

CHAPTER 2

THE GLOBAL CONTEXT

2.1 The broad picture

A strong global recovery, but losing momentum

The global economic recovery continued in 2004. World output increased by some 5 per cent, up from 3.9 per cent in 2003.⁷⁷ This was the fastest average annual rate of increase in 30 years. The strong growth in output led to a marked acceleration in world trade of goods and services, which increased in volume by nearly 9 per cent in 2004, double its growth rate in 2003. The annual average, however, masks the fact that the global recovery had started to lose momentum after the first quarter of 2004. A major factor behind this deceleration in the course of the year appears to have been the sharp rise in oil prices; but the gradual withdrawal of the economic policy stimulus in the major economies has also played a role. Moreover, the depreciation of the dollar, which resumed in the second half of the year, recalled the fact that large financial imbalances remain a major downside risk for the global economy. Against the backdrop of uncertain labour market prospects and the adverse effect of higher energy prices on households' purchasing power, consumer confidence fell in the United States and remained subdued in western Europe throughout the second half of 2004. Business confidence in the United States fell after the first quarter of 2004 and in western Europe, a modest strengthening of industrial confidence petered out into stagnation in the second half of the year.

Among the major economies, the United States and China provided the main stimuli to global growth in 2004. The rate of economic expansion in the other six major economies slowed down significantly between the second and third quarters of 2004. Real GDP in the G7 combined (which does not include China) slowed to 0.6 per cent in the third quarter compared with 1 per cent in the first quarter. Virtually all of this slowdown was due to weak growth in Japan and the four major west European economies. A direct consequence of the latter was a marked deceleration in the rate of economic growth in the euro area. But there were also indications of a weakening, albeit moderate so far, of the still buoyant growth of the Chinese economy.

Looking at 2004 as a whole, all the major regions shared in the global recovery, although growth rates varied, reflecting the differences in the strength of external and domestic demand as well as the stance of economic policy. The continued dynamism of the Asian economies stood out, reflecting especially the continued strong growth in China and India and the accelerating growth in south-east Asia. There has also been remarkably rapid growth in the CIS largely because of the boom in commodity prices. Economic activity also picked up strongly in Latin America, and in most of central and eastern Europe, economic activity continued at high momentum. The euro area, as in 2003, remained the laggard of the global recovery.

Changing preoccupations of policy makers

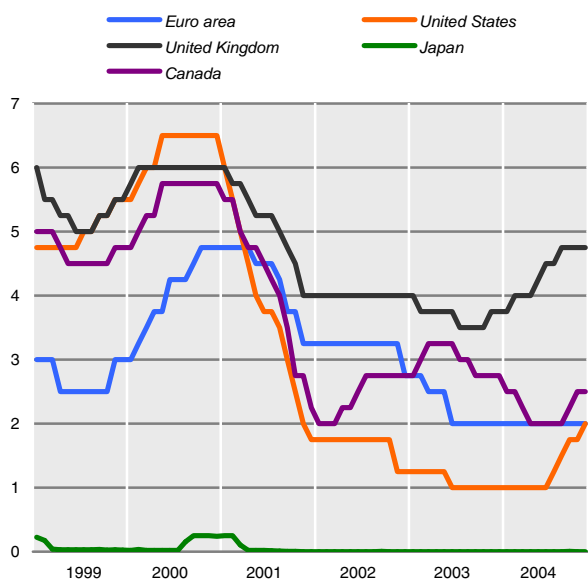
In early 2003, policy makers were still concerned at the prospect of continued sluggish growth in the aftermath of the bursting of the ICT and stock market bubbles in 2000. But the progressive lowering of interest rates by the major central banks to historically low levels (chart 2.1.1) contributed, together with a massive fiscal stimulus in the United States, to a gradual recovery of the world economy, which strengthened in the second half of 2003 and continued into 2004. Attention has now switched to the risks of higher inflation and overheating, as well as the emergence of asset price bubbles which have followed the surge in global liquidity. The main challenge now is to withdraw this massive monetary stimulus without undermining the sustainability of the global recovery.

In the United States, where the recovery was well entrenched, the Federal Reserve started to raise its key policy interest rate (the target for the federal funds rate) gradually from 1 per cent in June 2004 in four steps to 2 per cent in November 2004. In the United Kingdom, the Bank of England's Monetary Policy Committee already started to tighten monetary policy in November 2003, a process that continued during the first eight months of 2004. The central banks of Canada and Switzerland also raised their key policy rates. In contrast, in the euro area, the ECB has so far maintained a wait-and-see attitude in view of the still fragile recovery of output, leaving its main refinancing rate unchanged at 2 per cent (chart 2.1.1). There has also been a tightening of monetary controls and an increase in interest rates (among other policy measures) in China, which for a long time has

⁷⁷ Based on national GDPs using weights at purchasing power parity rates. Using weights based on market exchange rate, global real GDP rose by 4.1 per cent in 2004, up from 2.4 per cent in 2003. Consensus Economics, *Consensus Forecasts* (London), 6 December 2004.

CHART 2.1.1

Key official interest rates of major central banks, January 1999–November 2004
(Per cent per annum)



Source: Central bank publications.

Note: Euro area: main refinancing rate; Canada: target for overnight rate; Japan: uncollateralized overnight rate; United States: intended federal funds rate.

been “disconnected” from the international business cycle, to prevent overheating and ensure a “soft landing”. Fiscal policy (as judged by changes in cyclically adjusted primary balances) was slightly expansionary in the United States, but somewhat restrictive on average in the euro area in 2004. In Japan, there was a more pronounced fiscal tightening. Governments are increasingly preoccupied by the need to consolidate the public finances in the face of the mounting fiscal challenges presented by ageing populations.

A major and more immediate concern of policy makers remains the large current account imbalances across the main regions of the world economy. The United States current account deficit rose to record levels in 2004 and further increases are forecast for the next two years. The main counterparts to this deficit are large current account surpluses in Japan and Asia (especially China), and to a lesser extent in the euro area (mainly Germany). These imbalances reflect not only the differential strength of domestic demand in the United States and the rest of the world, but also the misalignment of exchange rates among the major currencies. The latter remains a potential source of disruption to the pattern of international capital flows, given the unsustainability of the large United States current account deficit and the consequent cumulative increase in net foreign debt. These concerns appeared to be the main factor behind the strong depreciation of the dollar against other major currencies in November and December 2004. The gradual reduction of the United States current account deficit without

endangering the sustainability of the global recovery is therefore the other major policy challenge.

Buoyant growth in developing markets

Real GDP in the developing countries grew by an estimated 6.1 per cent in 2004, the largest increase in three decades.⁷⁸ While this largely reflects the dynamism of Asian economies, economic growth accelerated in all developing regions. Economic activity was reinforced by a faster rate of expansion of international trade, and stimulated by competitive exchange rates, strengthening domestic demand, favourable international financing conditions, and in some regions high commodity prices.

Net private capital flows to developing markets rose somewhat in 2004 to an estimated \$226 billion, their highest level since the east Asian crisis.⁷⁹ Investors were attracted by the economic performance of these economies, ample liquidity and the relatively low rates of return to financial assets in industrialized countries. The increase in capital flows was due entirely to foreign direct investment (FDI), other types of net financial flow either falling or remaining more or less stable. The bulk of the FDI went to Asia (which received a net \$62 billion), where China accounted for over 80 per cent of the regional total (amounting to some \$50 billion). Emerging market borrowers intensified their bond emissions, so that the estimated value of their gross issuance reached the record set in 1997.⁸⁰ This reflects borrowers' efforts to lock in low interest rates and extend maturities, in anticipation of higher borrowing costs from 2005. Spreads over United States treasury bills finished the year close to the level of early 2004, when they had reached record low levels.

In developing Asia economic growth accelerated to 7 per cent in 2004, matching the pace of 2000, which was the highest since the crises of 1997-1998.⁸¹ Growth was favoured by the rise in global spending on ICT products⁸² and the dynamism of regional and global trade. The strengthening of fixed investment and the continued strong growth of domestic consumption has meant that growth became more broadly based. Rising domestic demand led to a rapid increase in imports, so that the region's current account surplus fell somewhat from its four-year high in 2003. Nevertheless, the accumulation of foreign reserves continued on a large scale in the region.

⁷⁸ World Bank, *Global Economic Prospects 2005* (Washington, D.C.), November 2004 [www.worldbank.org].

⁷⁹ Institute of International Finance, *Capital Flows to Emerging Market Economies* (New York), 2 October 2004 [www.iif.com].

⁸⁰ BIS, “International banking and financial market development”, *BIS Quarterly Review* (Basel), December 2004 [www.bis.org].

⁸¹ Asian Development Bank, *Asian Development Outlook Update* (Manila), October 2004 [www.adb.org].

⁸² Worldwide spending on ICT grew by an estimated 4.6 per cent in 2004, after a rhythm of 1.4 per cent in the previous year. EITO, *EITO Update 2004*, October 2004 [www.eito.com].

In China, economic growth has been accelerating since 2001, accompanied by a rapid expansion of credit and fixed investment to the point where higher rates of inflation and capacity bottlenecks began to emerge in some sectors. In order to fend off the dangers of overheating, the authorities have introduced since mid-2003 a number of largely administrative macro-control measures to cool down the economy. In late October 2004, the central bank raised interest rates, albeit only slightly, for the first time in nine years, a first step towards greater emphasis on market-driven mechanisms for slowing the growth of loans and fixed investment. At the same time, the ceiling on bank lending rates was abolished, a move which should help to increase the efficiency of financial intermediation. While there are signs that the growth of investment and imports were slowing down during 2004, real GDP still rose by nearly 9 per cent. In India economic growth was 6.5 per cent in 2004, high but clearly below the 8.2 per cent in 2003. The slowdown was brought about by significantly less favourable conditions in the agricultural sector, which strongly influences personal income and consumption.

In Latin America, GDP growth accelerated to an average 5.5 per cent in 2004, the fastest rate in over 25 years.⁸³ This was the first time in seven years that all economies in the region grew (except for Haiti). They benefited from the strong import demand in the United States and Asia (particularly China), increased receipts from tourism, favourable external financing conditions and from higher commodity prices.⁸⁴ The current account surplus increased somewhat from 2003, when the region had a current account surplus for the first time in more than a quarter of a century. The external stimulus was underpinned by competitive exchange rates and prudent macroeconomic policies. The combination of rising exports, improving confidence and a more positive economic outlook helped to stimulate domestic demand.

In the Middle East, economic growth was supported by the surge in oil prices. But the stimulus from the latter was partly offset by the uncertainties created by political tensions, terrorist attacks and war. In Africa, real GDP rose by some 4.5 per cent in 2004 compared with 3.7 per cent in 2003. A fairly stable macroeconomic environment contributed to the improvement as did higher commodity prices, which led to significantly improved terms of trade. There was also an increase in FDI. There were, however, large differences in economic performance across the continent, reflecting, in addition to macroeconomic fundamentals, differences in factor and natural resource endowments, in socio-political stability and in climatic conditions.

⁸³ ECLAC, *Preliminary Overview of the Economies of Latin America and the Caribbean 2004* (Santiago), December 2004 [www.eclac.org].

⁸⁴ The main commodities exported by Latin America are petroleum and petroleum products, coffee, bananas, soya beans and oil, meat, copper and iron ore.

A boom in international commodity markets

International commodity prices rose strongly in 2004 in response to unexpectedly strong demand combined with low stock levels and a relatively weak supply response. The pressure on prices appears to have been accentuated by the activities of speculative investment funds seeking alternatives to low returns on financial assets, although their actual influence on developments is difficult to gauge. Non-energy commodity prices in 2004 were some 22 per cent higher than in 2003, the biggest increase in 10 years. They were driven by metal prices, which increased on average by almost 40 per cent during the year (table 2.1.1), led by copper, lead, tin, nickel and ferrous raw materials. Demand for metals was spurred by the growth of world industrial output, particularly in China and other Asian countries. But the sharp rise in non-energy prices levelled off and was partly reversed in the second half of the year (chart 2.1.2).

Oil prices rise to record levels

Oil prices were rising rapidly during the first 10 months of 2004. They peaked at a nominal record of \$52.3 per barrel (Brent spot) in the second half of October 2004, but fell back to \$37 per barrel by mid-December (chart 2.1.3). World oil demand in 2004 rose by an estimated 3.4 per cent⁸⁵ – the largest increase in over two decades – driven by the strengthening of world economic activity and, particularly, by rising consumption in China and the United States. The large increase in demand occurred in a context of very low margins of spare capacity. Actual or potential supply disruptions in several major producing areas (Gulf of Mexico, Iraq, Nigeria, Norway, Russia, Venezuela) thus had a strong additional impact on prices. Oil prices started to retreat from their peaks in November, reflecting the emergence of excess of supply over demand and rising inventories. In November 2004, the average monthly oil price (Brent crude) was 50 per cent higher than 12 months earlier; in euros, the increase was 35 per cent. The average price for the first 11 months of 2004 was \$38 per barrel, some \$9.2 (or 32 per cent) higher than during the same period of 2003. Given the appreciation of the euro against the dollar, the rise in the euro price of oil was about 20 per cent over the same period.

In real terms (deflating nominal oil prices by an index of unit values of manufactures exported by developed countries), prices in 2004 were some 22 per cent above those of 2003 but they were still some 30 per cent below the level reached after the second oil price shock in 1980-1981 (chart 2.1.3).

⁸⁵ International Energy Agency, *Oil Market Report* (Paris), 10 November 2004 [www.iea.org].

TABLE 2.1.1

International commodity prices, 2002-2004
(Annual percentage change)

Items	Weights	Prices in dollars			Prices in euros		
		2002	2003	2004 ^a	2002	2003	2004 ^a
Energy	67.4	-0.4	14.4	35.6	-5.9	-3.9	23.0
Non-energy raw materials	32.6	2.7	14.2	21.6	-2.6	-4.5	10.6
Industrial raw materials	22.6	-1.6	17.3	25.6	-6.5	-2.1	14.2
Non-ferrous materials	9.1	-4.2	11.9	38.1	-8.8	-6.8	25.5
Iron ore, scrap	3.4	2.7	17.9	38.4	-2.6	-1.4	25.6
Agricultural raw materials	10.1	-0.6	21.6	10.5	-5.8	1.7	0.5
Food	9.9	12.0	8.1	13.2	6.1	-9.4	2.9
Total above	100	0.6	14.4	30.9	-4.8	-4.2	18.9

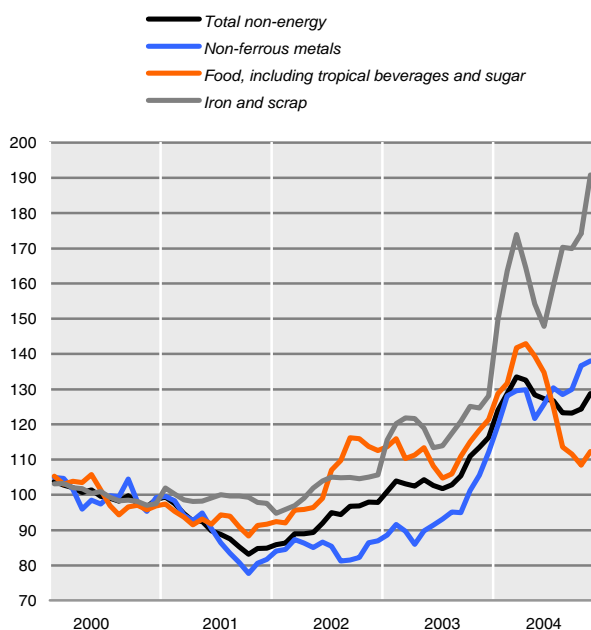
Source: Hamburg Institute of International Economics (HWWA).

Note: Weights correspond to the average shares of the various product categories in total OECD commodity imports in 1999-2001.

^a January-November.

CHART 2.1.2

Non-energy commodity prices, January 2000-November 2004
(Selected commodity groups, indices, 2000=100)



Source: Hamburg Institute of International Economics (HWWA).

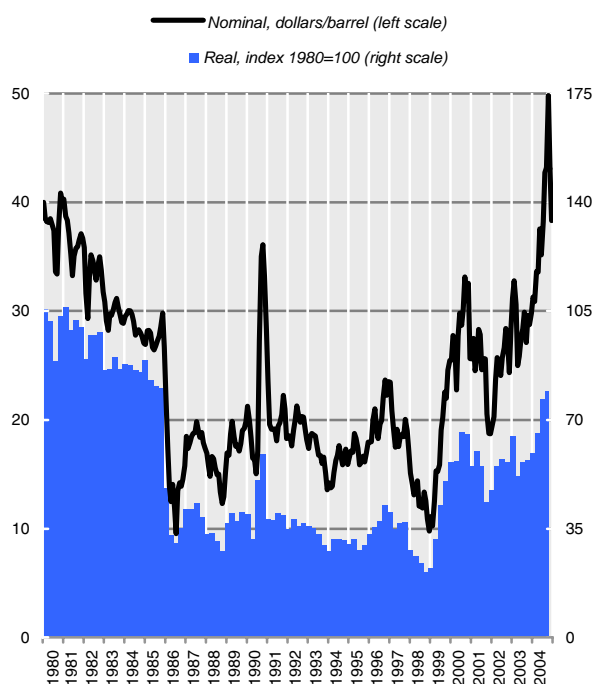
Note: Indices calculated on the basis of current dollar prices and weighted by the average shares of the various product categories in total OECD commodity imports in 1999-2001.

Equity markets remain lacklustre

In the international equity markets there was a great deal of volatility during 2004. After a buoyant start in the first quarter – sustained by positive prospects for world economic growth, improved corporate earnings and a renewed willingness of investors to take risk – global equity markets moved erratically around a basically flat trend. Investor confidence appears to have been depressed by lingering geopolitical uncertainties, concerns about the oil price, a possible hard landing in

CHART 2.1.3

Nominal and real crude petroleum prices, 1980-2004
(Dollars/barrel, index)



Source: United States Department of Energy, *Weekly Status Petroleum Report* (Washington, D.C.), various issues [www.eia.doe.gov]; IMF, *International Financial Statistics* (CD-Rom); United Nations, Common Database.

Note: Brent crude spot price, monthly averages for nominal prices and quarterly averages for real prices. The real price of crude oil was calculated by deflating the nominal price index by the unit value index of manufacturing exports of developed market economies.

China and the lowering of global growth forecasts for 2005. In late 2004, when oil prices fell sharply from their record levels in October, equity prices rallied again in the wake of renewed confidence in the continuation of the global recovery. All told, between January 2004 and end-November, prices in the major equity markets increased on average by only 5 per cent.

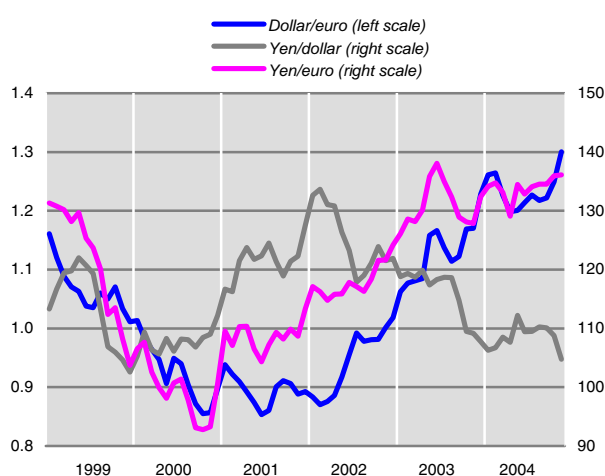
The dollar depreciation continues

The main development on the foreign exchange markets in 2004 was the further weakening of the dollar in the second half of the year, which accelerated in November and more than reversed an appreciation in the first five months of the year (chart 2.1.4). This slide of the dollar has been mainly due to the increasingly perceived need for a fundamental realignment of the exchange rate in order to correct the large United States current account deficit and the associated rise in external financial liabilities. Concerns about the large and persistent government budget deficit have likely also played a role.

The exchange rate between the dollar and the euro rose to a record \$1.33 in early December 2004. The yen/dollar rate fell to ¥102.6, a five-year low, with no apparent attempt by the Japanese authorities to intervene in

CHART 2.1.4

Bilateral exchange rates between the dollar, the euro and the yen, January 1999–November 2004

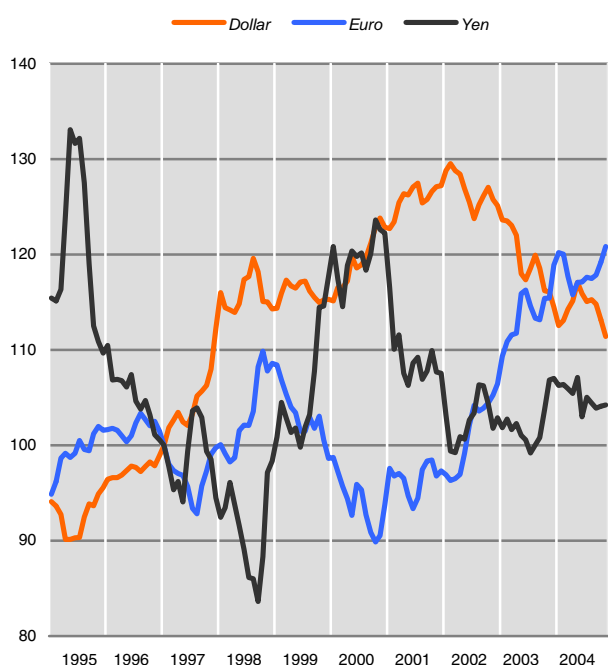


Source: Eurostat, NewCronos Database; Board of Governors of the Federal Reserve System [www.federalreserve.gov].

Note: Average monthly values.

CHART 2.1.5

Nominal effective exchange rate indices of the dollar, the euro and the yen, January 1995–November 2004
(Indices, 1997=100)



Source: Dollar: Board of Governors of the Federal Reserve System [www.federalreserve.gov]; euro: ECB [www.ecb.int]; yen: Datastream.

Note: Broad index for the dollar and the euro.

the market. Since reaching a monthly low in February 2002, the euro had appreciated by nearly 50 per cent against the dollar in November 2004. The yen has risen against the dollar by some 27.5 per cent over the same period. The dollar also weakened markedly against other

major currencies, such as the UK pound and the Swiss franc, as well as several Asian currencies, in late 2004. The Chinese monetary authorities, however, maintained the parity of their currency peg to the dollar for the ninth consecutive year, although there have been increasing pressures from speculative capital inflows and from the United States for a revaluation.

From its previous high in February 2002, the nominal trade-weighted exchange rate of the dollar had fallen 15 per cent by November 2004 (chart 2.1.5). Over the same period, the nominal effective exchange rate of the euro appreciated by some 25 per cent. In contrast, the effective exchange rate of the yen rose by only about 5 per cent over the period between February 2002 and November 2004.

2.2 The United States and Japan

(i) The United States

Recovery continues, driven by domestic demand and exports

In the United States, economic activity grew at a brisk pace in 2004, driven by domestic demand. Exports picked up in a favourable external environment and helped by the weaker dollar. But the ongoing surge in imports meant that the change in real net exports continued to be a drag on domestic output. Real GDP rose by 4.4 per cent, significantly above the trend rate of output growth of some 3¼ per cent; as a result, the gap between potential and actual output became quite small in 2004.⁸⁶ Private consumption, supported by a slowly recovering labour market, low interest rates and the wealth effects from the booming housing market, was the mainstay of economic activity (table 2.2.1). Households also lowered their savings rate from its already low level of 1.4 per cent of disposable income in 2003. Buoyed by continued low mortgage rates, the housing market remained strong, with a solid expansion of residential investment and a record number of home sales. Some cooling in house sales, however, appears to have dampened the rise in house prices in late 2004. The growth in consumer spending also appears to have levelled off in the final months of 2004 against a background of declining consumer confidence, high energy prices and expectations of more moderate economic growth in 2005 with associated concerns for the labour market (chart 2.2.1).

Business spending on equipment and software was buoyant, stimulated by improved profitability, rising capacity utilization rates and tax incentives. The decline in spending on industrial buildings in the previous three years appears to have bottomed out in 2004. But business confidence declined after the first quarter of

⁸⁶ OECD Economic Outlook No. 76, Preliminary edition (Paris), November 2004.

TABLE 2.2.1

Changes in real GDP and main expenditure items in the United States, 2003QIII-2004QIII
(Percentage change over previous period)

	2003		2004		
	QIII	QIV	QI	QII	QIII
Private consumption	1.2	0.9	1.0	0.4	1.2
Final consumption expenditure of general government	-0.3	0.5	0.5	0.2	0.8
Gross fixed capital formation	3.7	2.1	1.1	3.1	1.5
Stockbuilding ^a	0.1	0.1	0.3	0.2	-0.2
Total domestic expenditure	1.6	1.2	1.2	1.1	1.0
Exports of goods and services	2.7	4.1	1.8	1.8	1.6
Imports of goods and services	0.7	4.0	2.6	3.0	1.5
Net exports ^a	0.2	-0.2	-0.2	-0.3	-0.1
GDP	1.8	1.0	1.1	0.8	1.0

Source: United States Department of Commerce, Bureau of Economic Analysis.

Note: Data are seasonally adjusted. 2004QIII figures are preliminary estimates.

^a Percentage point contribution to real GDP growth.

2004, against the background of a less optimistic economic outlook (chart 2.2.1). This is also reflected in the downward tendency of the ISM business activity indicators, although they remained well above the threshold of 50, a pointer to the ongoing expansion of business activity (chart 2.2.2).

Labour markets improve gradually

The recovery, with an unusually long lag, was also reflected in an upturn of employment, although this was relatively subdued by historical standards. Non-farm payrolls in November 2004 were 1.9 million higher than

at the beginning of the year, an increase of 1.4 per cent. The number of employees, however, was still slightly below its previous peak in March 2001. The unemployment rate fell by only 0.2 percentage points to 5.4 per cent over the same period, reflecting an increase in the labour supply. Slowing productivity growth in the third quarter of 2004 combined with rising wage costs put some upward pressure on unit labour costs, which have nevertheless remained moderate. Intense competition has limited the ability of producers to pass on the higher cost of energy.

Consumer price inflation edged up somewhat, largely because of higher energy prices. The headline inflation rate averaged 2.5 per cent, year-on-year, during the first 10 months of 2004, but the rate of core inflation, which excludes food and energy products, was only 2 per cent.

External imbalances deteriorate further

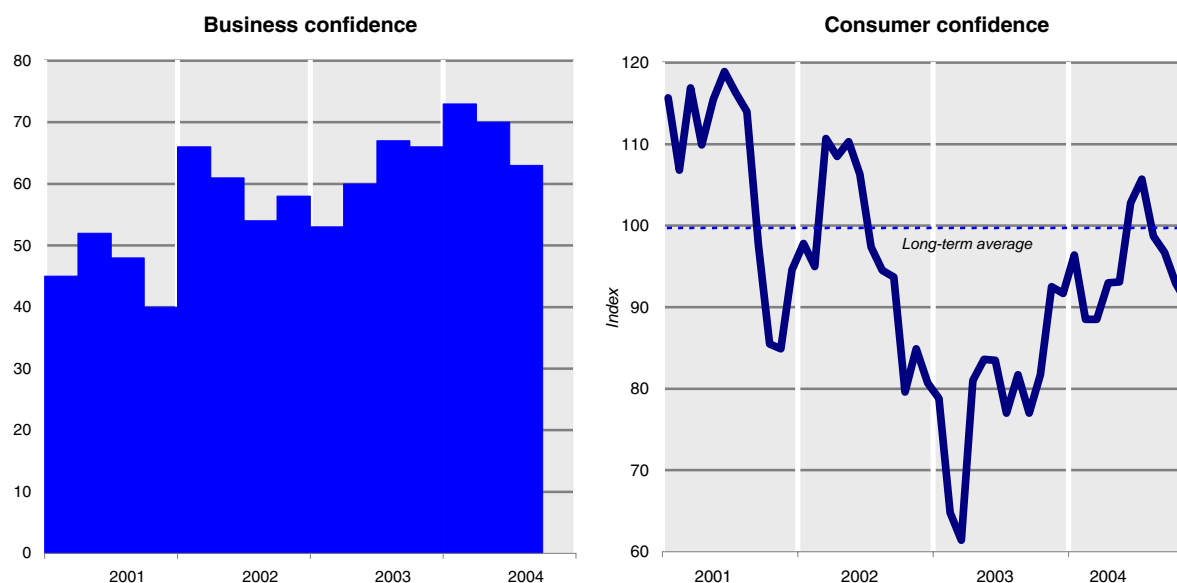
The trade deficit surged to record levels in 2004, increasing by some \$100 billion to around \$605 billion. The current account deficit amounted to some \$670 billion or 5.7 per cent of GDP, up from 4.8 per cent in 2003. The gap between the current account and trade deficits widened in 2004 (a trend which is expected to continue in 2005 and 2006) due to a deterioration in the net balance of factor income, a result of the net outflow of dividend and interest payments to foreigners holding dollar denominated financial assets.

A gradual reversal of the expansionary monetary policy stance

Against a background of economic growth, the Federal Reserve started to gradually raise the target for

CHART 2.2.1

Business and consumer confidence in the United States, January 2001-November 2004
(Business confidence, balances; consumer confidence, index 1985=100)

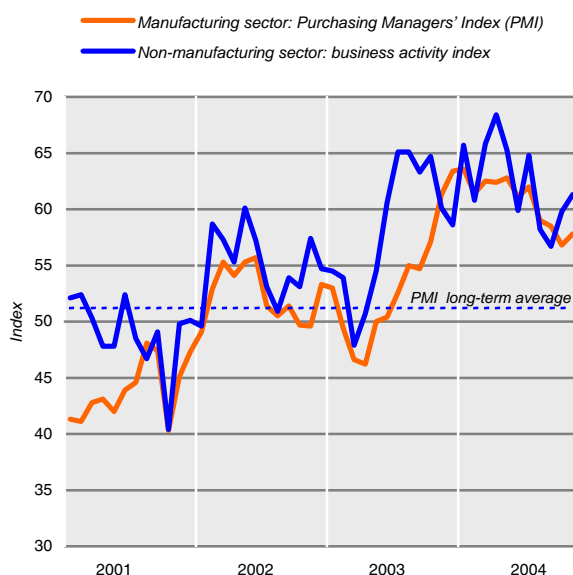


Source: The Conference Board [www.conference-board.org].

Note: For business confidence, a value above 50 indicates more positive than negative responses (quarterly values, 2001Q1-2004QIII). Long-term average value of consumer confidence for 1990-2003.

CHART 2.2.2

Surveys of business activity in the United States, January 2001–November 2004
(Per cent)



Source: Institute for Supply Management (Arizona) [www.ism.ws].

Note: An index value above (below) 50 indicates that the sector is generally expanding (contracting). Long-term average of PMI for 1990-2003.

the federal funds rate, which had been at a 46-year low of 1 per cent since June 2003. The target rate was raised in four steps each of a quarter of a percentage point to 2 per cent between June and November 2004. Monetary policy, however, is still very supportive of economic growth. Real short-term interest rates (based on the CPI) continued to be negative. Moreover, the moderate tightening of monetary policy was offset by the further depreciation of the dollar in the second half of 2004. At the long end of the maturity spectrum, yields on 10-year treasury bonds rose by 90 basis points to 4.7 per cent between March and June 2004, reflecting, *inter alia*, concerns about the inflationary impact of higher oil prices and the large fiscal deficits. Long-term yields fell back to 4.2 per cent in November in the face of expectations of weaker growth in 2005. Contemporaneous real long-term yields were close to 2 per cent in 2004.

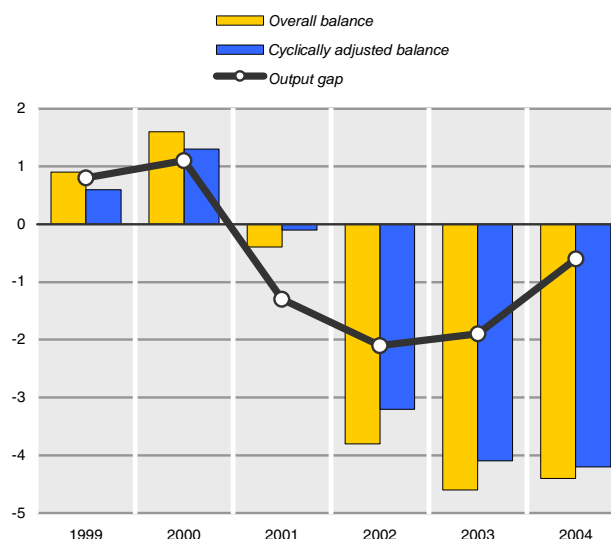
Following two years of strong fiscal stimuli (chart 2.2.3), fiscal policy was only slightly expansionary in 2004. The general government deficit is estimated at 4.4 per cent of GDP, compared with 4.6 per cent in 2003. The bulk of this deficit is structural.⁸⁷

Short-term prospects remain favourable

The short-term outlook for the United States is for continued expansion but at a rate more in line with the

CHART 2.2.3

General government financial balance in the United States, 1999-2004
(Per cent of GDP)



Source: OECD Economic Outlook No. 76 (Paris), November 2004.

Note: Overall balance as a per cent of actual GDP; cyclically adjusted balance as a per cent of potential GDP. Figures for 2004 are estimates.

underlying trend of output growth. Real GDP is forecast to increase by 3.5 per cent in 2005. The level of employment is expected to pick up somewhat and the unemployment rate to fall again. The stimulus from monetary policy will be further reduced in 2005. Long-term interest rates are thus expected to edge upward during 2005. At the same time, fiscal policy is expected to have a small contractionary impact on economic activity, *inter alia*, a reflection of the phasing out of special investment incentives for the business sector and smaller income tax refunds. Against this background, the recovery will continue to be supported by a strong, albeit moderating, growth of private consumption. The personal savings rate is expected to remain below 1 per cent of disposable income in 2005. Non-residential business investment should remain buoyant, stimulated by shrinking margins of idle capacity and favourable prospects for profitability. The boom in residential investment is expected to level off, partly because of the rise in interest rates. Exports should benefit from the favourable global environment and the depreciation of the dollar. Changes in real net exports, moreover, will exert less of a drag on overall economic activity. The current account deficit is expected to rise to a level corresponding to more than 6 per cent of GDP.

Apart from high oil prices, the major downside risks to this benign scenario include uncertainty about the spending behaviour of private households in the face of high levels of debt, a fading house price boom and less favourable financing conditions due to rising interest rates. If labour market performance were to be less

⁸⁷ Ibid.

favourable than expected, that would also weigh on consumer confidence and risk an increase in the household savings rate with a corresponding reduction of demand. The current account deficit in combination with the large government budget deficit may trigger adverse reactions in the international financial markets with concomitant upward pressures on interest rates in the bond markets.

(ii) Japan

Another false dawn?

In Japan, the strong recovery, which started in the second quarter of 2003, faltered in the second quarter of 2004. Economic growth slowed down sharply to near stagnation in the second and third quarters. Nevertheless, real GDP still rose by some 3.4 per cent in 2004 due to the strong statistical carry-over effect⁸⁸ from the end of 2003. While consumer spending remained strong, business fixed investment and the growth of exports slowed down. At the same time, the cuts in public investment continued at a rapid rate. The loss of cyclical momentum was also visible in a weakening of industrial production and the continuing fall of prices in 2004. The decline of the consumer price index decelerated in 2004, in contrast to the continued rapid decline of the GDP deflator, the broadest measure of price changes in an economy. Land prices also continued to fall. The financial sector, however, has made progress

in the consolidation of non-performing loans, and the long-term decline in bank lending appears to be bottoming out. The stance of monetary policy remained unchanged in 2004, with the central bank's overnight lending rate being held at virtually zero per cent. Yields on 10-year government bonds were only 1.5 per cent in late 2004. Interventions in the foreign exchange market designed to stem the appreciation of the yen against the dollar appear to have ceased after the first quarter of 2004 leading to some tightening of overall monetary conditions. Fiscal policy was contractionary in 2004. The actual government budget deficit is estimated at some 6.5 per cent of GDP in 2004, down from 7.7 per cent in 2003.

The assessment of the underlying cyclical momentum, however, has been made more difficult than usual by revisions to the national accounts statistics.⁸⁹ Based on currently available data, forecasts are for economic growth to slow down in 2005 to an average annual rate of 1.5 per cent. This reflects both a moderate increase in domestic demand and a weaker growth of exports. Given the dependence of the Japanese economy on exports, a strong appreciation of the yen will risk an even further weakening of economic growth. Given the explosive trajectory of government debt, which was equivalent to 170 per cent of GDP in 2004, the main medium-term challenge for policy makers in Japan is to correct and consolidate the public finances.

⁸⁸ Maintaining real GDP throughout 2004 at the level of the final quarter of 2003 would anyway have ensured an average annual growth rate of 2 per cent.

⁸⁹ Preliminary estimates of GDP based on a new (chain-linked) deflation method, put the annual average rate of economic growth in 2003 at 1.3 per cent compared with an estimate of 2.5 per cent based on the old methodology. Based on the latter method, real GDP rose by 4.4 per cent, year-on-year, during the first three quarters of 2004. Preliminary revised data using the new methodology put the growth for the same period at only 3.2 per cent.