIREP funds in the budget enlarges it from \$5.42 billion to \$6.00 by the end of 2005.

Minister Correa's reform is gaining wide population support, since it completely departs from previous orthodox policy-making; however, different business groups and conservative political parties oppose the initiative, considering it populist and irresponsible in the use of oil rents. The position abroad is not better. Authorities have distanced from the International Monetary Fund and its surveillance program, under which Ecuador's economic performance was revised on a quarterly basis without any

IMF disbursement. This in turn will affect Ecuador's ability to obtain loans from other multilateral organizations, like the World Bank, the Inter American Development Bank (IADB), and the Andean Development Corporation (CAF), which previously waited for IMF go-ahead before disbursing funds. The government expects to receive form these three institutions $315 million in new loans. In addition, authorities expect to raise $503 million from other domestic sources in order to cover all its financing needs for the rest of 2005.

Trade and External Accounts

The current-account deficit reached $122 million (0.4% of GDP) in 2004, a significant decline from $445 million (1.7% of GDP) a year earlier. Strong exports—especially oil, which jumped 62.4% in 2004—and an increase in the amount of remittances are among the main factors contributing to the improvement in the current account. Meanwhile, imports grew 19.4% in 2004 due to strong domestic demand. As a result, the trade balance improved from a $71 million deficit in 2003 to a $261 million surplus in 2004.

Results among different export categories were mixed. Oil exports, which accounted for 54.6% of Ecuador's total exports, performed very well because of higher prices and higher exported volume. Between the non-oil exports, both traditional and non-traditional products posted contractions in 2004, decreasing their total exported value by 2.2% and 2.1%, respectively. It is worth mentioning the 7.0% reduction in banana exports, which represent 13.4% of total exports.

All import categories posted solid growth in 2004. Imports of gasoline and other oil derivatives increased 21.1%, given higher oil prices and the limited oil refinement capacity of the Ecuadorian petrochemical industry, while imports of raw materials and capital goods grew 26.7% and 14.5% year-on-year (y/y), respectively. Consumption goods also posted an increase in both durables (18.2%) and non-durables (14.1%). Net service and net income balances remained negative; almost unchanged.

The latest release by the Ecuadorian Central Bank shows a stronger position during the first four months of 2005 with respect to last year's figures. Total exports during the period January-April reached $2.87 billion, which represents a 24.3% increase on a yearly basis (y/y). Oil exports, equivalent to 51.8% of total exports, jumped 35.2%, thanks to higher oil prices since volume exported increased only 5.1%. On the other hand, total imports increased by 19.2% y/y. All, Consumption, raw materials, and capital goods categories showed important advances, increasing by 18.3%, 23.0%, and 25.5% respectively. Total trade surplus during the first four months reached $280.3 million, $144 million higher than in 2004.

Ecuador, together with Colombia and Peru, is in negotiations with the United States to enact the US-Andean Free Trade Agreement. Global Insight does not expect this trade agreement to promote Ecuadorian exports to a great extent, in either volume or product diversification. From the main 50 products that the country exported to the United States in 2003, which represented 96.7% of total exports to the United States, 48 were tariff-free under the Andean Trade Promotion and Drug Eradication Act (ATPDEA, previously

Andean Trade Preferences Act), signed in August 2002. Nevertheless, it is important for the country to guarantee that, under a new free-trade agreement, the main products reaching the American market maintain their preferred access after the ATPDEA expires in 2006. In any case, at least one additional round has been scheduled for the second half of 2005, meaning that the trade agreement will be signed during the third or maybe the fourth quarter

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	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	13.56	27.93	41.08	97.82	15.5	8.0	6.0
Nominal GDP per capita, US dollars	1,070	1,988	2,643	4,714	13.2	5.9	3.9
Real GDP, billion real 2000 US dollars	13.56	16.60	19.87	32.85	4.1	3.7	3.4
Real GDP per capita, real 2000 US dollars	1,070	1,181	1,278	1,583	2.0	1.6	1.4
Real private consumption, billion real 2000 US dollars	8.44	10.24	12.03	18.97	3.9	3.3	3.1
Real government consumption, billion real 2000 US dollars	1.08	1.23	1.52	2.72	2.7	4.4	4.0
Real fixed investment, billion real 2000 US dollars	2.20	3.76	4.98	9.97	11.3	5.8	4.7
Real exports, billion real 2000 US dollars	5.77	7.36	8.23	9.50	5.0	2.3	1.0
Real imports, billion real 2000 US dollars	4.19	7.20	7.15	9.24	11.4	-0.1	1.7
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	1.69	2.35	2.63	3.23	6.7	2.3	1.4
Mining	3.43	4.67	5.39	8.74	6.4	2.9	3.3
Manufacturing	0.81	1.56	1.88	3.21	14.0	3.9	3.6
Utilities	0.17	0.29	0.33	0.44	11.7	2.3	1.9
Construction	1.13	1.52	1.77	2.20	6.2	3.1	1.5
Wholesale & Retail Trade	2.68	3.06	3.78	6.21	2.6	4.3	3.4
Transport & Communication	1.72	1.96	2.52	4.59	2.6	5.2	4.1
FIRE	1.31	1.58	2.07	4.01	3.9	5.6	4.5
Other Services	1.78	2.43	3.01	4.80	6.5	4.4	3.2

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	63.9	65.5	61.9	68.0	1.7	-3.6	6.1
Government consumption share of GDP	7.9	7.7	7.6	9.5	-0.3	0.0	1.9
Fixed investment share of GDP	16.2	21.2	23.7	35.0	5.0	2.5	11.3
Exports share of GDP	42.6	31.6	28.9	30.0	-10.9	-2.8	1.1
Imports share of GDP	30.9	33.9	30.7	32.2	3.0	-3.2	1.5
Net extports share of GDP	11.7	0.0	0.0	0.0	-11.7	0.0	0.0

Chile

Overview

Short-Term

The 2005 outlook for the Chilean economy is very bright, but there is also a moderate degree of uncertainty around it. The economy is expected to grow 6.1% as the benefits of high commodity prices for exports experienced since 2004 spread to the other sectors of production. Domestic demand, particularly investment, has taken off, which will guarantee solid, consistent, and sustainable growth.

Public finances are healthy, backed by the Copper Stabilization Fund (CSF) and prudent management by authorities. The boom in copper prices during 2004 and early 2005 allowed the government to fill the CSF, which in turn will allow a smooth execution of the 2005 and 2006 budgets, even if the economy does not grow as anticipated or copper prices go below the assumed value.

While the volatility of the exchange rate is expected to continue through 2005, there is relative certainty regarding domestic prices. Inflation is forecasted to fall within the targeted band (3% +/- 1%), the central bank is already taking preemptive measures to avoid excess demand or an overheating of the economy, and interest rates will continue to increase during the year.

On the external front, while copper prices are unlikely to continue to increase, volume exported should remain at current levels or increase slightly. Non-copper exports will grow almost 10%, taking advantage of free-trade agreements. Overall, Chile enjoys a solid external position with expected surpluses in the current account for the next couple of years and a manageable external debt. Presidential elections scheduled for December 2005 should not impose any constraints to economic growth, nor create any imbalances in the fiscal accounts that might create future problems. Chile has a proven record of democratic transitions since 1990, and fiscal management will not be affected by the so-called political business cycle.

The uncertainty surrounding the bright outlook for Chile derives mainly from external conditions. A sudden deceleration in China's economic growth (hard landing) might reduce drastically not only copper prices, but volume exported. In addition, the indirect effects of a slowdown in the world economy would also hurt Chile's prospects of high economic growth. There is also uncertainty regarding the US economy and its twin deficits (fiscal and external gap) and how fast the Federal Reserve might increase interest rates. All these factors, coupled with oil price volatility, might contribute to erode consumer confidence and business sentiment in Chile, which are the key to sustainable high economic growth.

Medium Term

The cyclical upturn is expected to come to an end by the first quarter of 2006, growth is forecasted to slowdown, albeit slightly. For 2006 as a whole, we expect GDP to increase by 5.4% down from 6.1% in 2005. Strong investment should keep growth rates relatively robust next year, despite a decrease in exports as copper prices return to their medium term level. In 2007–10 economic growth is forecasted to converge to the long-term growth rate, this forecast assumes no major structural reforms in the labor market, thus, it will remain relatively inflexible. Consumer spending is expected to continue to grow, but at slower rates, consistent with the deceleration of overall economic growth.

Consumer price inflation should edge up marginally, from 2.0% in 2005 to 2.8% in 2006; largely reflecting the narrowing of the output gap, that is, as real output comes closer to potential output, and, to some extent, perhaps also due to the realignment of prices in tradable goods pushed by the devaluation of the Chilean peso. In 2007–10, inflation will gradually approach to its long term value of 3%.

Public finances will remain in good shape, even if copper prices drop drastically in 2006, a rather unlikely event by the way; government spending will be financed by saved surpluses from 2004 and 2005. The Structural Fiscal Surplus Rule will continue to be observed by the next administration, which we assume will be again the center-left coalition Concertacion.

Also in the medium term, exports growth will slowdown to 6-8% and will be driven by higher volume rather than prices; free trade agreements with United States, the European Union, and South Korea are already in place, and Chilean diplomacy is working diligently on new trade agreements with Asian economies.

Long Term

Looking beyond 2010, Chile's GDP growth rate should remain at around 5%, which is a strong rate for potential growth. Long-term growth will be supported by traditionally high investment (on average 20% of GDP), as well as moderate growth in the labor force supported by an increasing population. The size of the population is expected to increase from 17 million people in 2010 to almost 20 million at the end of 2005.

Strong potential growth is also explained by the relatively small base from which the economy is departing: Chile is still a developing economy with GDP per capita below US$6,000. Capital is relatively scarce and the infrastructure of the country is still incipient. In other words, there are many areas and sectors with investment opportunities still unexplored. Assuming inflation rates average 3% in the long term, then the Chilean peso should depreciate only at a 1% rate per year. Finally, the government's fiscal balance should converge toward zero as percentage of GDP.

Economic Growth

GDP rose by 5.7% year-on-year (y/y) in the first quarter, driven by an impressive acceleration in domestic investment, which expanded 26.1%. Purchases of machinery and equipment increased substantially as firms executed new projects and updated technology. The Chilean economy continues to show strong growth rates supported by a sound macro-economic framework and a favorable international environment.

High domestic investment not only pushes domestic demand and overall economic activity, but also guarantees future economic growth. On seasonally adjusted terms, GDP grew 1.4%, which confirms that the economy is still at the peak of the business cycle.

Investment Accelerates
Investment in Chile has been growing quickly since late 2003 and increased further to double-digit rates in the second half of 2004. In the first quarter of 2005, investment jumped 26.1%, pushed by purchases of machinery and equipment, which expanded 44.7%, while investment-related construction grew 13.6%. The Corporation for Technological Development of Capital Goods estimates that the portfolio of private investment projects for the period 2005-2009 is 25% higher than one year ago. Mega-projects in the energy and mining sectors, in addition to several medium-sized industrial projects (in which investment is US$5-20 million) and real estate developments, account for the majority of programmed investment. High copper prices and the energy crises resulting from gas-export restrictions from Argentina to Chile have prompted the construction of hydroelectric plants and the expansion of copper mines. In the first three months of the year, external demand (volume of exports) increased 6.7%, a significant drop over the previous two quarters, during which export volume grew 15.6% on average.

The bank has not published detailed data on consumption; the item "remainder of domestic demand" (which incorporates private and public consumption and changes in inventories) grew 6%.

Construction Sector Leads Growth
From a supply perspective, GDP expansion was driven by the construction, commerce and transport sectors, which grew 11.5%, 7.9% and 6.0% y/y, respectively. Meanwhile, mining expanded 5.0%, since copper output was encouraged by high international prices. Agriculture's growth rate slowed to 4.2%. However, this deceleration is due to a statistical effect, since this sector grew strongly in the past four quarters. Manufacturing grew 3.4%. This sector was heavily affected by seasonal factors, since Easter fell in March this year but in April last year.

Outlook
Seasonally adjusted data suggest that the Chilean economy continues at the peak of the business cycle, since the benefits of higher copper prices are now spreading to other sectors of the economy. Strong investment is expected to continue over the medium term. Therefore, robust output growth should remain. Current fiscal surpluses guarantee consistent moderate growth in public consumption even if external conditions are not favorable. For the remainder of the year, the outlook for exports is very positive, since international copper prices are expected to remain high and non-copper exports have proven to be a dynamic sector. Although volume exported may not grow as fast as in 2004, the positive effect of higher commodity prices will be spread to the rest of the economy through taxes on higher profits, new investment, and demand for goods produced in other sectors. After growing an estimated 6.1% in 2004, up from 3.7% in

2003, the Chilean economy is expected to continue its strong growth path in 2005. Global Insight's latest forecast calls for a 6.1% expansion

Consumer Demand

There are mixed signals regarding consumer confidence in Chile; new car sales amounted to 15,372 units in April, up 27% from April 2004, and the latest data on supermarket sales show a 10% expansion in March year-on-year (y/y). During the first quarter of the year, imports of consumption goods increased 39%, and imports of durable goods, a subset of consumption goods and a better indicator of consumer sentiment, jumped 37%. Nevertheless, the index of economic perception (IPEC), which is published by the private think-tank ADIMARK, decreased to 48 in April, from 49 in March; it was its third consecutive drop. According to the ADIMARK methodology, an IPEC below 50 points means that the economy is in a negative phase in the consumption cycle. The index is based on a survey that includes questions on consumer perceptions of economic growth, unemployment, expected inflation, personal finances, and future income. Like the University of Michigan's index of consumer sentiment, the IPEC uses a 0-100 scale and the higher the score, the higher the consumer confidence. According to the survey, higher oil prices coupled with the energy crises (derived from gas export restrictions from Argentina to Chile) have sparked some pessimism among consumers, who now expect higher inflation during the year.

While the survey by ADIMARK shows consumers as more cautious about future economic prospects, other indicators signal more optimism in the consumption side. At Global Insight we forecast overall private consumption to increase at the same rate as GDP (+6.1%) and interpret ADIMARK numbers only as a warning signal. Private consumption should remain strong in the second half of the year unless oil prices resume their upward trend and the energy crises worsen.

Inflation

The National Statistics Institute (INE) reported that the consumer price index (CPI) increased 0.3% in May. Although driven by higher fares for local transport and higher utility tariffs (water, electricity, and telephone), the increase was partially offset by lower prices in gasoline and liquefied natural gas. Prices in the transport sector climbed 0.8%, and housing costs increased 0.4%. In January-May, inflation amounted to 1.4%, and in the 12-month period ending in May 2005, the CPI expanded 2.7%. A relatively stable exchange rate is also helping to keep inflation at low levels.

The central bank uses inflation targeting as its main monetary policy strategy; for 2005 it targets inflation at 3%, +/-1.0 percentage point. Since September 2004, the monetary authority has been increasing the policy rate to reduce medium-term inflationary pressures. In theory, a higher interest rate discourages private consumption and investment—two major components of aggregate demand—thus upward pressure on prices is reduced.

The rate of growth of wholesale prices is now more in line with the CPI and other price indicators. Tradable prices decreased, in part helped by a lower exchange rate. Annual inflation for core prices is still below consumer price inflation but is closer; the core price index excludes from the calculation of the CPI those items with high price volatility: namely, gasoline and perishable food (fruits and vegetables). In the last 12 months, the wholesale price grew 4.5%; however, the core price index expanded only 2.4%. The fact that most price indicators tend to converge to the CPI inflation is a signal of relative price stability.

Labor Markets

As reported by the National Statistics Institute (INE), the unemployment rate amounted to 8.2% in the three-month period ended in April, down from 8.7% a year earlier. It was also the lowest rate recorded in this particular quarter since 1998. Compared with January–March, the jobless rate was up 0.2 percentage point due to lower seasonal employment in the agricultural and construction sectors as the austral summer came to an end. The year-on-year improvement is consistent with the strong economic expansion started in the second quarter of 2004 (see Economic Growth). April's figure also confirms the change in the unemployment trend observed the previous month. From April 2004 through February 2005, the unemployment rate had been increasing despite a favorable economic environment of robust growth. While the economy created 223, 000 jobs, it was not enough to offset a fastest growing labor force. Due to seasonality, the unemployment rate will continue to increase until it reaches its peak in August–September, but we expect better figures in year-on-year comparisons.

The INE also reported gains of 10.1% in industrial production; growth in this sector was boosted by a seasonal factor as Easter Week occurred in March this year, while last year it fell during April, so that there were more working days in April this year. In January–April, industrial production grew 5.3% year-on-year (y/y). The institute also released figures for mining and electricity production and supermarket sales. According to these reports, mining activity dropped 4.4% as copper output shrank 6.2%; electricity production expanded only 1.5% y/y in April, due to gas-export restrictions from Argentina to Chile, while supermarket sales jumped 9.8% y/y.

Strong economic growth is finally translating into better labor market figures, particularly unemployment. Other indicators, except for mining and energy, are also consistent with the economy's overall well-being. Although copper output is not growing, it will not affect the rest of the economy given that extraordinarily high prices for the red metal are boosting revenue from copper sales. The energy crisis is now being solved by replacing Argentinean gas for other, more expensive, sources of energy.

Monetary Policy

The central bank of Chile (CBC) guides its monetary policy by an inflation-targeting strategy. In the six-month period from September 2004 through February 2005, the bank decided to raise its policy interest rates 25 basis points in four out of the six monthly meetings; thus, the country's interest rates for monetary regulation credits (open market operations) increased by 1 percentage point, from 1.75% to 2.75%.

In its latest announcement, on February 12, the bank acknowledged rapid economic growth and pointed out that consumer price inflation is now under control despite the expansionary nature of monetary policy. In order to gradually align interest rates with the current domestic conditions of strong economic growth and increasing domestic demand, and also with the higher interest rates dictated by the US Federal Reserve, the Central Bank of Chile decided to increase its monetary policy rate. According to the central bank, data on IMACEC (see Economic Growth) suggests that economic activity and domestic spending are increasing faster than expected; although prices are very much under control, the monetary authority is signaling the market's commitment to low inflation, and the move (i.e., increasing rates) is being taken as a preemptive measure to avoid future pressure on prices derived from excess demand. Another factor that has encouraged the Central Bank of Chile (CBC) to increase its rates sooner rather than later is the progressively restrictive monetary stance adopted by the US Federal Reserve, which has also increased its policy rates.

The CBC has proven its determination not to intervene directly in the foreign exchange market, and will continue to conduct its monetary policy by focusing on inflation-targeting.

Fiscal Policy and Public Finances

In 2004, public finances benefited largely from higher copper prices. The government collects not only income tax from mining companies but also profits from the state-owned mining corporation CODELCO, the largest copper mine in Chile. The central government posted a surplus of 1,246 billion pesos, equivalent to 2.2% of GDP, which compares with a deficit of 0.4% of GDP in 2003. Government revenue jumped 19.9% in real terms (that is, after discounting inflation) while expenses increased only 5.9%, also in real terms. Tax revenue and social security contributions expanded 11.1% and 12.5%, respectively—the higher income tax paid by mining companies is included in tax revenue growth. In addition, strong economic growth and higher domestic demand contributed to the growth in tax revenue. Direct copper revenues amounted to 1,764 billion pesos in 2004, or four times the figure collected in the previous year.

Government expenses were constrained, as usual, by the so-called 1% Structural Fiscal Surplus rule, which requires the government to assume that copper and tax revenues are derived from medium-term equilibrium copper prices and potential GDP growth. For 2004, the medium-term price of copper was estimated at US$0.88 per pound while the potential GDP was set at 4.0%. The actual average price of copper turned out to be US$1.30/pound and GDP growth has been estimated at 5.9%: under these parameters, government revenue is underestimated (on purpose) and government expenditure is limited to the "assumed" revenue, such that the fiscal balance yields a surplus equivalent to 1% of GDP. In previous years (2001–03), the opposite had occurred—actual copper prices and GDP growth were below the assumed parameters, and thus the government could spend more than it collected in revenue and still complied with the Structural Fiscal Surplus.

Most of the actual surplus obtained in 2004 was allocated to pre-paid public debt—programmed and pre-paid debt amounted to 1,173 billion pesos. The ratio of public debt to GDP went down from 13.3% in 2003 to 11.0% at the end of 2004. Another 540 billion pesos from the financial assets of the government (derived from the 2004 surplus) were used to prepay debt in the first 40 days of 2005.

Pre-paid debt will save the government future interest payments; savings are estimated at US$200 million in net present value. The fiscal budget for 2005 allocates approximately US$ 50million from those monies to social expenses such as the health reform and the increase in pension payments.

Exchange Rates

During March and through the end of the first week of April, the exchange rate oscillated in the 580-590 pesos/US dollar range, a very narrow band for the Chilean peso, which is normally very volatile. What happened is that during March the exchange rate decoupled from copper prices: usually higher copper prices lead to a lower exchange rate, i.e., a stronger peso, since Chile's copper exports amount to 45% of the total, so, at least theoretically, higher copper prices should increase supplies of foreign exchange. Copper prices increased from US$1.47/pound in February to US$1.53/pound in March; however, the exchange rate went up from 573 pesos/US dollar to 586 pesos/US dollar in the same period. In the aforementioned period, the Chilean peso followed the path of the Brazilian real, which depreciated 4% against the US dollar; it is not clear why the foreign-exchange (forex) market in Chile behaves in this way but it seems that forex traders do not expect high copper prices to remain at their current, record levels. Traders also seem to read the evolution of the Brazilian real as the actual sentiment of foreign investors toward the Latin American region.

In April, May, and early June, the trends described above continued: on 6 June copper prices hit a 16-year record high (US$1.60 per pound) and at the same time the US dollar exchanged for 594 Chilean pesos, its highest value since November 2004. This is explained by two major events: in Brazil the local currency depreciated heavily as a political scandal that involves the president's party shook the foreign-exchange market, meanwhile, the US dollar has kept on strengthening against the euro after the French and Dutch voted rejected the European constitution in their respective referendums.

Although a soft landing is still the most probable ending for China's overheated economic growth, a major risk to Chile's foreign-exchange forecast is the likelihood of a sharp deceleration in economic activity in China. Chinese demand for copper is estimated to have grown 300,000 tons last year to a total of three million tons, and its share in world demand is almost 20.0%.

One of the major risks to the exchange rate is the volatility and highly speculative nature of the foreign-exchange market. The players in this market overreact to any piece of information: oil prices, copper prices, the US stock market, the Brazilian forex market, other regional news, Argentina, Mexico.

We must acknowledge a couple of sources for volatility: on the supply side, foreign-exchange revenue depends largely on copper exports (more than one-third of total exports), and therefore on the fluctuations of the price of copper; on the demand side, given Chile's dependence on imported oil (Chile imports about 80% of the oil it consumes), it is subject to the ups and downs of oil prices in the international markets.

Trade and External Accounts

After jumping almost 50% in 2004, exports continued to grow in the first quarter of 2005, expanding 23%. The strong push for exports is being bolstered by extraordinarily high copper prices, exports of manufactures, wood pulp, and fruit, which also made a significant contribution, growing at double-digit rates. The average price of copper in the first quarter of 2005 was US$1.48/pound, up 19% from the first quarter of 2004.

Meanwhile, imports grew 34% in January-March 2005, led by higher imports of capital goods (up 54%) and consumption goods (up 39%). Domestic demand is accelerating, as both investment and consumption increase in an environment of strong economic growth.

In the first quarter of 2005, the current account posted a surplus of US$369 million, down from US$688 million a year earlier. Most of the drop is explained by the wider deficit in the income account (a subset of the current account), since the trade and service balances in the first quarter of 2005 do not differ significantly from the values recorded in the same period of 2004. In January-March 2005, both exports and imports increased substantially, and the trade surplus remained almost unchanged. The income-account deficit was US$400 million wider than in the previous year. Income payments to residents of other countries increased by 25%, as multinational firms reinvested profits in their home countries. Net unilateral transfer amounted to US$286 million - almost twice the figure recorded a year earlier. Most of these transfers are remittances from relatives working abroad.

Although the current-account surplus narrowed in the first quarter of the year, Chile is still in a very strong external position. Not only is its current-account balance positive, but its debt profile is manageable and is backed by a sizeable amount of international reserves: as of 15 May, they amounted to US$ 17.1 billion - twice the short-term debt of the country and almost 40% of the total debt.

CHILE

	2000	2005	2010	2025	Avg. Anuual Compound Growth 2000-05	2005-10	2010-25
Nominal GDP, billion US dollars	75.21	94.00	116.41	318.88	4.6	4.4	6.9
Nominal GDP per capita, US dollars	4,944	5,801	6,776	16,075	3.2	3.2	5.9
Real GDP, billion real 2000 US dollars	75.21	92.19	117.86	244.51	4.2	5.0	5.0
Real GDP per capita, real 2000 US dollars	4,944	5,689	6,861	12,326	2.8	3.8	4.0
Real private consumption, billion real 2000 US dollars	48.00	58.66	76.58	162.83	4.1	5.5	5.2
Real government consumption, billion real 2000 US dollars	9.37	10.98	13.58	29.95	3.2	4.3	5.4
Real fixed investment, billion real 2000 US dollars	15.59	20.41	26.95	56.94	5.5	5.7	5.1
Real exports, billion real 2000 US dollars	23.76	35.00	48.17	101.29	8.1	6.6	5.1
Real imports, billion real 2000 US dollars	22.36	33.03	48.34	108.08	8.1	7.9	5.5
Real GDP by sector, billion real 2000 US dollars:							
Agriculture	4.17	4.86	5.66	9.28	3.1	3.1	3.4
Mining	5.33	5.79	6.20	7.47	1.7	1.4	1.3
Manufacturing	12.97	17.44	23.56	57.20	6.1	6.2	6.1
Utilities	2.14	2.62	3.85	11.02	4.2	8.0	7.3
Construction	5.42	6.08	7.26	11.93	2.3	3.6	3.4
Wholesale & Retail Trade	7.77	9.23	12.36	29.40	3.5	6.0	5.9
Transport & Communication	5.35	7.19	10.12	27.29	6.1	7.1	6.8
FIRE	14.49	17.56	24.94	66.97	3.9	7.3	6.8
Other Services	12.73	14.56	19.16	42.07	2.7	5.6	5.4

	2000	2005	2010	2025	Share change, percentage points 2000-05	2005-10	2010-25
Private consumption share of GDP	63.8	63.0	65.0	66.3	-0.8	2.0	1.2
Government consumption share of GDP	12.5	12.2	12.5	14.2	-0.2	0.3	1.7
Fixed investment share of GDP	20.7	19.8	20.9	18.9	-0.9	1.1	-2.0
Exports share of GDP	31.6	39.6	43.4	44.8	8.0	3.8	1.5
Imports share of GDP	29.7	32.9	39.6	44.4	3.1	6.7	4.9
Net extports share of GDP	1.9	6.7	3.8	0.4	4.9	-2.9	-3.4

Appendix A: Specific Sources of Data and Other References

Asia

China
China Statistical Yearbook.
China Statistical Information & Consultancy Service Center
Customs General Administration of China
People's Bank of China
Shanghai Securities Exchange
Shenzhen Stock Exchange

Hong Kong
Hong Kong Census and Statistics Department
Hong Kong Futures Exchange
Hong Kong Investment Fund Association
Hong Kong Monetary Authority
Hong Kong Rating and Evaluation Department
Hong Kong Stock Exchange
Hong Kong Tourism Association

Korea
National Statistics Office
Bank of Korea
Korea Automobile Manufacturers Association
Korea Foreign Trade Association
Korea National Tourism Corp
Korea Stock Exchange
Ministry of Labor

Taiwan
Directorate-General of Budget, Accounting and Statistics (BAS)
Central Bank of China
Department of Statistics
Ministry of Transportation and Communications
Taiwan Stock Exchange

Europe

United Kingdom
Bank of England
Office of National Statistics (ONS)
HBOS plc Group

DTLR –Department of Transport, Local Government, and the Regions
DTI Enquiry Unit, Department of Trade and Industry.
CBI Confederation of British Industries.

Germany
Deutsche Bundesbank (DBB)
Statistisches Bundesamt (STBA)
Statistischer Informationsservice,
IFO Institut
Bundesanstalt für Arbeit

France
INSEE
Chambre de Commerce et D'industrie de Paris
Ministère de l'Économie, des Finances et de l'Industrie
Banque de France
Direction de la Communication, Service releations
Direction régionale du Travail, de l'Emploi et de la Formation professionnelle CENTRE

Italy
Banca d'Italia Servizio Studi - Divisione Bibloteca e Pubblicazioni
ISTAT
Ufficio Italiano dei Cambi (UIC)
ISAE

Americas

Venezuela
Banco Central de Venezuela
Veneconomy
Central Office of Statistics and Information (OCEI)
International Monetary Fund

Ecuador
Banco Central del Ecuador
International Monetary Fund

Chile
Banco Central de Chile
Instituto Nacional de Estadisticas (INE)
Federation of Chilean Industry (SOFOFA)
International Monetary Fund
Reuters America, Inc

United States
U.S. Department of Commerce

U.S. Bureau of Labor Statistics
U.S. Treasury
U.S. Department of Housing and Urban Development
U.S. Bureau of Economic Analysis

Canada
Bank of Canada
Statistics Canada-
  Economic Division
  Labor Division

GLOBAL INSIGHTalso has an extensive network of proprietary national and international databases which are linked to the major financial institutions of the world.

Other publications by GLOBAL INSIGHTused for this report include:

- World Economic Outlook, Global Insight.
- Industrialized Countries Monthly Monitor, Global Insight.
- Middle East and Africa Economic Outlook, Global Insight.
- Asia Monthly Monitor, Global Insight.
- Latin America Economic Outlook, Global Insight.
- Latin America Monthly Monitor, Global Insight.
- Industrial Analysis Service Monthly Monitor, Global Insight.
- Emerging Europe Economic Outlook, Global Insight.
- Foreign Exchange Rate Outlook, Global Insight.
- U.S Agriculture and World Trade Long Term Forecast and Analysis, Global Insight.
- World Car Industry Forecast and Analysis, Global Insight.
- International Livestock Market Report, Global Insight.
- Canadian Provincial Economic Outlook and Forecast Tables, Global Insight.

Appendix B: GLOBAL INSIGHT Model of the U.S. Economy

This description is provided here for the ACP because of the large role played by the US model, and the US economy, in developing an outlook for the world macroeconomy. While somewhat technical in nature, the discussion mimics that produced in 2001 when a similar macroeconomic and trade scenario project was undertaken.

The Model's Theoretical Position

An Econometric Dynamic Equilibrium Growth Model: The Global Insight Model (formerly DRI-WEFA Model) strives to incorporate the best insights of many theoretical approaches to the business cycle: Keynesian, New Keynesian, Neoclassical, Monetarist and Supply-side. In addition, the Global Insight Model embodies the major properties of the *Neoclassical* growth models developed by Robert Solow. This structure guarantees that short-run cyclical developments will converge to robust long-run equilibrium.

In growth models, the expansion rate of technical progress, the labor force, and the capital stock determine the productive potential of an economy. Both technical progress and the capital stock are governed by investment, which in turn must be in balance with post-tax capital costs, available savings, and the capacity requirements of current spending. As a result, monetary and fiscal policies will influence both the short- and the long-term characteristics of such an economy through their impacts on national saving and investment.

A modern model of output, prices, and financial conditions is melded with the growth model to present the detailed, short-run dynamics of the economy. In specific goods markets, the interactions of a set of supply and demand relations jointly determine spending, production, and price levels. Typically, the level of inflation-adjusted demand is driven by prices, income, wealth, expectations, and financial conditions. The capacity to supply goods and services is keyed to a production function combining the basic inputs of labor hours, energy usage, and the capital stocks of business equipment and structures, and government infrastructure. The "total factor productivity" of this composite of tangible inputs is driven by expenditures on research and development that produce technological progress.

Prices adjust in response to gaps between current production and supply potential and to changes in the cost of inputs. Wages adjust to labor supply-demand gaps (indicated by a demographically-adjusted unemployment rate), current and expected inflation (with a unit long-run elasticity), productivity, tax rates, and minimum wage legislation. The supply of labor positively responds to the perceived availability of jobs, to the after-tax wage level, and to the growth and age-sex mix of the population. Demand for labor is keyed to the level of output in the economy and the productivity of labor, capital, and energy. Because the capital stock is largely fixed in the short run, a higher level of output requires more employment and energy inputs. Such increases are not necessarily equal to the percentage increase in output because of the improved efficiencies typically achieved during an upturn. Tempering the whole process of wage and price determination is the exchange rate; a rise signals prospective losses of jobs and markets unless costs and prices are reduced.

For financial markets, the model predicts exchange rates, interest rates, stock prices, loans, and investments interactively with the preceding GDP and inflation variables. The Federal Reserve sets the supply of reserves in the banking system and the fractional reserve requirements for deposits. Private sector demands to hold deposits are driven by national income, expected inflation, and by the deposit interest yield relative to the yields offered on alternative investments. Banks and other thrift institutions, in turn, set deposit yields based on the market yields of their investment opportunities with comparable maturities and on the intensity of their need to expand reserves to meet legal requirements. In other words, the contrast between the supply and demand for reserves sets the critical short-term interest rate for interbank transactions, the federal funds rate. Other interest rates are keyed to this rate, plus expected inflation, Treasury borrowing requirements, and sectoral credit demand intensities.

The old tradition in macroeconomic model simulations of exogenous fiscal or environmental policy changes was to hold the Federal Reserve's supply of reserves constant at baseline levels. While this approach makes static analysis easier in the classroom, it sometimes creates unrealistic policy analyses when a dynamic model is appropriate. In the Global Insight Model, "monetary policy" is defined by a set of targets, instruments, and regular behavioral linkages between targets and instruments. The model user can choose to define unchanged monetary policy as unchanged reserves, or as an unchanged reaction function in which interest rates or reserves are changed in response to changes in such policy concerns as the price level and the unemployment rate.

Monetarist Aspects: The model pays due attention to valid lessons of monetarism by carefully representing the diverse portfolio aspects of money demand and by capturing the central bank's role in long-term inflation phenomena.

The private sector may demand money balances as one portfolio choice among transactions media (currency, checkable deposits), investment media (bonds, stocks, short-term securities), and durable assets (homes, cars, equipment, structures). Given this range of choice, each medium's implicit and explicit yield must therefore match expected inflation, offset perceived risk, and respond to the scarcity of real savings. Money balances provide benefits by facilitating spending transactions and can be expected to rise nearly proportionately with transactions requirements unless the yield of an alternative asset changes.

Now that even demand deposit yields can float to a limited extent in response to changes in Treasury bill rates, money demand no longer shifts quite as sharply when market rates change. Nevertheless, the velocity of circulation (the ratio of nominal spending to money demand) is still far from stable during a cycle of monetary expansion or contraction. The simple monetarist link from money growth to price inflation or nominal spending is therefore considered invalid as a rigid short-run proposition.

Equally important, as long-run growth models demonstrate, induced changes in capital formation can also invalidate a naive long-run identity between monetary growth and price increases. Greater demand for physical capital investment can enhance the economy's supply potential in the event of more rapid money creation or new fiscal policies. If simultaneous, countervailing influences deny an expansion of the economy's real potential, the model *will* translate all money growth into a proportionate increase in prices rather than in physical output.

"Supply-Side" Economics: Since 1980, "supply-side" political economists have pointed out that the economy's growth potential is sensitive to the policy environment. They focused on potential labor supply, capital spending, and savings impacts of tax rate changes. The Global Insight Model embodies supply-side hypotheses to the extent supportable by available data, and this is considerable in the many areas that supply-side hypotheses share with long-run growth models. These features, however, have been fundamental ingredients of our model since 1976.

Rational Expectations: As the rational expectations school has pointed out, much of economic decision-making is forward looking. For example, the decision to buy a car or a home is not only a question of current affordability but also one of timing. The delay of a purchase until interest rates or prices decline has become particularly common since the mid-1970s when both inflation and interest rates were very high and volatile. Consumer sentiment surveys, such as those conducted by the University of Michigan Survey Research Center, clearly confirm this speculative element in spending behavior.

However, households can be shown to base their expectations, to a large extent, on their past experiences: they believe that the best guide to the future is an extrapolation of recent economic conditions and the changes in those conditions. Consumer sentiment about whether this is a “good time to buy" can therefore be successfully modeled as a function of recent levels and changes in employment, interest rates, inflation, and inflation expectations. Similarly, inflation expectations (influencing financial conditions) and market strength expectations (influencing inventory and capital spending decisions) can be modeled as functions of recent rates of increase in prices and spending.

This largely retrospective approach is not, of course, wholly satisfactory to pure adherents to the rational expectations doctrine. In particular, this group argues that the announcement of macroeconomic policy changes would significantly influence expectations of inflation or growth prior to any realized change in prices or spending. If an increase in government expenditures is announced, the argument goes, expectations of higher taxes to finance the spending might lead to lower consumer or business spending in spite of temporarily higher incomes from the initial government spending stimulus. A rational expectations theorist would thus argue that multiplier effects will tend to be smaller and more short-lived than a mainstream economist would expect.

These propositions are subject to empirical evaluation. Our conclusions are that expectations do play a significant role in private sector spending and investment decisions; but, until change has occurred in the economy, there is very little room for significant changes in expectations in advance of an actual change in the variable about which the expectation is formed. The rational expectations school thus correctly emphasizes a previously understated element of decision-making, but exaggerates its significance for economic policy-making and model building.

The Global Insight Model allows a choice in this matter. On the one hand, the user can simply accept Global Insight's judgments and let the model translate policy initiatives into initial changes in the economy, simultaneous or delayed changes in expectations, and subsequent changes in the economy. On the other hand, the user can manipulate the clearly identified expectations variables in the model, i.e., consumer sentiment, and inflation expectations. For example, if the user believes that fear of higher taxes would subdue spending, he could reduce the consumer sentiment index. Such experiments can be made “rational" through model iterations that bring the current change in expectations in line with future endogenous changes in employment, prices, or financial conditions.

Theory As a Constraint: The conceptual basis of each equation in the Global Insight Model was thoroughly worked out before the regression analysis was initiated. The list of explanatory variables includes a carefully selected set of demographic and financial inputs. Each estimated coefficient was then thoroughly tested to be certain that it meets the tests of modern theory and business practice. This attention to equation specification and coefficient results has eliminated the “short circuits" that can occur in evaluating a derivative risk or an alternative policy scenario.

Because each equation will stand up to a thorough inspection, the Global Insight Model is a reliable analytical tool and can be used without excessive iterations. The model is not a black box: it functions like a personal computer spreadsheet in which each interactive cell has a carefully computed, theoretically-consistent entry and thus performs logical computations simultaneously.

Major Sectors

The Global Insight Model captures the full simultaneity of the U.S. economy, forecasting over 1200 concepts spanning final demands, aggregate supply, prices, incomes, international trade, industrial detail, interest rates, and financial flows. Chart 1 summarizes the structure of the eight interactive sectors (noted in Roman numerals). The following discussion presents the logic of each sector and the significant interactions with other sectors.

Spending-Consumer: The domestic spending (I), income (II), and tax policy (III) sectors model the central circular flow of behavior as measured by the national income and product accounts. If the rest of the model were “frozen," these blocks would produce a Keynesian system similar to the models pioneered by Tinbergen and Klein, except that neoclassical price factors have been imbedded in the investment and other primary demand equations.

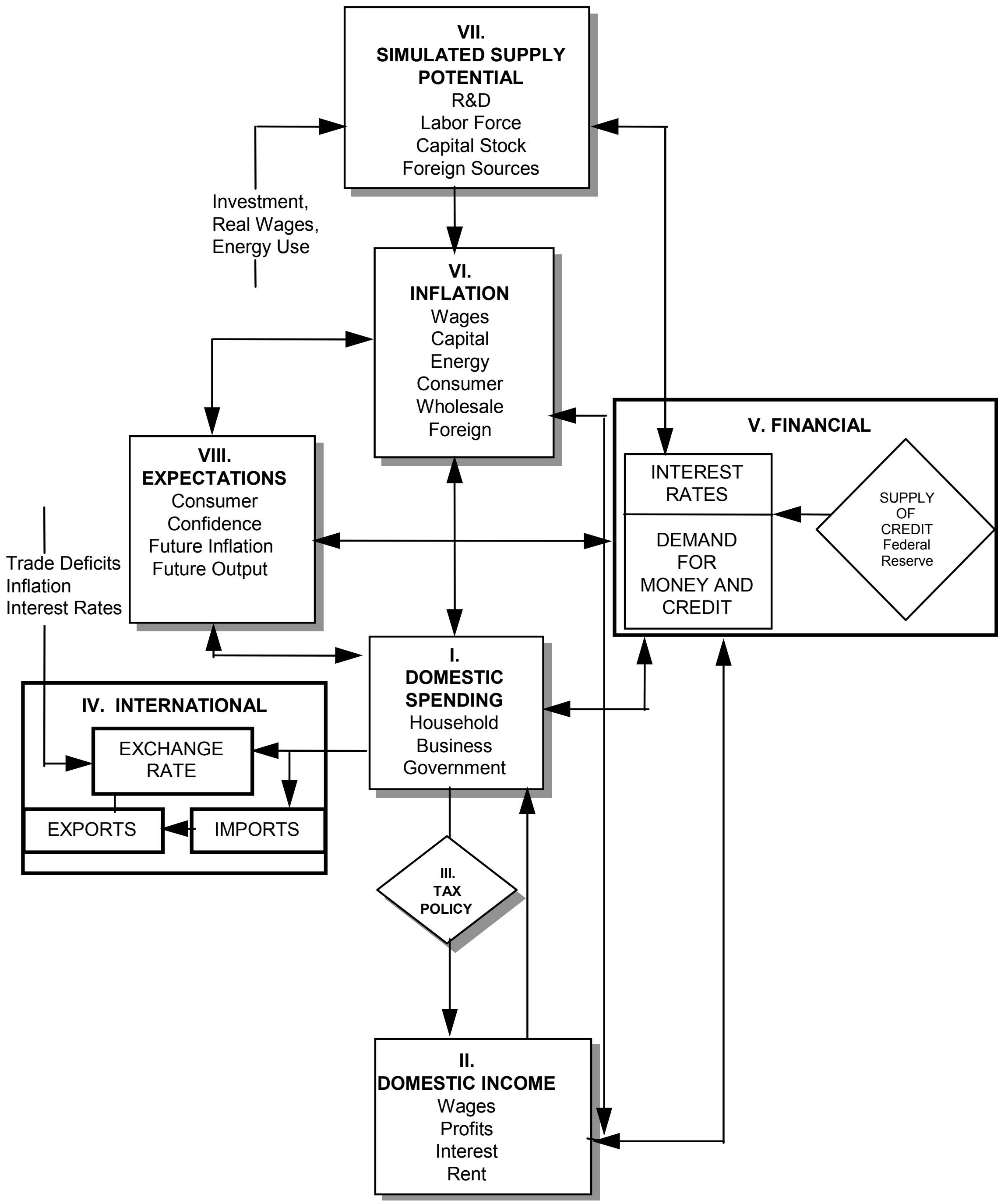
Consumer spending on durable goods is divided into eleven categories: two light vehicles categories; net purchases of used cars; motor-vehicle parts; recreational vehicles; computers; software; other household equipment and furnishings; medical devices; and “other." Spending on nondurable goods is divided into nine categories: three food categories; clothing and shoes; gasoline and oil; fuel oil and coal; tobacco; drugs; and “other." Spending on services is divided into sixteen categories: housing; six household operation subcategories; four transportation categories; medical; recreation; two personal business service categories; and “other." (See Table A1.) In nearly all cases, real consumption expenditures are motivated by real income and the user price of a particular category relative to the prices of other consumer goods. Durable and semidurable goods are also especially sensitive to current financing costs, and consumer speculation on whether it is a “good time to buy." The University of Michigan Survey of Consumer Sentiment monitors this last influence, with the index itself modeled as a function of current and lagged values of inflation, unemployment, and the prime rate.

Spending--Business Investment: Business spending includes nine fixed investment categories within equipment and software: four information processing equipment categories; industrial equipment; three transportation equipment categories; other producers’ durable equipment. Within structures, there are three building categories; mining and petroleum structures; power and communication structures; land and all others. (See Table A2.) Equipment and (non-utility, non-mining) structures spending components are determined by their specific effective post-tax capital costs, capacity utilization, and replacement needs. The cost terms are sophisticated blends of post-tax debt and equity financing costs (offset by expected capital gains) and the purchase price of the investment good (offset by possible tax credits and depreciation-related tax benefits). This updates the well-known work of Dale Jorgenson, Robert Hall, and Charles Bischoff.

Given any cost/financing environment, the need to expand capacity is monitored by recent growth in national goods output weighted by the capital intensity of such production. Public utility structure expenditures are motivated by similar concepts except that the output terms are restricted to utility output rather than total national goods output. Net investment in mining and petroleum structures responds to movements in real domestic oil prices and to oil and natural gas production.

Chart 1. Overview of the Global Insight Model of the U.S. Economy

The Global Insight Model of the U.S. Economy



Inventory demand is the most erratic component of GDP, reflecting the pro-cyclical, speculative nature of private sector accumulation during booms and decumulation during downturns. The forces that drive the six nonfarm inventory categories are changes in spending, short-term interest rates and expected inflation, surges in imports, and changes in capacity utilization or the speed of vendor deliveries (See Table A2.). Surprise increases in demand lead to an immediate drawdown of stocks and then a rebuilding process over the next year; the reverse naturally holds for sudden reductions in final demand. Inventory demands are sensitive to the cost of holding the stock, measured by such terms as interest costs adjusted for expected price increases and by variables monitoring the presence of bottlenecks. The cost of a bottleneck that slows delivery times is lost sales: an inventory spiral can therefore be set in motion when all firms accelerate their accumulation during a period of strong growth but then try to deplete excessive inventories when the peak is past.

Spending—Residential Investment: The residential investment sector of the model includes two housing starts categories (single and multi-family starts) and three housing sales categories (new and existing single family sales, and new single family units for sale). Housing starts and sales, in turn, drive investment demand in five GDP account categories: single family housing; multi-family housing; improvements; miscellaneous; and residential equipment. (See Table A3.)

Residential construction is typically the first sector to turn down in a recession and the first to rebound in a recovery. Moreover, the magnitude of the building cycle is often the key to that of the subsequent macroeconomic cycle. The housing sector of the Global Insight Model explains new construction as a decision primarily based on the after-tax cost of home ownership relative to disposable income. This cost is estimated as the product of the average new home price adjusted for changes in quality, and the mortgage rate, plus operating costs, property taxes, and an amortized down payment. “Lever variables" allow the model user to specify the extent to which mortgage interest payments, property taxes, and depreciation allowances (for rental properties) produce tax deductions that reduce the effective cost.

The equations also include a careful specification of demographic forces. After estimating the changes in the propensity for specific age-sex groups to form independent households, the resulting “headship rates" were multiplied by corresponding population statistics to estimate the trend expansion of single- and multi-family households. The housing equations were then specified to explain current starts relative to the increase in trend households over the past year, plus pent-up demand and replacement needs. The basic phenomenon being scrutinized is therefore the proportion of the trend expansion in households whose housing needs are met by current construction. The primary determinants of this proportion are housing affordability, consumer confidence, and the weather. Actual construction spending in the GDP accounts is the value of construction “put-in-place" in each period after the start of construction (with a lag of up to six quarters in the case of multi-family units), plus residential improvements, and brokerage fees.

Spending--Government: The last sector of domestic demand for goods and services, that of the government, is largely exogenous (user-determined) at the federal level and endogenous (equation-determined) at the state and local level. The user sets the real level of federal nondefense and defense purchases (for compensation, consumption of fixed capital, CCC inventory change, other consumption, and gross investment), medical and non-medical transfer payments, and medical and non-medical grants to state and local governments. The model calculates the nominal values through multiplication by the relevant estimated prices. Transfers to foreigners, wage accruals, and subsidies (agricultural, housing, and other) are also specified by the user, but in nominal dollars. One category of federal government spending – interest payments - is determined within the model because of its dependence on the model's financial and tax sectors. Federal interest payments are determined by the level of privately-held federal debt, short and long-term interest rates, and the maturity of the debt. (See Table A4.)

The presence of a large and growing deficit imposes no constraint on federal spending. This contrasts sharply with the state and local sector where legal requirements for balanced budgets mean that declining surpluses or emerging deficits produce both tax increases and reductions in spending growth. State and local purchases (for compensation, consumption of fixed capital, other consumption, and construction) are also driven by the level of federal grants (due to the matching requirements of many programs), population growth, and trend increases in personal income. (See Table A5.)

Income: Domestic spending, adjusted for trade flows, defines the economy's value-added or gross national product (GNP) and gross domestic product (GDP). Because all value-added must accrue to some sector of the economy, the expenditure measure of GNP also determines the nation's gross income. The distribution of income among households, business, and government is determined in sectors II and III of the model.

Pre-tax income categories include private and government wages, corporate profits, interest, rent, and entrepreneurial returns. Each pre-tax income category except corporate profits is determined by some combination of wages, prices, interest rates, debt levels, and capacity utilization or unemployment rates. In some cases such as wage income, these are identities based on previously calculated wage rates, employment, and hours per week.

Profits are logically the most volatile component of GNP on the income side. When national spending changes rapidly, the contractual arrangements for labor, borrowed funds, and energy imply that the return to equity holders is a residual that will soar in a boom and collapse in a recession. The model reflects this by calculating wage, interest and rental income as thoroughly reliable near-identities (e.g., wages equal average earnings multiplied by hours worked) and then subtracting each non-profit item from national income to solve for profits. (See Tables A6 and A7.)

Taxes: Since post-tax rather than pre-tax incomes drive expenditures, each income category must be taxed at an appropriate rate; the model therefore tracks personal, corporate, payroll, and excise taxes separately. Users may set federal tax rates; tax revenues are then simultaneously forecast as the product of the rate and the associated pre-tax income components. However, the model automatically adjusts the effective average personal tax rate for variations in inflation and income per household, and the effective average corporate rate for credits earned on equipment, utility structures, and R&D. Substitutions or additions of “flat” taxes and value-added taxes for existing taxes are accomplished with specific tax rates and new definitions of tax bases. As appropriate, these are aggregated into personal, corporate or excise tax totals.

State and local corporate profits and social insurance (payroll) tax rates are exogenous in the model, while personal income and excise taxes are fully endogenous: the Model makes reasonable adjustments automatically to press the sector toward the legally-required approximate budget balance. The average personal tax rate rises with income and falls with the government operating surplus. Property and sales taxes provide the bulk of state excise revenue and reflect changes in oil and natural gas production, gasoline purchases, and retail sales, as well as revenue requirements. The feedback from expenditures to taxes and taxes to expenditures works quite well in reproducing both the secular growth of the state and local sector and its cyclical volatility. (See Table A8.)

International: The international sector (IV) is a critical, fully simultaneous block that can either add or divert strength from the central circular flow of domestic income and spending. Depending on the prices of foreign output, the U.S. exchange rate, and competing domestic prices, imports capture varying shares of domestic demand.

Depending on similar variables and the level of world gross domestic product, exports can add to domestic spending on U.S. production. The exchange rate itself responds to international differences in inflation, interest rates, trade deficits, and capital flows between the U.S. and its competitors. In preparing forecasts, Global Insight's U.S. Economic Service and the World Service collaborate in determining internally consistent trade prices and volumes, interest rates, and financial flows.

Eight categories of goods and two service categories are separately modeled for both imports and exports, with one additional goods category for oil imports. (See Table A9.) For example, export and import detail for computers is included as a natural counterpart to the inclusion of the computer component of producers' durable equipment spending. The computers detail allows more accurate analysis because computers are rapidly declining in effective quality-adjusted prices relative to all other goods, and because such equipment is rising so rapidly in prominence as businesses push ahead with new production and information processing technologies.

Investment income flows are also explicitly modeled. The stream of huge current account deficits incurred by the U.S. have important implications for the U.S. investment income balance. As current account deficits accumulate, the U.S. net international investment position and the U.S. investment income balance deteriorate. U.S. foreign assets and liabilities are therefore included in the model, with the current account deficit determining the path of the net investment position.

The reactions of overseas prices, interest rates and GDP to U.S. development are robust and automatic. In the case of dollar depreciation, for example, U.S. activity may expand at the expense of foreign activity and U.S. inflation may rise while the rate in other countries slows.

Financial: The use of a detailed financial sector (V) and of interest rate and wealth effects in the spending equations recognizes the importance of credit conditions on the business cycle and on the long-run growth prospects for the economy.

Interest rates, the key output of this sector, are modeled as a term structure, pivoting off the federal funds rate. As noted earlier, the model gives the user the flexibility of using the supply of reserves as the key monetary policy instrument, reflecting the Federal Reserve's open market purchases or sales of Treasury securities, or using a reaction function as the policy instruction. If the supply of reserves is chosen as the policy instrument, the federal funds rate depends upon the balance between the demand and supply of reserves to the banking system. Banks and other thrift institutions demand reserves to meet the reserve requirements on their deposits and the associated (exogenous) fractional reserve requirements. The private sector in turn demands deposits of various types, depending on current yields, income, and expected inflation.

If the reaction function is chosen as the monetary policy instrument, the federal funds rate is determined in response to changes in such policy concerns as inflation and unemployment. The reaction function recognizes that monetary policy seeks to stabilize prices (or to sustain a low inflation rate) and to keep the unemployment rate as close to the natural rate as is consistent with the price objective. A scenario designed to display the impact of a fiscal or environmental policy change in the context of “unchanged” monetary policy is arguably more realistic when "unchanged" or traditional reactions to economic cycles are recognized, than when the supply of reserves is left unchanged.

Longer-term interest rates are driven by shorter-term rates as well as factors affecting the slope of the yield curve. In the Global Insight Model, such factors include inflation expectations, government borrowing requirements, and corporate financing needs. The expected real rate of return varies over time and across the spectrum of maturities. An important goal of the financial sector is to capture both the persistent elements of the term structure and to interpret changes in this structure. Twenty interest rates are covered in order to meet client needs regarding investment and financial allocation strategies. (See Table A10.)

Inflation: Inflation (VI) is modeled as a carefully-controlled, interactive process involving wages, prices, and market conditions. Equations embodying a near accelerationist point of view produce substantial secondary inflation effects from any initial impetus such as a change in wage demands or a rise in foreign oil prices. Unless the Federal Reserve expands the supply of credit, real liquidity is reduced by any such shock; given the real-financial interactions described above, this can significantly reduce growth. The process also works in reverse: a spending shock can significantly change wage-price prospects and then have important secondary impacts on financial conditions. Inspection of the simulation properties of the Global Insight Model, including full interaction among real demands, inflation and financial conditions, confirms that the model has moved toward central positions in the controversy between fiscalists and monetarists, and in the debates among neoclassicists, institutionalists, and "rational expectationists."

The principal domestic cost influences are labor compensation, nonfarm productivity (output per hour), and foreign input costs; the latter are driven by the exchange rate, the price of oil, and foreign wholesale price inflation. Excise taxes paid by the producer are an additional cost fully fed into the pricing decision. This set of cost influences drives *each* of the nineteen industry-specific producer price indexes, in combination with a demand pressure indicator and appropriately weighted composites of the other eighteen producer price indexes (See Table A11.) In other words, the inflation rate of each industry price index is the reliably-weighted sum of the inflation rates of labor, energy, imported goods, and domestic intermediate goods, plus a variable markup reflecting the intensity of capacity utilization or the presence of bottlenecks. If the economy is in balance--with an unemployment rate near 5%, manufacturing capacity utilization steady near 80-85%, and foreign influences neutral--then prices will rise in line with costs and neither will show signs of acceleration or deceleration.

Supply: The first principle of the market economy is that prices and output are determined simultaneously by the factors underlying both demand and supply. As noted above, the "supply-siders" have not been neglected in the Global Insight Model; indeed, substantial emphasis on this side of the economy (VII) was incorporated as early as 1976. In the Global Insight Model, aggregate supply (or potential GDP excluding the energy sector) is estimated by a Cobb-Douglas production function that combines factor input growth and improvements in total factor productivity. Factor input equals a weighted average of labor, business fixed capital, public infrastructure, and energy provided by the energy sector. Based upon each factor's historical share of total input costs, the elasticity of potential output with respect to labor is 0.65 (i.e., a 1% increase in the labor supply increases potential GDP 0.65%); the business capital elasticity is 0.26; the infrastructure elasticity is 0.025; and the energy elasticity is 0.07. Factor supplies are defined by estimates of the full employment labor force, the full employment capital stock, end-use energy demand, and the stock of infrastructure. Total factor productivity depends upon the stock of research and development capital and trend technological change.

The energy sector employs its own capital and labor. Potential GDP is the sum of the energy and non-energy sector outputs less energy imports.

Taxation and other government policies influence labor supply and all investment decisions, thereby linking tax changes to changes in potential GDP. An expansion of potential first reduces prices and then credit costs, and thus spurs demand. Demand rises until it equilibrates with the potential output. Thus, the growth of aggregate supply is the fundamental constraint on the long-term growth of demand.

Inflation, created by demand that exceeds potential GDP or by a supply-side shock or excise tax increase, raises credit costs and weakens consumer sentiment, thus putting the brakes on aggregate demand.

Expectations: The contributions to the Model and its simulation properties of the rational expectations school are as rich as the data will support. Expectations (Sector VIII) impact several expenditure categories in the Global Insight Model, but the principal nuance relates to the entire spectrum of interest rates. Shifts in price expectations or the expected capital needs of the government are captured through price expectations and budget deficit terms, with the former impacting the level of rates throughout the maturity spectrum, and the latter impacting intermediate and long-term rates, and hence affecting the shape of the yield curve. On the expenditure side, inflationary expectations impact consumption via consumer sentiment, while growth expectations affect business investment.

Quantitative Properties and Policy Lessons

To demonstrate the interrelationships of the sectors and their responses to traditional policy initiatives, two basic shocks were introduced into simulations of the US2001A version of the model: the first is a $20 billion deficit reduction package that increases taxes and cuts real expenditures (with the change in each tax and expenditure component proportional to its 2001 level); the second is a sustained reduction in nonborrowed reserves. The cut in reserves has been scaled to have the same full model impact on real GDP as the fiscal policy shock for quarters five to eight of the simulations: this interval was selected because the peak GDP impacts occur five quarters after the introduction of the fiscal shock and seven quarters after the credit restraint.

The six graphs presented as Chart 2 summarize the direct and indirect changes in fiscal and monetary policy indicators in the two shock simulations. Note that the indirect effects are substantial, and that these have been reliably, automatically calculated by the Model.

For example, pure monetary restraint does raise federal spending (interest costs) and substantially cuts federal tax receipts (lower nominal GDP and particularly weak profits). These impacts on the deficit are much greater than the savings from general lower inflation: as a result, within two years, a 0.6% reduction in the money supply raises the federal government's annual deficit by $19 billion.

Fiscal restraint, on the other hand, produces a significant reduction in interest. The reduction is assisted further by the Federal Reserves response to higher unemployment and lower inflation rates. Moreover, the public's demand for money (often mistakenly referred to as "the money supply") is reduced because weaker income and spending discourages usage of currency and checks to a greater extent than the lower interest rates encourage such usage.

A switch to either restrictive monetary or fiscal policy produces a sharp cycle in the economy. There are notable differences in the responses, however (Charts 3A, 3B). First, as just noted, the greatest impact on real GDP from the composite fiscal shock occurs within five quarters while the greatest impact from the monetary shock takes seven or more quarters. The quicker fiscal response is logical given the immediacy of the cuts in government purchases and the evidence of relatively prompt private sector responses to lower after-tax income. In contrast, changes in monetary policy affect spending with several delays: lower reserves induce higher long-term credit costs with a lag; higher interest rates in turn inhibit housing and consumer durables with a one-to-two quarter lag, and then business fixed investment with a longer lag. The feedbacks to these reactions cause the full GDP impact to build for almost two full years before the benefits of lower inflation begin to bring the economy back toward equilibrium.

Second, the relative strength of specific GDP components is quite sensitive to the type of policy restriction. Fiscal restraint has sharp and immediate negative impacts on consumption and imports: investment initially drops due to weaker output but then recovers strongly in response to lower interest rates. Housing is first trimmed modestly due to lower income but then leads the way to a general recovery in response to lower interest rates. Inflation is reduced as the gains from weaker labor and product markets are offset by the costs of a lower exchange rate. The exchange rate declines as U.S. interest rates fall more than foreign rates.

Monetary restraint significantly curbs all sectors within two years, with housing and business capital spending cut back promptly and significantly. Inflation drops in response to weaker demand, and a stronger foreign exchange value of the dollar. By year three, the lower spending level implies nominal money and credit demand reductions which are roughly proportional to the initial credit supply restraint; interest rates thus retreat back to baseline levels and the real economy begins to bounce back. These patterns resemble monetarist conclusions that real output losses are largely transitory and that the price level will drop by about the same percentage as the decline in the nominal supply; but these findings are tempered by the growth model lesson that capital formation losses will also occur, and these imply persistent real production restraints and hence real income losses.

An important goal of the Global Insight Model of the U.S. Economy is the provision of policy insights and guidance. Restrictive monetary policy is clearly the strategy of last resort for slowing the economy, even if inflation is the highest priority problem. The long-term consequences of restricted credit growth are clearly adverse: business investment and housing are significantly weaker, entailing a permanent reduction in the nation’s capital stock and labor productivity. Also important is the real appreciation of the dollar, leading to expanded imports and lost exports. The best cure for inflation is a carefully targeted reduction in federal spending.

Chart 2
Simulation Results: Indicators of Policy Changes

FISCAL
($billion change from base case)

MONETARY
(Percent difference from base case)

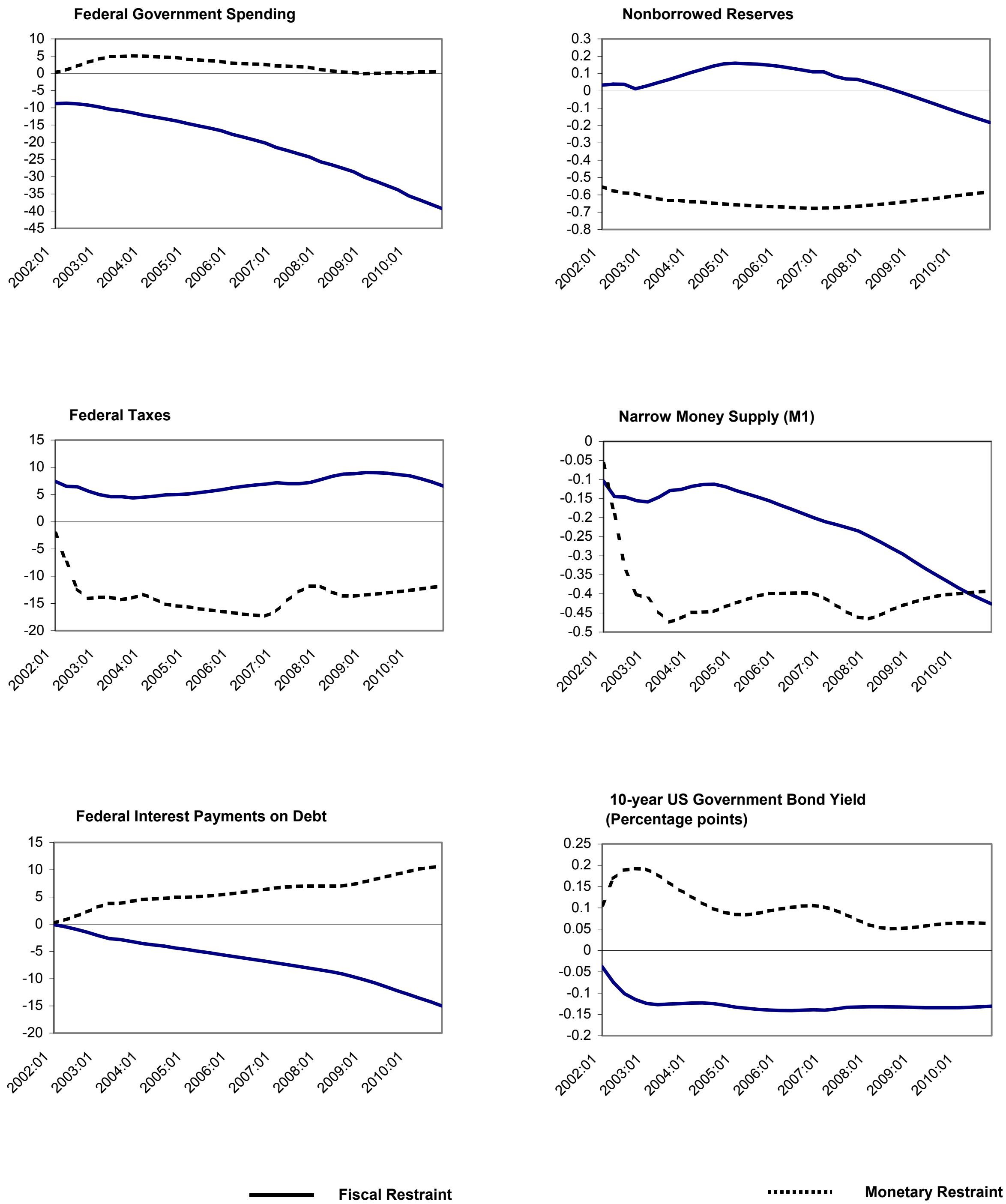


Chart 3A
Simulation Results: Macroeconomic Responses to Fiscal and Monetary Policy Changes
(Percent difference from base case)

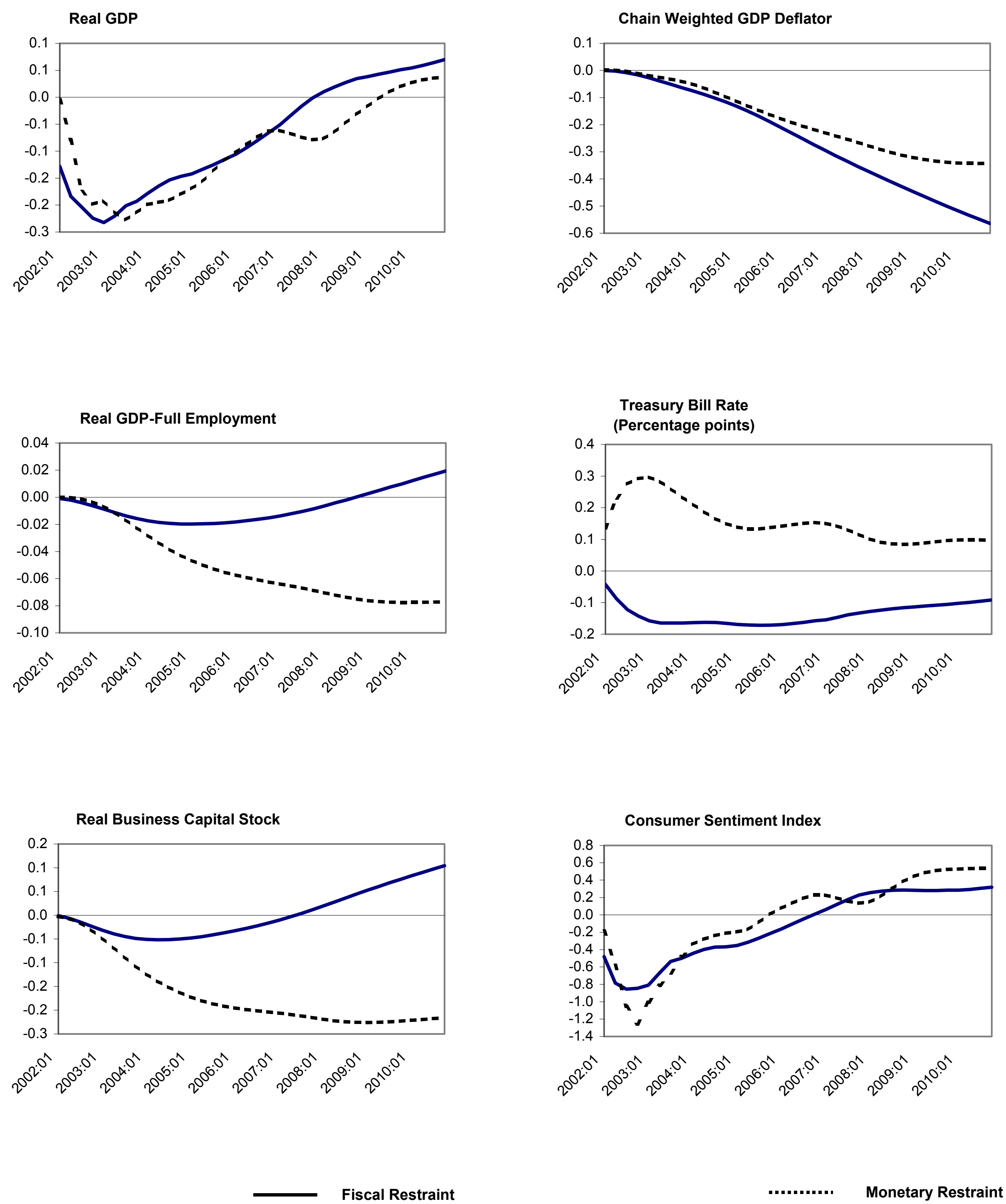
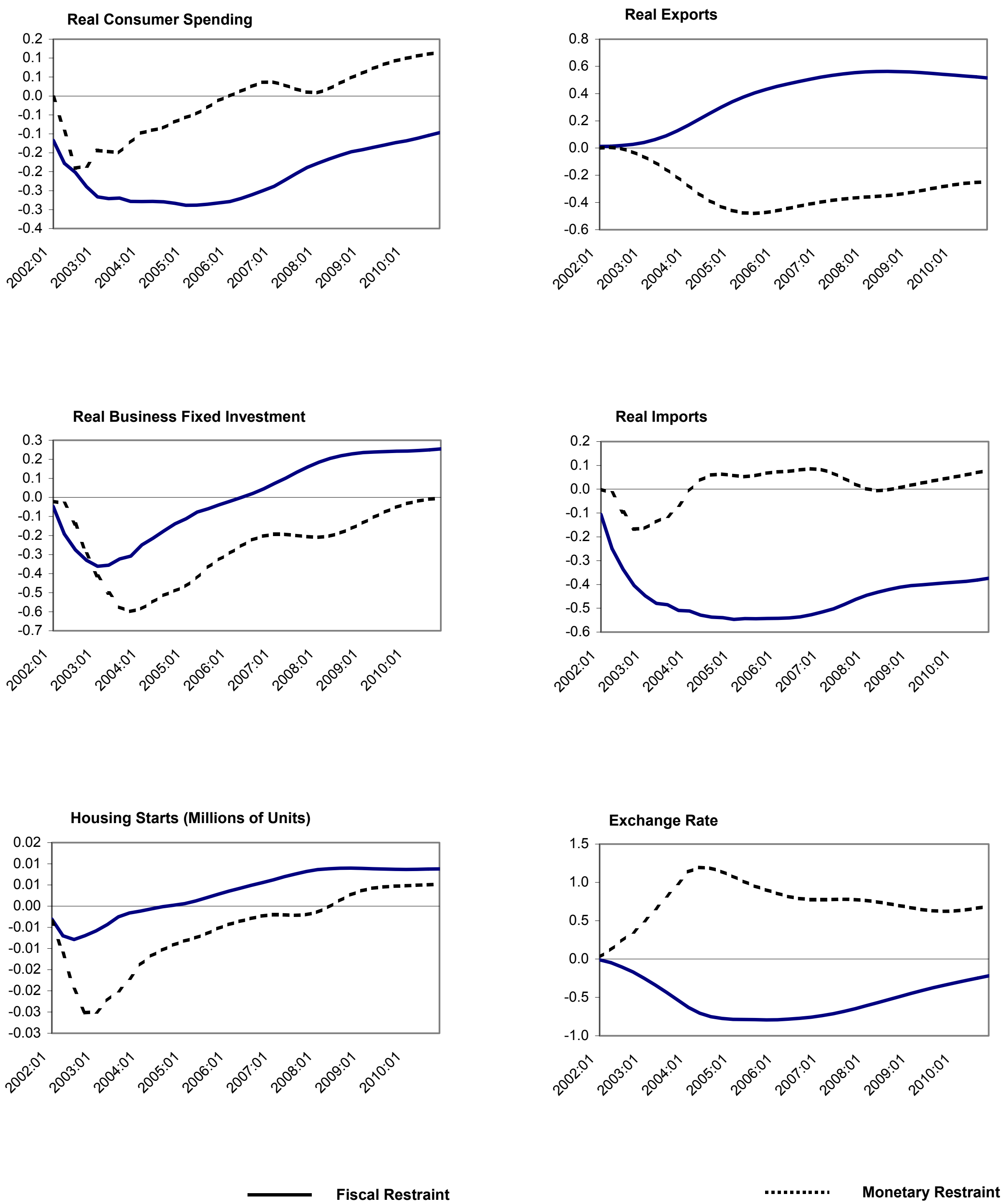


Chart 3B
Simulation Results: Macroeconomic Responses to Fiscal and Monetary Policy Changes
(Percent difference from base case)



Sub-Appendix I. Macro Model Detail

Concepts by Sector

Table A1. Personal Consumption Variables in the Global Insight Model of the U.S. Economy *

Personal consumption expenditures (2000 $)	**CONSR**
Durables	**CDR**
Motor vehicles & parts	CDMVR
Light vehicles	CDMVLVR
New autos	CDMVNAR
New light trucks	CDMVNTLR
Net purchases of used cars	CDMVPUNAR
Tires, tubes, accessories & parts	CDMVTTPR
Other motor vehicles	CDMVOR
Furniture & household equipment	CDFHER
Computers and Software	CDFHEMAVCR
Computers	CDFHEMAVCCPR
Software	CDFHEMAVCSWR
All else	CDFHEXCASR
Other Durables	CDOR
Medical devices	CDOOAOR
All else (1)	CDOOR
Nondurables	**CNR**
Food	CNFR
Purchased meals & beverages	CNFOUTR
Purchased for off-premise consumption	CNFHOMER
All else	CNFFREER
Clothing & shoes	CNCSR
Gasoline & oil	CNEGAOR
Fuel oil & coal	CNEFACR
Other Nondurables	CNOR
Tobacco	CNOTOBR
Drugs	CNODRUGR
All other (2)	CNOOR
Services	**CSVR**
Housing	CSVHSR
Household operation	CSVHOPR
Gas	CSVHOPGR
Electricity	CSVHOPER
Telephone	CSVHOPTR

Water & sewer	CSVHOPWASR
Domestic service	CSVHOPDOMR
All other (3)	CSVHOPMSCR
Transportation	CSVTSR
Motor vehicle leasing	CSVTSURPLLSR
Purchased local	CSVTSPLR
Purchased intercity	CSVTSPICR
All else (4)	CSVTSUOXLSER
Medical Care	CSVMR
Recreation	CSVRECR
Personal business services	CSVOPBR
Financial services furnished free	CSVOPBFREER
All other	CSVOPBXFREER
All else (5)	CSVOOR

Special aggregates

Medical care goods and services	**CMEDR**
Energy goods and services	**CENERGYR**

Additional variables related to consumption

Consumer Sentiment Index (University of Michigan)	JCSMICH

* Variables denoted in bold are defined by identities.

(1) – sports equipment, jewelry, boats, books,etc.
(2) – toilet articles, semidurable house furnishings, cleaning stuff, toys, magazines, flowers, net foreign remittances, etc.
(3) – insurance, postage, etc
(4) – repairs, insurance, tolls, parking, etc.
(5) – education, personal care, net foreign travel, etc.

Table A2. Key Real Business Investment Variables in the Global Insight Model of the U.S. Economy *

Private Fixed Nonresidential Investment (2000 $)	**IFNRER**
Equipment and software	**IFNREER**
Information processing equipment	IFNREEIPR
Computers & peripherals	IFNREEIPCCR
Software	IFNREEIPCSR
Communications equipment	IFNREEIPCTR
All else (1)	IFNREEIPOR
Industrial equipment	IFNREEINDR
Transportation equipment	IFNREETR
Aircraft	IFNREETACR
Light vehicles	IFNREETLVR
All else (2)	IFNREETOR
All else (3)	IFNREEOR
Structures	**IFNRESR**
Commercial & Health Care	IFNRESCR
Manufacturing	IFNRESMFGR
Power and Communication	IFNRESPR
Power	IFNRESPPR
Communication	IFNRESPCR
Mining Exploration, Shafts & Wells	IFNRESMIR
All else	IFNRESOR
Other Nonfarm Buildings (4)	*IFNRESOBR*
Land (mainly railroads)	*IFNRESOTLR*
All else (5)	IFNRESOTHR
Inventory Investment	**IIR**
Nonfarm	**IINFR**
Manufacturing	IIMR
Wholesale trade	IIWR
Retail trade	IIRTR
Motor vehicles	IIRT441R
All other	IIRTX441R
Construction, Mining and Utilities	IICMIUR
Other	IIOR
Farm	**IIFR**

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

(1) – copiers, instruments, office & accounting equipment
(2) – buses, railroad equipment, ships
(3) – furniture, farm equipment, electrical equipment, service industry machinery less sale of used equipment other than vehicles
(4) – religious, educational & vocational, lodging, amusement and recreation, air

(5) – farm, other, brokers' commissions, net purchases of used structures

Table A3. Key Residential Investment Variables in the Global Insight Model of the U.S. Economy *

Housing starts including manufactured homes	**HUS**
Housing starts	**HUSPS**
Single family starts	HUSPS1
Multi-family starts	HUSPS2A
Manufactured home shipments	HUSMFG
Housing sales	
New single family homes sales	HU1NSOLD
New single family homes for sale	HU1NFSALE
Existing home sales	**HUESOLD**
Single family	HU1ESOLD
Condos & Co-ops	HUCCESOLD
Investment in residential construction (2000 $)	**IFRESR**
Permanent Site	**IFRESPER**
Single family housing	IFRESPESFR
Multi-family housing	IFRESPEMFR
Other	**IFRESO**
Manufactured Homes	IFRESOMFGR
Improvements	IFRESOIMPR
All Else (1)	IFRESOOR
Investment in residential equipment (2000 $)	IFREER
Housing Costs	
Average price of existing single-family home	PHU1EAVGNS
Average price of constant-quality new home	PHU1NAVG96NS
Average price of new single-family home	PHU1NAVGNS
Median price of new single-family home	PHU1NMEDNS
30-year fixed mortgage rate	RMMTG30CON

* Variables denoted in bold are defined by identities.

(1) – Dormitories, brokers' commissions, net purchases of used structures

Table A4. Key Federal Government Expenditure Variables in the Global Insight Model of the U.S. Economy *

Purchases (2000 $)	**GFR**
Defense	**GFMLR**
Consumption	**GFMLCR**
Compensation	*GFMLCWSSR*
Consumption of fixed capital	GFMLCKFR
All else	*GFMLCOR*
Gross investment	*GFMLGIR*
Nondefense	**GFOR**
Consumption	**GFOCR**
Compensation	*GFOCWSSR*
Consumption of fixed capital	GFOCKFR
CCC inventory change	*GFOCINTNCCR*
All else	*GFOCOR*
Gross investment	*GFOGIR*
Infrastructure	**GFINFRAR** (defined by *GFINFRAPCGI*)
Interest, dividends, transfer payments, subsidies and accruals	
Interest payments	GFINTPAY
Transfers to individuals	**YPTRFGF**
Cyclical component	YPTRFGFO
Non-cyclical component	
Medicare	**YPTRFGFSIHI**
Medicare (2000 $)	*YPTRFGFSIHIR*
Social security payments	YPTRFGFSISS
Other	YPTRFGFFEO
Social Insurance payments to rest-of-world	*TRFGFSIRW*
Other transfers to rest-of-world	*TRFGFORW*
Grants-in aid to state & local governments	**GFAIDSL**
Medicaid	**GFAIDSLSSMED**
Medicaid (2000 $)	*GFAIDSLSSMEDR*
Other	**GFAIDSLO**
Other (2000 $)	*GFAIDSLOR*
Subsidies	**SUBGF**
Agricultural programs	*SUBGFAG*
Housing programs	*SUBGFHSNG*
Other	*SUBGFOTH*
Wage accruals less disbursements (1)	*WALDGF*

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

(1) Negative expenditure.

Table A5. Key State & Local Government Expenditure Variables in the Global Insight Model of the U.S. Economy *

Purchases (2000 $)	**GSLR**
Consumption	**GSLCR**
Compensation	GSLCWSSR
Consumption of fixed capital	GSLCKFR
All else	GSLCOR
Gross investment	**GSLGIR**
Equipment	GSLGIER
Structures	GSLGISR
Infrastructure	**GSLINFRAR** (defined by *GSLINFRAPCGIS*)
Interest, dividends, transfer payments, subsidies and accruals	
Interest payments	GSLINTPAY
Transfers to individuals	**YPTRFGSL**
Medical	YPTRFGSLPAM
Non-medical	YPTRFGSLPAO
Subsidies	*SUBGSL*
Wage accruals less disbursements (1)	*WALDGSL*

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

(1) Negative expenditure.

Table A6. Components of National Income in the Global Insight Model of the U.S. Economy *

Gross National Product	**GNP**
less	
Consumption of Fixed Capital	**CKF**
Statistical Discrepancy	*STAT*
equals	
National Income	**YN**
Compensation of employees	**YPCOMP**
Wage and salary accruals	
Disbursements	**YPCOMPWSD**
Accruals less disbursements	**WALD**
Supplements	
Fringe Benefits	**YPCOMPSUPPAI**
Employer-paid Payroll Taxes	**TXSIEC**
Proprietors' income	
Nonfarm	YPPROPADJNF
Farm	YPPROPADJF
Rental income	**YPRENTADJ**
Corporate Profits	**ZBECON**
Net Interest and misc. payments	**INTNETBUS**
Taxes on production and imports	
Federal	**TXIMGF**
State and Local	TXIMGSL
Business current transfer payments	TRFBUS
Current surplus of government enterprises	
Federal	*SURGFE*
State and Local	*SURGSLE*
less Subsidies	
Federal	**SUBGF**
State and Local	**SUBGSL**

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

Table A7. Components of Personal Income in the Global Insight Model of the U.S. Economy*

Personal income		**YP**
Equals	Compensation of employees, received	
	Wage and salary disbursements	**YPCOMPWSD**
	Private sector	**YPCOMPWSDP**
	Government	YPCOMPWSDG
	Supplements	
	Fringe Benefits	**YPCOMPSUPPAI**
	Employer-paid Payroll Taxes	**TXSIEC**
	Proprietors' income	
	Nonfarm	YPPROPADJNF
	Farm	YPPROPADJF
	Rental income	**YPRENTADJ**
	Personal income receipts on assets	
	Interest income	YPAINT
	Dividend income	**YPADIV**
	Transfer receipts	
	Federal	**YPTRFGF**
	Social Security	YPTRFGFSISS
	Medicare	**YPTRFGFSIHI**
	Other full-employment transfers	YPTRFGFFEO
	Remaining cyclical component	YPTRFGFO
	State and Local	**YPTRFGSL**
	Medical	**YPTRFGSLPAM**
	All other	YPTRFGSLPAO
	Business transfers	**YPTRFBUS**
Less	**Social insurance contributions**	**TXSI**
	Personal Income	**YP**
Less	Personal Tax Payments	**TXP**
Equals	Personal Disposable Income	**YPD**

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

Table A8. Key Variables in the Tax Sector of the Global Insight Model of the U.S. Economy*

Federal tax receipts	**TXGF**
Personal	**TXPGF**
Corporate	**TXCORPGF**
Payroll	**TXSIGF**
Excise	**TXIMGF**
VAT	**TXIMGFVAT**
Windfall Profits Tax	*TXIMGFEWP*
Other	TXIMGFOTH
Federal tax rates	
Personal (effective)	RTXPGF
Personal (marginal)	*RTPMARGF*
Corporate	
Statutory rate	*RTXCGFS*
Investment Tax Credits	
Equipment	*RITC*
Research & development	*RITCRAD*
Payroll	*RTXSIGF*
State & local tax receipts	**TXGSL**
Personal	**TXPGSL**
Corporate	**TXCORPGSL**
Payroll	**TXSIGSL**
Excise	TXIMGSL
Property	TXIMGSLPROP
Grants-in aid to state & local governments	**GFAIDSL**
Medicaid	**GFAIDSLSSMED**
Medicaid (2000 $)	*GFAIDSLSSMEDR*
Other	**GFAIDSLO**
Other (2000 $)	*GFAIDSLOR*
State & local tax rates	
Personal	RTXPGSL
Corporate	*RTXCGSL*
Payroll	*RTXSIGSL*

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

Table A9. Key Variables in the Trade Sector of the Global Insight Model of the U.S. Economy *

Exports (2000 $)	**XR**
Goods	**XGR**
Food	XGFFBR
Industrial supplies	XGINR
Capital equipment other than motor vehicles	**XGKR**
Aircraft	XGKCAEPR
Computers	XGKCPPR
All else	XGKOR
Motor vehicles & parts	XGAUTOR
Consumer goods other than motor vehicles	XGCR
Miscellaneous goods	XGOR
Services	**XSVTOTR**
Tourism	XSVTOUR
Other	XSVXTOUR
Special aggregates	
Goods exports less computers	**XGXCPPR**
Imports (2000 $)	**MR**
Goods	**MGR**
Food	MGFFBR
Industrial supplies	**MGINAPETR**
Petroleum and products	MGPETR
Other	MGINR
Capital equipment other than motor vehicles	**MGKR**
Aircraft	MGKCAEPR
Computers	MGKCPPR
All else	MGKOR
Motor vehicles & parts	MGAUTOR
Consumer goods other than motor vehicles	MGCR
Miscellaneous goods	MGOR
Services	**MSVTOTR**
Tourism	MSVTOUR
Other	MSVXTOUR
Special aggregates	
Goods imports less petroleum and computers	**MGNPETXCPPR**

Exchange Rates

Major Currency Trading Partners	JEXCHMTP
Other Important Trading Partners	JEXCHOITP

Prices

Major Currency Trading Partners	WPIWMTP
Other Important Trading Partners	WPIWOITP

Foreign GDP

Major Currency Trading Partners	*JGDPMTPR*
Other Important Trading Partners	*JGDPOITPR*

Long-term government bond yield

Major Currency Trading Partners	RMGBLMTP

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

Table A10. Key Variables in the Financial Sector of the Global Insight Model of the U.S. Economy *

Interest rates	
Federal funds rate	**RMFF**
Determined by reserves	RMFFRES
Determined by reaction function	RMFFRCT
NY Fed discount rate	RMDWPRIME
Treasury yield curve	
3-month bill rate	RMTB3M
6-month bill rate	RMTB6M
1-year bill yield	RMTCM1Y
2-year note yield	RMTCM2Y
5-year note yield	RMTCM5Y
10-year note yield	RMTCM10Y
30-year bond yield	RMTCM25AY
Private security rates	
Prime rate	RMPRIME
3-month CDs, secondary market	RMCD3SEC
3-month commercial paper	RMCMLP3M
3-month Libor	RMEUROD3M
Auto Loans	RMCBLV
11th district cost of funds	RMCOF11D
30-year mortgage rate	RMMTG30CON
Existing-home mortgage rate	RMMTGEXIST
Aaa corporate bonds	RMCORPAAA
Baa corporate bonds	RMCORPBAA
Aa public utility bonds	RMCORPPUAA
Aaa Municipal bonds	RMMUNIAAA
Other Financial Variables	
M1 money supply	**M1**
Currency & travelers' checks	M1CURATC
Checkable deposits	M1DCHK
M2 money supply	M2
M3 money supply	M3
Household Net Worth	**HHNETW**
Nonfinancial Assets	HHAO
Financial Assets	**HHAF**
Equities	HHAFEQ
Money	HHAFM
Other	HHAFO
Household liabilities	HHLB
Home mortgages outstanding	**MTGHO**
Non-mortgage consumer credit	LCNMTGO
Business loans at commercial banks	LCBCAI
S&P 500	SP500

Wilshire 5000	WL5000

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

Table A11. Key Variables in the Inflation Sector of the Global Insight Model of the U.S. Economy *

Labor Costs	
Employment Cost Index (private)	
Compensation	JECIWSSP
Wages and Salaries	JECIWSP
Benefit Costs	JECIBP
Nonfarm Business Labor Costs	
Hourly Compensation	JWSSNF
Productivity	JQPCMHNF
Unit Labor Costs	**JULCNF**
Producer Prices – by Commodity	
Farm Products	WPI01
Processed Foods and Feeds	WPI02
Textiles and Apparel	WPI03
Energy	**WPI05**
Coal	WPI051
Gas fuels	WPI053
Electric power	WPI054
Utility natural gas	WPI055
Crude petroleum	WPI0561
Refined petroleum products	WPI057
Residual petroleum fuels	WPI0574
Chemicals & allied products	WPI06
Rubber & plastic products	WPI07
Lumber & wood products	WPI08
Pulp, paper & allied products	WPI09
Metals & metal products	WPI10
Machinery & equipment	WPI11
Furniture & household durables	WPI12
Transportation equipment	WPI14
Automobiles	WPI141101
Other industrial commodities	WPIINDO
All Items	**WPI**
Industrial Commodities	**WPIIND**
Less Energy	**WPIIND_05**
Producer Prices – by Stage of Processing	
Crude Materials	WPISOP1000
Intermediate Materials	WPISOP2000
Finished Goods	**WPISOP3000**
Consumer Goods	**WPISOP3100**
Foods	WPISOP3110

Energy	WPISOP3510
Other	WPISOP3600
Capital Goods	WPISOP3200
Finished Goods Less Food and Energy	**WPISOP3500**

Consumer Prices

All Items	**CPI**
Food	CPICF
Energy	**CPIE**
Commodities	CPICE
Services	CPISVE
Core (ex-food and energy)	**CPIXFAE**
Commodities	CPICXFAE
Services	CPISVXE

The model also includes price indexes for all expenditure components of GDP identified in Tables A1-A5 and A9.

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

Table A12. Key Automotive Sector Variables in the Global Insight Model of the U.S. Economy *

Consumer Durables Spending	**(2000 $)**	
	Motor vehicles & parts	**CDMVR**
	Light vehicles	CDMVLVR
	New autos	**CDMVNAR**
	New light trucks	**CDMVNTLR**
	Net purchases of used cars	**CDMVPUNAR**
	Tires, tubes, accessories & parts	CDMVTTPR
	Other motor vehicles	CDMVOR
Business Investment Spending (2000 $)		
	Gross Purchases of light vehicles	**IFMVNATLR**
	Net Purchases of used autos	IFMVPUNAR
	Net Purchases used light trucks	*IFMVPUNTLR*
Prices		
	Price indexes for all spending categories listed above	
And	Average Price of a new light vehicle ($)	PLVAVG
Unit Sales		
	Light Vehicles	**SUVLV**
	Automobiles	**SUVA**
	Light Trucks	**SUVTL**
	Heavy and Medium Trucks	SUVTHAM
Stock of Registered Vehicles		
	Automobiles	**KREGCARS**
	Light Trucks	**KREGTRUCKS**
Gasoline Consumption		
	Consumer spending on gasoline & oil (2000 $)	CNEGAOR
	Total highway consumption (gasoline & special fuels) (bill. gallons)	QGASASF
Gasoline Prices And Taxes		
	Consumption Price Index, gasoline & oil	JPCNEGAO
	Taxes on gasoline & diesel fuel (cents)	**GASTAX**
	Federal	*GASTAXF*
	State and Local	*GASTAXSL*
Crude Oil Prices ($)		
	West Texas Intermediate	POILWTI
	Average Domestic	POILDOM
	Average Imported	POILIMP

* Variables denoted in bold are defined by identities; variables denoted in italics are exogenous.

Table A13. Key Demographic Variables in the Global Insight Model of the U.S. Economy *

Population	*NP*
Under 5	*NP0T4*
16 & over	*NP16A*
55-64	*NP55T64*
over 65	*NP65A*
65-84	*NP65T84*
85 and over	*NP85A*
5-21	*NP5T21*
Males 25-54	*NPM25T54*
Labor Force And Employment	
Labor Force	**NLFC**
16-64	NLFC16T64
65-	NLFC65A
Employment (Household Survey)	**EHHC**
Unemployment Rate	RUC
Employment (Establishment Survey)	EEA

* Variables denoted in bold are defined by identities. Exogenous variables are identified by italics.

Table A14. Key Employment Variables in the Global Insight Model of the U.S. Economy *

Total Nonfarm Payrolls	EEA
Private	**EEAP**
Education & Health Services	**EEHS**
Educational Services	EEHS61
Health Care & Social Assistance	EEHS62
Natural Resources & Mining	EENRM
Professional & Business Services	EEPBS
Financial Activities	**EFIN**
Finance & Insurance	EFIN52
Real Estate, Rental & Leasing	EFIN53
Information	**EINF**
Publishing Industries	EINF51
Other Information	EINFO
Leisure & Hospitality	**ELHS**
Arts, Entertainment & Recreation	ELHS71
Accommodation & Food Services	ELHS72
Manufacturing	**EMF**
Durable Manufacturing	**EMD**
Wood Products	EMD321
Nonmetallic Mineral Products	EMD327
Primary Metals	EMD331
Fabricated Metal Products	EMD332
Machinery	EMD333
Computer & Electronic Products	EMD334
Electrical Equipment & Appliances	EMD335
Transportation Equipment	EMD336
Furniture & Related Products	EMD337
Miscellaneous Durable Manufacturing	EMD339
Nondurable Manufacturing	**EMN**
Food Manufacturing	EMN311
Beverages & Tobacco Products	EMN312
Textile Mills	EMN313
Textile Products	EMN314
Apparel	EMN315
Leather & Allied Products	EMN316
Paper & Paper Products	EMN322
Printing & Related Support Activities	EMN323
Petroleum & Coal Products	EMN324
Chemicals	EMN325

Plastics & Rubber Products	EMN326
Government	**EG**
Federal	EG91
State & Local Government	EGSL