GLOBAL ECONOMY IN 2007

2007 was a successful but also pivotal year for global economy – mainly for the US but also for the economic cycles of other G3 countries. According to the International Monetary Fund, annual global economic growth totalled 4.9%, which is almost as much as in 2006 (5%; see Table 1). In 2008, growth is expected to decelerate to 4.1%.[1]

Regionally, growth was relatively different in 2007. Developing Asian countries were in the lead with 9.6%, China's growth even accelerating to 11.4%. In Central and Eastern European countries growth diminished from 6.4% to 5.5%. US economic growth decelerated further and reached an estimated 2.2% (2.9% in 2006). Euro area's growth figure stood at 2.6% and Japan's at 1.9%; growth decelerated also in these regions but less than in the US. Compared to the forecasts made at the beginning of the year, US economic growth was 0.2 percentage points below the target, whereas in the euro area 0.6 and in Japan 0.1 percentage points above the target.[2]

Meanwhile, inflation picked up in advanced economies. In OECD countries it rose to 3.3% by the end of the year; that is the highest level in six years. Inflation was driven by the continuing oil price surge from 60 dollars per barrel to almost 100 dollars at year-end, and also by upward price pressures stemming from heightened demand for consumption. Labour market trends reflected the differences in the economic situation of the G3 countries quite accurately: unemployment increased in the US, but decreased in the euro area and fluctuated up and down in Japan.

Significant developments took place in global financial markets. The first half of 2007 saw a continuation of the upward trend that had prevailed in the stock markets in earlier years, whereas mid-July witnessed a clear downturn. The key determinant was the ongoing decline of the US housing sector, which passed on to other economic sectors and caused problems related to credit quality and liquidity conditions in money markets all over the world. These problems and the worsened economic outlook increased investors' risk aversion and caused a significant drop in interest rates in the second half-year. The increasing uncertainty was also reflected in the great increase in gold price during that period.

Table 1. Economic indicators of advanced countries

	GDP growth (%)		Annual average CPI growth (%)		State budget surplus or deficit (% of GDP)		Current account balance (% of GDP)	
	2006	2007*	2006	2007*	2006	2007*	2006	2007*
World	5.0	4.9						
Advanced economies	3	2.7	2.4	2.2	-2.6	-2.2	-1.5	-1.2
United States	2.9	2.2	3.2	2.9	-2.6	-2.5	-6.2	-5.3
Japan	2.4	2.1	0.3	-	-3.8	-3.4	3.9	4.9
Euro area	2.8	2.6	2.2	2.1	-1.4	-0.6	-0.1	-0.2
Germany	2.9	2.5	1.8	2.3	-1.6	-	5.0	5.6
France	2.0	1.9	1.9	1.6	-2.5	-2.4	-1.3	-1.3
Finland	4.9	4.4	1.3	1.6	4.1	5.3	4.6	4.6
Other EU countries								
United Kingdom	2.9	3.1	2.3	2.3	-2.6	-3	-3.9	-4.9
Sweden	4.1	2.6	1.5	1.7	2.3	3.2	8.5	8.3

* Data for 2007 are preliminary.
Source: IMF World Economic Outlook (April 2008)

[1] IMF World Economic Outlook Update, January 2008.
[2] Consensus Forecasts, January 2007.

THE UNITED STATES AND JAPAN

US economic growth weakened in 2007 and economic problems became more pronounced. The year-end even witnessed speculations of a potential economic recession. This was mainly induced by the continually deteriorating situation in the real estate sector, comparable to the period of economic downturn in early-1990s. Namely, housing prices dropped and the country faced a crisis of subprime mortgage loans. This was the burst of the real estate bubble that had evolved in earlier years, followed by a stock market decline in the second half of the year.

This situation had a negative impact on other sectors too. At the beginning of 2007, industrial activity improved slightly but started to decrease again in the second half-year. In December, the industrial sector's activity index fell even below 50 points (the borderline between growth and contraction). Private consumption was also relatively weak: annual growth in retail trade ranged within 3–6%. Employment growth slowed further and in 12 months unemployment increased from 4.4% to 5.0%. In the second half-year when the stock market decline added to other economic difficulties, also consumer confidence suffered considerably.

As concerns US external balance, a slight decrease in the current account deficit could be noted, which may be related to the downward trend of the dollar's exchange rate and weakening domestic demand. Nevertheless, the deficit was still 5–6% of GDP. Budget balance did not change significantly, as its deficit stayed in the range of 1–2%.

Inflation remained mostly at the level of 2–3%. Headline inflation exceeded 4% towards year-end, whereas core inflation stood at 2.4% in December; thus, inflationary pressures mainly stemmed from the prices of energy and food.

In the light of heightened risks surrounding economic growth, problems in financial markets and the financial sector and the increasing possibility of an economic decline, the Federal Reserve started to lower the key interest rate in September. By the end of the year, it had declined from 5.25% to 4.25%.

Japan's growth rate decreased from 2.4% to 1.8% over four quarters. Thus, last year faced a moderation in growth; estimated average annual growth was 1.9%. Industrial activity declined primarily in the first half of the year, and thus second-quarter growth posted negative results. In the second half-year, industrial activity gained momentum again. No clear trends could be identified in the labour market; unemployment ranged within 3.6–4.0%. The growth rate of retail trade was negative in the first half-year but became positive later on. However, the situation is far from being stable, as the decline in stock markets and deterioration of economic outlook entailed a significant decrease in consumer confidence in 2007. Inflation rose to 0.7% by the end of the year but was still close to zero with energy and food prices excluded. Since economic growth was close to its potential rate at the beginning of the year, the Japanese central bank increased the monetary policy interest rate from 0.25% to 0.5% in February and retained this level until the year-end.

EURO AREA

Growth in the euro area decelerated from 2.8% to an estimated 2.6% in 2007. Activity weakened in the industrial as well as service sector; industrial output growth slowed to 1.7% by the end of the year. This was mainly brought about by the consistent tightening of monetary policy over the past two years (the key interest rate was last raised in June 2007 – to 4%), the strengthening euro exchange rate and the decrease in external demand (growth decelerated in the US as well as Japan). Yet another contributor was the rise in food and energy prices. Similar to the US and Japan, the decline in stock markets and difficulties in the financial sector prompted a sharp fall in consumer confidence also in the euro area in the second half-year.

Inflationary developments of the euro area were similar to those of the US: by the end of the year, price pressures arising from the oil price increase drove annual consumer price growth to the highest level since the adoption of the euro; that is, to 3.2%. Meanwhile, within 12 months the core inflation (CPI excluding food, energy, alcohol and tobacco) increased from 1.5% to 1.9%. Unemployment in the euro area continued to decrease and eased to 7.2% by the year-end.

The economic outlook of the euro area was relatively positive in the first half of 2007. Consequently, the European Central Bank raised the key interest rate twice to 4% in that period. However, later developments deteriorated the outlook, which is why the key interest rate was maintained at the same level until the end of the year.

Euro area's economic outlook for 2008 is considerably weaker compared to the 2007 figures. The International Monetary Fund expects a 1.5–1.6% growth in all G3 countries (1.6% in the euro area) in 2008.[3]

[3] IMF World Economic Outlook Update, January 2008.