Bank of Finland

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The world economy has continued to grow at a brisk pace, but there are clear signs of a slowing in the pace of growth in some industrial countries. US growth has eased as a consequence of the slower housing market, while in Japan growth has been subdued by more sluggish private consumption. In the euro area, growth has remained relatively robust, primarily due to the recovery in investment. The broadly based growth in the Finnish economy has continued. The fall in the world market price of crude oil has slowed inflation worldwide in recent months.

According to data on the third quarter of 2006, there has been a slight deceleration in the pace of economic growth in some of the main industrial countries (Chart 1). At the same time, the improvement in confidence has come to a halt, although industrial confidence is in general still strong (Chart 2). Outside the major industrial economies, the brisk pace of growth seems to be continuing, contributing to a fairly rapid pace of growth in the world economy, at around 4%. The fastest phase of growth in the world economy is, however, already over, and the focus of growth is shifting. The emerging economies are continuing to grow rapidly, while in the United States in particular output growth in the near future is likely to be slower than in recent years. In the euro area, too, the recovery in growth has already given way to a more even trajectory.

Since August, there has been a marked drop in the price of crude oil, largely due to the dissipation of short-term uncertainties over supply. This has led to lower inflation in the major economic areas in September–October (Chart 3). This was particularly marked in the United States, where slower growth and reduced inflation pressures have convinced the financial markets that the period of tightening monetary policy is now at an end. In Japan, the expected gradual raising of the exceptionally low policy rate has been slightly delayed. In the euro area, the markets expect the ECB to continue to raise interest rates until the first half of 2007. Thus, the interest rate cycles of the major economic areas are currently at different phases. Monetary policy nevertheless continues to be accommodative in both the euro area and Japan.

The risks relating to world growth have not disappeared in recent months. They include the imbalances in the world economy, primarily concerning the large current account deficit and low level of household savings in the United States and the considerable current account surpluses of many emerging economies. The US housing market has long been subject to risks, and these have to some degree begun to be realised. Although, to date, the slowdown in the US economy appears to be moderate, the risk of a total halt to growth has not disappeared. Indeed, there is at present an exceptionally large degree of uncertainty surrounding the short-term future for the US economy. In addition, uncertainty still remains surrounding the future price of oil and other commodities, and the implications this has for inflation.

In contrast to the pattern of recent years, euro area growth is being sustained primarily by domestic demand, while the growth impact of net imports is declining as a result of the slower pace of the world economy. On the other hand, there is to date little sign of a recovery in private consumption. At present it looks possible that euro area growth, too, peaked in the first half of 2006. Present evidence nevertheless suggests growth will continue at a reasonable level in the near future.

The Finnish economy has continued to grow strongly, supported by both domestic demand and exports. Survey data indicates that both business and household confidence remain bright. The decline in the unemployment rate has, however, come to a halt. The drop in oil prices has slowed inflation in Finland, too, although service price inflation has picked up somewhat during 2006.

A marked drop in the price of oil

The price of crude oil began to come down in August 2006, and the dollar price is currently around 20% below the summer peak (Chart 4). Petrol prices have also fallen steeply. There are several reasons for the fall in oil prices: the decline in geopolitical uncertainty in the Middle East, the accumulation of large inventories of crude oil and oil derivatives, and the reduction of demand pressures due to the easing of growth in the world economy. In particular, uncertainty over the scarcity of free production capacity in the OPEC countries appears to have eased in recent months.

The drop in the price of oil has caused an easing in the pace of inflation in all major economic areas. This trend has been further strengthened by comparison with the same period last year, as the price of oil was rising in autumn 2005 due to the hurricanes in the United States. The drop in the price of oil and petrol could boost household consumption via the increase in real purchasing power. This could in turn increase future domestic inflation pressures, particularly in oilimporting countries. However, the recent halt in the downward trajectory of oil prices means the positive impact on world growth is likely to be relatively small.

Despite the recent decline, the price of oil is likely to remain relatively high, and eg the futures market supports the general expectation that there will be no further drop in prices. OPEC apparently believes prices have fallen far enough, as it was able to reach rapid agreement on production cuts to begin in November 2006. The uncertainty surrounding the supply of crude oil has not disappeared, and there is therefore no current prospect of the price of oil falling to the levels prevailing at the turn of the millennium.

US housing market recession dampens growth

US economic growth slowed more quickly than expected in the second and third quarters of 2006. Third-quarter growth was 2.2% (at annual rate) compared with the previous quarter. Relative to the previous year, growth was 3.0%.

The main factor behind the slower US growth is the contraction in housing construction. Housing prices have begun to fall as a result of declining sales and a marked increase in unsold properties (Chart 5). Although there were already signs of activity slowing down in the US housing market towards the end of 2005, the trend recently has been stronger than expected. The latest sales figures hold out no hope of a recovery in the US housing market in the near future.

Despite the weaker activity on the housing market, US household consumption has shown little sign of slowing down in 2006. Thus, the wealth effect from falling housing prices has so far had little effect in depressing consumption. Household consumption has recently been supported particularly by a growth in incomes underpinned by the accelerating pace of wage rises (Chart 6). In contrast, the pro-growth effect of the tax cuts in the early years of the decade and the decline in the household saving ratio in 2005 has ceased during 2006. Even so, the saving ratio has remained negative, and in the third quarter it stood at -1.3% of disposable income.

US inflation slowed markedly in September–October as a result of the fall in the price of oil. At the same time, however, underlying inflation (inflation excluding food and energy) has remained fairly high since the acceleration that began in spring 2006. Meanwhile, the pace of increase in unit labour costs has accelerated, with a more rapid rise in labour costs and slower improvement in productivity. This could sustain inflationary pressures.

The US growth outlook is still fairly bright, although the pace of growth is easing as private consumption subsides. If the continued low saving ratio were to start to climb, however, this could slow growth in private consumption more than forecast, particularly if there were to be a simultaneous and marked weakening in the labour and housing markets.

Share prices up; less movement in exchange and interest rates

Of the major economic areas, the United States and Japan have not altered their key interest rates since the summer, while the euro area has continued to raise its policy rate (Chart 7). In the United States, the signs of slower growth have increased market participants' belief that the period of tighter monetary policy is coming to an end. In Japan, meanwhile, interest rates are expected to continue their gradual rise.

Long-term interest rates in the major economic areas have fallen slightly during the autumn (Chart 8). The tightening of monetary policy in the euro area has led to the 12-month money market rate rising close to the 10-year rate, and at times even above it. In the United States, this has been the situation for around a year already. Based on CPI-linked bonds, it would appear the financial markets' long-term inflation expectations have in recent months receded somewhat, especially in the United States, most probably as a consequence of the drop in the price of oil.

Stock markets have developed very positively during the autumn, with share prices rising in all major economic areas. The rise in share prices reflects market participants' confidence in continued strong corporate earnings development. At the same time, indicators of future stock market uncertainties have continued to decline and are now very low historically. This reflects a fairly rapid recovery in investors' readiness to take on risk after the dip that occurred during the financial market turbulence of the spring. The drop in the price of oil has also presumably had a positive impact on share prices. All in all, it would seem the stock markets expect world growth to continue at a relatively brisk pace, while the risks of significantly slower US growth or accelerating inflation are not considered to be very great.

On the foreign exchange markets, movements in the euro and the US dollar, measured by the trade-weighted currency index, have been small in recent months, although the euro has appreciated slightly in recent weeks. Meanwhile, the Japanese yen has begun to depreciate again following the spring pause (Chart 9). This is presumably partly because rate-hike expectations have been slightly delayed as a result of the weakening outlook for the Japanese economy. At the same time, the recovery of readiness to take on risk has once again encouraged investors to use cheap yen-denominated loans to fund higher-yielding investments abroad. These carry trades attempt to exploit interest rate differences between currencies and could contribute to the weakening of the yen against currencies with a higher expected return on investment.

Signs of slower growth in Japan, China still growing briskly

Economic growth in Japan faded slightly in the second and third quarters of 2006. In the third quarter, quarterly growth was around 2% (at annual rate). The slower rate of growth is largely due to a marked cooling off in private consumption growth. Third-quarter growth was due almost entirely to inventory accumulation and increased exports. Indeed, viewed from the perspective of the near-term outlook, the structure of recent growth could be unfavourable, especially if the fading of world growth puts the brakes on Japan's export growth and there is no recovery in private consumption. Meanwhile, Japanese inflation remains sluggish after several years of deflation.

Chinese economic growth continued briskly in the third quarter of 2006, at around 10.5% on the same period in 2005. Growth was, however, almost one percentage point down on the previous quarter, largely due to slower investment growth. The slower pace of growth could be a sign that the actions of the central bank and other authorities, eg to dampen lending growth, are beginning to bear fruit.

Euro area growth slowing after a strong first half

There was a marked acceleration in euro area growth in the first half of 2006. Second-quarter growth was almost 4% up on the first quarter (at annual rate). This was the fastest growth in the euro area for five years. In large measure, the faster growth in the first half of the year can be attributed to a recovery in investment, whereas private consumption growth was subdued, particularly in the second quarter. Euro area growth slowed to around 2% in the third quarter, although private consumption growth was relatively robust.

Viewed country by country, euro area growth in the first half of 2006 was broadly based. At the same time, national differences in the pace of growth between the large euro area countries were smaller than in previous years. Second-quarter growth in Germany, Spain, France and the Netherlands was within the range of 4–5% on the previous quarter (at annual rate), while Italian growth was under 2%. The Italian economy is still suffering from structural problems, and the country has lost further ground in respect of foreign trade competitiveness relative to the other large members of the euro area. In most of the smaller countries in the euro area second-quarter growth was around 4%. Advance data on the third quarter suggests growth was particularly weak in France, while the engines of euro area growth would appear to be Germany and Spain.

Euro area growth has continued at a reasonable pace in the second half of 2006, if slightly more slowly than in the second quarter. Business confidence has remained strong at the same time as industrial output and company order books have continued their strong growth. Earnings development in euro area companies has also continued to be mainly favourable in the third quarter. Thus, the slower US growth does not so far appear to have been reflected in the outlook for businesses in the euro area.

Euro area exports have also continued to perform strongly during the autumn, which means the negative impact on exports of the earlier euro appreciation has at least so far been fairly negligible. Exports have grown, particularly to the new EU member states, China and the oil-producing countries. Exports to the United States have, in contrast, declined, due to the slowdown in US growth. The euro area current account has, however, gone slightly into deficit, as imports, too, have grown strongly.

There are some signs that private consumption growth in the euro area has picked up in the second half of the year. Both retail trade and consumer confidence indices have remained high compared with recent years. Euro area labour market trends have also been positive in 2006, although the fall in the unemployment rate has come to halt during the autumn at just under 8%. Second-half household consumption has been further supported by the increase in real income caused by the drop in the price of oil. In addition, German households are likely to bring forward some of their consumer durables purchases from early 2007 to the end of 2006, as the turn of the year will bring an increase in value-added tax in Germany.

The recovery in investment activity in the euro area has been gaining strength since the beginning of 2005 (Chart 10). In 2006, investment growth has gathered pace across a fairly broad front, as there has been a strong increase in investment in equipment and machinery and in construction investments. The increased level of investment has been helped by corporate confidence in the recovery of the euro area economy and continued strong growth in the world economy. Moreover, the financial environment for investment has been favourable, as corporate earning capacity has generally been good and interest rates low.

The recent strong economic growth in the euro area has improved the financial position of general government. According to the forecast by the European Commission, the general government deficit ratio will contract in 2006 by almost ½ percentage point to 2%, and this trend is expected to continue in the immediate years ahead. General government debt is, in turn, forecast to decrease by around 3.5 percentage points to 67% of GDP between 2005 and 2008. General government finances have been boosted particularly by higher tax revenues due to the favourable business cycle. However, Germany, Italy, France, Greece and Portugal are still within the sphere of the euro area's Excessive Deficit Procedure. Of these countries, the most positive trend in general government finances has been in Germany, and for all the others apart from Italy the Commission forecasts the deficit will be reduced in 2006.

Euro area inflation dampened by drop in the price of oil

Inflation according to the harmonised index of consumer prices (HICP) for the euro area remained above 2% in summer 2006, but slowed considerably in September–October to around 1.6–1.7%. This was due almost entirely to the fall in energy prices during the autumn and their high level in the comparable period a year earlier.

The extent to which the strong rise in the price of oil in recent years has been passed onto the prices of other products in the euro area is still very limited. The pace of rise in the prices of other industrial products and of services has remained almost unchanged in 2006. There has also been no sign so far of any increase in wage pressures in the euro area. Although the pace of increase in labour costs has accelerated somewhat, productivity growth has also been relatively brisk. As a result, unit labour costs, which influence future inflationary pressures, have risen relatively slowly. Even so, there is still a risk of higher inflation. This relates primarily to the passing on of the earlier rise in the price of crude oil into the prices of other products and to the supply-side restrictions caused by the favourable economic and employment trends. The next few months could see higher inflation, primarily due to the increase in value-added tax being introduced in Germany at the turn of the year.

The volume of money and credit in the euro area has continued growing rapidly in autumn 2006, indicating ample monetary conditions. Particularly strong has been the growth in corporate lending, whereas growth in households' demand for housing loans has eased somewhat. The high level of corporate lending partly reflects the recovery of investment in the euro area, while the slower growth in housing loans is in part a consequence of higher interest rates.

The Governing Council of the European Central Bank has continued the policy begun at the end of 2005 of reducing the easiness of monetary policy. At the beginning of December 2006 the policy rate was raised to 3.50%, an increase of 1.50 percentage points in the past year. Despite the raising of the policy rate, monetary policy continues to be accommodative. By raising the policy rate, the Governing Council is seeking to forestall longer-term risks to price stability. The financial markets expect the ECB to continue raising the policy rate in the first half of 2007.

Finnish economy still going strong

The Finnish economy continued to grow strongly in the first half of 2006 (Chart 11). Growth from the same period the previous year was approximately 5.6%, but this figure was boosted by the paper industry labour dispute in the first half of 2005. Based on the monthly GDP indicator, the economy continued to grow fairly briskly in the third quarter; but in Finland, too, there have been some signs of a slowing in the pace of growth.

The strength of Finnish growth has been broadly based. Positive household confidence, growth in aggregate wages and rising asset values have supported growth in private consumption. At the same time, the outlook for industry has also remained bright and the strong performance of Finland's export markets – particularly Russia and the euro area – has sustained export growth.

The downward trend in Finland's unemployment rate has come to a halt during 2006 at around 8%. At the same time, there has been an increase in the number job vacancies and employers have experienced a shortage of skilled labour, particularly in the construction sector. This suggests that a significant proportion of Finnish unemployment is currently structural.

The Finnish housing market has gradually cooled during the second half of 2006. Annual growth in the stock of housing loans has slowed and the number of house sales has declined relative to 2005. Despite the slowdown, the housing loan stock has continued to grow relatively briskly, particularly in view of the rising trend in interest rates that began at the end of 2005. This is partly because there is a time lag in the rise in the 12-month Euribor (the most common reference rate in Finland) being passed on to the interest charged on housing loans (Chart 12). The deceleration in the pace of growth in the housing loan stock can be expected to continue as the higher interest rates filter through into interest charged on housing loans.[1]

General inflation lower in Finland, but service prices rising faster

The fall in the price of oil has slowed the pace of inflation as measured by the harmonised index of consumer prices in Finland, too. Finland's annual inflation in September–October was under 1%, while in the summer it was still in the region of 1.5%.

[1] The household sector debt burden is dealt with in the forthcoming Bank of Finland publication *Financial stability in Finland* (Finnish version, *Rahoitusjärjestelmän vakaus*, published on 14 December 2006).

In product categories other than energy the average price rise has been fairly steady in recent months (Chart 13). Prices for non-energy industrial goods have remained more or less stationary, due eg to increased competition. In contrast, the upward trend in service prices has gradually accelerated during the course of 2006. The main reason for this has been the upturn in telecommunications service prices following years of declining prices.

Wages in Finland have been rising faster in 2006 than the average for the euro area. The rise in unit labour costs has, however, remained moderate due to favourable productivity development, and the inflationary pressures from rising wages have therefore been small so far.

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