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## Introduction

This global economic forecast was prepared by staff of the Economic Monitoring and Assessment Unit of the United Nations Department of Economic and Social Affairs, based on inputs from national LINK centres and information from other sources as of 15 November 2004. The major global assumptions underlying the forecast are set out in the Box below. Most of the LINK Country Reports, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available on the websites of both the United Nations and the University of Toronto.<sup>1</sup>

### Major assumptions for the baseline forecast

The United States Federal Reserve is expected to raise the Federal Funds interest rate to 3.5 per cent by the end of 2005; the European Central Bank is expected to increase the policy interest rate by 0.5 per cent in 2005; and the Bank of Japan is expected to maintain the policy interest rate at zero in 2005.

Fiscal policy worldwide will in general be less stimulatory in 2005 than that in 2004. The assumptions regarding fiscal policy in individual countries are based mainly on official budget plans or policy statements.

The average international price of oil is assumed to be \$38 per barrel of Brent crude oil in 2005, compared with an estimated average of \$40 in 2004.

The future international prices of other major commodities are based on the forecasts contained in the World Bank publication *Global Economic Prospects 2004*, with some adjustments to take into account more recent developments.

The United States dollar is projected to continue depreciating against the euro and the Japanese yen, reaching on average \$1.26 per euro and Yen 108 per dollar in 2005.

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<sup>1</sup> <http://www.un.org/esa/analysis/link> and <http://www.chass.utoronto.ca/link>.

## Global trends

At 3.8 per cent, the estimated growth of world gross product (WGP) in 2004 is the highest and most broad-based for a number of years, but is expected to moderate to 3.0 per cent in 2005 (see table).

The *LINK Global Economic Outlook* of April 2004 suggested that the strength of the world economy remained largely cyclical and that the accelerating phase of the global expansion would end gradually in 2004. After strong growth in the second half of 2003 and early 2004, the world economy indeed decelerated around midyear. A number of factors were responsible for the moderation in global growth: higher oil prices, the weak and delayed recovery of employment in a large number of economies, a relapse in the global information and telecommunication technology (ICT) sector in its recovery from the bursting of its bubble in 2001, and an unwinding of policy stimuli in some economies. These factors are likely continue to weigh on the world economy in 2005.

### *Oil price developments and their impact*

Among these factors, the surge in oil prices has been the most salient. In the previous *LINK Global Economic Outlook*, the average annual price of for Brent oil was assumed to be \$28 per barrel (pb) for 2004, but it is likely to be around \$40.

Oil prices have been on an upward trend since 2003, but soared to record highs in 2004, reaching \$55 pb in October. This triggered two main concerns: first, about the risk of another global oil crisis which, according to some analysts, could dwarf the crises of the 1970s and the 1980s, both of which wreaked havoc on the world economy; second, about the possibility of a permanently high level of oil prices in the long run.

The causes of the recent rise in oil prices, however, seem to be different from the past. A large scale of disruption in oil supply was behind the oil crises of the 1970s and 1980s whereas a strong increase in global oil demand is the key factor for this round. Rapid industrialization in such large developing countries as China and India has lifted these economies' demand for oil to a much higher level. Moreover, this increase coincided with a stronger-than-expected cyclical global economic recovery in late 2003 and early 2004. As a result, global oil demand has increased by more than 3 per cent over the past year, the highest annual rate in more than two decades.

Global oil production has also increased, but has not kept up with demand. During 2003 and early 2004, OPEC underestimated the strength of global oil demand and member countries kept restraining their production; later, OPEC increased production quotas. However, global oil production seemed to be near its short-run capacity, partly because of underinvestment in the oil sector for the past two decades (when oil prices were low).

With strong demand and tight production capacity, global oil markets became highly sensitive to any events that would suggest a possible future disruption. For example, the

## Growth of gross domestic product and world trade, 2003-2005

(Annual percentage change)

	April 2004 forecasts			November 2004 forecast	
	2003 <sup>b</sup>	2004	2005	2004	2005
Gross world product	2.6	3.7	3.4	3.8	3.2
PPP weighted	3.1	4.2	3.9	4.5	3.8
Major developed economies					
Canada	2.0	2.2	3.2	2.8	2.7
Japan	2.5	3.1	2.0	3.6	2.0
United States	3.1	4.7	3.6	4.0	3.0
European Union (EU25)	0.9	1.9	2.4	2.3	2.3
France	0.5	1.7	2.5	2.5	2.5
Germany	-0.1	1.5	2.3	2.0	1.7
Italy	0.4	1.0	2.3	1.1	1.7
United Kingdom	2.2	3.3	2.7	3.3	2.9
<i>Memo item: Euro Zone</i>	0.5	1.6	2.4	2.0	2.1
Russia	7.3	7.8	6.4	6.5	5.3
Developing countries and regions					
Latin America and the Caribbean	1.8	3.6	4.1	5.0	3.9
Argentina	8.6	4.0	4.0	7.1	4.0
Brazil	-0.2	3.2	4.4	4.4	3.7
Mexico	1.3	3.5	4.5	4.1	3.9
Africa	4.0	4.1	4.8	4.4	4.6
North Africa	4.5	4.0	5.2	4.5	5.1
Sub-Saharan Africa <sup>c</sup>	2.9	5.1	5.5	5.5	5.7
Nigeria	10.2	3.8	3.9	6.4	5.0
South Africa	1.9	3.3	3.5	3.0	3.1
South and East Asia	4.6	5.5	5.2	5.5	5.3
India	7.0	6.3	6.1	6.4	6.5
Indonesia	4.2	4.5	4.4	4.5	4.4
Korea, Republic of	2.5	5.5	5.1	4.9	4.5
Malaysia	5.3	6.1	5.2	7.0	5.9
Philippines	4.5	4.9	5.3	5.5	5.3
Thailand	6.7	5.9	4.8	6.0	5.5
China	9.1	8.5	8.2	9.2	8.8
Western Asia	3.6	3.2	4.2	6.2	5.0
Oil-exporting countries	3.4	3.1	4.2	5.6	5.1
Oil-importing countries	3.8	3.4	4.1	6.7	4.9
World export volume	5.5	6.8	7.4	9.3	8.0
Oil price (Brent, \$/pb)	28.8	28.0	27.0	40.0	38.0

<sup>a</sup> Pre-Meeting forecasts.

<sup>b</sup> Actual or most recent estimates.

<sup>c</sup> Excluding Nigeria and South Africa.

geopolitical uncertainty in the Middle East, the Yukos affair, the domestic unrest in Nigeria and Venezuela and the hurricanes in the Gulf of Mexico all led to growing upward pressure on oil prices, although none of these events, except the damage caused by the hurricanes, caused any substantial reduction in global oil production. The heightened fear of a possible future shortage of oil has also driven a number of oil-importing countries to replenish their strategic reserves, propelling prices even higher. Moreover, speculative behaviour in the oil futures market, in a bubble-creating process similar to that in other financial markets, has exacerbated the situation.

The increase in oil prices over the past year has been less than during the oil crises of the 1970s and 1980s. Moreover, if adjusted for inflation, the equivalent of the historically high oil prices that were reached in 1980 would be about \$80 pb in current prices, about \$25 higher than the peaks recorded in October 2004.

So far, the surge in oil prices is an indication that global economic growth is at or beyond the limit created by short-run global oil production capacity rather than a consequence of a supply-side oil shock such as those resulting from the oil crises of the past. However, higher oil prices have distributional effects, transferring income from consumers to oil producers and from oil-importing countries to oil-exporting countries. Poor oil-importing countries and low-income groups within countries are always the most vulnerable to higher oil prices.

Historically, higher oil prices have resulted in a deterioration in the terms of trade and balance-of-payments of many oil-importing developing countries. Currently, the adverse impact of higher oil prices seems to have been largely offset by the positive effects of the increased prices of non-oil commodities for a large number of oil-importing developing countries in Africa and in Latin America, with only a few exceptions.

Higher oil prices have a discernable impact on global inflation, with the headline inflation rates in a majority of economies moving upward. The pass-through of the increased oil price to prices in other sectors has, however, been minimal, but may increase in the future if high oil prices persist.

In the LINK baseline outlook, assuming no large-scale disruption in global oil supply because of a deterioration in the geopolitical situation around the major oil supply areas, oil prices are expected to stay around \$50 pb in late 2004 and early 2005 and to decline gradually to about \$35 pb in the second half of 2005, as a result of a projected slowdown in the growth of GWP (and a consequent softening of global oil demand) and an anticipated gradual increase in global oil production capacity.

Nevertheless, there remain risks of much higher oil prices. For example, if tensions around major oil supply areas deteriorate, panic, as well as speculation, could continue to drive oil prices higher, for instance, to the historical high of \$80 pb reached in the 1980s. In such an alternative scenario, the adverse impact on the global economy could be grave: the psychological effects on consumer and business confidence could lead to a much larger reduction in aggregate demand. However, as long as there is no large-scale disruption in oil supply, oil prices should not stay at such a high level: as global demand for oil falls and speculators abandon their long

positions in the oil futures market, oil prices can be expected to drop in a manner typical of a boom-bust cycle.

Despite some moderation lately, the prices of many other commodities have also increased substantially during 2004, particularly base metals and other raw materials, although the prices of a few agricultural products have been softening. As with oil, strong growth in China and, to a lesser degree, India has been the key factor driving up the prices of these commodities. The economic prospects of China therefore remain important for the outlook for these prices: the recent mild reversal in some of these prices was caused by a slight downward adjustment in expectations regarding China's growth because of its macroeconomic tightening. On the supply side, reduced stocks of some base metals and strikes in a few major metal supplying countries suggest tight market conditions and thus firm prices in the near term. As mentioned earlier, higher prices of non-oil commodities have played a crucial role in offsetting the adverse impact of higher oil prices in many net-energy importing developing countries and in boosting their growth in 2004. Some analysts believe the rapid development of China, India and a few other large developing economies means the secular downward trend in commodity prices is being reversed.

### *Macroeconomic policies*

Fiscal policy continues to pose challenges as growing deficits, particularly in several developed countries and economies in transition, need to be addressed. In contrast, developing countries have been making continuous progress in addressing their fiscal imbalances. With fiscal stimuli fading or reaching limits in several economies and prudence reigning in many others, fiscal policy is expected to be less supportive of growth in the forecast period, with the notable exception of fuel exporters.

Among the developed economies, addressing the U.S deficit is relevant not only for the United States itself but for the global economy, as the growing fiscal imbalance might raise long-term interest rates, dampening investment and growth prospects. The linkages between the fiscal deficit and the current account deficit, their financing and the value of the dollar also imply that the fiscal deficit represent a source of risk and instability for the global economy. As indicated below, the expansionary fiscal policy of the United States appears to have reached its limit. Similarly, the major euro zone economies are tightening their fiscal policies and a significant effort is required for these countries to regain or stay below the 3 per cent deficit to GDP ratio embodied in the Stability and Growth Pact. Similarly, fiscal policy in the new EU members is driven by the eventual goal of joining the monetary union and therefore also targeting a deficit of below 3 per cent of GDP. Meanwhile, Japan is expected to continue with its restrictive policy, largely focusing on expenditure restraint and reducing public investment spending.

Among the fuel exporters in developing countries and CIS economies, higher oil prices contributed to improved fiscal positions and have allowed for increased public expenditures. Signs of prudence, however, were visible in several of them. Windfall proceeds were deposited in stabilization funds and, in some instances, used to reduce external indebtedness. Although oil prices will soften and oil production declines in 2005, oil revenue will still remain high to allow fiscal flexibility in most countries. Conversely, fiscal policy will be cautious in most fuel

importers, particularly in those confronting debt sustainability challenges. In South Asia, however, fiscal policies will remain expansive in the fiscal year 2004/2005, with a trend towards improved revenue collection and a new, stronger focus on development and social spending. Fiscal deficits are likely to overshoot targets, with the largest deficits occurring on India and Sri Lanka.

Many central banks have begun to raise interest rates, gradually reversing the process of monetary easing adopted in the past few years. Leading the tightening have been the Bank of England and the Federal Reserve (Fed) of the United States, the latter having increased the Federal Funds rate four times by a total of 100 basis points since mid-2004. A number of central banks in other developed economies, such as the Bank of Canada, have also increased their policy interest rates. In contrast, the Bank of Japan (BoJ) and the European Central Bank (ECB) have not tightened, as the growth in these economies remains weak or below their potential. Since interest rates are still at historical lows, more tightening is expected in 2005. While BoJ is expected to maintain its zero-interest rate in 2005, the ECB will likely raise its rate slightly.

Monetary policy in a large number of developing economies in Asia, and Latin America, and some European countries has also been tightened modestly, while a few other economies, such as Korea, Hungary, South Africa and Turkey, have reduced interest rates, either because of weakening growth, or due to currency appreciation and reduced inflationary pressures. Unless there is a severe supply-side oil shock that raises global inflation substantially, the monetary policy stance is expected to remain generally accommodative, both worldwide and in most individual countries across all regions in 2005,

Historically, global monetary tightening cycle has created financial difficulties, even crises, in many developing countries. So far, this impact seems to be benign, partly because the absolute level of interest rates in global capital markets remains low. The yield curve in global capital markets has even flattened during 2004: long-term interest rates have not gone up along with short-term rates and have even moved lower. This, together with improved domestic economies and macroeconomic balances in many developing countries, continues to support a recovery in the external financing conditions for these countries, as indicated by the narrowed yield spreads for the sovereign bonds of emerging markets.

Meanwhile, global equity markets have been fairly stable during 2004, with equity markets in most developed countries registering moderate gains and those in some emerging markets rising considerably. In contrast, foreign exchange markets have been active, with foreign exchange turnover increasing markedly. In early 2004, the exchange rates of the United States dollar vis-à-vis other major currencies launched a rebound from the protracted downward trend of the previous three years, but this failed and lately the dollar has renewed its depreciating trend to reach new lows against the euro. The LINK baseline forecast is based on an assumption that the exchange rates among the major currencies will stabilize at the current level, but the large and widening twin deficits of the United States pose considerable risks for a further decline of the dollar in 2005, thus increasing revaluation pressures on currencies that are currently pegged closely to the dollar.

## *Trade flows and imbalances*

International trade flows started 2004 at a very strong pace, but there was a measurable slowdown around mid-year, particularly in the trade of ICT goods. The upward momentum has, however, not abated and the annual growth of world exports in real terms is estimated to be about 9 per cent in 2004. The outlook for 2005 is slightly lower, although the phase-out of the Agreement on Textiles and Clothing (ATC) at the beginning of the year may lead to a notable relocation of global manufacturing and trade in the sector and thus boost international trade flows to a higher level than forecast.

After a period of stalemate, some tentative progress was also achieved in multilateral trade negotiations in 2004: the General Council of the WTO adopted a decision on how to proceed with the Doha Work Programme by setting out a framework for future negotiations on trade liberalization. A major step forward was the agreement on modalities on agriculture, which had been impeding progress in other areas of trade liberalization, due to the “single undertaking” nature of the Programme. Despite the progress, many difficult issues remain and more swift action needs to be taken in order to fulfill the Programme’s declared goal of promoting the economic development of developing countries.

Trade balances across regions widened further in 2004. As in previous years, the deterioration in the United States’ current account in 2004 was due to an increased merchandise trade deficit; this reached more than \$ 600 billion, compared to \$ 544 billion in 2003. As in 2003, merchandise imports grew faster than exports while the terms of trade declined as a result of a combination of the depreciation of the dollar and higher commodity prices. Robust import demand of consumer goods, as the economy recovered, continued to underlie the increase in imports, but the country has also become a net importer of capital goods since 2003.

These global imbalances, particularly the United States twin deficits, continue to raise concerns not only about their sustainability in the medium to long term and the risks they represent to the global economy. The current account balance is the mirror image of the balance of saving and investment net of depreciation. Net national savings in the United States reached 1.4 per cent of net national product (NNP) in 2003—with negative government saving of 3.8 per cent of NNP (on a national account basis)—and continued to deteriorate in 2004. The low level of personal savings is worrisome: it fell to 0.4 per cent of disposable personal income in the third quarter of 2004.

The United States’ imbalance thus reflects a public deficit in a context of low private savings. This implies that, under present conditions, the current account adjustment, in addition to increases in private savings, requires a fiscal adjustment within a framework of pressures for increased homeland security and military expenditures and at a time of gradual tightening of monetary policy. While the United States has successfully adjusted before, fiscal adjustment in the 1990s was conducted in an environment where military expenditures fell due to the end of the cold war (“the peace dividend”) and interest rates declined. These conditions mitigated the difficulties of the fiscal adjustment.

Repeated current account deficits have led to an increase in the external indebtedness of the United States, as measured by the country's net investment position, estimated to reach some 28 per cent of GDP by the end of 2004. The counterpart of such trends is the accumulation of huge, largely dollar-denominated, international reserves by creditors, mostly Asian economies, in many instances well beyond what would be required by precautionary motives.

With its external liabilities denominated in dollars, the United States does not face the same constraints and risks as countries that issue debt in foreign currency. Moreover, the dollar's role as a reserve currency implies that the increased indebtedness of the United States has different implications for its economy and for the world. In particular, the devaluation risk can be seen as being shifted to creditors who suffer a reduction in wealth, lower export growth and possibly deflation when the dollar falls. Currency mismatch is thus a problem for creditors, not debtors, in this case.

As the trade deficits persist, the country's indebtedness and the cost of carrying such debt increases, thus adding to the financial pressures. It could also feed into a further deterioration of the current account (as net income turns negative), eventually requiring even more external resources for its financing and leading, again, to increased indebtedness, producing a vicious circle.

With an increasing savings-investment gap but without the participation of official investors, the price of United States assets would have needed to fall sharply (involving either a higher interest rate or a correction of the dollar exchange rate, or a combination of both) in order to attract additional private inflows. The depreciation of the dollar vis-à-vis other major currencies since early 2002 attests to this and the recent renewed volatility in foreign exchange markets, with the dollar falling rapidly, may suggest a disorderly adjustment.

Some commentators, however, have argued that the present imbalances are sustainable, because it is in the interest of both the United States and the Asian creditors to maintain such arrangements. The United States benefits from the status quo because it enjoys cheap financing, while the creditors can continue to rely on export-driven growth. In addition, maintaining the status quo allows creditor countries to build up and hold large US dollar denominated assets without a decrease in their value.<sup>2</sup>

Others have suggested that the U.S. capacity for borrowing abroad has risen due to technological advances, an apparent decline in "home bias", and a continuing rise in global financial deregulation, transparency and investor protection, which have created room for more specialized financial products and institutions. Although there is still an upper limit for this international savings transfer, these trends allow the United States to finance the current account deficit without apparent signs of funding stress.<sup>3</sup> The implication is that, at least for the United

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<sup>2</sup> For arguments regarding the sustainability of the imbalances, see M. Dooley et al, *An Essay on the Revived Bretton Woods System* (NBER Working Paper No. 9971), September 2003., C. Mann, *Managing Exchange Rates: Achievement of Global Re-balancing or Evidence of Global Co-dependency* (Business Economics, July 2004, 20-29) and R. McKinnon and G. Schnabl, *The Return to Soft Dollar Pegging in East Asia Mitigating Conflicted Virtue* (July 2004).

<sup>3</sup> A. Greenspan, *The Evolving U.S. Payments Imbalance and Its impact on Europe and the Rest of the World*, *Cato Journal*, Vol. 24, Nos. 1-2 (Spring/Summer 2004)

States, the commonly accepted limit of sustainability (a current account deficit of around 5 per cent of GDP) has been pushed up.

The foregoing views suggest that the current global imbalances could persist for some time. However, even if accepted, the argument does not imply that the current situation can be maintained at no cost. The United States and its main creditors, as well as third countries, are paying a price and running risks for sustaining the imbalances.

Although the United States presently seems to benefit from the imbalances, enjoying cheap international financing which helps the interest-sensitive sectors of the U.S. economy, its productive structure is shifting away from tradables. This implies a much larger adjustment cost for the United States if the country is eventually forced to reduce its current account deficit. Countries with a large tradable sector usually incur smaller exchange rate correction and consumption losses as the required cuts in tradable absorption is proportionally less than in economies with a small tradable sector.<sup>4</sup>

The bulk of the direct costs of maintaining the United States' imbalance is, however, born by the creditor countries. The impact of increased reserves on domestic monetary supply must be sterilized if the monetary authorities want to contain inflationary pressures. Both China (until early 2003) and Japan were experiencing deflation so that the increased liquidity brought about by reserve accumulation contributed to achieving inflation objectives. For the majority of countries, however, reserves needed to be sterilized and this often has fiscal costs due to the interest rate differential between local currency debt and US government debt. Hong Kong SAR is an exception to this rule, due to its low domestic interest rate environment. Furthermore, there is an opportunity cost of foregoing potentially higher return investment in the domestic economy (or elsewhere). Additionally, an eventual devaluation of the dollar would have negative consequences for the national treasuries of these economies because of the reduced domestic currency receipts of interest on the country's foreign assets,<sup>5</sup> as well as overall negative wealth effects for the rest of the economy.

At the global level, the costs associated with maintaining the imbalances include the danger of a protectionist backlash because of the competitive pressures emanating from misaligned exchange rates or their uneven correction (in the case of the euro). These may take the form of anti-dumping measures and other forms of non-tariff trade barriers but non-trade measures, such as more active exchange rate management of floating currencies in order to ensure export competitiveness, might also herald a return to "beggar-my-neighbour" policies.

Addressing the imbalances would contribute to decreasing the uncertainties and risks facing the global economy. The preferred approach would involve a gradual rebalancing of global demand away from the United States to other economies, particularly to the major developed economies that currently have an external surplus. This would require a change in fiscal stance, as well as a rise in private savings, in the United States. For the other countries,

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<sup>4</sup> G. Calvo et al, *Sudden Stops, the Real Exchange Rate and Fiscal Sustainability: Argentina's Lessons* (NBER Working Paper No. 9828), July 2003.

<sup>5</sup> M. Higgins and T. Klitgaard, *Reserve Accumulation: Implications for Global Capital Flows and Financial Markets*, *Current Issues in Economics and Finance*, Vol. 10, No. 10, September/October 2004.

particularly the major developed economies and other countries accumulating large current account surpluses, it is necessary to increase reliance on domestic consumption as a source of growth. Ideally, it would also involve some degree of improved international cooperation in exchange rate policy, not only among the major economies but also, because of their external surpluses and their increased integration into the world economy, including the leading economies in Asia.

## **Regional prospects**

### *North America*

The economy of the *United States* started 2004 on a strong note, but GDP growth has decelerated considerably since the second quarter of 2004, as consumer spending softened and exports stalled. However, there was a rebound in economic activity entering the 4<sup>th</sup> quarter, particularly a strong gain in employment, and GDP growth for 2004 is estimated to be above 4 per cent. Nevertheless, the economy faces a large number of growing constraints and unsustainable imbalances, pointing to a deceleration of growth in 2005 to 3 per cent.

The resilience of the economy, specifically the unflinching propensity of consumers to spend, is surprising, given the surge in energy prices and the lacklustre job market; the latter is only now beginning to show tentative signs of improvement. With interest rates moving up, fiscal stimuli waning, oil prices remaining at their increased levels, the household saving rate at an historical low, household debt at a record high, the twin deficits possibly approaching their limits and the dollar depreciating, the United States economy seems vulnerable to a setback.

So far, the surge in oil prices in 2004 has not been fully passed through to the prices of gasoline and heating oil and to an even lesser degree to the prices of other goods and services. Nevertheless, if high oil prices persist, business profits will be squeezed further and consumers' welfare losses will increase.

A key factor behind the seemingly unstoppable consumer buying spree of the past few years has been the gains in wealth from the appreciation of housing prices and the additional net income that homeowners have realized from lower interest rates on mortgages. As a result, household debt has reached a record high and the saving rate a record low. Although they have not declined, housing prices seem to have peaked and interest rates are moving upwards, although in a gradual steps and with levels remaining low. With the two forces providing the stimulus waning, consumer spending seems unlikely to grow. If interest rates increase quickly – for example, if high oil prices cause inflation to escalate – or if housing prices fall precipitously, the debt burden will squeeze consumer spending markedly.

The expansionary fiscal policy – in the form of both increased expenditures and reduced taxes – of the past few years seems to have reached its limit, as indicated by the rapid growth of the fiscal deficit. Some of the tax reduction measures seem likely to be extended, but fiscal spending is expected to decline.

Although views are split over whether the large external deficit will be rebalanced in a benign or an abrupt manner, it is generally agreed that the the external deficit may be about to decline, as indicated by the further depreciation of the dollar vis-à-vis other major currencies.

These constraints will weigh on the economy, auguring a slow growth for 2005. Nevertheless, high productivity growth, robust business investment and an expected improvement in employment may prevent the economy from decelerating too rapidly and growth declining too far.

The United States continues to lead global technological innovation. High productivity growth, about 4.5 per cent in both 2002 and 2003, has been a key to the economy's resilience. Although productivity growth has slowed, including a drop to 1.9 per cent in the third quarter of 2004, it may still exceed 2 per cent for the next few years, as the diffusion of ICT continues to the economy.

The strong growth in business investment spending continues and is not expected to retreat in the near future. It has been boosted by a surge in corporate profits (which have completely recovered from the past cyclical downturn and reached a record high) and was not affected by the mid-year deceleration in the economy.

The recovery in employment has been slow, but the latest data indicate a strengthening labour market, with payrolls registering monthly average growth of more than 200,000. Government hiring has increased notably, but private job growth is still below the historical average and manufacturing employment continues to decline. While these weaknesses remain, further improvement in employment is expected to provide a support for the economy.

The *Canadian* economy has accelerated since the second quarter of 2004, driven by both strong external demand and an improvement in the terms of trade. Despite the appreciated currency, rising interest rates and high dependency on demand from the United States and other countries, Canadian GDP is projected to grow by 3 per cent for 2005, the same pace as estimated for 2004.

The Canadian currency has appreciated substantially against the United States dollar in the past two years, but the negative impact on the Canadian economy has been offset by the increases in the prices of oil and other commodities and by strong external demand. As a result, corporate profits reached record highs, boosting business investment and employment growth which, along with wage gains, supported consumer spending. However, with further strengthening of the currency and some moderation in non-oil commodity prices, the contribution of net exports to growth is expected to be limited in the outlook. High frequency data show some sign of weakening in exports in the last quarter of 2004.

The government sector showed a lull in mid-2004, with a weak expenditure and employment. However, stronger growth in government expenditure is expected in the outlook. The fiscal position remains balanced, with the federal government running modest surpluses while the provinces have some deficits. The federal budget surpluses are expected to continue, as

the government adheres to its plan to steadily reduce the debt/GDP ratio. Canada may be the only G7 country with an aging population that has a sustainable fiscal position.

Canadian interest rates are already higher than US rates by at least about 70 basis points. Monetary tightening in Canadian is expected to be less aggressive than that in the United States over the next two years.

### *Western Europe*

Growth in Western Europe has remained highly dependent on external demand and consequently has slowed marginally from earlier in 2004, as a result of slowing external demand as well as the negative impact of rising energy prices. The recovery remains on track but it is not expected to be robust. In the 2<sup>nd</sup> quarter of 2004, GDP in the eurozone grew by 0.5 per cent, with net exports contributing 0.4 percentage points while domestic demand contributed only 0.1 percentage points. The driving force was an acceleration in exports from the surge in world demand, with some impetus from government consumption. The growth of private consumption decelerated and gross fixed investment picked up only marginally. The driving forces behind the growth profile are expected to change however, with domestic demand picking up gradually in line with a normal maturing recovery. Growth in the eurozone is expected to register 2.0 per cent in 2004 and 2.1 per cent in 2005.

Industrial production has picked up since last year, but the decline of production in June and August demonstrates the continuing risks to sustainability. The Ifo Business Climate index in Germany, an indicator for overall eurozone performance, shows a continuing but not robust recovery; the assessment of current conditions has moved steadily upwards but future expectations have dropped from the heightened levels at the beginning of 2004. Consumer confidence had been rising steadily since the second quarter of 2003, but stalled in the second half of 2004 and remains below its long term average.

The outlook remains heavily dependent on the prospects for external demand. With world demand slowing only moderately from its pace in the first half of 2004, the outlook for exports remains relatively optimistic. The recent appreciation of the euro is a risk, but exports have held up well at the exchange rates that have prevailed for most of 2004. The growth of exports is expected to decelerate in 2005 but to remain a significant direct impulse to growth, indirectly spurring investment spending, particularly in the capital goods industry. Investment should also be supported by continuing low interest rates and gradually improving financing conditions as companies improve balance sheets. Consumption should pick up but its strength is in doubt because it is driven by labour market conditions. Employment is lagging so far, but is expected to improve with continued moderate growth. In addition, productivity growth has increased so wages should increase. Nevertheless, both employment and wages are bounded by competitive pressures.

Core inflation remains below 2 per cent but, as measured by the Harmonized Index of Consumer Prices (HICP), it increased to 2.5 per cent in May 2004, due to the increase in energy prices, before moderating to 2.1 per cent in September. The persistence of higher-than-expected oil prices means that the anticipated fall to below 2 per cent will be delayed until 2005.

Unemployment has remained stable for many months, at 8.9 per cent for the eurozone. On a positive historical note, the long period of slow growth during the earlier downturn did not result in a major deterioration in the labour market, as happened in the 1992/93 downturn, but this earlier resilience is now likely to hold back the improvement in labour market conditions, especially when coupled with a tepid recovery. The unemployment rate is expected to improve only marginally over the course of 2005.

Monetary policy is still on hold in the eurozone, with no major pressures yet to make a change. Inflation, particularly core inflation, is close to the ECB target of less than 2 per cent and its future trajectory is expected to be downward, as oil prices are expected to moderate in 2005. At the same time, growth prospects continue to improve moderately, and downside risks are not significant enough to take action. The ECB is assumed to start raising rates in the first quarter of 2005, but by only a cumulative 50 basis points over the course of the year.

Fiscal policy is expected to play a restraining influence over the forecast period. The major eurozone economies are tightening policy, as they all require significant efforts to regain or stay below the 3 per cent deficit to GDP ratio threshold embodied in the Stability and Growth Pact. While modifications to the Pact are being discussed, it is unlikely that the outcome will extend beyond making the deficit target a more medium-term goal, so that consolidation remains inevitable.

#### *Developed Asia and Pacific*

The economic recovery in Japan, initiated in the summer 2003, continues, but has shifted to a low gear. Despite some sluggish signs since the second quarter of 2004, GDP growth can still reach 4 per cent for the year, the best annual performance in the past decade. Growth in 2005 is, however, expected to decelerate to 2 per cent. The prospects for the Japanese economy remain largely dependent on a number of external factors, including the strength of the United States and China, oil prices, and the global ICT demand cycle.

The recovery was originally driven by the expansion of the external sector, but the strength has gradually been feeding through to other sectors, from manufacturing to non-manufacturing, and from large firms to small firms. An improvement in corporate profits continues to support strong growth in business capital spending, and employment and household income has finally shown some tentative improvement.

The risks of financial system instability have subsided noticeably. Considerable progress has been made in dealing with non-performing loans, conditions for corporate finance have improved, commercial banks continue to ease their attitude to lending, Japanese equity prices have been rising for more than a year and the decline in land prices in a few metropolitan areas has slowed, although land prices overall continue their prolonged downward trend. The yen has appreciated vis-à-vis the United States dollar over the past year, but has not slowed the economy yet.

The protracted deflationary trend has abated notably, but has not yet been uprooted. Increases in the prices of oil and raw materials have led to higher producer prices, but consumer

prices, excluding food prices, continue a slight downtrend. These crosscurrents are expected to continue in 2005, with the upward pressures on the prices of raw materials, and thus producer prices, being offset by restraints on labour costs and firms' lack of pricing power due to intense competition. As the economic recovery gradually narrows the output gap, consumer prices are expected to register a small rise in late 2005, finally ending the country's period of deflation.

Monetary policy in Japan has been accommodative, as the Bank of Japan has been increasing the quantitative monetary target to provide ample liquidity by various instruments of money market operations. The Bank has committed to a zero-interest-rate until the annual change in the CPI is above zero on a sustainable basis; this is unlikely to be until late 2005.

On the other hand, the country's restrictive fiscal policy will continue, mainly through expenditure restraint, such as cuts in public investment spending. The government fiscal position remains precarious: the gross public debt/GDP ratio is 166 per cent, the net debt/GDP ratio is 80 per cent and the structural deficit (including social security) is 6 per cent of GDP. Japan is aiming for a primary balance before 2010: raising the consumption tax could be an option in the medium term, while the privatization of the country's Post Saving system is already on the agenda.

Downside risks for Japan in the short run include a further increase in oil prices, a "hard-landing" in China, and a downturn in the United States. In the longer run and in addition to the fiscal situation, the structural challenges include high corporate debt levels, particularly for non-manufacturing firms, and restoring the financial soundness in the banking system, where progress to date has been uneven.

The economies of *Australia* and *New Zealand* have performed well in 2004, with GDP growth in the former at 3.5 per cent and in the latter above 4 per cent. However, growth in both countries, particularly New Zealand, is expected to moderate in 2005.

In Australia, a scaling-back in house construction, which had been the most vibrant driving force for economic growth in the past few years, has been offset by an improvement in the terms of trade, due to the higher prices of Australia's commodity exports, and a substantial fiscal stimulus. In New Zealand, domestic demand has been booming, bolstered by rising business investment and robust house construction. Both economies have achieved notable employment growth, reducing unemployment rates to historical lows. While import demand has grown at more than 10 per cent in real terms in both economies, real exports have also increased markedly, although more slowly than imports. Both economies are facing external deficits of about 5 per cent of GDP. Australia's deficit declined slightly in 2004 because of higher exports in value terms, but New Zealand's deficit has deteriorated further. The large external deficits and the appreciation of their currencies suggest a deceleration in these economies in 2005, amplified in New Zealand's case by slower immigration.

Inflation has moved upwards slightly in both economies, but remains within the targets set by the central banks. After raising interest rates in 2003, the Reserve Bank of Australia has been maintaining them in 2004, while the Reserve Bank of New Zealand has increased them by

150 basis points in 2004. No further tightening is expected in 2005, although New Zealand may reverse some of the earlier tightening if the deceleration in the economy is excessive.

### *The New EU members*

Economic growth in the new EU members accelerated in 2004. The driving forces behind this acceleration were booming exports throughout the region and the recovery of investment in part of Central Europe. In many countries, private consumption, fueled by expanding credit, also remained strong, leading to a more broad-based growth. At the same time, growth in Central Europe may contain a one-off effect of the EU enlargement; inflationary expectations in the wake of EU accession boosted private spending and the countries tried to increase their exports to Southeastern Europe while bilateral trade agreements still are in place. Average growth in the region is expected to moderate slightly in 2005, largely due to slower export growth.

In many countries of the region, exports have expanded at double-digit rates in 2004, in spite of the slow recovery in their main export markets and the appreciation of their currencies. One reason for this is almost full trade liberalization between the new EU members and the EU-15. As an example, Polish agricultural exports to the EU increased dramatically in 2004, following the abolition of quotas. Other contributing factors were the improved quality of products, participation in international distribution networks, the effect of previous interest rate cuts and an increase in exports to developing countries. An upturn in investment in Central Europe, on the other hand, is explained by stronger business confidence, improved corporate profits, expectations of lower corporate taxes and the implementation of EU-related programmes.

From close to zero in some countries in 2003, inflation in the region accelerated slightly in 2004 as a result of higher excise taxes, VAT unification in many new EU members and higher energy prices. Increased export demand, in particular for Polish food products, limited supply to the domestic market and was another inflationary factor. Continuing productivity growth and slower growth of real wages should, however, keep inflation in check. With price deregulation in the new EU members mostly completed, slower real wage growth, strong retail competition and stronger currencies, the outlook is for decelerating inflation in 2005,

Monetary policy in the region has been mixed in 2004. It was tightened in response to higher inflation and strong credit expansion in the Czech Republic, Latvia and Poland. Although interest rates were cut in Hungary, they still remain among the highest in the region, following a drastic increase in 2003. Monetary policy was relaxed in Slovakia to weaken the currency, which appreciated due to strong fiscal position and inflows of capital. Estonia, Lithuania and Slovenia meanwhile joined ERM-2, aiming at adoption of the euro in two years.

Fiscal policy in the new EU members is driven by the goal of joining the monetary union and they are therefore targeting a deficit of less than 3 per cent of GDP. This has already been achieved in the three Baltic states and in Slovenia, where budgets are close to balance in part due to fixed exchange rate arrangements. For most of the Central European countries, however, balancing the budget is still a distant target and only gradual measures are being implemented. The structural component of their deficits remains almost the same, and is complicated by the subsidies to loss-making enterprises in a number of countries and state loan guarantees. Fiscal

consolidation should be combined with the co-financing of EU assistance, since revenues from custom duties from trade with the EU were eliminated.

Strong economic growth had only a marginal impact on employment for most of these countries, since industrial restructuring is still not completed, productivity growth is strong and the growth in real wages often exceeds the gains in productivity. Some improvement was registered in Slovakia, due to strong FDI inflows and a tightening of benefits.

Strong exports had a favourable effect on the current accounts of the Czech Republic, Poland and Slovakia, but for Hungary the deficit is expected to remain at 8 per cent of GDP and low FDI inflows may prompt external borrowing. The deficits also remain high in the Baltic States and are affected by high oil prices everywhere in the region.

For these countries, the goal of EU convergence is becoming an anchor of macroeconomic policy. However, these countries should endeavour to finalize EU-related harmonization without detriment to economic growth. Among other policy issues are the financing of small and medium businesses, the efficient use of EU funds and increasing the competitiveness of their farmers in the EU.

### *South-eastern Europe*

The countries of Southeastern Europe have registered strong economic growth in 2004, driven both by good export performance and by growing domestic demand. Intra-regional trade also increased, following a number of bilateral trade agreements.

Both exports and domestic demand remained strong in Bulgaria, Croatia and Romania. Private consumption grew strongly in these countries in line with private credit, and investment was driven by infrastructure spending and privatization-related upgrades. In Macedonia, on the other hand, there was a drop in industrial production. A rapid industrial recovery was registered in Serbia and Montenegro, in addition to recovery in the agricultural sector, and external assistance will provide a further impetus to the economy.

Inflation in the region decelerated on average (although it increased in Bulgaria), since disinflation continued in the high inflation countries, Romania and Serbia and Montenegro. This disinflationary trend is expected to continue. Following pressure from the IMF, mandatory reserve requirements for commercial banks were tightened in Bulgaria and Croatia, in response to a strong credit expansion and higher foreign borrowing.

These countries continue to run large current account deficits, mostly covered by FDI, as privatization in the region continues.

Fiscal policy in the region is mostly influenced by the conditions of IMF stand-by loans, and budgets are closer to balance.

There has been some improvement in employment levels in Bulgaria and Croatia, due to state-sponsored programmes, but the situation remains difficult in many of the former Yugoslav states.

Bulgaria and Romania aim to finalize preparations for EU accession, in order to be admitted to the Union in 2007. Romania was granted a status of “functioning market economy” by the European Commission in October, and Croatia is to start negotiations with the EU. The macroeconomic policies of these countries are in part defined by the conditions of stand-by agreements with the IMF. Other countries of the sub-region need to encourage investment and stronger regional links in order to upgrade their industries.

### *CIS countries*

Robust economic growth continues in the CIS region in 2004, supported by the surge in world commodity prices. After an average rate of over 7 percent in 2003 and in the first half of 2004, growth is expected to moderate somewhat by the end of year but to remain solid in 2005, at about 6 percent.

Driven by strong external demand for oil and natural gas and by buoyant consumption and investment, vigorous output growth is ubiquitous in the region. Robust economic growth in the Russian Federation in the last two years has benefited from the combination of high oil prices, increased external demand for oil and expanding domestic demand. A deceleration of growth started in the second half of 2004 and is expected to continue in 2005, reflecting slowing growth of industrial output, weakening world oil prices and continuing real effective appreciation of the rouble. Output continues to grow vigorously in other large economies in the region, such as Ukraine and Kazakhstan.

After a slowdown in 2003 and in the first half of 2004, inflation is picking up due to higher producer prices, in combination with rising wages and continued money supply growth.

Monetary policy in the Russian Federation will remain neutral because of the limited room for maneuver created by the soaring capital inflows. The real appreciation of the rouble continues in 2004 and could adversely affect local manufacturing companies by lowering their international competitiveness. In other countries of the region, monetary policy is being tightened in view of rising inflationary pressure.

Stabilization funds in Azerbaijan, Kazakhstan and the Russian Federation have accumulated windfall gains from export revenues due to the high oil prices in 2004. This will allow looser fiscal policy over the forecast period, which could add inflationary pressure. Elsewhere in the region, fiscal policy is expected to remain tight to contain inflationary pressure in many countries and insure for repayments of foreign debt.

The downside risks for the region are associated with the heavy dependence on oil and other natural resources, whose price volatility may reduce growth prospects. Recent uncertainties in the Russian Federation related to the banking sector in the summer of 2004 and to Yukos, a major oil producing company, highlight the fragility of the macroeconomic stability of confidence and underscore the need to restructure the economy and build up institutions. Large wage increases and sluggish investment in the non-oil sector are also likely to have a negative impact on growth.

## *Africa*

Africa is expected to record GDP growth of 4.5 per cent in 2004. Many countries have benefited from increased domestic demand and a more favourable external environment as a result of continued high oil prices, increases in the prices of several non-oil commodities and increased global demand for Africa's exports. Growth is expected to accelerate to 4.8 per cent in 2005 as these favourable conditions continue to prevail.

In Algeria, Egypt and Libya, increased oil revenues will continue to support growth of private and public consumption, increased investment for infrastructure development and expansion of oil-production capacity. Other countries in North Africa will benefit from increased agricultural output, growth in manufacturing and other industrial output and increased earnings from tourism and related service sector activities.

GDP growth for sub-Saharan Africa, excluding Nigeria and South Africa, is estimated to reach 4.4 per cent in 2004, with most countries achieving growth rates in the range of 3 to 7 per cent. South Africa is on track to achieve 3.3 per cent GDP growth in 2004 based on strong domestic demand and increased exports. Nigeria's growth performance has continued to be underpinned by higher oil and gas revenues and increased agricultural output. Some oil producing countries, such as Angola, Chad, and Equatorial-Guinea, are expected to continue growing at double-digit rates in 2005. In contrast with this improved outlook, GDP growth in such countries as Central African Republic, Congo, Côte-d'Ivoire and Guinea-Bissau is expected to be seriously constrained by fragile, post-conflict, political developments.

Many African countries have continued to consolidate the benefits of improved political governance and economic management in recent years. Monetary and fiscal policies remain cautious and subdued while inflation has generally been contained to single-digit or double-digit rates in countries such as Angola and the Democratic Republic of Congo that recently suffered from hyperinflation. At the same time, rising incomes and improved confidence in economic management have enabled countries such as South Africa, some oil-producing countries and CFA Franc zone countries to adopt expansionary fiscal policies. Increased government expenditures have generally been targeted at increased expenditures in the social sector and infrastructure development.

## *East Asia*

East Asia has continued to see relatively strong economic growth in 2004, driven particularly by the positive international economic environment, the brisk expansion of the Chinese economy and a more significant role of domestic demand. However, some economies in the region appear to have passed the peak of the current growth cycle so that, for East Asia as a whole, growth in real GDP is expected to slow in 2005.

Despite policies aimed at cooling the economy (such as tighter credit lines and an increase in interest rates), China is expected to achieve economic growth of 9.2 per cent in 2004, an insignificant change from the 9.1 per cent in 2003. A further tightening in monetary policy is expected to lead to slight slowdown in China's economic growth in 2005.

Besides China, economic prospects for the region remain positive, although more moderate growth levels are expected for 2005 due to the predicted relative slowdown in the Chinese economy, the effect of higher oil prices and global policy tightening. However, several countries still have considerable upside potential with regard to their economic performance in 2005. These include Hong Kong SAR, in view of stronger retail sales and the end of its deflationary trend, as well as Singapore, where structural policies in the face of increasing competition from China are likely to be supportive of future economic growth. On the other hand, the Republic of Korea will continue to see its economic growth limited by relatively weak domestic demand due to a large private debt burden as well as weaker exports in light of a less dynamic electronics market. The latter is also likely to have a dampening effect on the economy of Taiwan Province of China.

The generally positive economic conditions in the region also had some limited positive effect on the employment picture. This applies, for example, to Hong Kong SAR, where the end of the deflationary trend was accompanied by a fall in the unemployment rate from the peak of 8.7 percent in July 2003 to 6.8 percent in August 2004. Overall, however, both unemployment and underemployment continue to represent a policy challenge in several economies, notably in China, where the restructuring of public firms creates additional pressure on the supply side of the labour market.

Inflation has picked up throughout the region, although it remains at moderate levels in Singapore, the Republic of Korea, Malaysia and Thailand. While Hong Kong SAR has moved out of deflationary territory during the course of 2004, several other economies like, for example, China and Vietnam, have seen a more pronounced upward trend in inflation. As for 2005, the region will see continued upward pressure on prices, especially due to the effect of higher oil prices, but this upward trend may at least partially be mitigated by fiscal and monetary policy tightening, as well as the expected relative slowdown in economic growth in the region.

### *South Asia*

Economic growth in 2004 has been affected by unfavourable weather conditions, as well as by unexpectedly high oil prices. After exceptionally strong agricultural growth in 2003, erratic monsoon rains in summer 2004 have especially affected India and Bangladesh, and agricultural output in both countries is expected to contract. High oil prices have put additional strain on all economies in the region, except for the only net oil exporter, Iran, where GDP growth in 2004 reflects high oil windfalls. Overall regional growth is expected remain strong in 2005. The services and manufacturing sectors remain the main drivers of growth for the net oil-importing countries in 2004 and 2005, the former especially in India, Sri Lanka and Nepal, and the latter in Pakistan. Agriculture in the region is expected to recover in 2005.

International trade has been buoyant in 2004 and is expected to remain strong in 2005, although export growth will slow somewhat from its performance in 2004, due to weakening external demand growth and to the possibly adverse effects of the phasing out of the Agreement on Textiles and Clothing on the region's less competitive textile exporters. Iran's strong export

growth in 2004 is expected to be reversed in 2005, since its oil production seems to be close to capacity limits and a decrease in oil prices is anticipated.

Inflationary pressures have picked up in most of the region, driven by increased oil prices, as well as higher food prices. Only Iran has witnessed a fall in inflation following a decline in the inflationary pressures caused by the foreign exchange rate unification in 2002. In the countries with rising inflation rates, the cycle of monetary easing has come to an end and measures have been taken to tighten money supply growth. A further rise in inflation rates is expected in early 2005 before further policy tightening helps bring them down again.

Fiscal policies in the region remain expansive in the fiscal year 2004/2005, with a trend towards improved revenue collection and a stronger focus on development and social spending, especially in the agricultural sector, education, and health. Fiscal deficits are likely to overshoot targets, with the largest deficits being in India and Sri Lanka.

### *West Asia*

Economic prospects in West Asia improved sharply during the course of 2004 and are expected to remain favorable in 2005 as well. The region's real GDP increased by about 6.8 per cent in 2004 from 4.1 in 2003 but is expected to decelerate to around 5.4 per cent in 2005. Both oil- and non-oil-exporting countries contributed to the region's economic expansion in 2004 and the momentum are likely to be maintained in 2005. Improved domestic liquidity, together with low interest rates, boosted private consumption and investment in most countries. Inflation picked up throughout the region in 2004 but, with the exception of Turkey and Yemen (where inflation is still at double digits levels), the increase in the CPI was below 3 per cent in most countries. The region's inflation is expected to rise slightly in 2005. Unemployment rose again in 2004 and expected to remain high in 2005.

There was a reversal in policy stance in the region in 2004 as most countries embarked on expansionary fiscal policies and raised interest rates in line with the US Federal Reserve monetary policy.

Fiscal and external balances improved substantially in most oil-exporting countries of the region owing to windfall, part of which has been saved in "Stabilization Funds for Future Generations". Increased oil revenues also led to changes in policy stance as most countries shifted from restrictive to expansionary fiscal policies. The rise in government expenditures was accompanied by sharp increases in oil revenues, resulting in unprecedented budget surpluses in oil-exporting countries in 2004. Although oil prices will soften and oil production will decline in 2005, oil revenue will remain high, providing ample budget surpluses in most countries. In the oil-importing sub-region, fiscal positions continue to be in deficit although the imbalances in most countries (Israel, Turkey, Lebanon, Yemen and Jordan) are expected to be lower than 2003.

With the exception of Iraq, external balances in all oil-exporting countries have improved substantially, thanks to rising oil production and higher oil prices. Non-oil exports, such as aluminum and fertilizers, also increased and helped boost exports earnings in 2004. Meanwhile, import demand has strongly risen in 2004, responding to buoyant economic activities, exchange

rates movements and the firming of non-oil commodity prices. Because of the higher portion of euro-denominated imports, the continued appreciation of the euro against the US dollar to which most countries' currencies are pegged has also contributed to the surge in import bill. But the huge oil exports receipts offset the rise in imports resulting to large trade surpluses. Despite the structural deficits of services account (lower tourists earnings and high transportation costs), transfer and income (workers' remittances and profit repatriation outflows), most oil-exporting countries of the region have displayed current account surpluses in 2004 and this outcome is expected for 2005. With the exception of Jordan and Yemen, current account balances deteriorated in most oil-importing countries in 2004 and expected to further deteriorate in 2005.

### *Latin America and the Caribbean*

The Latin American region had a better than expected performance in 2004, with output growth rate of around 5 per cent. The improvement in both external and domestic conditions allowed for broader-based growth in the region. However, growth in 2004 can be considered mostly cyclical in nature since it is the result of several countries coming out of either recession or slow growth in 2003. In addition, some downside risks linger and may affect short and medium term performance. Growth will continue in 2005 albeit at a slower pace of less than 4 per cent.

Domestic demand explains most of the real growth in the region in 2004. Although exports have recovered, the effect of their growth was weakened by strong demand for imports, except for Brazil where both real net exports and domestic demand contributed to the strong recovery. Much of the domestic demand in the region came from private consumption which has been favoured by lower interest rates and greater economic activity fostering consumer confidence. Public consumption has remained subdued, while fixed investment has rebounded.

Recovery of activity in the United States has boosted growth in export dependent economies like Mexico and the Central American region. The Caribbean countries have been favoured by increased tourism. Only Haiti and the Dominican Republic are still trying to come out of political and economic crises, in addition to coping with losses from recent natural disasters. Continued favorable export commodity prices, especially in metals, will also continue to favour exporters in the Andean region. Increased prices have benefited the region's oil exporters countries, especially Venezuela which will have the highest growth rate in the region in 2004, reflecting the normalization of its oil production after a setback in 2003 due to a general strike.

Macroeconomic policy has been more restrictive than expected, despite better conditions. Monetary policy has been more cautious due to wariness of inflationary pressures and higher US interest rates. These measures, along with appreciated national currencies because of the weak dollar, will help abate the inflationary pressures from higher fuel prices and inflation will continue its decline in 2005. Fiscal policy will also contribute to keeping prices down as it has continued to be restrictive, giving priority to fiscal consolidation and thereby attending to external financial requirements.

Although regional unemployment decreased below 11 per cent in 2004, relieved by greater output growth, it remains at high levels. Most of the reduction in 2004 can be attributed to substantial improvements in Argentina, Uruguay and Venezuela, countries where unemployment figures had shot up because of economic crises from which they are now recovering. Unemployment in most other countries has either remained stagnant or increased.

Foreign direct investment, the bulk of which is flowing to Mexico, returned during 2004 after an overall sharp decline in 2002 and 2003 due to a series of crises, slowdowns and a general decrease in the number of privatizations. The region may experience a third consecutive year of current account surplus, although small, in 2005, supported by a trade surplus. Higher international interest rates may affect external debt stances of some countries.

Some concern lingers regarding the external debt renegotiations of Argentina, which are still under consideration. Mexico continues to grapple with ways to confront greater competition vis-à-vis its exports to the United States. This will be a longer term concern as Chinese exports continue to compete against many of the manufactured exports coming from this sub-region. At the same time, growing Chinese demand for primary products will favor the economies of South America.