1. State of the Economy

Data for the first nine months of 2005 provide indications that the Maltese economy has started to register a gradual but consistent turnaround from the challenging environment it was operating in during the past few years. The noticeable expansion in the GDP, improvements in the labour market performance and further progress along Government's ambitious fiscal consolidation plans are noteworthy. On the other hand, one notes that a host of external and domestic challenges needs to be addressed if such a recovery is to be sustained in the future. In particular, on the international front, the economic situation in Malta's main trading partners is still relatively weak, whilst the risk of further exogenous shocks stemming from rising energy prices is still considerable. In addition, the international environment is becoming increasingly competitive due to stronger market positions by emerging low-cost countries. On the domestic side, the fiscal consolidation process is expected to exert further drag over the short run expansionary prospects of the domestic economy. Furthermore, a number of economic sectors continue to face competitiveness challenges.

At 1.7 per cent, real growth in Gross Domestic Product (GDP) shows an improvement over the negative or positive, but marginal, rates registered in recent years. Nevertheless, this growth rate remains relatively low when compared to historical growth rates. During the January-September 2005 period, economic growth was mainly underpinned by a significant increase in gross fixed capital formation, which reflected Government's capital programme. A marginal increase was also recorded in private final consumption expenditure. Domestic demand thus increased in real terms, as these advances offset the decline registered in Government's final consumption expenditure. On the other hand, the contribution of the external sector to GDP growth was negative as the drop in exports of goods and services in real terms was significantly higher than the decline registered in imports of goods and services. In this context, it is pertinent to note that the performance of a major company in the semi-conductor sector influenced significantly the external sector of the economy.

Labour market data also indicates some positive results. In particular, the rise in unemployment registered in recent years appears to have been halted, with the unemployment rate falling to 4.5 per cent from 5.1 per cent a year earlier. Furthermore, employment has increased, by a significant degree as regards part-time employment, and more modestly, as regards the full-time gainfully occupied population. Within the context of a challenging economic environment, this performance shows a certain degree of resilience of the domestic labour market. Furthermore, the significant increase in part-time employment, continuing the trend registered in recent years, indicates a shift towards part-time work as the primary occupation, reflecting changing work patterns and increased labour market flexibility.

Despite the relatively subdued domestic demand conditions, the inflation rate remained relatively high during 2005 and reached 2.76 per cent in September 2005, from 2.57 per cent a year earlier. Both domestic factors, as well as international factors, namely higher international oil prices, underpinned the rise in the inflation rate registered during the period under review. Meanwhile, a review of collective agreements currently in force shows that average weekly wages increased by 3.5 per cent between September 2004 and September 2005.

During the first nine months of 2005, exports by the manufacturing industry declined by 10.6 per cent. However, this was attributed to the performance of the semi-conductor sector. Indeed, various sectors have managed to register positive results, despite the weak demand in Malta's main trading partners. On the other hand, local sales by the manufacturing industry declined marginally, being mainly affected by the removal of levies on agro-industrial products last year. In this context, it is noteworthy that an increase in local sales by the furniture sub-sector was registered during the period under review, thus partly reversing the declining trend of the previous years.

In the tourism industry, the increase in tourist departures registered in the first three quarters of 2003 was sustained during the Survey period. Nevertheless, at 1.2 per cent, the increase remains modest and the domestic tourism industry continues to face challenges from international competition. Gross earnings from tourism improved, while the number of nights spent declined. Employment in hotels and restaurants stood at 8,360, representing 6.1 per cent of the gainfully occupied population. Meanwhile, cruise passengers' arrivals increased, thus recouping part of the decline registered in 2004.

During the period under review, the current account deficit widened by Lm45.4 million. This was mainly the result of developments in the goods account. In particular, in the merchandise account, the drop in exports of semi-conductors outweighed the decline in the import bill, which in turn was influenced by the significant increase in international oil prices. On the other hand, improvements were registered in the services balance and in current transfers, whilst the negative balance in the income account registered a marginal increase.

The Survey period was characterized by a continuation of budgetary consolidation, in line with Government's medium-term fiscal policy framework. The structural deficit declined by Lm24.5 million to Lm85.4 million. This reflected an expansion in recurrent revenue which exceeded by a significant margin the rise in total expenditure.

Whilst the data for the January-September 2005 period highlights certain positive developments in the Maltese economy, further efforts need to be undertaken by various sectors in order to sustain these improvements in the future. In particular, the increasingly competitive and changing international environment call for a strengthening of competitiveness and increased flexibility in the domestic economy. Furthermore, the attainment of Government's fiscal targets is necessary to ensure a stable macroeconomic framework.

Local Scene

Economic Growth

During the first nine months of 2005, real GDP advanced by 1.7 per cent. In nominal terms, GDP advanced by 3.7 per cent to reach Lm1,417.1 million. Within the domestic demand component of GDP, private final consumption expenditure advanced marginally in real terms by 0.2 per cent. In nominal terms, this component of expenditure advanced by 2.4 per cent to reach Lm872.4 million. An increase of 4.1 per cent was registered in household disposable income, and given that consumption expenditure increased at a lower rate compared to the increase in household disposable income, the savings ratio improved to 5.8 per cent.

Government consumption expenditure declined by 1.7 per cent in nominal terms during the first nine months of 2005. In real terms, a decrease of 3.8 per cent was recorded. A significant increase of 7.0 per cent in nominal terms was recorded in the gross fixed capital formation component of GDP, primarily driven by Government's capital programme. In real terms, gross fixed capital formation advanced by 5.1 per cent to Lm268.6 million.

Exports of goods and services declined by 6.8 per cent in real terms, whilst imports of goods and services declined by 2.9 per cent. In nominal terms, exports of goods and services declined by 5.7 per cent and stood at Lm988.8 million, whilst imports of goods and services fell by 0.9 per cent to Lm1,095.9 million.

The external sector of the economy was significantly affected by developments in a major company in the semi-conductor sector.

Sectoral Contribution to Gross Value Added

During the first nine months of 2005, Gross Value Added (GVA) at basic prices rose by 2.0 per cent in nominal terms and stood at Lm1,208.4 million. Sectoral increases were registered in financial intermediation, real estate, renting and business activities, transport, storage and communications, wholesale and retail trade, construction and other community, social and personal services activities. The growth registered in these sectors as well as minor increases in other sectors offset the declines registered in electricity, gas and water and manufacturing sectors of the economy.

Gross National Income (GNI) advanced by Lm50.4 million during the first nine months of 2005, to reach Lm1,391.7 million. The increase was primarily underpinned by an increase in GDP at current market prices. Compensation of employees increased by Lm15.8 million, or 2.4 per cent when compared to the level of Lm645.7 million recorded for the January-September 2004 period. Average weekly compensation per employee in nominal terms stood at Lm124.84, registering an increase of 1.4 per cent over the same comparable period of last year. Real average weekly compensation per employee for the Survey period declined by 1.3 per cent. At Lm556.1 million, gross operating surplus and mixed income registered an increase of 2.9 per cent. Taxes on products and imports increased by Lm22.2 million to reach Lm226.0 million, whilst subsidies only registered a marginal increase.

Labour Market

In spite of the challenging economic environment, the performance of the labour market during the twelve months to September 2005 indicates a certain degree of resilience of the domestic economy. During the Survey period, the full-time gainfully occupied population rose by 213 to 137,813. The number of persons registering as unemployed under Part I of the Register declined by 874 to 6,508 at the end of the period under review. Since the decline in persons registering as unemployed exceeded the rise in the full-time gainfully occupied population, the labour supply declined by 717 reaching 145,023 at the end of September 2005. In the meantime, the number of persons with a part-time job as their main occupation stood at 23,138 representing an increase of 2,190 or 10.5 per cent over September 2004. In recent years, increasing importance is being attached to part-time work as the main occupation, reflecting changing work patterns as well as the relative degree of flexibility in the labour market.

During recent years, developments in the gainfully occupied population were marked by increased reliance on the private sector, especially private market services as the source of job creation in Malta. Employment in the private sector, inclusive of temporary employment, increased by 1,515 to 92,514 at the end of September 2005. This expansion reflected an increase in private market services that exceeded the drop recorded in private direct production. On the other hand, employment in the public sector, inclusive of temporary employment stood at 45,299, representing a decline of 1,302 employees over September 2004. Consequently the share of private sector employment in the gainfully occupied population increased by 1.0 percentage point to 67.1 per cent, while the share of total public sector employment declined to 32.9 per cent.

Productive Activities

Turnover in the manufacturing industry registered a decline of 8.6 per cent when compared to the previous Survey period. This was underpinned by a 10.6 per cent decline in exports, reflecting the performance of a major company in the radio, TV and other communication equipment sector. It is pertinent to note that despite the sluggish international economic environment, exports in other sectors in the industry, such as the food and beverages (which traditionally was domestic oriented), textiles and textile products, chemicals and chemical products and electrical machinery and apparatus sectors registered improvements. Local sales registered a marginal decline and stood at Lm161.0 million, mainly due to increased competition from imports in the food and beverages sector. On the other hand, improvements were recorded in the other non-metallic mineral products, fabricated metal products, the furniture and other manufacturing products, publishing and printing and machinery and equipment sectors. Investment declined by 19.1 per cent in the period under review, whilst employment income remained practically unchanged at Lm89.8 million.

In per capita terms, average weekly sales declined by 7.4 per cent and stood at Lm914.85 whilst average weekly exports per capita fell by 9.4 per cent, to Lm704.76. On the other hand, per capita weekly compensation levels rose marginally to reach Lm117.24.

Although accounting for a small proportion of GDP, the agriculture and fisheries sector still maintains its importance in the local economy and various financial assistance and incentive schemes are designated to assist this sector. During the first nine months of 2005, the amount of livestock slaughtered was less than that recorded in the same period in 2004. While the amount of fruit and vegetables sold was less than that sold in the previous Survey period, the wholesale value of fruit and vegetables increased minimally by 1.5 per cent. During the period under review, both total fish landings and the wholesale value of fish landings registered substantial increases. Exports of fish increased considerably following a substantial increase in the exports of tuna. However the value of these exports declined by 6.2 per cent compared to the previous Survey period.

Although faced by increasing competition from low cost shipyards in the Black Sea, Croatia and Turkey, the first six months of this year were positive for Malta Shipyards Limited, and although the summer period has seen a drop in activity, significant activity at the yard is expected in the coming months. In line with Government's objective of transforming the industry from a net beneficiary of state aid into a commercially viable enterprise by 2008, Malta Shipyards Limited is seeking to diversify into new markets so as to attract more ship repair business and enhance its commercial prospects.

Services Activities

Service activities are an important pillar of the Maltese economy, being reflected in the contribution to output growth, employment and foreign exchange earnings. The decline in tourism departures recorded during the first three quarters of 2002 was partly reversed during the nine months ending September 2003 and further gains were recorded in the corresponding 2004 and 2005 periods. Tourist departures during the period under review increased by 1.2 per cent over the same period of 2004. Nevertheless, these growth rates remain modest and the domestic tourism industry continues to face challenges from international competition. Gross earnings from tourism increased by 1.3 per cent to Lm204.7 million during the first nine months of 2005. Per capita earnings remained stable at a level of Lm219.8. Earnings per night spent increased marginally to Lm22.9 for the period under review from Lm22.3 for the corresponding period in 2004. Employment in hotels and restaurants as at September 2005 stood at 8,360 persons, representing 6.1 per cent of the gainfully occupied population. Cruise liner passengers recorded an increase of 10.7 per cent during the Survey period, thus recouping part of the decline registered in the previous year.

During the Survey period, the Malta Financial Services Authority continued to act as the supervisor and regulator of the financial services sector in Malta. Malta Enterprise, as Government's main agency responsible for attracting foreign direct investment and supporting enterprises in Malta, has provided financial assistance and advisory services to both foreign and local companies based in Malta or considering establishing operations in Malta.

Prices and Incomes

Percentage changes in the 12-month moving average for the Retail Price Index (RPI) show that the inflation rate in Malta in September 2005 stood at 2.76 per cent. The inflation rate remained relatively high during 2005, with the lowest level of 2.63 per cent being recorded in October 2004 while the highest level was recorded in June 2005 with a reading of 2.94 per cent. During the observed period, the inflation rate was attributable to higher average prices in all the commodity groups composing the RPI, with the exception of the clothing and footwear category. In particular, the inflation rate was affected by the rise in average prices of transport, housing, water and electricity.

An analysis of average wage levels in 2005, compiled from the collective agreements of 209 companies employing a total workforce of 30,506 persons, shows that the average weekly wage rate increased by 3.5 per cent or Lm3.37. The analysis also shows that the highest wage rise in percentage terms was recorded in the Banking and Other Financial Institutions which registered an increase of 9.7 per cent. Wages increases in other sectors were relatively lower, ranging from 1.6 per cent to 4.4 per cent. The largest share of employees (53.3 per cent) for all firms earned on average a weekly wage rate of over Lm94.00.

Foreign Trade and Payments

An increase of Lm45.4 million in the current account deficit was underpinned by international trade developments, particularly the significant increase in international oil prices, falling semi-conductor prices on the international market, and their effect on an international firm in the semi-conductors industry which represents a major share of Malta's exports. In addition, economic activity in Malta's main trading partners remained below potential, further contributing to a lower demand for Maltese exports. Indeed, exports to Malta's major trading partners registered a decline. In this scenario, an increase in exports of chemicals and semi-manufactures must be commended.

The decline of Lm86.1 million in export activity registered during the Survey period was not followed by a corresponding decline in imports. Indeed, imports of industrial supplies recorded a relatively modest decline of Lm12.4 million during the Survey period. This indicates that manufacturing production continued despite lower demand for Maltese exports. In addition, excluding the one-off importation of yachts recorded last year, imports of capital goods remained stable at 2004 levels, reaching Lm160.0 million in the first nine months of 2005.

The increase in imports of consumer goods recorded in 2004 continued during the Survey period. This partly reflects higher imports of food and beverages following the removal of levies upon to EU accession. An increase in imports of durable consumer goods was also registered.

The marginal increase in the fuel import bill at a time when international oil prices have increased substantially is related to the termination of bunkering services by a major operator in 2004. If account is taken of this development, the oil import bill would increase significantly in line with international developments in this market.

The increase in the deficit in the merchandise account was partly offset by higher net receipts from services. This was due to lower net payments on transport services and higher net receipts on other services such as communications and business services. Meanwhile, tourism earnings were marginally higher than the receipts recorded in the January-September period of 2004.

Higher receipts, primarily in the form of interest income were offset by higher payments resulting from the improved profitability of foreign-owned companies during the Survey period. As a result, the balance on the income account remained stable. On the other hand, net outflows by way of current transfers increased, partly reflecting Malta's contribution to the EU.

Financial Developments

Developments in Government's fiscal position in the first nine months of 2005 reflect ongoing efforts to consolidate public finances. In fact, the structural deficit declined from Lm109.9 million in the first nine months of 2004 to Lm85.4 million during the Survey period. This reduction in the fiscal imbalance was attributable to an expansion in recurrent revenue which more than offset an increase in total expenditure. Government recurrent revenue increased by Lm68.7 million to Lm606.9 million during the first nine months of 2005, driven by both higher tax and non-tax revenue.

Total Government expenditure (excluding contribution to the Sinking Fund in respect of local and foreign loans and direct repayment of loans) increased by

Lm44.3 million to Lm692.3 million. This expansion was attributable to higher recurrent expenditure and capital expenditure as well as higher interest on public debt. Recurrent expenditure, which constitutes around 79 per cent of total expenditure, increased from Lm518.1 million to Lm543.5 million. Meanwhile, capital expenditure increased from Lm75.6 million in the first nine months of 2004 to Lm93.1 million during the period under review. Interest payments on public debt, which accounts for around 8 per cent of total expenditure, increased by Lm1.5 million to Lm55.8 million. The decline in the structural deficit, which more than offset a decline in extraordinary receipts, was reflected in a lower public sector borrowing requirement. In fact, the public sector borrowing requirement declined from Lm107.3 million to Lm86.5 million during the Survey period.

During the period under review, broad money (M3) continued to increase, albeit at a decreasing rate. The more rapid growth in net foreign assets and the slowdown in growth of other counterparts of M3 were offset by a slower growth in domestic credit, resulting in a deceleration in the monetary growth.

During the period under review, the central intervention rate was raised by 25 basis points, up to 3.25 per cent. During the first nine months of 2005, the Maltese lira weakened against the US dollar, Japanese yen and the UK sterling, but appreciated against the Euro. Malta joined the ERM II mechanism in May, and thus the pegging of the Maltese lira changed from a three currency basket peg to a single currency peg.

International Scene

Global economic expansion has remained broadly on track, mainly driven by a robust growth in the services sector output that more than offset slowing global growth in manufacturing. However during the year, signs of weakening emerged, in part reflecting the impact of higher crude oil prices further exacerbated by the catastrophic effects of subsequent hurricanes that hit the Gulf of Mexico and North America.

Growth has been stronger than expected in the United States, in China and in most developing countries. Several years into the recovery, activity in the US is still largely driven by domestic demand and solid productivity growth, with the contribution of net exports to growth still rather weak despite a substantial depreciation of the real effective exchange rate of the dollar. As a result, the US current account deficit is projected to rise further. In China, after a very robust growth in 2003 and in the beginning of 2004, GDP growth decelerated considerably in the second quarter of last year, but picked up again in the last two quarters of the year.

In contrast, growth in Europe and Japan has been disappointing, reflecting stammering exports and weak final domestic demand. In Europe, after a promising first half of 2004, growth weakened in the second half of last year. Although apparently economic growth has recovered in 2005, GDP growth forecasts have been marked down, given continued weak final domestic demand and the Euro area's lack of resilience to external shocks, principally to higher oil prices. Japan experienced slight decreases in real GDP in the second and third quarters of 2004, according to revised national accounts data, such that apparently, the Japanese economy has been through a technical recession. Nonetheless, Japan's economy is regaining momentum, with GDP growth rising sharply in the first quarter of 2005, though this is expected to moderate later on in the year.

Relevant macroeconomic indicators are displayed in Tables 1.1 to 1.6 and Charts 1.1 and 1.2.

The most recent forecasts currently available from the European Commission (Spring 2005) suggest that the pace of world GDP growth is projected to ease to a still robust 4.2 per cent this year. Growth is expected to be driven by a number of factors, including supportive macroeconomic policies, low real interest rates, housing-market-induced wealth effects, and particularly strong growth in emerging economies, such as China and India.

Outlook for Industrialised Economies

Growth in industrialised countries is expected to slow down, given that growth in EU 25 and the Euro Area, the US and Japan has moderated.

After gathering momentum in the first half of last year, the growth performance in both the Euro Area and the EU was less propelling in the second half, with growth rates for 2004 averaging 2.0 and 2.4 per cent respectively. Projections for 2005 anticipate growth to slow down to reach 2.0 per cent in EU 25 and 1.6 per cent in the Euro Area, as the recent surge in oil prices seems to have taken toll on business confidence. Inflation is expected to fall to 1.9 per cent in both EU 25 and the Euro Area, as a result of weak domestic price pressures. The modest labour market response in the prolonged downturn has been followed

World GDP, Volume

annual percentage change

Table 1.1

	2002	2003	2004	2005*
World	2.8	3.7	5.0	4.2
Industrialised Countries	1.5	2.0	3.4	2.6
EU 25	1.1	1.0	2.4	2.0
Euro Area	0.9	0.6	2.0	1.6
Germany	0.1	-0.1	1.6	0.8
France	1.2	0.5	2.5	2.0
Italy	0.4	0.3	1.2	1.2
United Kingdom	1.8	2.2	3.1	2.8
United States	1.9	3.1	4.4	3.6
Japan	-0.3	1.4	2.7	1.1
Canada	3.4	2.0	2.8	2.6
Others	4.4	5.9	7.1	6.2
Russia	4.7	7.3	7.1	6.0
China	8.3	9.3	9.5	8.6

*Projections

Source: European Commission

Inflation: Harmonised Index of Consumer Prices*

percentage change on preceeding year

Table 1.2

	2002	2003	2004	2005**
EU 25	2.1	1.9	2.1	1.9
Euro Area	2.3	2.1	2.1	1.9
Germany	1.3	1.0	1.8	1.3
France	1.9	2.2	2.3	1.9
Italy	2.6	2.8	2.3	2.0
United Kingdom	1.3	1.4	1.3	1.7
United States	1.6	2.3	2.7	2.6
Japan	-0.9	-0.3	0.0	-0.1

*National index if not available
**Projections

Source: European Commission

Unemployment Rate*
per cent of labour force

Table 1.3

	2002	2003	2004	2005**
EU 25	8.7	8.9	9.0	9.0
Euro Area	8.2	8.7	8.8	8.8
Germany	8.2	9.0	9.5	9.7
France	8.9	9.5	9.6	9.4
Italy	8.6	8.4	8.0	7.9
United Kingdom	5.1	4.9	4.7	4.7
USA	5.8	6.0	5.5	5.2
Japan	5.4	5.3	4.8	4.4

*Series following Eurostat definition, based on the labour force survey
**Projections

Source: European Commission

Current Account Balance
per cent of GDP

Table 1.4

	2002	2003	2004	2005*
EU 25	0.4	0.1	0.2	0.0
Euro Area	1.2	0.6	0.6	0.6
Germany	2.4	2.4	3.8	4.1
France	1.5	0.4	-0.2	-0.5
Italy	-0.3	-0.8	-0.4	-0.5
United Kingdom	-1.7	-1.8	-1.9	-2.2
USA	-4.4	-4.7	-5.4	-5.9
Japan	2.8	3.2	3.7	3.8

*Projections

Source: European Commission

by a slow response in the upturn, such that the change in the unemployment rate has been quite restrained in comparison to previous cycles. The unemployment rate is expected to remain stable at 9.0 per cent in the EU and 8.8 per cent in the Euro Area this year. The appreciation of the Euro since 2002 has resulted in a deterioration of Euro Area cost competitiveness. Consequently, and in view of the expected slowdown in global growth, the growth rates of exports of goods are projected to decline to 6.4 per cent in the EU and 5.9 per cent in the Euro Area. Meanwhile, import growth rates for EU 25 and the Euro Area are expected to reach 7.0 and 6.4 per cent respectively. As a consequence, the EU 25 current account balance as a percentage of GDP is expected to deteriorate slightly, while the balance for the Euro-zone is expected to remain broadly stable at 0.6 per cent of GDP.

In Germany, growth is set to continue despite a recent setback. After registering the highest annual GDP growth in four years last year, a mild annual growth rate of 0.8 per cent is expected over the course of this year. Unemployment is projected to start falling by the end of the year, favoured by low wage growth and strong export performance. Nonetheless, projections for 2005 still set the unemployment rate at a higher level than that registered last year, owing to variations throughout the year. Export growth rates are anticipated to fall as the international demand for investment goods, for which Germany enjoys a comparative advantage, slows down. On the other hand, import volumes are projected to increase at a faster pace than exports, in line with domestic demand, thus reaching 7.2 per cent in 2005. Nonetheless, the current account balance as a percentage of GDP is expected to achieve an even higher surplus in 2005, at 4.1 per cent of GDP.

Real GDP in France grew by 2.5 per cent in 2004, its best performance since 2000, such growth being supported by domestic demand, especially by private consumption. Nonetheless, in 2005, real GDP growth is expected to slow down. Economic activity is projected to be driven once again by domestic demand, further strengthened by a decline in inflation. Although employment growth may be slow to pick up, a rise in the demand for labour is foreseen, in part the result of the planned reform of the 35-hour working week. The improvement of price competitiveness and a better cyclical position in the car transport and the aeronautical sectors are expected to support export growth. Notwithstanding the increase in exports, a worsening of the current account balance as a percentage of GDP is anticipated for 2005.

Following two years of near stagnation, reflecting both a cyclical slowdown in the Euro Area and structural problems specific to Italy, economic growth

Exports of Goods, Volume

percentage change on preceeding year

Table 1.5

	2002	2003	2004	2005*
EU 25	2.0	1.7	7.1	6.4
Euro Area	1.9	0.9	7.1	5.9
Germany	3.2	2.6	10.1	6.9
France	2.3	-1.5	3.9	5.3
Italy	-2.9	-2.1	3.3	5.1
United Kingdom	-1.7	-0.1	1.6	6.5
USA	-4.1	2.2	8.8	7.4
Japan	8.1	9.1	14.3	8.0

*Projections

Source: European Commission

Imports of Goods, Volume

percentage change on preceeding year

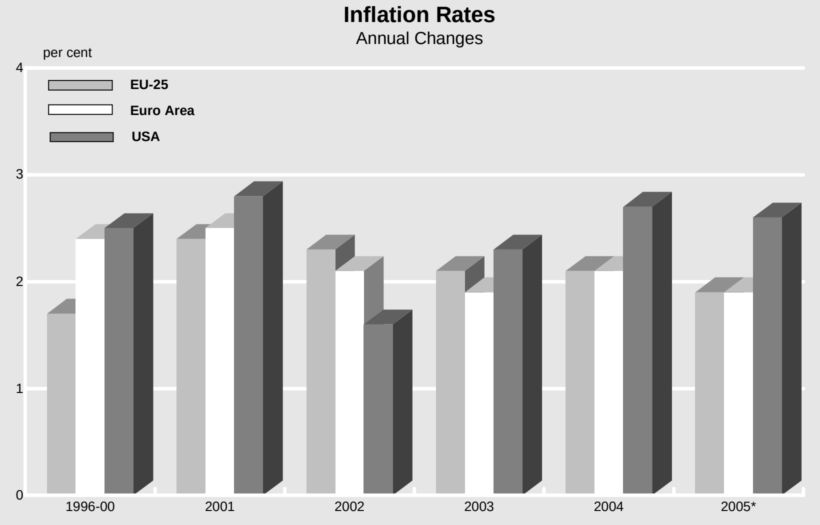
Table 1.6

	2002	2003	2004	2005*
EU 25	1.4	3.3	7.6	7.0
Euro Area	0.6	2.9	7.3	6.4
Germany	-1.5	5.8	7.9	7.2
France	3.2	-0.1	8.0	6.6
Italy	-1.0	0.9	3.2	5.4
United Kingdom	4.1	1.9	5.8	6.8
USA	3.7	4.7	10.8	7.5
Japan	1.1	3.8	8.9	7.1

*Projections

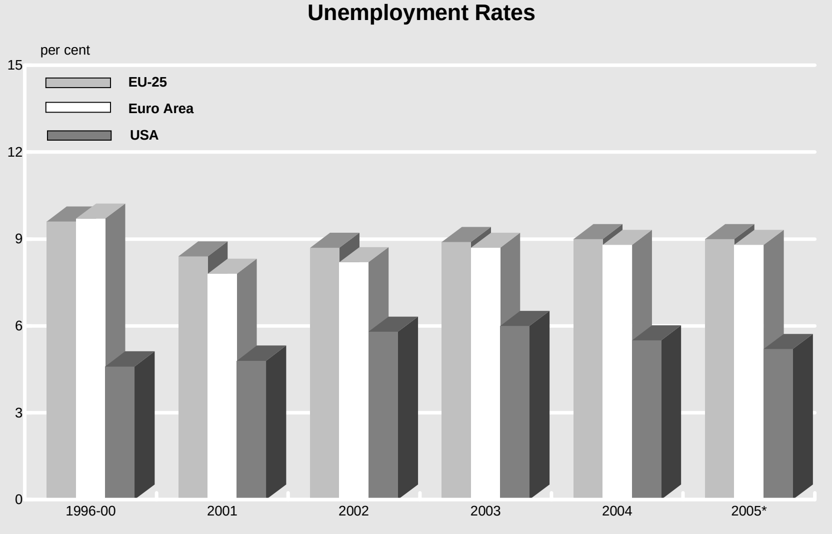
Source: European Commission

Chart 1.1



*Projections

Chart 1.2



*Projections

accelerated somewhat in 2004 reaching an average rate of 1.2 per cent. Growth in 2005 is expected to remain moderate, reflecting the persistence of structural rigidities and high oil prices. In spite of the fact that around half of the contractual wages are due to be renegotiated in 2005, these are not expected to fuel inflation, that is forecast to gradually decline to 2.0 per cent by the end of this year. However, the unfavourable product specialisation towards low-growth goods coupled with a loss of cost competitiveness hinders Italy to fully benefit from the still robust expansion of world trade. Hence, despite a recovery in export growth, the growth in imports is expected to offset the growth in exports, leading to a slight worsening of the current account balance as a percentage of GDP.

After peaking in 2004, GDP growth in the UK has moderated and is expected to reach 2.8 per cent in 2005, domestic demand growth being once again the key driver of this performance. Although unemployment has remained close to record-low levels at 4.7 per cent, average earnings growth has not given rise to considerable inflationary pressures, such that the HICP is expected to reach 1.7 per cent in 2005. Global economic growth is expected to propel UK export performance, which is projected to register the highest growth rate since 2002. Nonetheless, it is foreseen that the continued increase in imports will outpace the growth in exports, leading to a worsening of the current account deficit.

Growth in the US has eased moderately, even though it is projected to remain the highest amongst the group of industrialised countries, underpinned by solid productivity growth, supportive financial market conditions and rising housing market prices. The direct impact of Hurricane Katrina on GDP growth is likely to be moderate, however its indirect effects, stemming from high crude oil prices, may result in a sharp decrease in private consumption growth. With US growth continuing to outstrip that of other large advanced economies, and with higher oil prices, the current account deficit is projected to widen to 5.9 per cent of GDP in 2005. Inflation is expected to remain more or less at the same level registered last year, backed by a steady increase in unit labour costs and high oil prices.

Although the Japanese economy has expanded strongly in the first half of 2005, driven by a recovery in private final domestic demand, growth in the rest of the period is forecast to be more subdued, such that the GDP growth rate is expected to average 1.1 per cent during this year. Robust private consumption was underpinned by a strengthening labour market, such that the unemployment rate is projected to reach an all-time low since 2002 at 4.4 per cent. Nonetheless, deflation in Japan is expected to be once again incumbent. The surplus in the current account balance as a percentage of GDP is forecast to ameliorate slightly as the growth in imports is outpaced by the growth in exports.

Russia and China are still expected to enjoy high growth rates, even though growth is forecast to decelerate during the course of this year, despite persistently high hydrocarbon prices in Russia and positive growth in net exports and consumption in China.

Commodity Markets

Between January and August of this year, energy prices rose by 41.0 per cent in US dollar terms, even though the growth in crude oil consumption has been broadly in line with expectations. While shortfalls in non-OPEC supply have contributed to this rise, it appears that crude oil prices are being increasingly driven by expectations of future tightness in the market, based on forecasts of continued robust global economic growth, low spare capacity among OPEC producers, and fears that the recent slowdown in non-OPEC production may be somewhat permanent.

With limited spare capacity, short-term disruptions to oil products production have become powerful catalysts for higher prices, as demonstrated by the impact of the terrorist attacks in London and Hurricane Katrina on crude oil and petroleum products prices.

In light of the above developments, the International Monetary Fund (IMF) has raised its projections for the average petroleum spot price for this year, such that the most recent projections published in the September World Economic Outlook, have been revised to $54.23, compared to $46.50 per barrel in previous forecasts.

Average non-energy prices rose by 5.0 per cent in U.S. dollar terms during the first eight months of this year, with metals and food prices being the main drivers of the recorded surge. Contrary to what was the case for oil prices, Hurricane Katrina, which devastated ports and cities in the U.S. southern region, appears to have had only a temporary impact on specific non-fuel commodity markets. Looking forward, the upward momentum in non-energy commodity prices is expected to ease for the remainder of 2005, as supply is anticipated to respond strongly to high prices.

Following a record increase in 2004, sales revenue of semiconductors grew at a substantially lower rate between January and July 2005 compared with the same period in 2004. Most of the decline reflects weak average semi-conductor prices. Eventually, semi-conductor prices are expected to rebound in the second half of the year owing to general seasonal factors, with the rebound muted somewhat by the release of inventories.

Future Economic Prospects

The global recovery is expected to continue, but at a somewhat slower pace. After growing briskly by about 5.0 per cent last year, the fastest pace in decades, the world economy is set to expand by just over 4.0 per cent in both 2005 and 2006. The deceleration in activity is expected to be accompanied by a somewhat slower expansion of global trade. The large global current account imbalances, in particular in the US and in industrialised countries, are projected to continue, while stabilising towards the end of the forecast period.

High oil prices, driven by the strong growth in demand and the low level of spare oil production capacity, are likely to have contributed to slower global growth. On the other hand, financial conditions, with low interest rates and low risk premia on corporate and emerging market debt, remain supportive for growth. While global economic activity is expected to stay robust, important downside risks exist, in particular the risk of disorderly adjustment of the large

Projections

Table 1.7

	2004	**2005***	**2006***
Real GDP (% change)			
EU 25	2.4	2.0	2.3
United States	4.4	3.6	3.0
Japan	2.7	1.1	1.7
Inflation (% change)			
EU 25	2.1	1.9	1.7
United States	2.7	2.6	2.3
Japan	0.0	-0.1	0.2
Unemployment Rate (% of labour force)			
EU 25	9.0	9.0	8.7
United States	5.5	5.2	5.0
Japan	4.8	4.4	4.1

*Projections

Source: European Commission

global current account imbalances. Furthermore, high oil prices remain a source of risk, in view of strong growth in oil demand and continued geopolitical risks.

As portrayed in Table 1.7, the European Commission Spring Economic Forecasts project growth in the European Union to decelerate slightly this year, but to regain momentum in 2006 to reach 2.3 per cent. Consequently, the unemployment rate is expected to decline to 8.7 per cent. As a result of weak domestic price pressures, inflation is expected to fall to 1.9 per cent this year and a further fall to 1.7 per cent is foreseen for next year.

Real GDP growth in the United States is expected to slow down to 3.0 per cent in 2006. Growth in consumer spending is projected to be more subdued, hence resulting in a lower inflation rate. Nonetheless, as a consequence of the lagged response to the depreciation of the dollar, the growth rate of exports is projected to outstrip that of imports. Consequently, the unemployment rate is expected to decline to 5.0 per cent next year.

Following a slowdown in GDP growth this year, the Japanese economy is expected to experience a rebound fuelled by continuous global growth, and sustained investment and private consumption growth. Consequently, unemployment is forecast to decrease to 4.1 per cent in 2006, while the year-on-year change in consumer prices is expected to turn positive by next year.