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Global Upturn Shaping Germany's Economy

The global economy is currently in a phase of sustained growth. Will higher oil prices have a dampening effect on the world economy? Has the risk of inflation increased so much that monetary policy needs to be tightened more than so far anticipated? Are there any signs that global economic imbalances are being corrected?

The global economic upturn further strengthened during the course of last year (Figure 1). Despite the strong rise in oil prices, output expansion again accelerated in the second half of the year. With monetary policy still charting an expansive course, momentum gained strength both in the industrialised countries and in the rest of the world. Most recently this was even true of the euro area, which for a long time had lagged behind the global economic upturn. While recovery here is still fragile, however, the upturn in the USA continued. In Japan, the years of economic weakness have apparently been overcome, even though the pace of expansion slowed considerably in the second half of 2005. In addition, China and India's very strong expansion continued unabated. In other emerging economies of eastern Asia, in Latin America and in Eastern Europe, aggregate output also continued to increase significantly. Altogether, global output for the year 2005 rose by just over 3%.[1] This was a slightly lower increase than in 2004 (3.8%), due above all to base effects.

On the whole, aggregate economic activity expanded faster than potential output. Only in the euro area has the utilisation of production potential not yet returned to a significantly higher level. The cyclical position of the individual countries and regions thus continues to vary considerably; while the utilisation of aggregate production capacity is almost normal in the USA and the United Kingdom, a substantial output gap remains in Japan and the euro area. As a result, the labour market situation also continued to differ significantly. While employment increased everywhere and there was a marked fall in the number of unemployed, the unemployment rate in the euro area is much higher than in the USA and Japan as well as most other EU countries.

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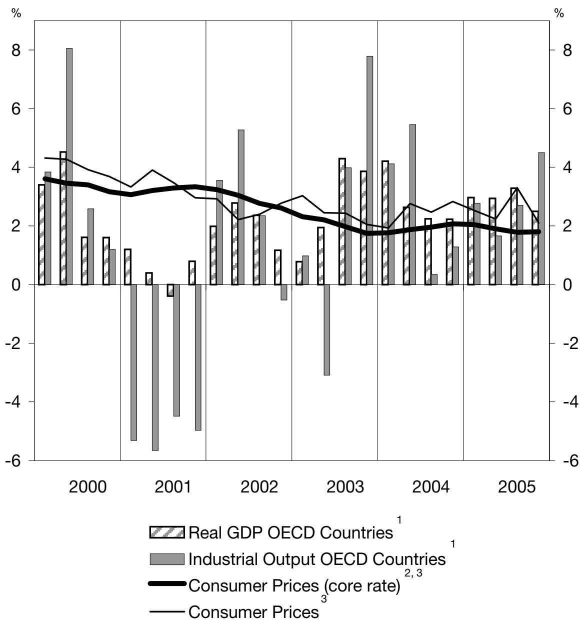
Although the strong increase in the price of oil up to last autumn did not have any discernible retarding effects on the global economy as a whole, it is having a dampening effect on the oil importing countries. One indication of this can be found in the development of consumer prices. During the autumn months the inflation rate in most of the industrialised countries was higher than it has been for some years. However, this increase was largely limited to the energy component of the price index. The core rate of inflation remained almost unchanged. In the euro area it remained little altered at 1.5% until very recently. In the USA, too, it is still within the stability range at slightly above 2%, albeit at the upper limit. For the OECD countries altogether it stood at just under 2% in November.

Increased Risk of Inflation

Oil prices have again fallen below their historical record levels in recent months. However, this should not be interpreted as a sign of weakening global economic growth. Rather, the risk of a further rise in oil prices is apparently considered to be significantly lower than it was as recently as last autumn against the background of the damage caused by hurricanes to production facilities and refineries in the Gulf of Mexico. This has probably helped reduce the magnitude of price-pushing speculation, so that the price of oil is now being increasingly determined by fundamental factors. There is little likelihood of a further marked fall in prices, however, as available output capacity remains in short supply. The high level of oil prices is being increasingly regarded as a permanent feature, thus providing incentives to develop new sources. Nonetheless, it will take some considerable time be-

[1] Weighted with gross domestic product in 2004 dollars. If weighting is carried out on the basis of purchasing power parities, and if all the countries of the world are included, as is the case at the International Monetary Fund (IMF), the resulting growth rates for the years 2005 and 2004 are 4.3 and 5.1% respectively. Cf. IMF: World Economic Outlook, September 2005.

Figure 1
World Economic Indicators



[1] Seasonally adjusted, changes over preceding quarter converted into annual rates ; 4th quarter 2005: partly estimated. [2] Total index, excluding food and energy. [3] Year-on-year change.

Sources: OECD; calculations by HWWA.

fore additional production can begin. Consequently there will be no more than a very gradual expansion of available supply in the short term. For the forecast it is assumed that the price of Brent crude will stay close to 60 dollars per barrel up to the end of the year – a level unchanged against the average for the year 2005. At the same time it is assumed that exchange rates will remain at the present level in real and effective terms.

Although oil is unlikely to be the source of any additional price pressure in the industrialised countries, the risks with regard to price stability have increased. On the one hand, hardly any countries are showing signs of sharp wage increases in reaction to the oil price-related higher inflation rate of recent months. So far there have been no apparent indications of a trend towards a sustained acceleration of price levels from this quarter. However, the scope for price increases does increase in the wake of an economic upturn or recovery. This is particularly true in view of the fact that liquidity is in ample supply worldwide. Eastern Asian countries, and China in particular, have for example bought up large amounts of US dollars which are likely to become more difficult to sterilise. In the industrialised countries liquidity expanded rapidly as a result of the low interest rate levels. This is not only true of the USA. In the euro area, too, liquidity has been increasing strongly for some time now; in the period from September to November 2005 the M3 money supply increased at a rate of 8% – almost twice as fast as the ECB considers to be compatible with stability. In Japan, on the other hand, the money supply in its broad definition continued to increase at a subdued pace; since deflationary developments and national economic weakness could not even be overcome with a central bank interest rate of zero per cent, banks' liquidity has for some years now been strongly enhanced by means of unconventional monetary policy measures.

The inflationary potential linked to such ample liquidity is nonetheless unlikely to become virulent for the time being at least. The ongoing intense pressure of international competition in particular should continue to put a brake on inflation. Experience has shown, however, that without a reduction in the high liquidity in the economy a stronger increase in prices is probable in the medium term. Moreover, current monetary policy, which has already been charting an expansive course for some considerable time, holds the danger of considerable misallocations of resources and possibly also risks to the stability of the financial system. There is concern for example that share prices, but also – despite their decline last year – those of long-term bonds, are too high. Above all, however, it is feared that the strong increase in the price of real estate in various countries during recent years may have been exaggerated.

Tightening the Monetary Reins

Consequently, major central banks are now anxious to raise their key interest rates to a neutral level. The USA has already made substantial progress in this direction, introducing a reversal in its interest rate policy as early as in summer 2004; the key rate has been raised in thirteen small steps by a total of 3¼ percentage points to 4¼%. One or two further interest rate increases are to be expected, so that a neutral level will be reached this year. In contrast to the Federal Reserve, the ECB did not begin to slightly raise its main refinancing rate – which had been held unchanged at the very low level of 2% since the summer of 2003 – until December. The difference in monetary policy has been due primarily to the divergent development of the respective economies. The upturn in the USA came much earlier. In contrast to the euro area, key interest rates there were not raised until the momentum of recovery appeared to be self-sustaining. In the euro area, economic activity has only recently picked up significantly, and the sustainability of the recovery is still uncertain. For this reason any further ECB interest rate increases in 2006 are likely to be minor, so that a neutral level will not be reached this year. Considering the sizeable output gap in the euro area, it is probable that the ECB will consider the risk of inflation to be limited for the time being. Finally, the key interest rate in Japan will probably remain at zero; however, the central bank has announced that it intends to gradually reduce its liquidity target. Interest rate increases will not take place, if at all, until the latter part of the year, and only if deflation should indeed prove to have been overcome.

Confidence in stability-oriented monetary policy should help prevent the emergence of inflationary expectations. As a result, even the long-term interest rates, which have been very low for a long time, will increase only gradually. Under these circumstances, their further increase will be largely determined by the development of the global savings surplus in relation to investments. This surplus has been very high in recent years, especially in the eastern Asian countries. For some time now, the export surpluses of the oil exporting countries have been the primary source of international capital. On the one hand it is likely to increase less rapidly in these countries because imports will expand strongly as oil prices remain constant, but on the other hand demand for capital can be expected to grow at a slower rate as the world economy moves into calmer waters. The demand for loans will ease off, particularly in countries with high private household debt levels, not least because real estate prices are likely to increase less rapidly.

Against this background, long-term interest rates will be largely determined by the expected interest rate policy. They are likely to increase approximately parallel to the rise in central bank interest rates, so that the yield curve remains flat. The differences between interest rates in the USA and the euro area as well as compared to Japan will hardly change at all. In real terms, too, capital market interest rates remain below the long-term average. From this point of view it is probable that economic development will be supported from this quarter, albeit not as strongly as was the case up to last summer.

Gradual Slowdown in the USA ...

With monetary conditions still favourable, the global economy will remain strong. This view is also supported by the fact that investor and consumer confidence has been increasing again for some time. For example, commercial investments in the USA – where monetary conditions further deteriorated as a result of the revaluation of the dollar during the course of last year – will continue to increase strongly for the time being. During the latter part of the year, however, investment in building construction – which is likely to increase strongly at first due to reconstruction work in the areas affected by last year's hurricanes – will expand at a weaker rate; last autumn's decline in construction permits is an early indication that building activity will decrease. Private consumption will also increase at a markedly slower rate during the course of the year, due primarily to the fact that growth in asset values will be considerably weaker. Prices for residential buildings in particular are flattening out perceptibly. In addition, higher interest rates will restrict the option to increase indebtedness, and refinancing has become virtually impossible as a means of reducing mortgage burdens. As a result, private consumption is being increasingly determined by income developments, especially as the savings rate – which is currently negative – is at least unlikely to fall any further. As far as wages are concerned, there are no signs of an accelerated increase in spite of the low level of unemployment, and employment will for cyclical reasons tend to grow more slowly. Exports on the other hand, which – together with imports – increased only slightly during the latter part of last year, probably due to some extent to the damage caused to the transport system by the hurricanes, could expand significantly once more. Altogether, growth of real gross domestic product will probably slow down during the course of the year; in the second half of the year it will likely be somewhat less than that of potential output. The danger of macroeconomic tension thus remains small. The inflation rate should return to the core rate.

... and in Asia

The second engine of growth in the world economy, China, but also some other emerging economies of eastern Asia and India, have not yet lost momentum either. Strong growth continued in China in particular, despite the measures taken at the start of last year to dampen expansion. Although investment in plant and equipment probably did not increase as strongly as before, private consumption and exports almost certainly expanded more rapidly. In sum, there was a further increase in the country's current account surplus despite higher oil prices. At the same time, foreign exchange reserves continued to increase substantially as the exchange rate to the dollar remained virtually unchanged, despite the transition from the strict unilateral pegging of the Chinese currency to a less rigid exchange rate regime. The fact that consumer prices increased only slightly is an indication that the rate of expansion has not yet led to any significant bottlenecks. Given the country's apparently very high growth potential it may be assumed that there will be little slackening of the pace of aggregate output expansion. This will affect neighbouring countries, some of which have considerable trade surpluses with China.

In Japan, where economic recovery was for a long time carried by exports, domestic demand has now stabilised. The financial problems faced for many years by banks and other enterprises appear to have been overcome. Corporate investments have been increasing substantially for some time now. Private consumption also increased markedly last year, spurred by the return to a more favourable employment situation and improved income prospects. The country's economic recovery should continue at the more modest pace it settled into last summer, particularly as fiscal policy is geared to dampen expansion. On the other hand, exports could continue to be a source of economic momentum, given that the international competitiveness of Japanese companies has improved as a result of currency devaluation. Real gross domestic product will increase by around 2% this year following growth of 2½% in 2005. Deflation should finally be overcome during the course of this year. However, the subsequent tightening of monetary policy that is to be expected will not have an effect on developments in the real economy until next year.

Stronger Recovery in the Euro Area

In contrast to the rest of the world, the economy in the euro area has seen only modest recovery since the middle of 2003. Following a year of renewed sluggishness, it has gained considerable momentum since the spring of 2005 and is now broader based. Exports have increased substantially again since the spring, having practically stagnated in the previous two quarters, partly as a consequence of the revaluation of the euro. Since then, however, domestic demand has also increased at an accelerated rate. Investments in plant and equipment in particular have increased considerably. In contrast, growth in private consumption continues to be negligible, although it has strengthened slightly. There were substantial differences here. In Spain, Ireland, France and Italy it expanded considerably, fostered by developments in house prices which had been rising sharply for a number of years. In other euro area countries on the other hand it stagnated or even fell slightly. Last summer's unexpectedly marked increase in final demand for industrial goods led to a reduction in stockpiles. However, the negative contribution to growth made by the change in inventories was offset by a clear rise in net exports.

Against this background there has been little improvement in the labour market situation. While unemployment has been falling significantly for some time now, this development primarily reflects – apart from revised statistics – labour market policies that are only partly linked to an increase in employment in the primary labour market. There has probably also been a marked increase in part-time work. Nevertheless, it does appear that the employment threshold has been lowered in some countries.

The rise in price levels has accelerated strongly in recent months. From September to November, consumer prices were 2½% higher than a year previously. This is not an indication of accelerated inflation, however. The higher rate is largely a result of the particularly sharp increase in oil prices which took place towards the end of last summer and had an almost immediate effect on the inflation rate. The energy component, which has a weight of 8.6% in the HICP, thus increased sharply while price developments among the other goods generally remained calm. The core rate stayed virtually unchanged at 1.5%. This was also helped by the fact that internal cost pressure remained moderate. Wage increases continued to be modest; in recent years the rise in hourly labour costs has slowed continuously to its most recent level of just over 2% compared to the previous year.

Monetary Policy Remains Expansive

Following a long period of wage restraint, however, concern is growing that the higher inflation rate could induce a change in approach to pay settlements. The ECB at any rate has been warning about the dangers of second round effects for some time. One reason for its appeal for more attentiveness, however, is that for some years now monetary policy has been charting a distinctly expansive course. While the most important central bank interest rate – which had been held constant at 2% for almost two and a half years – was raised by a quarter of a percentage point at the start of December, the Taylor rate for the euro area, which is seen as a benchmark for the ideal interest rate level in relation to the relevant phase of the economic cycle, stood at between 3 and 4½% depending on the method of calculation. Deflated by the core inflation rate, the key ECB interest rate is currently even less than 1% in real terms. Moreover, the M3 money supply expanded at a rate of 8.0% in the period from September to November – almost twice as fast as the ECB considers to be compatible with stability. The volume of loans to the private sector, which has also been expanding at an accelerated rate, is a further indication that demand and economic recovery are strengthening. Finally, the marked devaluation of the euro against the dollar that has taken place over this last year, not only nominally but also in real effective terms, has further relaxed the monetary environment.

However, monetary policy can also give rise to certain dangers if it is expansive for too long. This can be observed in the development of house prices for example. In the Mediterranean countries in particular, but also in Ireland, prices for residential buildings have – in contrast to Germany in particular as well as other central European countries – risen very steeply in recent years. For these countries there is an increased risk of price exuberation and thus of a later sharp decline. Partly in order to counteract such a development there has been an inclination at the ECB for some time now to tighten its monetary policy. In the euro area as a whole – which is the basis for any measures taken by the ECB – the increase in prices for residential property amounted to little more than 7% last year. In view of the considerable negative output gap that continues to exist, and given the prospect of a generally rather restrained path of economic recovery, it is probable that any further increase in key interest rates this year will again be slight. Altogether, monetary policy for the euro area thus continues to be expansive. However, should the relevant indicators suggest that underlying inflation is gaining strength – for example if second round effects become apparent, be they in reaction to the oil price rises that took place up to the autumn or, in Germany, in anticipation of the effects of the rise in value added tax planned for 2007 – further interest rate increases could be expected.

Any rise in long-term interest rates – which increased markedly from their historical low after the most recent oil price shock but which have since fallen again to a certain extent – will also be modest. There will be little change in the spread to interest rates in the USA that has developed over the past two years, even if there is a further slight increase in US rates. Moreover it is assumed that, following its decline last year, the external value of the euro will remain at its current level. Economic recovery will thus continue to be encouraged by the monetary environment this year.

In addition, fiscal policy should tend to be relatively expansive this year, if only for a limited period. The larger countries in particular are still under pressure to consolidate their budgets because they have already repeatedly violated the deficit ceiling established in the Stability and Growth Pact. Even so, the aggregate financial deficit in Italy will continue to grow significantly, to more than 4½%, partly because the political strength required for consolidation will be lacking in the run-up to next year's parliamentary elections. In Germany and France, the public financial deficit will be no lower than last year. Under these circumstances the aggregate deficit quota in the euro area will probably increase slightly, even though the economy develops more favourably in 2006 than it did last year, and despite the fact that the deficit is reduced in some smaller countries and Finland generates a budget surplus.

Euro Area Economy Continues to Strengthen

The global economic environment will remain favourable for the euro area, even though expansion in the rest of the world slows slightly. Furthermore, the international competitiveness of euro area companies improved considerably last year in the wake of devaluation. Exports will expand at a fast pace, while at the same time imports will increase strongly as economic recovery continues. As part of this development, the relationships with dynamic low-wage countries in particular, both within the EU and elsewhere, will further intensify. As a consequence there will be little change in the foreign trade balance.

As exports gain momentum, capacity utilisation will increase, as will earnings among the producers of tradable goods. This will raise the propensity to invest among these companies in particular. Furthermore, given that financing conditions continue to be favourable, investments in plant and equipment in particular will continue to expand rapidly. This all the more so since the consolidation of corporate finances is well advanced. Industry confidence has also recovered substantially since the middle of last year. There has even been a marked improvement in confidence in the construction sector, although building expenditure will see only modest expansion as price increases for real estate flatten out.

Private consumption will, however, continue to increase at a very moderate rate. This is also suggested by consumer confidence indicators, which have shown only modest improvements and continue to remain below the long-term average. There has even been a deterioration of expectations among private households regarding the development of the economy this year. However, with the better utilisation of companies' production capacity and with output increasing significantly once more, employment will tend to expand

Table 1
Real GDP, Consumer Prices and Unemployment Rates in the EU

	Gross Domestic Product				Consumer Prices[1]				Unemployment Rates[2]			
	Changes over preceding year in %								in %			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Austria	1.4	2.4	2.0	2.0	1.3	2.0	2.1	2.0	4.3	4.8	5.2	5.4
Belgium	0.9	2.6	1.4	2.0	1.5	1.9	2.5	2.1	8.0	7.9	8.4	8.1
Finland	2.4	3.6	2.0	3.0	1.3	0.1	0.6	1.5	9.0	8.8	8.3	8.0
France	0.8	2.3	1.6	2.0	2.2	2.3	2.0	1.9	9.5	9.6	9.4	9.2
Germany	-0.2	1.6	0.9	1.4	1.0	1.8	1.9	1.8	9.0	9.5	9.2	8.9
Greece	3.0	3.1	3.5	3.0	3.4	3.0	3.4	2.5	9.7	10.5	10.2	10.0
Ireland	4.4	4.5	4.2	4.5	4.0	2.3	2.3	2.8	4.6	4.5	4.3	4.2
Italy	0.3	1.2	0.0	1.0	2.8	2.3	2.2	2.2	8.4	8.0	7.7	7.3
Luxembourg	2.9	4.5	3.8	4.0	2.5	3.2	3.8	3.0	3.7	4.8	5.3	5.7
Netherlands	-0.1	1.7	0.5	2.2	2.2	1.4	1.4	1.3	3.7	4.6	4.7	4.4
Portugal	-1.1	1.2	1.0	1.5	3.3	2.5	2.1	2.5	6.3	6.7	7.5	7.6
Spain	2.9	3.1	3.5	3.2	3.2	3.1	3.4	3.2	11.5	11.0	9.1	8.5
Euro Area[3]	**0.74**	**2.042**	**1.357**	**1.880**	**2.078**	**2.143**	**2.161**	**2.077**	**8.699**	**8.825**	**8.441**	**8.140**
Denmark	0.7	2.5	2.5	2.2	2.0	0.9	1.2	1.5	5.6	5.4	4.9	4.5
Sweden	1.5	3.6	2.9	3.2	2.3	1.0	0.7	1.5	5.6	6.3	6.3	6.1
United Kingdom	2.2	3.1	1.7	1.8	1.4	1.3	2.0	1.9	4.9	4.7	4.6	4.9
EU 15[3]	**1.0**	**2.3**	**1.5**	**1.9**	**2.0**	**1.9**	**2.1**	**2.0**	**7.9**	**8.0**	**7.7**	**7.5**
Czech Rep.	3.2	4.4	4.8	4.0	-0.1	2.6	1.7	2.0	7.8	8.3	8.0	7.8
Cyprus	2.0	3.8	3.5	3.5	4.0	1.9	2.3	2.2	4.5	5.2	6.1	6.0
Estonia	6.7	7.8	8.5	7.5	1.4	3.0	4.2	4.0	10.2	9.2	7.5	7.1
Hungary	3.4	4.6	4.0	4.0	4.7	6.8	3.6	4.0	5.8	6.0	7.1	7.2
Latvia	7.5	9.8	8.5	8.5	2.9	6.2	6.9	6.5	10.4	9.8	9.0	8.5
Lithuania	10.5	7.0	6.9	6.5	-1.1	1.1	2.7	2.5	12.7	10.9	8.2	7.5
Malta	-1.7	0.1	0.5	0.7	1.9	2.7	2.2	2.1	8.0	7.7	8.0	6.2
Poland	3.8	5.3	3.0	4.0	0.7	3.6	2.5	2.5	19.2	18.8	17.8	17.3
Slovakia	4.5	5.5	5.5	5.2	8.4	7.5	2.7	3.0	17.5	18.2	16.5	15.7
Slovenia	2.7	4.2	4.0	4.0	5.7	3.6	2.5	2.5	6.5	6.0	5.8	5.8
New Member States[3]	**3.9**	**5.1**	**4.1**	**4.3**	**2.1**	**4.1**	**2.7**	**2.8**	**14.3**	**14.2**	**13.4**	**13.0**
EU 25[3]	**1.1**	**2.4**	**1.6**	**2.0**	**2.0**	**2.0**	**2.1**	**2.1**	**9.0**	**9.0**	**8.6**	**8.4**
Memo item:												
Export weighted[4]	-6.3	-5.4	-6.0	-5.7	2.1	2.3	2.2	2.1				

[1] Harmonised Index of Consumer Prices. [2] Standardised. [3] Total of listed countries. GDP and consumer prices weighted with GDP of 2004 in US-dollars; unemployment rates weighted with civilian labour force in 2003. [4] Total of listed countries. Weighted with shares of German exports in 2003.

Sources: OECD, Eurostat; calculations by HWWA; 2005 and 2006: HWWA forecast.

somewhat more rapidly than last year; expectations suggest that this will be the case in the service sector in particular. With wage rises remaining moderate, and only little in the way of higher transfer payments, income growth will nonetheless be subdued. In real terms, however, available income will increase more strongly as inflation is expected to fall once the effects of higher oil prices gradually diminish.

There will be hardly any decline in the savings rate in the euro area as a whole, particularly as wealth effects will tend to weaken as prices for residential buildings flatten out. During the further course of the year, however, private consumption will increase somewhat more rapidly as a result of pre-emptive effects triggered off in Germany by the increase in value added tax planned for 2007. On the other hand, this will be offset, especially in the first half of 2007, by correspondingly lower growth in private consumption.

Table 2
Real GDP, Consumer Prices and Unemployment Rates in the World

	Gross Domestic Product				Consumer Prices				Unemployment Rates			
	Changes over preceding year in %								in %			
	2003	2004	2005	2006	2003	2004	2005	2006	2003	2004	2005	2006
Industrialised countries												
EU 25	1.1	2.4	1.6	2.0	2.0	2.0	2.1	2.1	9.0	9.0	8.6	8.4
Norway	0.4	2.9	2.8	3.0	2.0	0.6	1.4	2.0	4.5	4.4	4.7	4.6
Switzerland	-0.4	1.7	1.0	1.5	0.7	1.0	1.5	1.4	4.3	4.4	4.3	4.3
Western and Central Europe[1]	1.1	2.4	1.6	2.0	1.9	2.0	2.1	2.0	8.8	8.8	8.5	8.2
Japan	1.8	2.3	2.5	2.2	-0.3	0.0	-0.3	0.2	5.3	4.7	4.4	4.2
Canada	2.0	2.9	3.1	3.3	2.8	1.8	2.3	2.0	7.6	7.2	6.8	6.7
USA	2.7	4.2	3.7	3.4	2.3	2.7	3.3	3.0	6.0	5.5	5.1	4.7
Industrialised countries, total[1]	**1.8**	**3.1**	**2.6**	**2.6**	**1.8**	**1.9**	**2.2**	**2.1**	**7.3**	**7.1**	**6.7**	**6.4**
Emerging economies												
Russia	7.3	7.0	6.0	5.5	-	-	-	-	-	-	-	-
East Asia[1,2]	3.9	5.5	4.1	4.6	-	-	-	-	-	-	-	-
China	9.3	9.5	9.5	9.0	-	-	-	-	-	-	-	-
India	7.3	7.0	6.8	6.5								
Latin America[3]	1.5	5.9	4.1	3.7	-	-	-	-	-	-	-	-
Emerging economies, total[1]	**5.6**	**7.1**	**6.2**	**6.0**								
Total[1]	2.5	3.8	3.2	3.2								
Memo item:												
Export weighted[4]	1.3	2.6	1.9	2.2	-	-	-	-	-	-	-	-
World trade, real	4.9	9.9	7.0	7.7	-	-	-	-	-	-	-	-

[1] GDP and consumer prices weighted with GDP of 2004 in US-dollars; unemployment rates weighted with civilian labour force in 2003. [2] Weighted average of: Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand. [3] Weighted average of: Argentina, Brazil, Chile, Columbia, Mexico, Venezuela. [4] Total of listed country groups. Weighted with shares of German exports in 2003.

Sources: Eurostat, ILO, IMF, OECD; calculations by HWWA; 2005 and 2006: HWWA forecast.

Altogether, real gross domestic product, which in 2005 was probably 1.3% higher than a year previously, will increase at a somewhat faster rate in 2006 (Table 1). In the second half of the year it will grow more rapidly than potential output. Employment will continue to increase slightly, and unemployment will gradually fall. It will, however, remain high. As a result, it is unlikely that wage pressure will increase. Moreover, should oil prices and the effective exchange rate remain more or less constant as is assumed here, inflation will instead tend to slow down, since, with an output gap that is only gradually closing, there is limited scope to pass on costs to the consumer in the form of higher prices. The year-on-year inflation rate will fall once more. On average for the year it will still amount to 2% due to the overhang, after 2.2% in 2005. This would mean that the stability ceiling of just under 2% would have been exceeded for the seventh year running. In view of the repeated external inflationary impulses, due in part at least to sharp rises in the price of commodities, particularly oil, this fact should not impair confidence in the ECB as the guardian of price stability. Moreover, the inflation rate will fall below the stability benchmark during the course of this year.

Only Slight Slowdown in Global Economy

All in all the world economy will remain on a distinctly upward course (Table 2). In view of the fact that much capacity is not yet being fully utilised, price developments will on the whole be calmer again. In many cases, economic momentum has gathered so much strength that an increasingly less expansive interest rate policy is required. At the same time, the robust state of the economy eases fiscal consolidation.

The expansion of world trade, which was significant again after a phase of weakness at the beginning of 2005, will continue this year. The exchange of goods can be expected to continue to expand particularly strongly in East Asia, where the high level of dynamic growth is joined by the rapid development of institutionally promoted trade integration. Among the industrialised countries on the other hand, the rate of expansion will probably be around half as great. For the year 2006 as a whole the volume of world trade will be more than 7½% higher than in 2005, when the corresponding rate was about 7%.

Considerable risk factors exist, however. For example, a flattening out of real estate prices in countries where expansion has so far been driven to a large extent by property asset developments could dampen private consumption more substantially than expected. Moreover, the global upturn has been accompanied by increasing imbalances. It is at least unlikely that these will diminish during the forecast period. Consequently there is still a significant risk that foreign countries will be less willing to finance the American current account deficit, and thus a danger of a falling US dollar and a more distinct rise in long-term interest rates in the USA; this would have a considerable dampening effect on the global economy. A further risk concerns the price of oil. Supply side disturbances could rapidly drive prices upwards once more. In contrast there appears to be little chance of a further significant fall in prices, especially as the low level of available production reserves means that OPEC can quickly influence the oil market as it desires.