United Nations
Department of Economic and Social Affairs
Expert Group Meeting on the World Economy (Project LINK)
31 October -2 November 2005
UNOG, Geneva

LINK Global Economic Outlook

October 2005

Abstract

After a measurable slowdown in 2005, the world economy is expected to continue a modest expansion of 3.0% in 2006. Employment growth is pervasively unsatisfactory and dealing with high unemployment and underemployment remains a key policy challenge, particularly for many developing countries. While headline inflation has been edging up worldwide—mainly due to higher oil prices—core inflation remains tame and inflation expectation is still well anchored in a majority of countries. The international economic environment facing most developing countries continues to be auspicious. However, many of the factors that determine these relatively favourable conditions are subject to change, including expected policy shifts in major developed economies which may tighten fiscal and monetary stances. Major downside risks for the world economy are primarily associated with the large and ever widening global imbalances, and the tight oil supply capacity, as well as the possible reversal of the appreciated house prices in a number of economies. The global imbalances, dominantly featured by the large external deficit of the United States, are inextricably linked to a global business investment anemia, rather than a global saving glut. Macroeconomic polices in most economies should remain accommodating and countercyclical (rather than tightening per se) to prevent global growth from weakening and global imbalances from widening further. Meanwhile, in order to mitigate risks of an abrupt and disorderly global rebalancing, more intense and broader international policy coordination is needed.

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Introduction

This global economic forecast was prepared by staff of the Development Policy and Analysis Division of the United Nations Department of Economic and Social Affairs based on inputs from national LINK centres and information from other sources as of 14 October 2005. 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.[1]

This paper outlines the main short-term prospects for the global economy and discusses the main risks and policy challenges for the short and medium run emanating, inter alia, from the widening global macroeconomic balances, global investment 'anaemia', persistently high oil prices and the weakening housing sector in some of the major economies.

Major assumptions for the baseline global economic forecast for 2006

The United States Federal Reserve (Fed) is expected to raise the Federal Fund interest rate to 4.5 per cent in the first quarter of 2006 and maintain it at that level for the rest of the year. The European Central Bank is assumed to continue business as usual in 2006, while the Bank of Japan is expected to maintain the policy interest rate at zero in 2006 and to become less stimulatory in terms of its quantitative target for monetary policy (i.e., the current-account balance of the central bank).

The assumptions regarding fiscal policy in individual countries are based mainly on official budget plans or policy statements. In general, fiscal policy worldwide is expected to be less expansionary in 2006 than in the previous year, with the exception of a few economies.

The price of Brent crude oil is expected to average US$ 59 per barrel in 2006, up from an estimated average of US$ 56.5 per barrel for 2005.

The dollar-euro exchange rate is projected to stay at the current level until the end of 2005. Subsequently, the dollar is expected to depreciate slightly during 2006 to an average of U$ 1.22 per euro. The yen-dollar rate is expected to stay around yen 110 per dollar in 2006.

[1] http://www.un.org/esa/analysis/link and http://www.chass.utoronto.ca/link.

Overview

After a discernable moderation in the course of 2005, the world economy is expected to continue a modest expansion in the near term. The baseline LINK forecast projects a growth rate of 3 per cent in world gross product (WGP) in 2006, maintaining the pace estimated for 2005. This recent trend is noticeably below the exceptionally strong and broad-based expansion during 2004 (see table 1).

As anticipated in the previous *LINK Global Economic Outlook*, part of the global slowdown has resulted from the maturing of the cyclical recovery in a number of economies and from the associated unwinding of the earlier policy stimuli. While varying in degree, several exogenous shocks, including a number of natural disasters and terrorist incidents, have also left their imprint on economic growth in the countries where these occurred. Moreover, a number of constraints on the world economy at large, some of which are structural in nature, have become more binding, portending downside risks for global growth in the years to come.

Widening global imbalances

The enormous global imbalances are perhaps the most prominent indication of these constraints. The imbalances have widened further during 2005 to levels above those expected in the previous LINK forecast: the annual external deficit of the United States has continued to increase, now surpassing US$ 800 billion. This growing imbalance in the world's major economy is matched by widening surpluses elsewhere, particularly in East Asia and in oil-exporting countries.

Meanwhile, views remain split over such issues as the sustainability of the global imbalances, the policy options for rebalancing, and their implications for the world financial markets and global economic growth. Some analysts attribute the global imbalances to a global saving glut, based on the observation of two coinciding trends:[2] a number of countries with high saving rates, mainly in Asia, seem to have enlarged their positive saving-investment gaps over the past few years, and long-term interest rates worldwide have been at exceptionally low levels. Hence, they suggest that the large external deficit of the United States is relatively easily financed and the adjustment in the United States in terms of raising domestic savings, particularly by reducing the fiscal deficit, would seem to be neither very relevant nor necessary. Others, in contrast, see current global imbalances as being rooted in policy decisions in the United States, specifically its allowing the fiscal position to deteriorate and monetary policies to expand, thereby causing the sharp drop in national savings through an increased government deficit, and increased housing wealth, which has pushed down household savings.[3] Redressing macroeconomic policies in the United States, therefore, should be the key to reversing the trend in global savings-investment imbalances.

[2] See Ben Bernanke (2005), "The Global Savings Glut and the U.S. Current Account Deficit", Sandridge lecture, Virginia Association of Economics, Richmond (VA), March 10.

[3] See, for example, Nouriel Roubini and Brad Setser (2005), "Will the Bretton Woods 2 regime unravel soon? The risk of a hard landing in 2005-2006", http://www.stern.nyu.edu/globalmacro/.

Table 1. Gross domestic product and world trade (Annual percentage change)

	Observed	November 2005 forecast [a]		May 2005 forecasts	
	2004 [b]	2005	2006	2005	2006
Gross World Product (GWP)	3.9	3.0	3.0	2.9	3.0
GWP - PPP weighted	4.6	3.7	3.6	3.6	3.5
Major developed economies					
Canada	2.9	2.7	2.6	1.6	2.8
Japan	2.6	2.1	1.9	0.7	1.5
United States	4.2	3.1	3.1	3.1	3.1
European Union (EU25)	2.4	1.6	2.2	2.0	2.4
France	2.3	1.5	2.1	2.0	2.2
Germany	1.6	0.8	1.2	1.0	1.8
Italy	1.0	-0.2	0.9	1.1	1.5
United Kingdom	3.1	1.7	2.3	2.7	2.5
Memo item: Euro Zone	2.0	1.2	1.9	1.6	2.1
Russia	7.2	5.8	5.5	6.0	5.2
Developing countries and regions					
Latin America and the Caribbean	6.1	4.7	4.1	4.5	4.2
Argentina	9.0	7.5	4.0	6.5	4.0
Brazil	5.2	3.5	4.0	3.8	4.1
Mexico	4.4	3.0	3.5	3.5	4.5
Africa	4.9	5.1	5.4	5.2	5.2
North Africa	4.8	5.1	5.7	5.1	5.0
Sub-Saharan Africa [c]	5.5	5.6	5.3	5.4	5.8
Nigeria	6.0	5.0	6.0	7.0	5.2
South Africa	3.7	4.5	4.4	4.0	3.8
South and East Asia	6.7	6.1	6.0	6.2	6.1
India	7.0	6.8	6.8	7.0	7.1
Indonesia	5.1	5.4	5.3	5.4	5.5
Korea, Republic of	4.6	4.0	4.3	4.0	4.3
Malaysia	7.1	5.5	5.6	6.3	6.4
Philippines	6.1	5.3	5.7	5.0	4.7
Thailand	6.1	4.0	4.2	5.5	5.7
China	9.5	9.4	8.8	8.8	8.3
Western Asia	6.5	5.3	5.1	5.3	5.0
Oil-exporting countries	6.0	5.9	5.5	5.8	5.4
Oil-importing countries	7.0	4.6	4.7	4.7	4.5
Memo: World export volume	10.8	7.1	7.4	7.2	8.1
Oil price (Brent, US$/pb)	38.3	55.6	59.3	46.0	37.0

Source: LINK Global Forecast.
[a] Pre-Meeting forecasts.
[b] Actual or most recent estimates.
[c] Excluding Nigeria and South Africa.

Both positions seem to be overemphasizing what has happened to savings and miss the more crucial point of what is happening to global investment. Furthermore, the least warranted position would be to become complacent about the sustainability of the global imbalances.

First, it seems somewhat paradoxical to speak of a savings 'glut' when global savings and investment rates are below 22 per cent of world GDP and have persistently been on the decline since 1990, reaching an historic low in 2002 and only modestly rebounding thereafter (IMF, 2005). Second, according to basic accounting rules, global savings must equal global investment, so that there are no excess savings *ex post*. An explanation of low world interest rates should thus look at why global financial markets are facing excess liquidity -- most likely because of a sluggish *ex ante* investment demand. Third, savings surpluses in some countries are simultaneously determined by the external deficits in the low-saving countries. Simply looking at the world's major economy could overlook the importance of specific conditions which are driving up savings surpluses elsewhere in the world. With high oil prices and low absorptive capacity, oil exporters have been fuelling financial markets with savings surpluses and contributing to low interest rates. But this will not be an enduring situation. Perhaps more importantly, a proper look at the data shows that the increased savings surplus in several Asian economies has been primarily due to a weakening of investment growth, as the trend in saving rates has been flat. Weak investment demand is not just an Asian phenomenon, but in effect there is a pervasive global trend showing that non-residential investment has been measurably weaker in the past few years in comparison with the 1990s. China is one of the few major economies that do not fit this pattern. Thus, instead of defining the current global macroeconomic condition as a 'glut' in savings, it seems more appropriate to speak of a global investment 'anaemia' which has pulled down the global savings rate. This anaemia is particularly present in the private, corporate sector. It is puzzling that corporate investment is not picking up in the major economies such as Japan and the United States, despite low interest rates and remarkably buoyant corporate profits and savings.

A number of factors could explain such a weakening trend in business investment around the globe. In many *East Asian economies* (excluding China), the post-crisis (1997) adjustment in reducing their excessive capacity may have been prolonged to impede a rebuilding of investment dynamism. In addition, investment growth has been curbed further by the ongoing relocation of some manufacturing bases from these economies to China. Investment rates are down in virtually all of *the developed countries*, but most starkly in Japan and the euro area. This partly reflects a cheapening of the cost of capital (through low interest rates and productivity growth in capital goods industries), keeping investment down in nominal terms (see IMF, 2005). Yet, investment has come down in volume terms as well, though more modestly, and despite high corporate profits. Several factors could explain this behaviour. In Japan and Europe, aggregate demand and consumer confidence have been weak. In addition, major firms (including in the United States) have gone through processes of balance sheet restructuring and have become more cautious about expanding economic scope. Meanwhile, the heightened geopolitical uncertainties, including international terrorism, in the past few years may have made investors more risk averse. This has led investors to adjust their portfolios by increasing their share of more liquid and/or less risky assets, such as government bonds and housing, to the detriment of business investment. It also seems to have made firms more cautious about making decisions on long-term investment projects. A different yet compounding factor in depressing global investment demand is the rise in capital productivity worldwide due to the ICT revolution, which requires lower investment to support a given level of GDP growth than before.

The upshot for world economic growth of these factors underlying the sluggish investment demand could be rather ambiguous. In the short run, they signal weak demand prospects, which could slow down global growth further. On the other hand, they also signal potential for strengthened long-term growth if uncertainties about global macroeconomic stability can be dampened and consumer confidence strengthened by more accommodating monetary and fiscal policies. This poses a policy challenge which is not without risk of a disorderly adjustment in global imbalances, as we shall discuss further below.

In addition to the primary concern about how global imbalances may affect the stability of the world economy, policymakers worldwide should also pay attention to other implications. Even if the imbalances were sustainable or could be smoothly adjusted without disruptions to financial markets and global growth, it is highly questionable whether such large and ill-distributed imbalances are consistent with an efficient and equitable allocation of resources worldwide, particularly with a view to the interests of developing countries. While the United States has been absorbing a lion's share of the global savings, many low-income countries with high unemployment are desperately short of funds to finance their growth. In this sense, there is no global saving glut, but a misallocation of capital, or a mismatch between capital and labour worldwide owing to an unbalanced global economic integration.

As pointed out in the previous LINK outlook, the large disequilibria in the world economy have resulted from a confluence of cyclical, structural and institutional factors, including the inherent deficiencies in the international monetary and reserve system. Given this complexity, a global re-balancing should not depend solely on a realignment of exchange rates. Meanwhile, any unilateral shift to protectionism would be counterproductive. A more desirable rebalancing would involve a recovery of domestic savings in the major deficit countries, particularly the United States, through fiscal consolidation and other policies. Surplus Asian developing countries should adopt more flexible exchange-rate policies and strengthen domestic demand, while oil-exporting countries should increase their expenditure in social infrastructure. In both the euro area and Japan, further structural reforms will be needed to boost growth and domestic demand.[4] Moreover, an orderly adjustment will require that these policy shifts be properly synchronized through international macroeconomic policy coordination. The recent practice, though, has been to urge a number of surplus countries, particularly those in Asia, to render their exchange rates more flexible. In itself this will not be sufficient to redress global imbalances, and it can by no means be taken as a substitute for the necessary adjustment in the United States and the need to stimulate investment demand around the globe.

Low interest rates could help, but they are at the same time part of the problem. The low interest rates and the implied ample liquidity in the world economy are related to the nature of the growing global imbalances and the underlying factors. As the issuer of the dominant international reserve currency, the United States has the privilege to finance its large external deficits by issuing dollar-denominated debt, and the amount of its annual current-account deficit equals the additional amount of the liquidity the United States injects into the world economy.

[4] A more detailed proposal in the same vein can be found in IMF *World Economic Outlook*, September 2005.

Nevertheless, factors such as a deterioration in inflation expectations and an erosion in investors' confidence can push interest rates upward swiftly, forcing the United States to pay higher costs to finance its external deficit. While the United States can always find a way to transfer part of the costs to other countries by devaluing the dollar to substantially reduce the value of its international indebtedness, a disorderly adjustment in its external deficit is counterproductive for both the United States and the rest of the world. Therefore, a benign adjustment should take place when interest rates are still low, as the risk of an abrupt adjustment is higher in an environment of rising interest rates.

Persistently higher oil prices

Persistent higher oil prices are another major concern for global economic development. Oil prices have surged on average by about 50 per cent so far during 2005, on top of an already significant increase in the previous year. The strong growth in global oil demand over the past two years has moderated recently, but global oil production is still running near full short-run capacity. The tight situation in the global oil market has been exacerbated by occasional shocks in the form of hurricanes and geopolitical instability. Oil prices are expected to remain high in 2006.

Many oil-exporting countries continue to benefit from the higher oil prices, boosting income and improving macroeconomic balances by reducing both external and internal public debt. These countries are further increasingly recycling their oil revenues into the global economy via growing imports and accumulating foreign assets. On the other hand, most oil-importing countries managed until recently to deal reasonably well with the adverse effects of higher oil prices, but now a growing number of them, particularly the low-income countries, are showing signs of deteriorating economic conditions in the form of rising inflation, worsening external and fiscal balances, declining profits in some sectors, and even energy rationing in some cities.

With higher oil and other commodity prices, the world economy is facing greater policy challenges. On the demand side, measures such as energy price control and subsidies adopted by a number of countries have mitigated the stress of higher oil prices on consumers, especially for low-income households. These policies can be justified, particularly in contexts where higher oil prices are a possible source of higher income inequality and social instability. Such policies should also be a good response if the oil price increase were essentially cyclical. These measures have, however, also produced market distortions by delaying the demand response to higher oil prices. Since oil prices are expected to remain high, it is unlikely that these policies will be sustainable in view of the substantial fiscal implications. In fact, many countries are already gradually reducing or lifting these measures. In the longer run, policies in large energy and other commodity consuming countries should aim at improving their efficiency and developing alternative energy sources.

On the supply side, the tight oil production capacity is a result of underinvestment in the energy sector over the past two decades. New investment plans and policy incentives as announced in some oil exporting countries are expected to raise global oil production capacity somewhat in the medium term. It is also necessary to reduce various uncertainties, including geopolitical tensions, which could generate supply disruptions. The claim by some analysts about the imminent advent of the "peak" in long-run global oil production remains moot, although a significant upward movement in the prices of the long-run oil futures reflects this concern to some extent.

Other risks and countervailing forces

There are a number of other constraints and downside risks facing the world economy. First, the continued rise in house prices in the major economies could soon come to an end. In fact, housing markets in Australia and the United Kingdom have already softened. Second, a significant rise in long-term interest rates could emerge and, third, potential new major disruptions may be caused by more terrorist attacks, natural disasters, and the possibility of the avian influenza becoming pandemic.

On the other hand, several positive factors may help to sustain global growth in the immediate future. International trade has continued to grow at a robust pace and financial markets worldwide have in general remained calm with both the benchmark interest rates and the yield spreads for emerging economies remaining at historical lows. In addition, the terms of trade for a large number of developing countries have improved considerably. Nevertheless, these factors supporting worldwide growth are also subject to possible downside risks. Among other things, unless prudently managed, the exceptionally low cost of international lending could lead some emerging market economies to engage in excessive external borrowing and become a source of new financial crises, as has been seen in the past.

These constraints and risks present themselves in different degrees across countries and, consequently, macroeconomic policies worldwide have become less synchronized, as governments have been seeking policy responses tailored to their needs. More generally, however, macroeconomic policies in most parts of the world are expected to become more restrictive and less accommodating as governments are seen to be increasingly concerned about higher inflation driven by energy prices. This entails a clear downside risk, since, as we have seen in the past, excessively contractionary monetary policies could be at least as harmful as the oil price shock to economic growth. The challenge is to maintain stability in both inflation and output growth. In the major economies, it appears that only in specific sectors, full capacity limits are being reached, such as in the production of energy and raw materials. For the global economy at large there is much slack capacity remaining, as should be apparent from persistent high unemployment rates in the majority of countries and the low degree of pass-through of energy prices into the general inflation (see below). For most of the major economies this implies that macroeconomic policies should be more counter-cyclical to prevent global growth from weakening and global imbalances from widening further.

Growth prospects

The slowdown in world economic growth in 2005 has been accompanied by a greater divergence in the economic performance across countries and regions. The deceleration of growth is more pronounced among developed than developing countries. Most visibly, growth in China and India has remained high and robust as before, while also many exporters of oil and other primary commodities have shown strong growth performances. Other developing countries are faring less well, however. Further differentiation across countries is expected in the outlook as a result of differences in economic structures and in policy options in different countries, even if they are facing some common challenges such as higher international oil prices. It should also be mentioned that individual regions and countries do face idiosyncratic uncertainties and risks.

Developed market economies

Among *developed countries*, the moderation in the economy of *the United States* during 2005 is expected to linger into 2006. The GDP growth forecast for 2006 is about 3 per cent, thus keeping a similar pace as the estimated growth in 2005. Some exogenous shocks, particularly Katrina and other devastating hurricanes, along with the associated spikes in energy prices, have contributed to the slowdown. However, the economy has also been increasingly challenged by a number of structural weaknesses, as reflected in the extremely low household saving rate, and the large and ever-growing external deficit. A modest economic expansion can still be attainable, supported by such auspicious factors as low interest rates, good corporate profitability and gradual improvement in the labour market. Nevertheless, most risks are tilted towards the downside. The growth of non-residential investment in the United States has not recovered to the pace of the late 1990s after the burst of the ICT bubble, thus contributing to the global investment anaemia. Household outlays and indebtedness seem overstretched in view of a combination of persistently high energy prices and a possible cooling down of frothy house prices. This inevitably will lead to lower growth in household spending, which has been the main driver for the economic expansion over the past few years. At the same time, the slowdown can be greatly aggravated by a considerable increase in interest rates, heightening the risk for a burst in house prices and a larger retrenchment in private consumption, which in turn could cause a disorderly adjustment in its large external deficit. Meanwhile, the recent discernable lapse in the productivity growth to the lowest level in several years, if confirmed to be a trend shift, would bode even deeper fundamental trouble for the economy in the longer run.

GDP growth in *Western Europe* remains anaemic and at even lower levels than anticipated in the previous outlook. Higher oil prices have had a depressing effect, although the region benefits from its high export share to oil-producing countries. On the other hand, the falling back of the euro against the United States dollar from its peak at the beginning of the year and the continuing decline in long-term interest rates represent some positive impulses to growth. In the region, the weakness is dominated by Germany, Italy and the Netherlands, while the United Kingdom and Spain are growing at a faster pace. The outlook is for a gradual recovery over the course of 2006, based on an expected rebound in exports, as the euro is not expected to appreciate by much from current levels. Consumption is expected to increase in line with disposable income, supported by moderate growth in employment but will be held back by high oil prices. The savings rate is expected to remain stable, although there remains uncertainty over public finances and the long-term prospects for health care and pensions. House prices and their effects on consumption vary across the region, supporting growth in France and Spain, but remaining adverse in Germany. Government spending is unlikely to add much to growth at the aggregate level due to severe fiscal constraints in most of the major economies but can be more supportive in some countries that are not so constrained. In the global forecast, business fixed investment is expected to pick up, supported by the improvement in foreign demand, favourable financing conditions, and strong corporate earnings. Growth in housing investment is expected to continue at a moderate pace, but again with substantial variation across countries. In the light of our discussion of the global investment anaemia, this could be an optimistic assumption if factors causing investors' uncertainty (including the global imbalances) are not addressed.

Growth in the economies of the *new EU members* is expected to strengthen in 2006, having decelerated slightly in 2005 in response to weak performance in the euro area. Growth still outpaces that of the EU-15, especially in the Baltic States. The stronger pace of growth will be driven by stronger exports, long-term investments through FDI and infrastructure projects, aid flows from the EU and increased fiscal spending associated with upcoming elections. Meanwhile, the catching-up process in productivity growth and the upgrading of the region's capital stock and infrastructure is continuing as the countries are increasingly benefiting from EU assistance and as the relocation of production from the EU is ongoing, despite rising labour costs. Domestic demand, especially investment, has been supporting the growth in these economies. In the biggest economy, Poland, however, domestic demand has still not fully recovered from the downturn in earlier years. Nevertheless, investment may also pick up here given that corporate balance sheets have improved considerably. Export performance of the new EU members was stronger than expected, despite appreciated currencies and weak import demand from the EU-15. Export growth is mainly due to increased productivity and improved product quality. In addition, intraregional trade has increased and trade has diversified through increased sales to South-Eastern Europe and Russia. Although a number of industries, such as textiles, face increased competition from China, the outlook for exports appears to be good, especially in the sectors that attracted significant FDI, such as automotive industry.

The *Japanese* economy has sustained an expansion, however modest, for about 4 years. Despite a notable deceleration in the second half of 2005, GDP growth can still reach 2 per cent for the year, and a similar rate is forecast for 2006. The economic expansion has been supported by a gradual strengthening in domestic demand, as the accumulated gains in corporate profits from the earlier years, especially from the export sector, have finally spread to household income, giving rise to a benign interaction between the corporate and household sectors. A prolonged adjustment in excess capacity and employment by many firms has come to fruition, as various measures of corporate profitability have surpassed the heights recorded before the decade-long stagnation. Meanwhile, progress continues in corporate financial restructuring, with non-performing loans declining. Although the economy seems to have been resilient in the face of rising oil prices, a further increase in oil prices still poses a risk. While fiscal consolidation to reduce the large public debt remains challenging, monetary policy will likely maintain an accommodative position until the economy extricates itself firmly from the protracted deflation.

In other developed countries, the *Canadian* economy has strengthened notably in the course of 2005 from an earlier soft patch, supported by higher commodity prices and a relatively accommodative monetary policy stance. GDP is expected to grow by 2.8 per cent in 2006, a pace near its potential. Growth in *Australia and New Zealand* has moderated for different reasons. A sharp cooling in the housing boom has been the key drag in Australia, as households have slowed their consumption and borrowing, and housing construction has been declining. On the other hand, buoyant employment and tax cuts in the second half of 2005 continue to support growth in household incomes, along with favourable terms of trade, suggesting that a further moderation in the overall economy will be limited. In New Zealand, the slowdown has been concentrated in sectors that have been exposed to the currency appreciation, but the housing market in particular has remained strong, underpinning consumption growth. The large current-account deficits in both economies encompass some risks.

Economies in transition

Among the *economies in transition*, after a moderation in 2005, growth in the *CIS* is expected to stay robust, stabilizing at about 5.8 per cent in 2006. Benefiting from higher commodity prices, in particular for oil, gas and metals, growth in many CIS members is driven by strong household consumption, fuelled by rising real wages and expansionary fiscal and monetary policies. The slowdown in 2005 was mainly due to a deceleration in the Russian Federation, as increased marginal tax rates in the oil sector led to significantly lower growth of output and exports of oil. In addition, growing costs and continued real appreciation of the ruble have curbed competitiveness, leading to a slowdown in manufacturing as well. Meanwhile, investment also weakened in early 2005, and its recovery so far still remains inadequate in view of the prolonged period of underinvestment. The deceleration in the Ukrainian economy has been rather sharp, as heavy industries shrank due to lower external demand, and as uncertainties regarding the revision of past privatization deals have increased. In contrast, rapid expansion in the oil and gas sector, in combination with rising wages, continues to boost growth in Azerbaijan and Kazakhstan, thus contributing to robust regional growth. Downside risks for the region include rising inflationary pressure; the volatility in commodity prices, in particular for oil and gas; and the continuing real appreciation. Institutional and structural weaknesses in these countries also need to be addressed, and achieving more diversified economies is one policy challenge in this context.

Growth slowed in *South-Eastern Europe* in 2005 and is expected to moderate further in 2006. Growth has also been contained by strong currencies and weaker agricultural production due to recent floods. In the outlook, tightening policies implemented to prevent overheating and to constrain private credit growth, such as the restrictions on bank lending imposed in Bulgaria, will continue to restrain growth, although investment will still be supported by privatization-related FDI flows and modernization of the existing firms, and by public projects. For Bulgaria and Romania, the major challenge is to make progress in implementing EU legislation in order to be admitted into the Union in 2007. The decision of the EU to start accession talks with Croatia should favourably affect its investment climate, although the required elimination of subsidies to State-owned industries may negatively affect growth. External imbalances pose certain risks for the subregion, as they may require further corrective policies.

Developing countries

Among the *developing countries*, the growth outlook for *Africa* remains optimistic, although subject to various risks, both economic and political. GDP growth is expected to remain at 5 per cent, supported by strong growth in exports of oil and non-oil commodities, particularly to China, India and other fast-growing developing countries, and robust domestic demand in many countries in the region. Meanwhile, civil and political conflicts have lessened in a number of countries in the region, and this will be conducive to improved economic activity. On the other hand, several other countries have been adversely affected by a decline in agricultural production caused by drought, while exports of textiles and clothing contracted sharply in several countries facing increased international competition as a result of the termination of the quota regime under the Agreement on Textiles and Clothing at the beginning of 2005.

In countries of *Northern Africa*, while Algeria and the Libyan Arab Jamahiriya will benefit from higher hydrocarbon revenues and increased public spending, growth in Tunisia will be driven by a recovery in tourism, vigorous growth in the telecommunications industry and increased access to international capital markets. In comparison, weaker agricultural output and a contraction in textile output and exports will take a toll on economic growth in Morocco.

GDP growth for *sub-Saharan Africa*, excluding Nigeria and South Africa, is expected to be above 5 per cent both in 2005 and 2006, with most countries achieving growth rates in the range of 3 to 7 per cent. South Africa's real GDP growth is expected to average a robust 4.5 per cent in 2005-2006, as real domestic expenditure continues to be supported by rising real incomes, low interest rates and moderate inflation. Investment in key areas such as residential construction and transportation equipment also contributes to growth, as do strong exports. In Nigeria, recurrent technical problems in the oil industry and civil unrest in the oil-producing areas are expected to dampen oil production and lower growth in 2005, with some improvement expected for 2006. Agriculture output continues to benefit from improved infrastructure and policy measures to promote economic diversification and revitalization of sectors other than the hydrocarbons sector. Oil-exporting countries, such as Angola, Chad and Equatorial Guinea, are expected to continue to grow at double-digit rates, while Sudan’s economy is likely to expand at a slightly lower rate. Mauritania will also join the group of fasting-growing economies in the region when new oil fields come on stream in 2006. In contrast, Lesotho, Malawi, Swaziland, Zambia and Zimbabwe were the countries most seriously affected by drought and food shortages in 2005. Some countries have also suffered from a decline in textile exports, with thousands of jobs reportedly lost in countries such as Kenya, Lesotho, Madagascar, Malawi, Mauritius, Swaziland and South Africa. Cotton exporters, including Benin, Burkina Faso, Mali and Togo, are facing an even more persistent adverse external environment as world cotton prices continue to slide as part of a long-term trend.

Improved political stability and economic governance have been critical in ensuring sustained growth rates in countries such as Cape Verde, Ghana, Madagascar, Mozambique, Senegal, the United Republic of Tanzania and Zambia. On the other hand, continued political uncertainties and tensions in Côte d’Ivoire and continued unrest in Zimbabwe have hampered growth and caused economic contraction in 2005.

Economic growth in *East Asia* remains strong in the outlook, although the downside risks have increased, particularly in view of higher oil prices and some early signs of a possible weakening of trade links with China. Meanwhile, China continues to see a strong economic expansion driven by exports and investment. Import demand, though, has decelerated significantly, partly reflecting the broadening in its own production and export capacity, which has reduced demand for intermediate goods from some of its neighbouring countries. Growth in Singapore has been unexpectedly strong and the Republic of Korea’s recovery from the earlier household debt hangover has also been stronger than expected. In contrast, the prospects for a few other economies have been downgraded somewhat for both 2005 and 2006. This applies especially to Malaysia and Thailand, owing to higher oil prices and weakening exports. In the case of Thailand, the renewed outbreak of avian influenza will also imply slower growth.

In *South Asia* only a marginal slowdown is expected for 2006 from its strong growth in 2005. Normal monsoon rains in most countries in 2005 have allowed the agricultural sector to recover from the lacklustre performance in the previous year, while industrial production and the service sector have remained strong. Manufacturing growth and investment have been driven particularly by the textiles and ready-made garment (RMG) sector, especially in India, Pakistan, Sri Lanka and Bangladesh. India and Pakistan, as expected, have benefited from the termination of the quota regime under the Agreement on Textiles and Clothing, while Sri Lanka and, even more so, Bangladesh have defied the earlier fears of disruption. While ICT services and business process outsourcing continued to grow strongly in India, the region as a whole benefited from high growth rates in tourism and tourism-related activities, with Sri Lanka witnessing a faster-than-expected recovery in tourism after the 2004 tsunami. In contrast, Nepal, while also hit by insufficient rainfall in 2005 and a decline in RMG exports, suffered from a continuing downturn in tourism due to political instability. In the outlook, the major impediment for the growth in the region continues to be higher oil prices, weighing on current-account balances and fiscal positions and contributing to rising inflationary pressures. As most countries in the region reduce various measures to shield their domestic demand from higher international oil prices, the negative impact on growth is likely to increase. The most noticeable slowdown is expected in the Islamic Republic of Iran due to an anticipated lull in oil revenues, and in Pakistan, after two consecutive years of high growth, although the direct effects of the earthquake in October 2005 are not expected to noticeably affect its GDP growth.

Growth in *Western Asia* is expected to maintain its robust pace into 2006, after reaching an estimated 5.3 per cent in 2005, based on the expectation that oil prices remain high and oil production stays at roughly similar levels, close to full capacity. Among the oil-exporting countries, the three largest ones, Saudi Arabia, the United Arab Emirates and Kuwait, are all growing at rates of between 6 and 7 percent, as increased oil revenues fuel domestic demand through the fiscal spending to increase investment and strengthen the non-oil sector, particularly construction and services. Many of the oil-importing countries in the region have benefited from spillover effects via trade, tourism and financial flows. While Jordan and Israel are benefiting, respectively, from economic linkages with Iraq and a continued recovery and strong external sector, Lebanon is suffering political instability. Growth in Turkey remains strong. On the downside, the region remains extremely vulnerable to adverse developments on the security and political front and potential disruptions in the oil infrastructure, as demonstrated by the predicament facing Lebanon and the political uncertainties in Iraq. In the oil-exporting countries, booming equity and real estate markets that could produce asset price bubbles are a source of concern going forward.

After “normalizing” downward in 2005 from the strong recovering pace of the previous year, growth in *Latin America and the Caribbean* is expected to slightly slowdown further in 2006. Many economies, particularly those in South America, continue to gain from a propitious external sector. This is due to higher commodity prices and strong external demand, especially from China, for example, for metals and mining in the Andean region, agricultural products from

Mercosur and hydrocarbon products from Bolivia, Ecuador, Colombia and the Bolivarian Republic of Venezuela. As a result, domestic demand in these economies will likely continue to strengthen. While investment in Brazil is expected to grow at a strong pace, GDP in Argentina is supported by robust growth in both private consumption, boosted by improving unemployment, and investment. The boom in commodity exports has also propelled new investment as in the case of Chile and Peru, while oil revenues in the Bolivarian Republic of Venezuela have been fuelling increases in public spending and investment. In contrast, some countries in the central and northern region face increasing pressure in their manufacturing sector from other international competitors. Growth in Mexico is estimated to be only 3 per cent as a result of weakening exports to the United States, as well as a tightening in monetary policy, although a recovery is expected for 2006 due to some policy easing. The region remains vulnerable to any worsening in external conditions, and domestic demand could be curbed by persistently high unemployment. Meanwhile, a certain degree of uncertainty is associated with the forthcoming elections in most countries from now until the end of 2006.

The international economic environment for developing countries

The international economic environment for developing countries remains mostly favourable. Despite a rise in protectionism in some regions and a near stalemate in the multilateral trade negotiations under the Doha Round, international trade flows continue to grow at a reasonable pace. While higher oil prices have had increasingly adverse effects on some oil-importing developing countries, a large number of developing countries have managed to gain from an improvement in their terms of trade and/or an increase in their volume of exports. Capital inflows to the emerging market economies[5] have increased steadily along with a fall in external financing costs to historical lows. In contrast, many of the least developed countries are still virtually unable to access the global financial market, relying largely on official flows and private transfers (remittances) for their external financial needs. Meanwhile, foreign exchange markets and other financial markets worldwide remain relatively calm, but measurable appreciations in the currencies of many developing countries vis-à-vis the currencies of major developed countries, if they continue, pose challenges for these countries. The key risk in the outlook is associated with the large global imbalances, as a disorderly global rebalancing could significantly worsen the international economic environment facing many developing countries.

Trade flows

Along with a moderation in the growth of global output, the growth of international *trade flows* has also slowed down proportionately. Measured by the volume of world export, the growth of international trade is estimated to be around 7 per cent in 2005, compared with 11 per cent in the previous year. A slightly higher growth is forecast for 2006.

While the deceleration in trade flows has been ubiquitous, exports of developing countries continue to grow relatively faster than those of developed countries, increasing their share in the world market. This is particularly evident for some of the most dynamic developing countries, such as China and India, with their exports growing at 20 per cent or more.

[5] This refers to a group of some thirty large developing countries and economies in transition which are fairly well integrated into the global financial and trade systems.

The phase-out of the Agreement on Clothing and Textiles (ACT) at the beginning of 2005 has brought a considerable disturbance to global textile and clothing markets, even though the ending of the Agreement was already agreed upon a decade ago. As exports of clothing and textiles from China to the United States and Europe surged in the first quarter of 2005, the latter two reinstated quotas on some products, and bilateral negotiations could not reach agreement after several rounds. As indicated, some of the other major textile-exporting countries, such as those in Asia, seem to have weathered the disturbance, but several African countries have witnessed a noticeable decline of their textile exports in 2005. This applies, for example, to Kenya, Lesotho, Madagascar, Malawi, Mauritius, Morocco, Swaziland and South Africa, while some Central American countries have also lost market shares.

In the outlook, an expected rebound of business investment in many countries from a weak trend in the past few years, presaged by low interest rates and sound corporate profitability, will likely increase global demand for capital goods and thus raise exports for major developed countries such as the United States and Germany. Meanwhile, continued robust growth in a few large developing countries should sustain strong international trade flows of energy and raw materials. However, a sizeable deceleration in China's growth of import in 2005, dropping from a pace of 30 per cent in 2004 to an estimate of 15 per cent, needs further assessment.

Merchandise trade imbalances across regions and countries have widened further, representing a major part of the global imbalances. While the trade deficit of the United States surged by more than US$ 100 billion in 2005, to reach US$ 800 billion in total, the sum of the surpluses of oil-exporting countries has surpassed that of the East Asian developing countries. Despite the higher export growth expected in the outlook for the United States, its large trade deficit will barely narrow in the short-run.

Commodity prices

Oil prices advanced steeply in 2005, particularly since May, amid tight supply; growing demand, albeit at notably moderated rates; geopolitical concerns; and a series of disruptions to production and refining capacities caused by natural disasters and other incidents.

Global oil demand is estimated to grow around 1.5 per cent for 2005, markedly lower than the 3.7 per cent registered in 2004. Growth in China's oil demand dropped to 3.4 per cent from 15 per cent in the previous year, and other major consumers in North America and Europe have also recorded notable decelerations in demand. In the outlook, global oil demand is expected to grow at an annual rate of about 2 per cent.

Global oil supply remains tight. Growth in non-OPEC production has been weak, as declines in production from the North Sea and a slowdown in production from the Russian Federation, among other developments, have recently been compounded by the loss of production from the Gulf of Mexico in the United States. Some spare production capacity exists, but it mainly consists of heavy and sour crude that does not match the refining capacity. Recovery of Iraqi oil production continues to be impeded by political instability. Strained refining capacity, particularly in the developed countries, places an additional premium on light sweet crude.

OPEC has been steadily increasing its production so as to allow for a significant increase in crude oil stocks in OECD countries. Following the Katrina hurricane in the United States, OPEC offered to produce as much crude as the market would demand and its spare capacity would allow. This promise has done little, however, to ease market tightness due to the relatively low quality of the marginal crude supply.

Balancing the oil market will require an increase in OPEC crude production in the medium term. Current investment plans in Saudi Arabia, the largest holder of proven reserves and spare capacity, involve increasing production capacity to 12.5 mbpd by the year 2009, up from about 11 mbpd at present,

Despite the increases in OECD stock levels during 2005, which in the wake of hurricane Katrina have returned to relatively comfortable levels, the market's stock level objective seems to have shifted upwards substantially, probably due to the historically low level of spare capacity. Thus, current stock levels are probably seen as insufficient in the prevailing market conditions.

Given the market situation and the coming winter heating season in the Northern Hemisphere, oil prices are expected to remain high in the near term (see the global assumptions at the beginning of this report for more details).

The *prices of non-energy commodities* displayed divergent movements in 2005, along a generally upward medium-term trend. While the prices of minerals and metals continued to advance substantially, the prices of most agricultural goods, except coffee, softened. In the outlook, demand for most commodities is likely to be sustained, given the projected GDP growth in major economies, particularly in China and India, but prices are expected to remain flat or even show a drop in the near term because of an expansion in supply and a build-up in inventories.

Many commodity-exporting developing countries have witnessed gains to varying degrees in their *terms of trade* in the past few years and/or benefited from increases in the volume of their exports. At issue is whether the upward trend is sustainable. Strong demand for many commodities stemming from the industrialization in China, India and some other developing countries seems to be enduring and thus supporting the upward trend of commodity prices in the longer run, but the probability of high volatility and a sharp reversal in prices in the short-run remain a challenge for many commodity-exporting developing countries.

Capital flows

Private capital flows to emerging market economies increased notably in 2005, reaching or even surpassing the record level registered before the Asian financial crisis of 1997. The momentum is, however, expected to taper off in 2006, as most of the favourable conditions that bolstered capital flows in the past two years seem to have peaked, even though the risks for a sharp deterioration are not high.

Driven by robust growth as well as the improved policy environment in emerging market economies, FDI flows continued to recover in 2005 from the trough registered in 2003. FDI flows remain concentrated in a small number of countries, with China at the top, accounting for about one third of the total. The level of FDI is expected to remain steady in the outlook, as many transnational corporations (TNCs) continue to expand their operations in major developing countries that are experiencing high growth, particularly in such sectors as natural resources, electrical and electronic products, and services. Meanwhile, intra-developing-country FDI flows have increased rapidly, and so has the outward investment by developing countries as companies based in these economies aim to gain access to overseas technology and management expertise, as well as natural resources.

All other types of capital flows to emerging market economies have also increased in 2005, with an especially rapid pace of bond issuance. The improving economic fundamentals in many developing countries, including low inflation, current-account surpluses and large capital inflows, in conjunction with low yields in developed markets, have generated strong demand for emerging market assets, even for lower-rated credits, despite historically high prices. Meanwhile, the favourable financing terms have allowed emerging market economies to optimize their debt structure, with some of them accelerating their borrowing programmes planned for 2006. Several Latin American countries even managed to issue local-currency-denominated bonds in international markets.

The external financing costs for emerging market economies have declined notably: the spreads in the EMBI index reached an all time low in September 2005 (see chart 1). The current level of spreads, however, may not be sustainable: debt ratios in some countries remain persistently high, structural reforms have slowed, and the tightening of policy interest rates in major developed countries continues, particularly in the face of an increased risk of inflation.

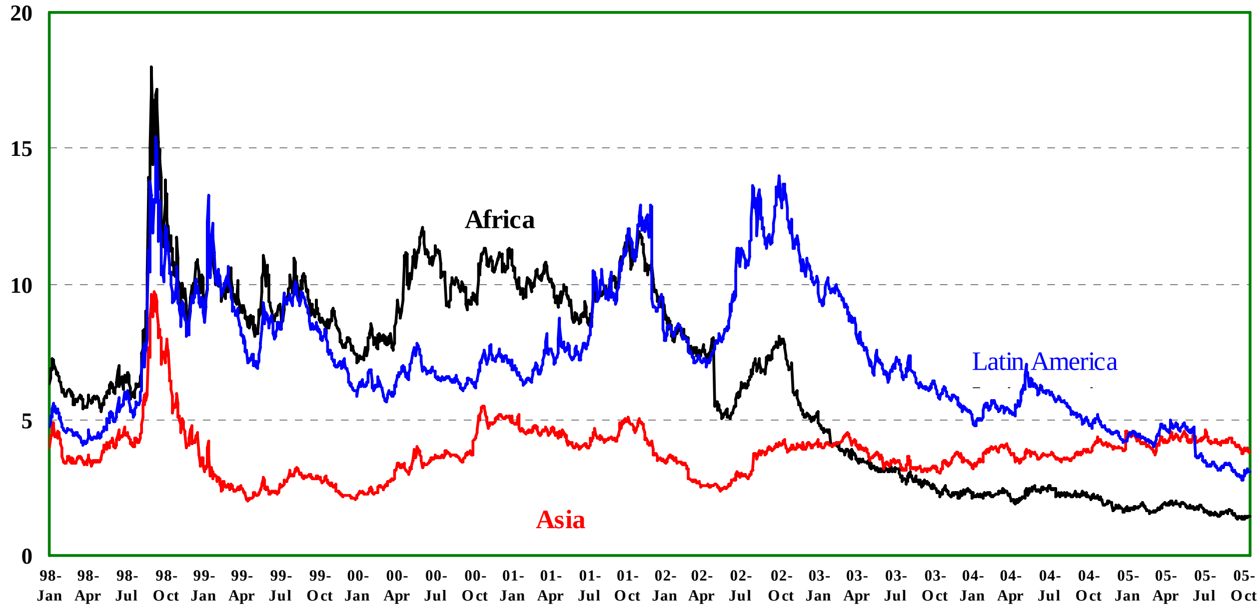
Exchange rates

The movement of *exchange rates* in 2005 has been characterized by two diverging trends. On the one hand, the United States dollar has managed to rebound measurably vis-à-vis the euro and Japanese yen after it had depreciated substantially in the previous few years. On the other hand, currencies in many developing countries have appreciated steadily against the dollar, along with a move towards more flexible exchange-rate regimes in some developing countries, most notably China. Such a dichotomy implies, among other factors, a shift of the potential burdens of adjusting the global imbalances from Europe and Japan to many developing countries.

Among the major currencies, the rebound of the United States dollar has mostly been driven by the increasing differential in interest rates between the United States, on the one hand, and the euro area and Japan, on the other, as the Fed has kept raising interest rates by 275 basis points from the trough about a year ago, while the euro area and Japan have left their policy interest rates unchanged. In the outlook, however, the dollar is expected to weaken somewhat, given continued concerns regarding the external deficit of the United States.

Currency appreciation in many developing countries has been accompanied by increases in their current-account surpluses and/or surges in capital inflows. The reported increases in

Chart 1. YIELD SPREADS FOR DEVELOPING COUNTRIES



Source: JP Morgan Chase Bank

foreign exchange market interventions by these countries seem to have very limited effects on curbing the appreciation. In the outlook, the appreciation pressures will likely continue, given the accumulation of large currency reserves in many of these countries.

The Chinese Government changed its exchange-rate regime from a de facto peg to the United States dollar to a managed float in July 2005. The renminbi is now pegged to a basket of currencies and has appreciated 2 per cent against the dollar. This move is too small to make a major impact on the trade balance, but the direction is significant in the context of China's overall economic and financial reforms. China has also since adopted measured steps to further liberalize its foreign exchange market, which is still underdeveloped by any standard. So far, the move has not led to any noticeable shocks to either international or domestic markets, except to an appreciation of many Asian currencies by the same magnitude. Challenges remain, however, as China continues to take additional steps towards opening its capital account in a context in which its financial system is still fragile and domestic firms and consumers lack awareness, as well as the means, to hedge exchange-rate risks. Until recently, such risks were covered solely by the government.

Outlook for employment and inflation

Employment

The *employment* situation worldwide remains unsatisfactory. During the recent phase of global recovery, employment creation has lagged behind output growth. Unemployment rates in the majority of economies are still notably higher than the levels prior to the global downturn of 2000-2001. Meanwhile, high employment and underemployment of a structural nature remain the key policy challenge in many developing countries, as they are inextricably linked to poverty problems in the long run.

A gradual but mild recovery in employment continues in most developed countries. In the United States, excluding the displacement of labour caused by the hurricanes, the average monthly increase in payroll employment is still below 200,000, the pace needed to avoid the unemployment rate from rising. Employment in the manufacturing sector continued to stagnate, with the total number of jobs in this sector still far below the level of 2000. In Western Europe, unemployment rates are still about one percentage point above their low levels of 2001, but a gradual improvement is discernable. It is noteworthy that the recent increase in unemployment rates in the past few years has not completely reversed the downward trend achieved by labour market reforms throughout Europe over the past decade. Lowering unemployment further will require a continuation of these reforms. The unemployment rate in Japan has been declining steadily in 2005, but is still higher than the levels of the 1990s. A few other developed economies, such as Australia, Canada and New Zealand, form an exception to these trends as unemployment rates have reached historical lows due to sustained high output growth.

The unemployment situation in developing countries and economies in transition is even more pressing, in both cyclical and structural terms. Official unemployment data, which usually cover only part of the unemployment in urban areas, would in general underestimate the severity of the unemployment situation in most developing countries by a large margin. Even by this measure, only a small number of countries in Asia, Latin America and in the group of economies in transition have registered a cyclical recovery in unemployment rates, although the unemployment rates for most Asian economies are still far above their levels prior to the Asian financial crisis of the 1990s, and, despite some improvement, unemployment rates in most Latin American countries and economies in transition are still at high levels, above 10 per cent for many of them. In China and many Asian economies, where rural areas still account for a large share of the population, large amounts of surplus labour or “repressed unemployment” in those rural areas remain a long-term policy concern. In South Asia, for example, the formal sector is unable to absorb a rapidly growing workforce and unemployment is highest among the young—which is true for many other developing countries in general.

The most difficult structural unemployment and underemployment problems are, however, found in Africa, with the official unemployment rates standing at 10 per cent or higher in some of these economies. The structural unemployment problems in some of these economies have also occasionally been aggravated by cyclical factors. For example, a decline in textile exports in 2005 in Africa has led to the loss of thousands of jobs in a number of countries.

Inflation

Headline *inflation* rates have edged up notably in a majority of countries, driven mainly by higher oil prices. Core inflation rates, which exclude such highly volatile components as the prices of energy and food, however, remain much more stable, indicating that the pass-through of higher oil prices into overall inflation is limited. The inflation expectation worldwide seems to be well anchored, although inflationary pressures are expected to increase in the outlook as oil prices remain at high levels.

The effects of higher oil prices on overall inflation in an economy will work through various channels in different stages. In the first round, the transmission of higher international oil prices (measured in United States dollars) into domestic oil prices and the prices of oil products such as gasoline is mostly direct in many countries, although the effects may not be so straightforward for some countries. Government controls on domestic energy prices, tax relief on oil products and changes in exchange rates can all shield, to some extent, domestic oil prices from higher international oil prices. For example, domestic oil prices in the euro area had increased little in 2004 because of the euro appreciation against the dollar, but the prices measured in euro were much higher in 2005 as the euro depreciated. In Asia, a number of economies have managed to slow the rise in domestic oil prices compared to the increase in international oil prices by way of various measures. However, such measures to smooth spikes in global oil prices can only be temporary. As these countries reduce these measures, more first-round effects of higher oil prices are expected.

The change in oil prices measured in domestic currency will add to the overall consumer price index, wholesale price index and other inflation measures, according to the weight of the oil consumption in these indices. The effects in the second round will depend on how much firms can pass the increase in their energy costs through to the prices of their products and services, and more importantly, how consumers and firms together will adjust their inflation expectations, as well as their wage and price setting.

So far, most firms find it difficult to pass the increase in oil prices through to the prices of their products and services, mainly because of a very competitive environment. For example, several large airlines in the United States have recently filed for bankruptcy partly because they were unable to raise the prices of their services accordingly. Meanwhile, the dynamic relocation of energy-intensive manufacturing activity worldwide observed in recent years has allowed the increase in energy prices to be absorbed mostly in the developing countries before the final consumer goods ship to the developed countries. Within the developing countries, the absorption is made possible partly by the growth in labour productivity (as labour moves from low-productive sectors to high-productive sectors) and partly by keeping wages at a relatively low level.

The labour market and wage formation play a key role in determining the second-round inflation effects of higher oil prices. As the employment situation in most countries remains weak, labour would have little bargaining power, and the wage-indexation mechanism, which was once popular, can scarcely be found in any economy today.

In some cases, higher oil prices can even have a dampening effect on core inflation. If higher oil prices are temporary, households, facing lower real income, may reduce their savings in order to maintain their real consumption. However, if higher oil prices persist, consumers may have to cut their spending on other goods and services, leading to lower prices of these goods and services. How these effects are evolving exactly varies from country to country, but so far no country has reported strong second-round effects.

Core inflation rates in most developed countries are between 1 to 3 per cent, below the upper bound of inflation targets set by these countries. In contrast, high inflation rates around 10 per cent can still be found in several countries. More specifically, inflation is accelerating in economies in transition. In Latin America, most countries have achieved disinflation, while in Africa, high inflation rates are mostly related to structural problems rather than to the increase in oil prices. Meanwhile, Hong Kong SAR has just come out of deflation and Japan is still working its way out.

Increased international competition has played a key role in curbing global inflation over the past decade, and in this regard, rising protectionism may be a larger threat to the inflation outlook than higher oil prices.

Risks and uncertainties

The baseline LINK forecast is based on the absence of a disorderly adjustment of the global imbalances and no further surge in oil prices. Consequently, the baseline scenario is optimistic compared to a scenario which would consider several downside risks.

One such risk would be a disorderly adjustment of the *global imbalances* leading to a worldwide recession and destabilization of global financial markets. The worst case scenario would be an abrupt retrenchment in the spending of households and businesses in the major deficit country, the United States, triggered, for example, by a sharp erosion of the willingness of the surplus countries to continue financing the foreign indebtedness of the United States. In such a scenario, the rebalancing would generate a substantial contraction, not only for the United States, but also for the world economy as a whole, accompanied by a precipitous change in exchange rates and a detrimental shock to financial markets. For instance, as quantified in an earlier LINK simulation and other studies, a reduction of the United States external deficit by half, mainly through a cut in its domestic private consumption and business investment, would lead to a drop in GDP by 4.6 percentage points in the United States and about 2 percentage points in the world. By contrast, a benign rebalancing process engendered by both a gradual adjustment in the United States and necessary policies in the surplus countries to boost their domestic demand would produce much smaller adverse effects. However, such a benign rebalancing would require international macroeconomic policy coordination and cooperation, for which there is currently no adequate framework in place. This heightens the risk of the worst case scenario to materialize as the global imbalances continue to widen.

The uncertainties related to *oil prices* emanate from a tight global oil production capacity. It has now become clearer that the rise in oil prices over the past few years is quite different from the price hikes associated with the two major oil crises in the 1970s and 1980s. The difference is both in terms of the causes of the increases in oil prices as well as the impact on the world economy. The current situation has mainly been driven by an upward shift in the demand curve (as well as some supply-side factors, such as the geopolitical uncertainty and natural disasters), while the crises in the past were, among other factors, essentially a downward shift in the supply schedule caused by large-scale disruptions in oil supply. Nevertheless, concerns about supply-side constraints have recently moved to the forefront.

In this regard, there are two kinds of uncertainties. First, barring any disruptive shocks to global oil production, there is the question of to what level oil prices must rise in order to balance oil demand and supply and what the implications of this equilibrium price level would be for global economic growth. Second, given the tight capacity, there is uncertainty regarding the effect of a large-scale disruption in global oil production on oil prices and world economic growth. While both of these questions are crucial for the outlook of the world economy, the second one seems to encompass greater downside risks.

As discussed in the previous LINK meetings, effects from a rise in oil prices caused by an upward shift in demand are likely to have a smaller impact on global economic growth than a rise in prices caused by a supply shock. An earlier LINK simulation suggested that the impact on GDP growth of a rise in oil prices by US$ 10 pb caused by a supply-side shock could be three times as high as that in a demand-driven scenario. Compared with the relatively benign outcome in the baseline scenario, any adverse supply-side oil shock – due to natural disasters or terrorism – would result in a much poorer world economic outlook.

The vulnerability of the global economy also derives from the increase in *house prices* in some countries. A number of economies have experienced substantial appreciation in house prices over the past decades, with the appreciation particularly strong in recent years. Various housing indicators in these countries, such as the affordability ratio, price-to-rent ratio, mortgage loans-to-GDP ratio, and ownership ratio are at historical highs, suggesting a peak in the value of houses relative to the underlying economic fundamentals. Moreover, indications of possible bubbles in house prices, at least in some countries, are also visible from the increase in speculative activities. For example, in the United States, turnover in housing markets has increased, the share of investment-oriented house purchases has risen and novel mortgage products such as interest-only loans, exotic forms of adjustable rate mortgages and the allowance for a limited amount of negative amortization have been proliferating, thus enabling many marginally qualified and highly leveraged borrowers to purchase homes at inflated prices.

Meanwhile, the booming housing sector has been a major driver for GDP growth in many of these countries. For example, in the United States, home equity extraction, namely cash-out taken during refinancing, has financed 30 to 40 per cent of the increase in consumer spending in recent years, accounting for one percentage point or more of total real GDP growth, with the residential-building sector contributing another 0.6 percentage point.

Part of the housing boom in recent years can be attributed to various country-specific features, but low interest rates and easier access to mortgage loans seem to be the common factors for most of these countries. Therefore, an increase in interest rates can lead to a flattening or reversal in the growth of house prices, turning the positive growth contributions of the housing sector into negative ones. As an example, the recent notable growth moderation in Australia and the United Kingdom was unambiguously attributable to a cooling down of the housing sector.

Meanwhile, house prices have a substantial impact on the banking sector, as mortgage loans account for a sizable proportion of total bank loans. Declining house prices will heighten the default risk and can trigger bank crises, as has happened in a number of countries in the past.

The risks associated with the housing sector for the global economy are serious not only because of the large size of the economies concerned, but also because of an inextricable linkage between the increase in house prices and the global imbalances. A number of these economies with substantial appreciation in house prices are also running large external deficits (relative to their GDP) and experiencing a decline in household savings to very low levels. In this regard, the housing boom in these countries has been to some extent financed by borrowing from those high-saving countries running external surpluses. Therefore, a burst in house prices is likely to lead to an abrupt adjustment in the global imbalances.

Other downside risks can also not be precluded, such as the risks of a pandemic avian influenza.

Implications for global macroeconomic policies

The slowdown in global growth and indicated downside risks pose enormous challenges to macroeconomic policies worldwide. The risks associated with oil prices and house prices in a number of countries pose particular challenges for *monetary policy*.

Although the two episodes of the oil crises in the 1970s and 1980s have been extensively studied, views are still split over the implications for monetary policy in dealing with the inflationary risks associated with higher oil prices. It is generally agreed that monetary policy should ignore the effects of short-term fluctuation in oil prices, particularly if they are caused by temporary supply-side shocks. There is also some consensus that even if there is a permanent rise in the level of oil prices, it will either be unnecessary or impossible for monetary policy to offset the first-round effects on overall inflation, and that monetary policy should focus on the second-round effects in the medium run, namely, a notable pass-through of higher oil prices to wages and overall inflation. However, some analysts would argue that by the time the second-round effects are actually ascertained, it would be too late to activate a monetary tightening, as it would take months or longer for monetary policy to show any effects on the economy. Others would suggest that policy makers should differentiate between demand-driven higher oil prices and supply-driven ones: a monetary tightening would exacerbate the already contractionary effects of supply-driven higher oil prices. Meanwhile, even in the case of higher oil prices driven by strong global demand, as in the current situation, monetary tightening in individual countries would also have only limited effects, unless the major economies initiate a coordinated tightening in monetary policy.

So far, monetary authorities in most countries have refrained from aggressive tightening, partly because of an expectation that oil prices will fall back in the medium term and partly because of the fact that the overall inflation remains stable and low. However, some nascent signs appear to indicate an upward movement in the core inflation rate so that, if higher oil prices persist longer, central banks will be faced with difficult challenges.

It is important to note that. according to some studies, most of the contractionary impact of the two major oil-price shocks in the past on the real economy was attributable to monetary policy tightening in response to the shocks, while inflation had already been on the rise prior to the oil shocks.

Monetary authorities in those countries with substantially appreciated house prices are also facing a significant quandary. The link between house prices and aggregate demand suggests that monetary policy should take into account the fluctuation in house prices. However, in practice, house prices are not included in overall inflation measures. Meanwhile, coexistence of strong inflation in house prices and low inflation in goods and services, as witnessed in recent years in many economies generates a conflict: monetary tightening consistent with stability in the housing market may risk deflation in the goods market, while low interest rates will continue to fuel the surge in house prices and the increase in household indebtedness.

Facing various challenges, macroeconomic policies and, in particular, monetary policies have become less synchronized worldwide in 2005, in contrast to a global tendency in 2004 when many economies were unwinding the policy stimuli injected in the earlier years. As indicated in table 2, while central banks in some countries have continued to raise policy interest rates, an equal number of those in other countries have managed to reduce interest rates or to maintain their policy stance for several months.

Among the developed countries, the United States Fed has so far raised interest rates by a total of 275 basis points from mid-2004, pushing up the Federal Fund interest rate to 3.75 per cent. Its recent policy statements imply that it will likely continue to increase interest rates until the Federal Fund rate reaches 4.5 per cent in 2006, with the real interest rate reaching about 2 per cent, a neutral position on the long-run average. Meanwhile, the expected change of the Fed Chairman at the beginning of 2006 might shift the monetary policy regime from a risk-management type to one of inflation targeting, though the initial signs are more of continuity. While no monetary tightening is expected in the euro area, the Central Bank of Japan will continue to maintain the policy framework of quantitative easing, creating an environment where short-term interest rates stay very close to zero in the outlook. The central banks in other developed countries will likely keep their policy stance at the current levels.

In the developing countries and economies in transition, further monetary tightening is expected, although in measured steps, for most Asian economies, along with continued intervention in foreign exchange markets and sterilization. In Latin America, room for easing remains in several countries with high interest rates, such as Brazil and Mexico, as inflation is contained within the target range, but other economies in the region, including those facing appreciation pressures are expected to adopt a policy mix of tightening, foreign exchange intervention and sterilization. While most African countries will maintain a cautious monetary policy stance, many economies in West Asia are likely to raise interest rates. Meanwhile, monetary policy in most economies in transition will remain accommodative.

Table 2. Monetary policy stance: policy interest rates (percentage)

	October 14, 2005	*Change from* Jun 04(bp)	*Change in* last 6 months
Australia	5.50	25	0
Brazil	19.50	350	-
Canada	2.75	75	+
Chile	4.25	250	+
China	5.58	27	+
Czech Republic	1.75	-50	0
Hong Kong SAR	5.25	250	+
Hungary	6.00	-550	-
India	5.00	50	+
Indonesia	11.00	366	+
Japan	0.00	0	0
Korea, Republic of	3.50	-25	+
Malaysia	2.70	0	NA
Mexico	9.25	275	-
New Zealand	6.75	100	0
Norway	2.00	25	+
Philippines	7.25	50	+
Poland	4.50	-75	-
Slovakia	3.00	-200	0
South Africa	7.00	-100	0
Sweden	1.50	-50	-
Switzerland	0.75	25	+
Taiwan Province of China	2.13	75	+
Thailand	3.25	200	+
Turkey	14.00	-800	-
United Kingdom	4.50	0	-
United States	3.75	275	+

Source: JP Morgan Chase Bank

Fiscal policies are even more country specific. Broadly speaking, in the outlook, fiscal policy in the United States will become slightly more expansionary because of the expected increase in government spending on post-hurricane reconstruction. While most European countries will maintain a neutral to mild expansionary stance, Japan should be expected to continue its fiscal consolidation. Among the developing countries and economies in transition, most countries in Latin America, Africa and East Asia are likely to adopt more restrictive or cautious fiscal policies, while fiscal policy in other countries can be defined as expansionary to varying degrees. Fiscal positions are also diverse among countries, with most oil-exporting countries continuing to improve their fiscal balance, while many other countries are experiencing large or larger fiscal deficits.

There are some further policy challenges. Macroeconomic policy alone is not sufficient to reduce the global imbalances and will require structural reforms, and more importantly, a benign global adjustment would call for more intense and broader international policy coordination than is currently the case.

International macroeconomic policy cooperation and coordination have faded since the 1980s, partly because of a qualified success in that decade when the previous episode of large global imbalances ended with a considerable shock to the world economy. The unsatisfactory policy coordination of the 1980s was, however, due exactly to the unwillingness of the major economies to sacrifice their national interests in the spirit of international coordination. Since then, even the international financial institutions that are supposed to advocate and lead international policy coordination have been shunning the subject, arguing that the best policy for the world economy, in terms of cost-benefit trade-offs, is for individual countries to adopt policies that fit best their own needs. Given the systemic risks associated with the global imbalance and the existence of externalities in national approaches to resolving the imbalances, there should be a net gain from a cooperative policy approach. Such an approach will also be needed to address the global investment anaemia with a coordinated fine-tuning of macroeconomic policies involving tightening fiscal and monetary policies in the major deficit countries and more accommodating policies in the surplus countries to avoid a collapse in global demand and future investment prospects.