Chris Caton sees a year of more moderate growth ahead. Energy prices and the drought will help decide the pace of that growth, and a US recession – while unlikely – could upset all the forecasts.

Economic overview

Dr Chris Caton

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The year in review

For the global economy 2006 was another banner year. Over the course of the year expectations for output growth kept being marked upwards and the International Monetary Fund (IMF) estimates that, measured on a purchasing-power-parity (PPP) basis, world GDP probably grew by about 5.1 per cent. This compares with 4.9 per cent in 2005 and 5.3 per cent in 2004. One has to go back about 30 years to find such a prolonged period of above-trend growth.

The "standouts" in the growth story were China and Europe. China recorded its fourth successive year of double-digit growth, while Euro-area growth improved from 1.3 per cent in 2005 to an estimated 2.4 per cent in 2006. Japan flattered to deceive early in the year, when it appeared set for significantly more than 3 per cent growth, but it lost momentum as the year went on. The United States recorded about 3.3 per cent growth for the year as a whole, but was clearly slowing in the second half, due mainly to weakness in the housing sector. Perhaps the biggest question mark hanging over world growth in 2007 is the US economy. Soft landing or recession? I will return to this issue later.

In recent years inflation around the world has remained low, remarkably so given what has happened to energy prices. The prolonged period of above-trend growth finally began to affect inflation in 2006. The year-to rate of increase of the US "core" CPI, for example, rose from 2.2 per cent at the beginning of the year to 2.9 per cent by September (some of this rise is artificial). The so-called core deflator for consumer spending is less distorted, but still shows a rise to its highest level in ten years (Figure 1).

As a result of increased concern about inflation, central banks around the world either began or continued to raise interest rates, thus reducing the significant degree of monetary accommodation

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that had been in place in recent years. The aim of such a monetary adjustment is to slow world growth to a sustainable pace, thus allowing inflation first to stabilise and then to come down. Of course, whenever the brakes are applied there is a chance of a skid. Managing the slowing of world economic growth in an orderly fashion will be one of the major tasks of 2007.

The Australian economy has had another interesting year. Growth as measured by total output (GDP) slowed more than seemed likely at the beginning of the year. In the September quarter the economy grew by just 0.3 per cent, the slowest quarterly rate of growth since June 2003. In the year to September, GDP grew by just 2.2 per cent.

The renewed drought was one big reason for the slower growth (the non-farm economy grew by 2.6 per cent in the year to September), but by no means the only one. If the national accounts are to be believed, growth was held back by an inventory cycle – in part, demand growth has been met by running stock off the shelves – and by the trade sector. Once again, imports have grown faster than exports, although the latter did put on a spurt in the September quarter. Policymakers could be forgiven for concluding that the slowing in growth, at least in the non-farm sector, was due mainly to the economy running out of room. Labour is getting tight (the unemployment rate hasn't been lower since the mid-1970s), and many industries are at or near full capacity.

Other indicators suggest that the economy continues to do well. For example, in the year to December, employment grew by 3 per cent. Perhaps it is doing a little too well, because the strength of the economy has clearly put upward pressure on inflation. In the year to the June quarter, the headline CPI rose by 4 per cent, well in excess of the Reserve Bank's target of 3 per cent. All of this "excess" was then due to petrol and bananas. When I look back at what I wrote last year, I am ashamed to note that I didn't even mention bananas!

Because of its concern about inflation, the Reserve Bank raised interest rates three times: in May, August and November. Its concern wasn't about the price of bananas but about "underlying" inflation. The Reserve Bank calculates underlying inflation in a couple of different ways (the trimmed mean and the weighted median, for those who need to know!). The average of these two measures has been rising for a year, and surpassed 3 per cent in the year to the September quarter. The big question now is: bearing in mind that monetary policy operates with a lag, has the RBA already done enough to quell inflation (Figure 2)?

What lies ahead?

What of 2007? It promises to be interesting. As intimated above, there is a major question about the US economy. All analysts and economists agree that growth in the US is slowing, and all agree on

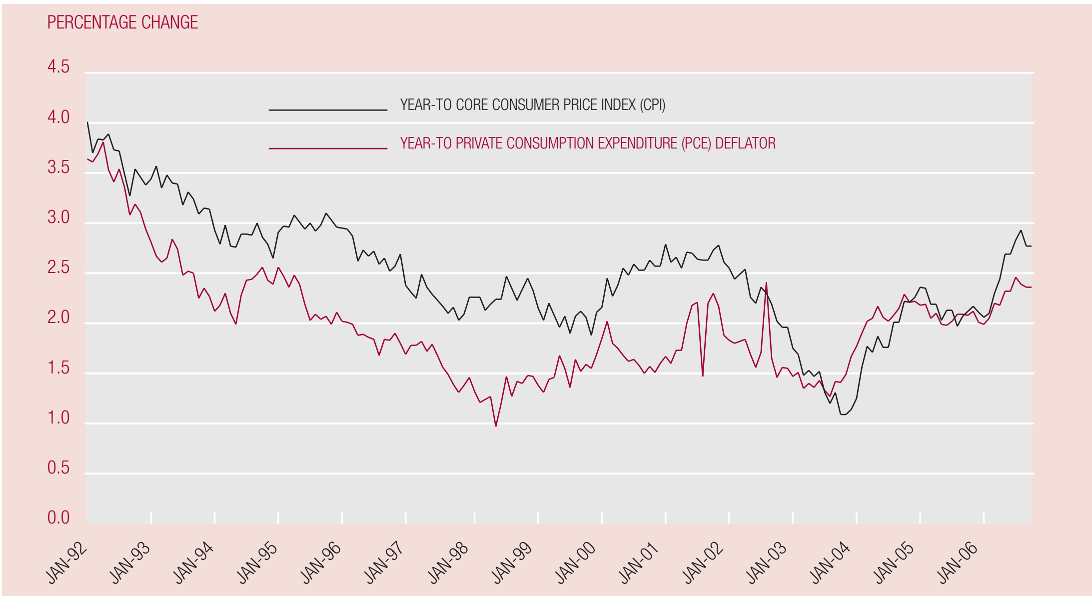
"The unemployment rate hasn't been lower since the mid-1970s …"

the reason: the housing sector is in decline. The chart shows housing starts and permits (to make a future start), but any other indicator relating to the sector would show the same thing (Figure 3).

In recent years, housing has been quite strong, and thus has added significantly to overall GDP growth. Since the beginning of 2006, housing starts have fallen by more than 30 per cent. The housing sector is now subtracting close to a full percentage point from GDP growth. And that is before account is taken of multiplier effects (unemployed construction workers and real estate agents will spend less) and wealth effects (now that US house prices are falling, homeowners will be less willing to withdraw equity from their homes).

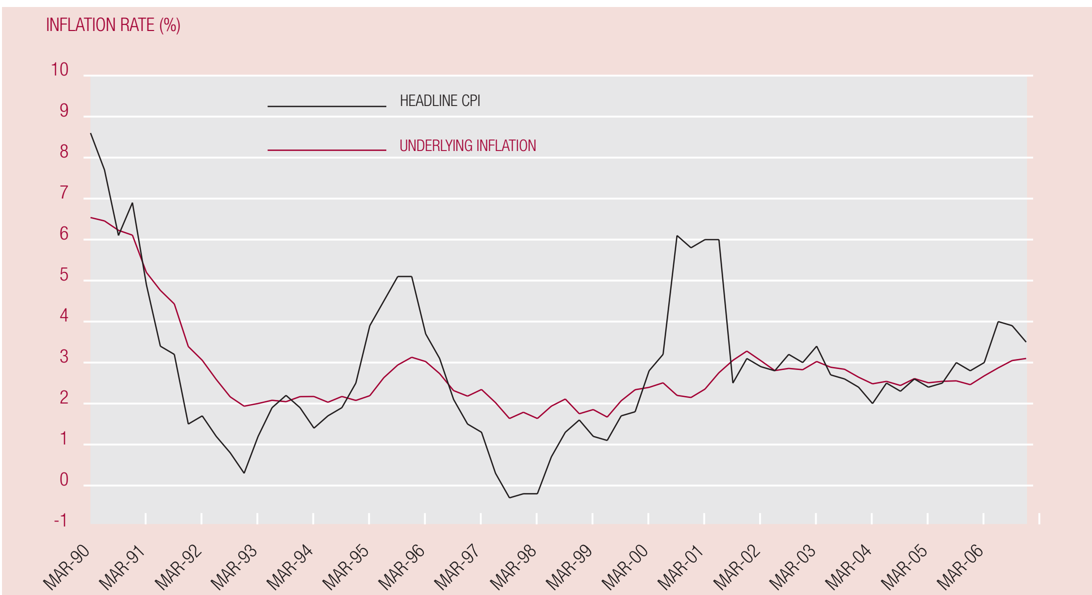
The analysts and economists also agree on one other thing: that nothing too bad will happen to the US economy as a result of this weakness in housing. In the consensus view, the economy is heading for a "soft landing", in which growth slows to trend or a little below, and the unemployment rate either stabilises (stops coming down) or drifts up marginally. One should always be suspicious of "soft landing" forecasts. In the past 46 years the US

Figure 1
US inflation, 1992 to 2006



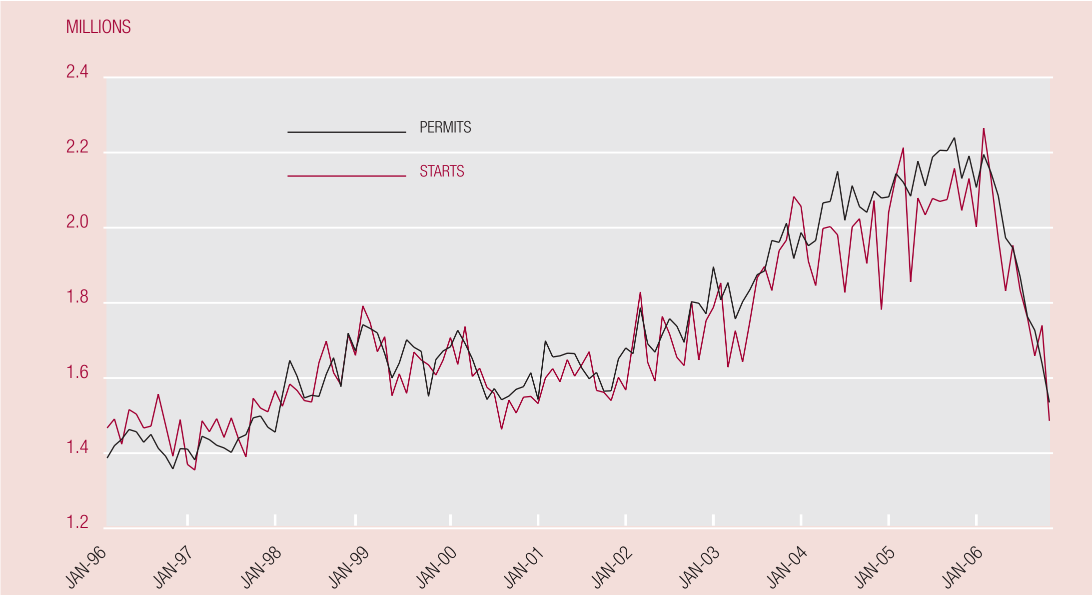
Source: Datastream

Figure 2
Australian inflation, 1990 to 2006



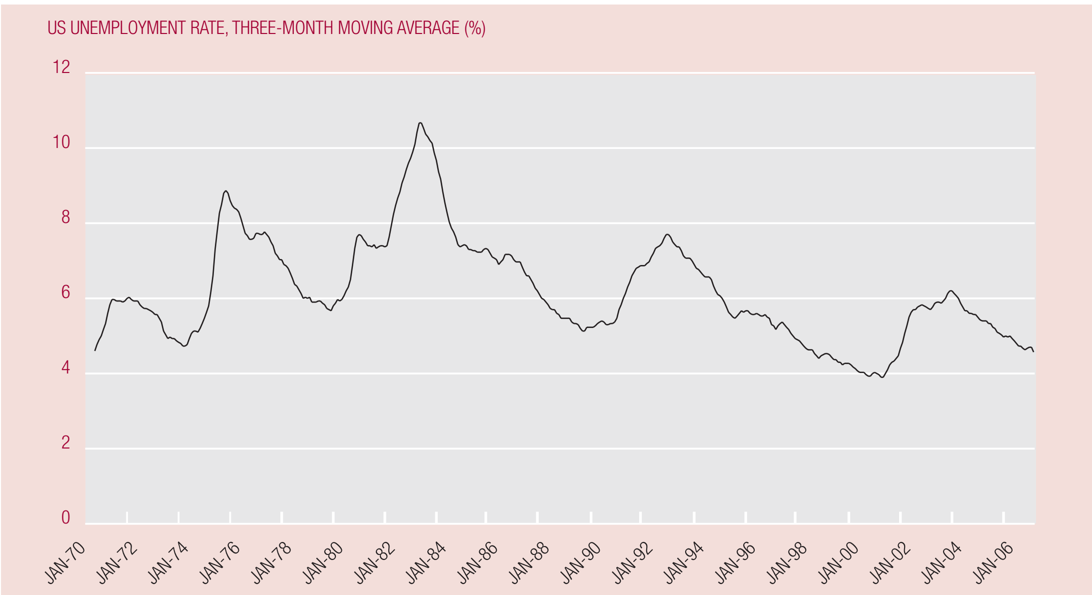
Source: ABS, RBA

Figure 3
US housing starts and permits



Source: Datastream

Figure 4
US unemployment rate



Source: Datastream

economy has experienced seven recessions, and before each one the consensus view was that there would be a "soft landing". There have also been three genuine soft landings, each correctly forecast. And the US economy has previously demonstrated its resilience to sectoral recessions. Between the 1982 and 1990 recessions, for example, the US withstood "rolling" recessions in both manufacturing and the energy sector.

History suggests that there are no firm landings. That is, there is nothing between a soft landing and a recession. For any economy, the unemployment rate is obviously a good cyclical indicator. Run a three-month moving average through the US unemployment rate, and then look to see what happens when the rate rises. It turns out, remarkably, that there are no occasions in history when such a moving average has gone up by more than 0.3 percentage points (any smaller rise than this is a soft landing) but by less than 1.5 percentage points (clearly a recession) (Figure 4).

Despite the track record, so far the "soft landing" forecast looks good. Figure 5 shows a three-month moving average of employment growth.

> History suggests that there are no firm landings.

The recessions in 1990–91 and 2001 are obvious. Less obvious is the soft landing of 1995. Right now, employment growth is holding up remarkably well. In particular, consumer spending remains strong, not least because of falling oil prices.

So a US recession in 2007 still seems unlikely, but it is not out of the question. Like a falling trapeze artist heading for the safety net, it requires only a small accident to change the outcome. And, as pointed out above, it's either the net or the ground.

A recession in the US would have major implications for commodities in particular and the Australian economy in general. History would also suggest that Asia, including China, could be severely affected.

There is an emerging body of opinion suggesting that Asia, and the rest of the world, can now be reasonably self-sustaining and continue to exhibit strong growth even in the presence of a weak US. The economic *mot de l'année* to describe this phenomenon is "decoupling". I will believe it when I see it.

And to our north

Napoleon said, "Let China sleep, for when she awakes she will shake the world." China fell asleep about 200 years ago. Until then, it was the largest economy in the world, accounting for about a third of world GDP. China has, of course, been stirring for some time, and it will continue to have a massive economic effect for a long time yet. Measured at PPP, the Chinese economy now accounts for about 12 per cent of world GDP. If, as the experts predict, it grows between 8 and 9 per cent per year for the next ten years, it will then be bigger than the US economy. Of course, there will still be four times as many Chinese as there are Americans, so even then they will still be a lot poorer.

More generally, something interesting has happened in the past year. If one measures all economies at PPP, the developing economies now account for more than 50 per cent of world economic output, and for about two-thirds of world economic growth.

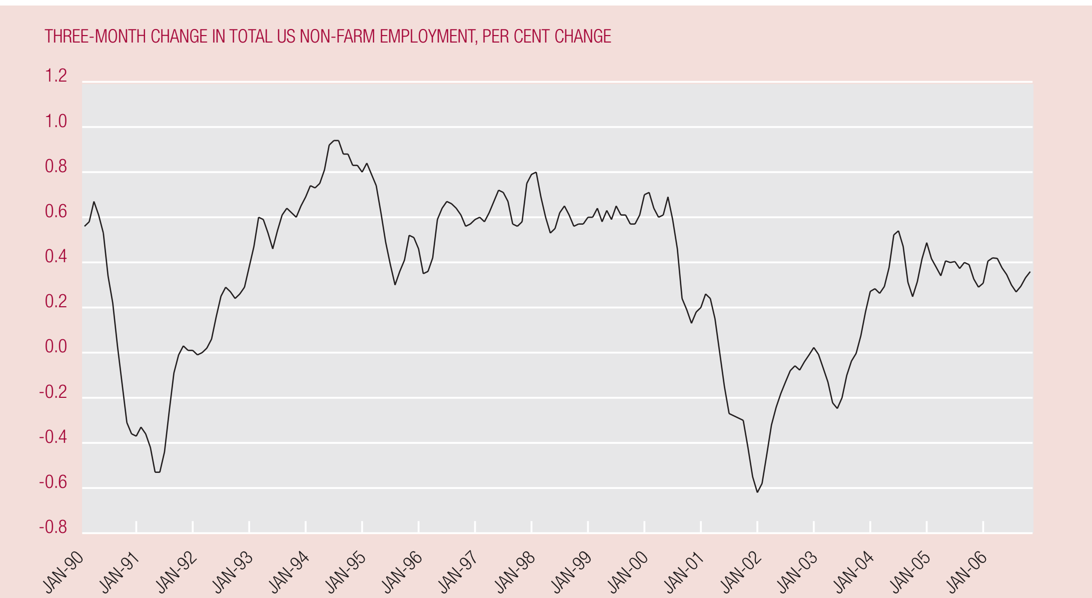
For most commodities the Chinese footprint is significantly bigger than its GDP weight. Across a range of commodities it accounts for something close to one-third of total world demand, and for 70 per cent or more of the recent (and prospective) growth in demand. The China story has to be very bullish for commodities, and hence for Australia, for a long time yet. That said, there will be disappointments in growth along the way, and history suggests that commodity price spikes are often followed by sharp falls (Figure 6).

As mentioned, China has years of stellar growth ahead of it. The short-term outlook remains good, even though the authorities have tried to slow the economy down. For the past four years China has grown at close to 10 per cent per year. The authorities have raised rates, increased the reserve requirements of the banking system, restricted lending to certain industries, and moved to quell property speculation. And still the growth goes on. Another, perhaps more substantial, revaluation of the renminbi may be in prospect, which would make things interesting for the rest of Asia.

The current consensus forecast for 2007 expects about 9 per cent GDP growth in China. If history

Figure 5

US jobs growth



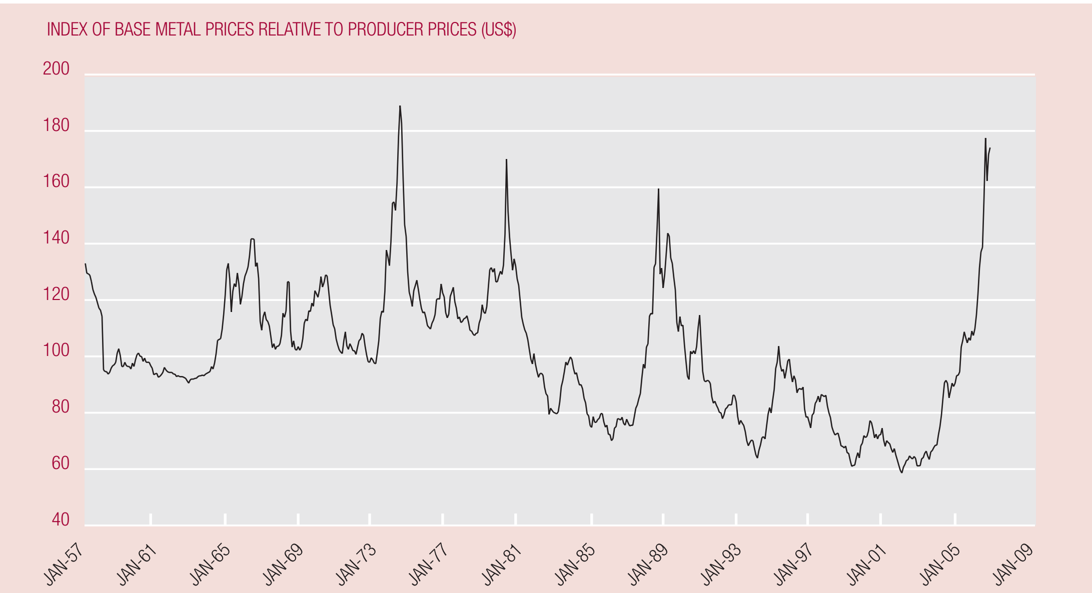
Source: Datastream

Table 1
Australian Economic Outlook

YEAR AVERAGE GROWTH (%)	2005	2006 (ESTIMATE)	2007 (FORECAST)	2008 (FORECAST)
GDP	2.8	2.5	2.8	3.5
Non-farm GDP	2.9	2.8	3.1	3.2
Farm product	–1	–10	–6.0	15.0
Private consumption	2.7	2.9	3.0	3.0
Residential construction	–2.9	4.5	4.0	4.0
Business investment	16.7	9.0	4.0	5.0
Private final demand	4.3	3.6	3.2	3.4
Public final demand	4.3	4.0	3.5	3.0
Stocks	0.7	–0.7	0.1	0.1
GNE	4.3	3.2	3.1	3.4
Exports	2.3	3.3	5.5	6.5
Imports	8.9	6.6	4.8	6.0
Unemployment rate	5.1	4.9	5.1	5.4
CPI inflation	2.7	3.6	2.7	2.7
Current account deficit ($b)	54.1	50.0	45.0	50.0
Exchange rate ($US/$A)	0.74	0.75	0.75	0.75

Source: ABS, RBA, BT Financial Group

Figure 6
Real base metal prices



Source: ABN AMRO

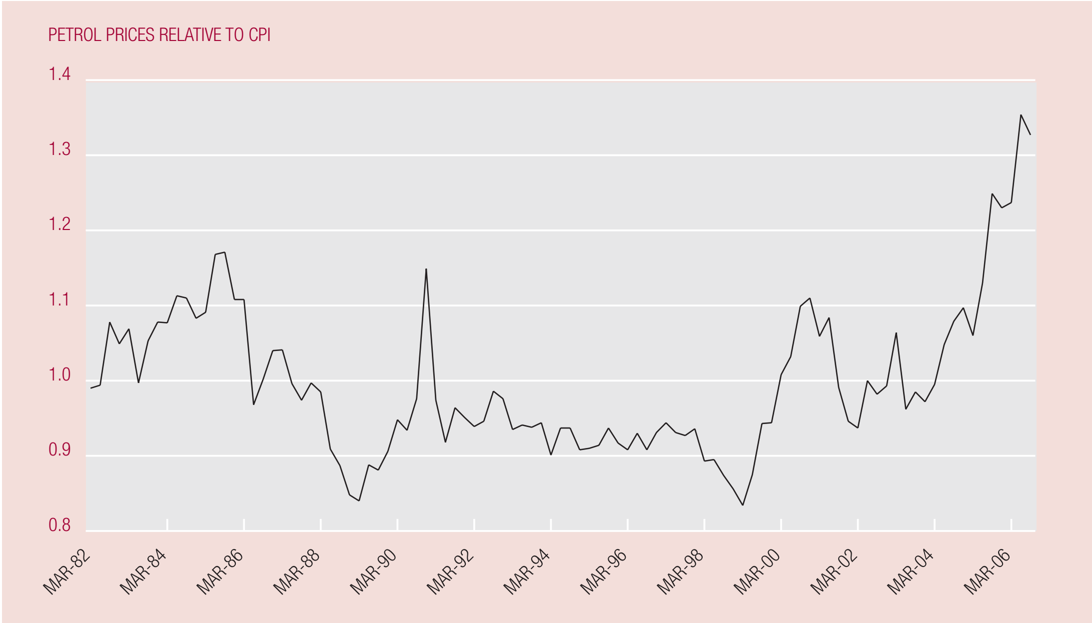
is any guide, this forecast will be marked up progressively over the course of the year.

As is well known, in recent years, particularly since joining the World Trade Organisation, China has run substantial trade surpluses. As a result, it has accumulated massive foreign reserves. Indeed, its reserves are now estimated to exceed US$1 trillion, which is about equal to six months' GDP. In the minds of many this raises a question as to what could ensue for financial markets if China chooses to change the form in which it holds these reserves (most are currently in US government bonds). My view is that any such change is unlikely to be dramatic.

The fact that China invests so heavily in the US bond market keeps long-term rates in the US lower than otherwise. This keeps mortgage rates low and thus US households are encouraged to refinance, often withdrawing cash to spend, and frequently on imports from China. This drives China's

Figure 7

The "real" price of petrol



Source: ABS

reserves up further, which leads to the purchase of more US bonds, further downward pressure on interest rates, and so on.

The sheer size of its reserves also limits China's ability to change the value of its own currency, since a 10 per cent increase would reduce the value of its reserves, at least when measured in its own currency, by 10 per cent.

By the way, the view that China should let its currency float is hopelessly unrealistic. It would be very rare for a country so poor (and it is still very poor on average, despite the pockets of prosperity that most foreigners see) to have a floating currency. I can think of only one poor country – Indonesia – with a floating currency.

In early November, just two days after the US mid-term elections, which saw the Democrats regain control of Capitol Hill, a record trade imbalance was announced between the US and China of $23 billion in a single month. China sells $6 of goods and services to the US for every $1 that it buys from the US. Much of what it sells, of course, comes from companies that are either owned or controlled by US interests. This isn't so much international trade as it is a supply chain! But that won't stop the solons from vexing themselves about the trade imbalance. Expect more sabre rattling from the US about the "artificially low" value of the Chinese currency in the New Year.

The sun also rises (slowly)

Japan had a moderately good year in 2006, growing by about 2¼ per cent. Early in the year the outlook appeared to be even better. The private sector suddenly strengthened, and there was some speculation the Japan could be the fastest-growing G7 nation for the year. This was not to be. The consensus forecast for 2007 foresees growth of just 1.8 per cent.

In the medium term, Japanese growth will be limited by the fact that its labour force is already experiencing negative growth, reflecting the ageing of the population. Thus any economic growth can only come from improved labour productivity.

Japan is still Australia's biggest export destination, but it is far less important than it used to be. In the late 1970s almost 40 per cent of our exports went to Japan; the share is now less than 20 per cent.

Europe stirs

Europe had a surprisingly good 2006. Western Europe is thought to have grown by about 2.7 per cent, a full percentage point higher than the growth recorded in 2005. The Euro area and the UK both tightened monetary policy, concerned about the escape of the inflation genie. Growth should moderate in 2007, not least in Germany, where the value-added tax (VAT) will increase by 3 percentage points on 1 January.

Greece wins the 2006 prize for innovative economic thinking. In order to join the European Union, it has to meet certain economic criteria, such as a central government budget deficit less than a certain percentage of GDP. Most countries would focus on the numerator, and try to figure out how to get the deficit down. Greece realised that it could get the denominator up if it expanded the definition of GDP, in particular to include the "value added" of illegal activities such as money laundering, tobacco smuggling and prostitution.

Bingo! Suddenly GDP is 25 per cent higher than previously measured.

The price of oil

In each of the past two years, this overview has devoted considerable space to the price of oil. On each occasion it was argued that the price would eventually come down because its level could not be justified by the fundamentals of supply and demand. The explanation for most of the “premium” in the price was concern that the supply of oil may be disrupted at some stage in the future, which led to market behaviour that pushed up the current price. Concern about supply apparently peaked in July 2006, when there were worries about both Iran and Israel/Hezbollah. The oil price hit $78, but has fallen substantially since then to more than $20 below that level. The fall has added to real income growth, and hence to overall growth. The mildness of the US winter has contributed to the drop in the price of oil in recent weeks.

Figure 7 shows the price of petrol in Australia deflated by the overall CPI, and indexed so that the long-run average is one. The real price peaked in the June quarter, when petrol was about one-third more expensive than “usual”. In mid-year the media focus always seemed to be on how much extra it cost the average family to fill the tank. What we never heard is that even when the price was at its peak the average family spent a significantly smaller share of its income on petrol than it had done 20 years previously. How could that be when the stuff was so expensive? Answer: because cars are now more fuel-efficient, and because real incomes have risen far more rapidly than kilometres driven.

Peak oil and oil that

The prolonged spike in oil prices, the strong growth in demand for oil in recent years, and the realisation that the energy needs of the developing world are likely to continue to grow have all led to increased focus on the concept of peak oil production. That is to say that no matter how much oil there may still be in the ground we are getting close to the point where it will simply be impossible to extract the oil at an ever-faster rate, so oil production will hit a peak.

Some adherents to this view believe that we are already close to this point. Indeed, they can point to more than 50 oil-producing countries, including the US and Australia, that are already producing less oil than they used to, indicating that they have already reached, and passed, their peaks.

If this view is correct, then you ain’t seen nothing yet as far as energy prices are concerned. Prices will have to rise much further just to ration the available (limited) supply. And it isn’t difficult to paint a picture where there is conflict for access to the limited supply, and where certain activities, such as air travel, simply become impossibly uneconomic. The world will have to settle for a far simpler way of life. Our grandchildren will be far worse off than we are.

Investment markets haven’t factored this world into their thinking. Today’s corporate world exists on the assumption of continued cheap (and available) energy, and is valued accordingly. So when it is realised that the assumption is wrong, capital markets will collapse.

Not so fast. It is true that there is only a finite quantity of oil still in the ground but, as Dr Greenspan and others have reminded us, there are

“Europe had a surprisingly good 2006.”

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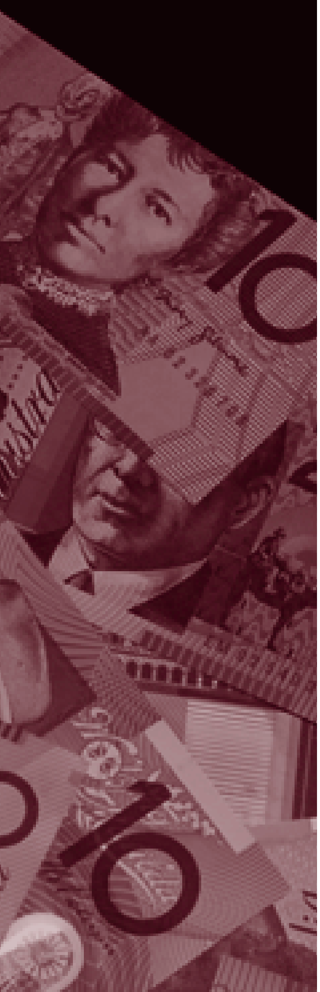

more recoverable reserves still in the ground than there were ten years ago, despite all the oil consumed in that ten-year period. It is estimated that the OPEC nations could continue to extract oil at their current rate for another 80 years, even if they don't find any more.

It is true that it has been decades since the last large new oil field was discovered, but most of the increase in recoverable reserves comes from already existing fields.

One of the reasons "peak oil" adherents have difficulty selling their view is that we've heard all this before. From the Club of Rome days in the early 1970s, we have been warned that the world will run out of oil and other commodities, and that prices will climb to very high levels. Indeed, I am told that the first forecast that the world will run out of oil was made prior to the first well coming online in the US, some time in the middle of the 19th century.

In a previous existence I ran a model-based long-run forecasting service in the US. We produced predictions of economic activity, industrial production, inflation etc with a 25-year horizon (Americans are a gullible lot). For my macroeconomic forecasts I took input from other sources within the same consulting company, including an energy group. In 1980 that group forecast an oil price of $180 per barrel by 2000.

Of course, in the fable about the boy who cried wolf there was eventually a wolf. Just because it hasn't happened yet doesn't mean that it can't. True, but it is also true that economics works. One of the reasons why the pace of oil discovery has slowed in the past 20 years is because the price was so low that the return to the capital spending necessary to find and deliver more oil simply wasn't high enough. With the price where it is now, that should and will change. We will find new ways to extract oil from existing fields; unconventional sources such as tar sands and shale oil will become progressively more economic; and still largely-untapped and fecund areas, such as Russia and Africa, will become more and more important.

Meanwhile, the relatively high price of oil will also work on the demand side. The world already uses far less energy per unit of output than it did 30 years ago. The capital stock (including cars) is far more energy efficient, and as the developed world grows it shifts its output towards services and away from goods, which tends to drive down the demand for energy. These days, of course, much of the world's growth comes from the developing world, where different considerations apply. The car fleets in China and India, for example, will obviously continue to grow rapidly for a long time. True, but the developing world is remarkably inefficient in its use of energy, and there is considerable scope for demand growth to be limited by increased efficiency.

The kernel of truth behind the "peak oil" view is that oil is likely to remain expensive for a long time. This will bring forth new supply, and limit demand. We will pay more to cool our homes and to drive our cars, but we will still be able to do it. The high price will lead to continued searching for

new technologies to replace the black gold.

There is a quote variously attributed to Sheik Yamani, the OPEC oil minister in the 1970s, or to *The Economist* magazine, as follows: "The Stone Age did not end for lack of stone, and the Oil Age will end long before the world runs out of oil." But don't be surprised if oil is never cheap again.

The Australian economy

Australia had a moderate 2006, with GDP growing by about 2.4 per cent. This compares with a forecast made here last year of 3.2 per cent. During the course of the year, the economic expansion celebrated its fifteenth birthday. The non-farm economy grew by close to 2.7 per cent (last year's forecast: 3.1 per cent). Thus one of the reasons for the overall weakness was the return of the drought. Arguably also, growth was held down by the appearance of capacity constraints in some industries, and by labour shortages.

The growth in 2006 was led again by business fixed investment (BFI), which grew by about 8 per cent after averaging more than 14 per cent growth in the previous four years. However, this is somewhat deceptive. BFI grew very rapidly over the second half of 2006, particularly in the resources sector. Thus it began 2006 at a very high level. Over the course of the year it was close to flat, but still showed significant growth for the year as a whole because of the high starting point.

Private consumer spending grew by about 3.0 per cent, its slowest growth for several years. Residential construction fell for the year as a whole, mainly because of a weak starting point. Dwelling investment grew from the June quarter on, and should add to overall economic growth in 2007.The trade sector subtracted from growth again, for the fourth successive year. The current account deficit fell for the first time in four years. In the September quarter it was running at 4.8 per cent of GDP, down from a quarterly peak of close to 7 per cent in 2005.

The most recent figures show employment growth of 3 per cent in the past year, and headline CPI inflation of 3.9 per cent. They also show credit growth of 15 per cent. As discussed above, the view that the strength of the economy was putting upward pressure on inflation led the Reserve Bank to raise interest rates three times. That is probably enough. It wouldn't surprise me to see rates stable over the course of 2007. If nothing else, the recent relatively weak growth news must give the Reserve Bank food for thought. The RBA has acknowledged that inflation is likely to be close to the top (3 per cent) of its target range for some time, which means that there is always the chance of a further increase.

Australia continued to benefit from the commodity price boom. In the year to September our terms of trade rose by 6.8 per cent to bring the increase over the past three years to more than 30 per cent. It is estimated that this is worth more than $3000 for every man, woman and child in the country. Investors in resource companies, and residents of Western Australia, have clearly benefited, but so have almost all Australians. The commodity price boom has led to very strong profits growth, which has led in turn to very strong growth in company profits taxes. This has been the single biggest source of the now annual income tax cuts and increased family allowances.

"But don't be surprised if oil is never cheap again."

It is remarkable that the improvement in commodity prices has not had more effect on the current account deficit. There are at least three reasons. First, imports have continued to grow rapidly. Second, much of the resource sector is foreign-owned, so much of the profits earned in that sector are recorded as part of the country's net income deficit, even if the money is reinvested in Australia! Third, the rate of increase of export volumes has been very sluggish in recent years. Oil exports have fallen significantly, and manufacturers have struggled to grow their exports with the exchange rate as high as it is. The recent September quarter national accounts did give some cause for hope on the export front. In volume terms, exports are now shown as having grown by 6 per cent in the past year, with the output of the mining industry up by 7.2 per cent in the quarter. The heavy capital spending in the resources sector in recent years may finally be paying off.

Exporters are unlikely to get much relief from the exchange rate. The Australian dollar has been

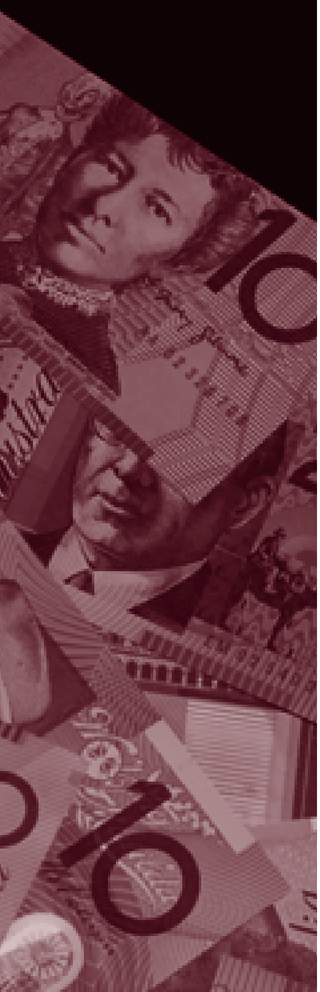

Figure 8
The Australian dollar and US Trade-Weighted Index (TWI)

Source: Datastream

"living in the seventies" (trading between US70 cents and US80 cents) for some years now, and there is little reason for it to change (Figure 8). I have previously outlined my view that the Australian dollar has, since the turn of the century, been driven primarily by the US dollar. That is, our currency has tended to go down when the US dollar has gone up (against the currencies of the developed world) and conversely. This is the reason why cross rates (eg against the euro) have been quite stable so far.

Thus any view about the future of the Australian dollar must start from a view about the US dollar, and I don't have a strong one. It is true that the US current account deficit (more than $850 billion) must eventually weigh on the US dollar, but presumably most, if not all, of the movement will be against the currencies of the developing world, and the consequences for the Australian dollar are by no means clear.

At time of writing, the Australian dollar has recently moved quite rapidly upwards, hitting US79 cents in early December. This move simply highlights the point: in recent weeks, the US dollar has been sold off aggressively, and thus we have again been pushed up. This could be the start of a prolonged weakening of the US dollar, which would then push us through 80 cents, but I doubt that.

Where is the growth coming from in 2007?

The consensus forecast for Australia's GDP growth in 2007 currently stands at 2.9 per cent, but there will be some change in the sources of that growth. Business fixed investment will contribute less, probably growing by about 4 per cent. Residential construction should contribute to growth while the trade sector and the inventory cycle should both be less of a drag. Consumer spending should remain moderately strong. My forecast is marginally below consensus, at 2.8 per cent growth.

The sort of growth envisaged for next year is likely to cause some easing of pressure on the unemployment rate which, in turn, should help to keep wage inflation under control. The best measure of wage inflation, the labour price index, currently shows growth of less than 4 per cent, although this measure has been held down temporarily by the transition to the new wage-fixing mechanism, the Australian Fair Pay Commission.

It is possible that the consensus forecast overstates likely growth in 2007 because the forecasters have not yet completely factored in the possible effects of the drought. The other major risk to the Australian economy in 2007 would appear to be the chance of a recession in the US.

Different rates for different states

It is generally accepted that, in recent years, there has been considerable diversity in performance between the various states. The general view is that WA is leading the way, with New South Wales bringing up the rear. There is clearly something to this; the unemployment rates in these two states are 3.1 per cent and 5.2 per cent respectively. More dramatically, in the year to the September quarter, Sydney house prices fell (again) while those in Perth have stormed ahead by 45 per cent (!!).

The source of this disparity is well known. WA has clearly benefited more from the commodity price boom. NSW has also suffered disproportionately from the house price boom/bust and the subsequent effects on household wealth.

Significant regional disparities don't make monetary policy any easier, since the RBA can set only one interest rate. Accordingly, it can only steer by the average economic condition across Australia.

Two things are worth pointing out. First, like the poor, regional disparities are always with us. And according to the RBA the current range of experiences is not unusually large. Second, the unemployment rate has come down in every state in the past year, while NSW has actually experienced faster jobs growth than WA (this may be because there is no one left to hire in WA!).

If regional disparities are viewed as a concern, then any remedial action must come through fiscal policy rather than monetary policy.

The drought. How bad could it be?

There is no question that overall economic growth is currently being affected by serious drought. Farm output is expected to fall by about 20 per cent in the current agricultural year. It is estimated that farm GDP fell by 10 per cent in the September quarter of 2006. The annual fall will take at least 0.5 percentage point off overall GDP growth.

If these estimates turn out to be correct, then the effects of the drought will be somewhat less than in 2002, mainly because of a smaller effect on livestock. The major effect will be on crop production in NSW and WA.

Crop output is expected to fall by about 30 per cent, with wheat output down by about 60 per cent. Wheat stocks are currently quite high, so rural exports need not be greatly affected.

Measured simply by annual rainfall deficiency, there have been more severe droughts. What makes this one so bad is the fact that it follows so closely the 2002/03 experience. Mean rainfall over the five years to September is at a historical low. Combine this with higher temperatures, and you finish with much-reduced sub-soil moisture and much-increased evaporation of surface water.

Conclusion

The year 2007 is shaping up to be an interesting one. The world economy has grown at an above-trend pace for the past four years, but monetary authorities have been raising rates in order to temper the effects on inflation of this prolonged period of strong growth. The consensus view is that the policymakers will get it exactly correct, slowing the world economy to a nice sustainable growth rate. The risk is either too much growth for too long (thus requiring still more eventual interest rate rises), or too little growth. My judgement is that the latter is the more serious risk, particularly in the US.

Asia will, of course, be affected by any US weakness, but it is difficult to see it being the source of weak world growth. Australia's remarkable economic expansion continues, although 2007 is likely to be the third year of less than 3 per cent output growth. The rest of the world is a risk, as is the drought.

Interest rates are more likely to fall than to rise further, and there seems less reason to be concerned about either oil prices or bird flu than there was a year ago.

Chris Caton is the chief economist for BT Financial Group. The views expressed here are his own, and should not be attributed otherwise.

> "Regional disparities are always with us …"

PHOTO: AAP IMAGE