

Less robust world economic growth in the wake of ageing populations

The Federal Planning Bureau presents a world macroeconomic projection for the 2007-2013 period in its January 2007 issue of "The NIME Outlook for the World Economy".

Less robust worldwide output growth and generally contained inflation rates are projected for the 2007-2013 period. Output growth is primarily supported by stable productivity growth and domestic demand. However, the rate of growth of gross domestic product (GDP) should decline in Japan over the entire projection period, and decline in the euro area as of 2010. In the euro area and Japan, growth is expected to be adversely affected by the fall in the working-age population, which will weigh on the labour supply. These demographic trends should make labour scarcer, thus fuelling inflation through real wage increases. Nominal interest rates trend upward over the 2007-2013 period, as monetary authorities in the euro area and Japan move to ensure price stability in the face of rising inflationary tensions. Inflation rates are, however, tempered by generally declining oil prices. Overall growth prospects currently appear to be subject to one major uncertainty. Though the fiscal imbalances in the United States should be gradually resorbed and give way to budget surpluses, the US current account deficit will remain high and thus constitute an ongoing threat to the external value of the dollar.

Euro area growth: currently solid economic fundamentals are put in peril by a decline in working-age population

After a year of sturdy economic growth in 2006, *euro area* gross domestic product (GDP) growth is forecast to come out at 2.1 per cent in 2007; at the same time, the deflator of private consumption should rise by 1.8 per cent. The pick-up in growth is largely based on a further strong rise in employment, on now positive real wage developments and comes despite the tightening of monetary policy.

Over the entire 2007-2013 period, the euro area's real GDP is projected to rise at an average annual rate of 1.8 per cent. Growth is underpinned primarily by robust domestic demand. Consumer price inflation should average 2 per cent per annum, edging up to 2.3 per cent toward the end of the projection period. The nominal short-term interest rate should rise from a year average level of 4 per cent in 2007 to 4.9 per cent in 2013, thus containing the build-up of inflationary pressures. The long-term interest rate rises from 4.4 per cent in 2007 to 5 per cent at the end of the period. After a depreciation of 1.8 per cent and 0.1 per cent respectively in 2005 and 2006, the euro area's nominal effective exchange rate is expected to appreciate by 1.9 per cent in 2007. The area's nominal effective exchange rate is further projected to appreciate at an average annual rate of 2.7 per cent over the 2007-2013 period due to a combination of rising euro interest rates and higher average inflation in the rest of the world. Despite the euro area's ageing population and the subsequent increase in public transfers to households, fiscal consolidation continues at a steady pace, as indicated by the fall in the area's fiscal deficit from 1.9 per cent of GDP in 2007 to 0.9 per cent of GDP in 2013. The euro area's economic fundamentals appear to be generally well-oriented, leading to balanced medium-term growth prospects that are over-shadowed only by the medium- to long-term economic effects of its ageing population.

US economic growth will be affected by the scheduled expiration of significant tax cut provisions which should also lead to the gradual elimination of the federal budget deficit

In the *United States*, real GDP growth is expected to remain robust and come out at 2.6 per cent in 2007. Over the 2007-2013 period, real GDP is expected to expand at an average annual rate of 2.6 per cent. However, growth should be uneven over the 2007-2013 period: after a period of strong growth, real GDP growth should falter in 2011 as a number of significant tax provisions expire. Consumer price inflation is expected to decline from 3.1 per cent in 2006 to 2.3 per cent in 2007 following the string of interest rate hikes over the previous years and the fall in oil prices. Moreover, strong productivity growth over the entire projection period limits the increases in real unit labour costs and thus helps to keep inflation under control. The nominal short-term interest rate should decline from a year average level of 4.9 per cent in 2007 to 3.8 per cent in 2013. On average, inflation should come out at 2.1 per cent a year over 2007-2013. Net exports make a small positive contribution to GDP growth only as of 2011. The dollar's nominal trade-weighted exchange rate

appreciates at an average annual rate of 2.5 per cent due to the higher average inflation rate in the rest of the world (excluding the EU and Japan) over the projection period. In the absence of any major shock to the external value of the dollar, the US current account deficit should stabilise but remain high throughout the 2007-2013 period. Under current laws and policies, the gradual expiration of tax cut provisions over the projection period should lead to the resorption of the US fiscal deficit and give way to a fiscal surplus of 0.3 per cent of GDP by 2013.

Japanese economic growth falters in the face of an ageing population

Japanese real GDP is expected to rise by 2.9 per cent in 2007 and to progress on average by 2.2 per cent per annum over the 2007-2013 period. However, growth is projected to slacken noticeably over the projection horizon as the labour supply contracts in the wake of an ageing population. In 2007, the deflator of private consumption should break free from an eight-year spell of deflation and rise at a year average rate of 0.2 per cent. Inflation is further projected to reach an average annual rate of 1.3 per cent over the 2007-2013 period. Accordingly, the country's nominal short-term interest rate rises from a year average level of 0.8 per cent in 2007 to 4.2 per cent in 2013. Assuming unchanged fiscal policy, Japan's budget deficit is expected to come out at 5.1 per cent of GDP in 2007 and to edge down to 4.5 per cent in 2011 before rising once again to 4.8 per cent of GDP in 2013. This projected rise in the fiscal shortfall after 2011 underscores the difficulty of striving for long-term fiscal consolidation when monetary authorities simultaneously raise interest rates in a move to normalise their policy stance, as such an attempt to rebalance the budget would unavoidably weigh on the country's medium-term growth prospects.

Prospects in other areas and main uncertainties

Over the 2007-2013 period, GDP growth in the *Western non-euro EU Member States* (Denmark, Sweden and the United Kingdom) should average 3 per cent per annum, firmly underpinned by a robust domestic demand. Consumer price inflation is projected to reach an average annual rate of 2.2 per cent over the projection horizon. The area's medium-term demographic trends are expected to be the main factor curbing an otherwise sound domestic-led economic expansion.

Real GDP in the *twelve new eastern EU Member States* is projected to rise at an average annual rate of 4.5 per cent over the 2007-2013 period, while the deflator of private consumption is expected to rise at an average rate of 2.1 per cent per annum.

Gross output in the *rest of the world* is projected to expand at an average annual rate of 5.5 per cent over the 2007-2013 period, while the rate of inflation should come out at an average level of 4.7 per cent per year over the same period.

Finally, in the light of its potential to adversely affect world economic growth and stability, the major downside uncertainty surrounding this world economic outlook lies in a still possible, abrupt and sharp depreciation of the US dollar.

Inquiries and comments on this Outlook for the World Economy

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