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WORLD ECONOMIC OUTLOOK

(As of September 2004)

NOTE BY THE

DEPARTMENT OF ECONOMIC AND SOCIAL AFFAIRS

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World Economic Outlook as of September 2004[1]

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The profile of the global economic outlook for 2004 and 2005 reported in the *World Economic and Social Survey 2004* remains valid. With the important exception of the continued increase in oil prices and some minor adjustments in the growth rates for some countries, the outlook for the world economy and the key risks and policy concerns identified at that time (and elaborated at greater length in E/2004/75) have not changed significantly in the intervening few months. Although the accelerating phase of the global recovery appears to be over, a further weakening in world economic growth in the rest of 2004 appears unlikely and global economic growth is forecast to settle at about 3 to 3¼ per cent in 2005. However, this generally positive outlook is tempered by the coexistence of a number of downside risks.

There are several signs of underlying resilience in the world economy: business investment continues to strengthen in a large number of economies; global inflation remains benign; macroeconomic policies worldwide, despite some tightening, remain accommodative; international trade has returned to a more solid rate of growth; external financing conditions remain favourable for most developing countries; and exchange rates among major currencies seem to have stabilized, although some Asian economies remain subject to revaluation pressures.

Global macroeconomic policy continues to be supportive of economic recovery, even though, as expected, the US Federal Reserve has raised interest rates, so far in three gradual steps, and a few other central banks have followed this lead. However, the central banks in the euro area, Japan and a number of other countries have maintained low interest rates to accommodate growth; a few other central banks, such as those in Hungary, the Republic of Korea and South Africa, have even reduced their interest rates further in 2004. Global monetary policy remains accommodative in general, with real interest rates in a number of countries at or below zero. Meanwhile, long-term interest rates have moved lower on global capital markets because expectations for inflation, as well as for GDP growth, have fallen. The low interest rates in international financial markets, together with their strengthened

[1] This note is a brief update of, and should be read in conjunction with, Chapter 1 of the *World Economic and Social Survey 2004* (E/2004/75, available at http://www.un.org/esa/policy/wess /part1_chap1_2004.pdf).

domestic economic conditions and macroeconomic balances, are supporting the improvement in the external financing conditions for many developing countries.

There is greater variation in fiscal policies across countries: it is expansionary in the United States and a large number of Asian developing countries; slightly stimulatory to neutral in most European economies and some African countries; and restrictive in Japan and in Latin American economies. However, many economies, including the largest, have large fiscal deficits.

International trade flows started the year strongly, but there was a slowdown around mid-year, particularly in the trade of ICT goods. Nevertheless, the increase in world trade in 2004 and 2005 could meet or exceed the forecast in the *Survey*. International trade has played an increasingly important role in initiating the recovery of economic growth in many economies during the past global business cycle. From a longer term perspective, growing global interdependency and changes in the geographical pattern and commodity composition of trade have resulted in corresponding changes in the impact of trade in individual developing countries..

The downward trend in the prices of most non-oil commodities, but particularly of metals and other raw materials, seems to have been reversed, although the opposite is the case for prices of a few agricultural products. The rapid development of China, India and a few other large developing economies suggest that there is unlikely to be a return to the previous secular downward trend in non-oil commodity prices in the medium term. This should have beneficial effects for many developing countries, including least developed and some other low-income countries.

Another encouraging sign, after a long period of stalemate, was the adoption by the General Council of the WTO of a decision setting forth a framework for future negotiations on trade liberalization under the Doha Work Programme. A major step forward was the agreement on modalities on agriculture, which had been impeding progress in other areas of trade liberalization owing to the "single undertaking" nature of the Round. Despite the progress, many difficult issues remain and more swift action needs to be taken in order to fulfil the goal of promoting economic development in developing countries.

The *Survey* warned that the earlier strength in the world economy was largely cyclical and that the accelerating phase of the global expansion would end gradually in the second half of 2004. Despite the generally favourable circumstances, the world economy softened earlier and, in some economies, to a larger degree than expected in the *Survey*. A number of factors contributed to the lull in mid-2004: the weak and unstable recovery of employment in a large number of economies, a setback in the recovery of the global information and communication technologies (ICT) sector, the effects of the policy-tightening measures adopted in a few countries and, above all, higher oil prices.

One factor responsible for the relapse was the lack of employment growth. Most economies continue to face serious unemployment - in developed economies, because of the delayed cyclical recovery in employment and in developing countries because of perpetually high structural unemployment and under-employment. Without adequate growth in employment, and in labour income, to bolster effective aggregate demand, robust growth of GDP cannot be sustained. A propitious economic environment is important to enhance business confidence and increase the hiring of workers, but government policies to support labour relocation and training are also crucial, particularly under the current situation of increasing international competition and rapid technological innovation. International protectionism, on the other hand, will not lead to an efficient solution of unemployment problems.

It was, however, the surge in oil prices that was the leading reason for the interruption in the recovery. In the *Survey*, an average annual price (for Brent oil) of $28 was assumed for 2004, but the average for the year to date has been more than $35 and the price may remain above $40 for the rest of 2004. The major driving force behind the persistent rise in oil prices has been stronger-than-expected global oil demand, which is growing by an annual average of more than 2 million barrels per day, the fastest rate in recent history. At the same time, major oil-producing countries had been restraining their supply until recently. These effects were exacerbated by other developments such as the geopolitical tension in the Middle East, political conditions in Nigeria and Venezuela, the uncertainty about the large Russian oil company Yukos, the weakness of the United States dollar vis-à-vis other major currencies, and the herd behaviour of speculative investors, including some hedge funds, in the oil futures market.

The higher oil prices have brought sizeable income gains to oil-exporting countries, stimulating their economic growth. On the other hand, consumer spending in the majority of economies has been squeezed: because the elasticity of demand for oil is very low: with no possibilities for substitution in the short run, consumers have to cut their spending on other goods and services in order to meet their higher oil bills. This was one key reason for the weakening of GDP growth in the second quarter of 2004 in many economies, especially the United States, Japan, and many Asian developing economies, although other factors also contributed.

As a result of the different developments in trade flows and prices, the global economic deceleration in mid-2004 occurred mostly in those economies that are relatively concentrated in manufacturing, particularly ICT products, and dependent on imports of energy and raw materials, while most commodity-exporting economies fared well. This dichotomy reverses the previous situation when there was rapid growth of manufactured exports from some developing countries while others faced declining prices for most non-oil commodities.

The future trend of oil prices remains the leading uncertainty for the world economic outlook. The upward pressure on prices is unlikely to dissipate soon, for three main reasons. First, the gap between the global oil demand and supply will persist unless - contrary to the forecast - growth in a number of large economies, such as the United States, Japan, China and other Asian economies, falls significantly. Second, most oil producers are running at, or near, their short-term capacity. Third, the supply-side uncertainties seem unlikely to disperse soon so that an unusually large risk premium will continue to inflate prices. The negative income effects of these higher oil prices will continue to curb global economic growth in the short run. The probability of a global oil crisis, however, is not high, because there has not been a major disruption in oil supplies on the scale necessary to engender a sharp, worldwide erosion of consumer and business confidence. To the contrary, major oil producers have become more amenable to responding to the increase in the global oil demand and have some capacity to do so.

A second major downside risk relates to the large fiscal and trade deficits of the United States. This remains a potentially major destabilizing factor for both that country's and the world economies. Moreover, the geopolitical uncertainty and the broader apprehensions about terrorism, although no longer as intense, have become a perennial anxiety, perpetually curbing consumer and business confidence. Growth in most developed economies is also being constrained by weak increases in employment and real wages, and further increases in growth in the leading developing economies may be constrained by the global availability of energy and raw materials. An unusual feature of the present global economic situation is therefore not only the scope of some of the leading downside risks but also the multiplicity of these risks and, in some cases, the interrelationships between them.

Developments in the main economies and regions

The economy of the *United States* started 2004 on a strong note, but GDP growth slowed down conspicuously in the second quarter, to below 3.0 per cent, as consumer spending was dampened by higher energy prices and a slow and unstable recovery in employment and exports softened. While some of these weaknesses continue to linger, GDP growth for 2004 as a whole could still be above 4 per cent, thanks to robust business investment that is expected to lead solid growth for the rest of the year. Inflation has been on the rise, largely due to higher energy prices, but the probability of escalating inflation remains low. Monetary policy, as anticipated, has been tightened from its easing position and further gradual increases in policy interest rates are expected. GDP growth is expected to stabilize in 2005 at 3.5 per cent. Meanwhile, the downside risks associated with the deteriorating fiscal position and the widening external deficit remain considerable. These risks, if combined with a continued rise in energy prices and a prolonged weakness in the labour market, could lead to an extended slowdown in GDP growth.

Despite some sluggish signs around mid-year, the economy of *Japan* is expected to grow by more than 3 per cent in 2004. The current recovery phase, initiated in the summer of 2003, is Japan's third attempt during the past decade to extricate its economy from the protracted stagnation and deflation inflicted by the bursting of the equity and real estate bubbles at the beginning of the 1990s. The previous two attempts failed, but the current one seems more enduring. The recovery was originally driven by the expansion of the external sector, but strength has gradually been feeding through to other sectors, from manufacturing to non-manufacturing, and from large to small firms. An improvement in corporate profits continues to support strong growth in business capital spending, and the period of deterioration in employment and household income has finally come to an end. Meanwhile, some progress has also been made in dealing with such structural problems as non-performing loans.

However, difficulties in restructuring the corporate sector to tackle the excesses of capital stock, debt and labour in many firms continue to weigh on the economy. General prices remain on a deflationary trend and the economy is still very vulnerable to fluctuations in the growth of its major trade partners. Monetary policy is therefore expected to remain accommodative, offsetting the restrictive fiscal policy, which is greatly constrained by the fragile state of public finances.

After a slowdown in 2003, GDP growth in Canada has been recovering in 2004, supported by low interest rates and an increase in exports. More recently, the central bank of Canada has started to raise interest rates as the economy is operating close to its capacity. In Australia, domestic demand has been growing robustly, buttressed by all-time-high consumer and business confidence. Meanwhile, net exports have also showed improvement. After strong growth for the past few years, housing prices have turned around, easing some of the concerns about overheating. However, the rise in household debt and the large external deficit seem to be unsustainable, triggering a continued tightening in monetary policy. In New Zealand, the economy is expected to moderate in 2004-2005, especially if housing prices reverse and net immigration slows. All three economies have experienced a substantial appreciation of their currencies vis-à-vis the United States dollar.

Growth in *Western Europe* has slowed marginally from earlier in the year, partly because of the rise in energy prices, but the recovery continues, with some gradual strengthening expected in 2005. Growth in the region has been overly dependent on external demand, with government consumption providing a complementary boost, but private consumption remains weak and business investment has expanded only marginally. The outlook for exports remains optimistic: the appreciation of the euro appears to have run its course and foreign demand is expected to remain strong. Supported by low interest rates and improving business financing conditions, exports should drive investment spending, particularly in the capital goods industry. However, it will be challenging to strengthen consumption as both employment and wages are bound by competitive pressures. The unemployment rate has remained stable for many months and is expected to improve only slowly over the course of 2005. Inflation, as measured by the HICP, has been above 2 per cent, but the core rate remains below 2 per cent. Monetary policy is still on hold in the euro area and likely to remain so until the beginning of 2005 whereas the United Kingdom economy is in a more expansionary phase and the Bank of

England has already raised rates. The risks for sustainability of the recovery in the region, however, remain, as indicated by the latest mixed readings from various business surveys.

Growth in *Central and Eastern Europe (CEE)* accelerated in 2004, driven by booming exports and a recovery of investment in Central Europe. As in 2003, the momentum of growth remained in South-eastern Europe. Although most of the region's currencies have resumed their appreciation, exports have expanded at double-digit rates in recent months, possibly because of the EU enlargement and virtually full trade liberalization between the new EU members and the EU-15. Other factors are the improved quality of products and participation in international distribution networks, the effects of previous interest rate cuts, and an increase in exports to developing countries. Monetary policy in the region is mixed and, from a very low level, inflation has accelerated slightly due to EU-related tax harmonization and higher energy prices. For its part, fiscal policy in the new EU member countries is driven by the goal of joining the monetary union, but only gradual measures are being implemented since this goal remains a distant target for most of these countries. In South-eastern Europe, budgets are close to balance since IMF stand-by loans influence fiscal policy.

Growth in the *Baltic States* remains robust in 2004, reflecting success in broad-based structural policies and gains in macroeconomic stability. Rising inflation expectations, partly due to higher energy prices, may become a reason for tightening monetary policy, as Latvia has done. Another risk is the large current-account deficits.

Strong economic growth continues in the *Commonwealth of Independent States (CIS)*. Driven by higher oil prices, strong external demand for oil and natural gas, and buoyant consumption and investment, regional GDP grew by about 8 per cent in the first half of 2004 but is expected to slow marginally in the second half of the year. Growth in the oil and non-oil commodity-exporting countries is expected to meet or exceed the previous forecast and these countries' strong demand for imports of manufactured goods is boosting recovery elsewhere in the region. As a result, the growth of intraregional trade has accelerated, reinforcing regional growth. Inflation remains on a downward trend in the region, although a few economies are experiencing increasing inflation in the short run as a result of some temporary supply-side problems. Some economies have tightened monetary policy, but monetary policy in the Russian Federation remains neutral because of the need to strike a balance between a target for inflation and exchange-rate stability. Fiscal policy will remain tight in the region to contain inflationary pressure in many countries and, in some countries, to ensure repayments of foreign debt. Meanwhile, the windfall gains from revenues in the resource-rich countries are being channelled into the Stabilization Funds. The diversification of economic growth away from the present heavy reliance on oil and gas will require steady progress in other sectors. Striking a balance between macroeconomic stability and implementing reforms to achieve longer-term growth remains the major challenge.

The improved prospects for *Africa* remain as delineated in the *Survey*. GDP growth is forecast to be sustained at around 4 per cent in 2004 and accelerate to 5 per cent in 2005. Many countries benefited from increased domestic demand and a more favourable external environment in the first half of 2004 as a result of continued high oil prices, increases in the prices of several non-oil commodities and increased demand for Africa's exports as a result of recovering global economic growth. In North Africa, the increased oil revenues of Algeria, Egypt and Libya continue to support the growth of private and public consumption, increased investment in infrastructure and an expansion of oil-production capacity. Other countries in North Africa benefited from higher agricultural output, growth in manufacturing and other industrial output and increased earnings from tourism and related service-sector activities. In Sub-Saharan Africa, most countries are achieving growth rates in the range of 3 to 7 per cent. South Africa is on track to achieve 3 per cent GDP growth in 2004 based on strong domestic demand and increased exports. Nigeria's growth performance continued to be underpinned by higher oil and gas revenues and increased agricultural output, although its GDP growth retreated to 4 per cent in 2004 from 10 per cent in 2003.

Many African countries continued to consolidate the benefits of improved political governance and economic management evident in recent years. Monetary and fiscal policies remain subdued while inflation has generally been contained to single-digit rates (or manageable double-digit rates in such countries as Angola and the DRC that only recently suffered from hyperinflation). Notwithstanding generally prudent fiscal and monetary policies throughout Africa, rising incomes and improved confidence in economic management have enabled countries such as South Africa and the oil-producing countries in North Africa to adopt expansionary fiscal policies. Increased government expenditures have generally been directed at increased expenditures in the social sector and infrastructure development.

Solid overall economic growth is expected for *East Asia* in 2004, but performance has become more diversified across economies. A number of economies, such as China, Indonesia, the Republic of Korea, Taiwan Province of China and Thailand experienced a notable deceleration, even weakness, around mid-year, but others, such as Singapore and Hong Kong SAR, were more resilient. The adjustment in China was policy engendered, aimed to curb some of its overheated sectors. Resorting mainly to administrative measures, China has cooled the growth of industrial production, investment and bank loans. This adjustment, together with higher oil prices, the deceleration in the United States and Japan and a cyclical adjustment in the global ICT sector, had adverse effects on many developing Asian economies. However, the risk of a "hard landing" in China now seems less likely so that any further downward adjustment to growth elsewhere in the region should be limited. Aggregate GDP growth for the region in 2005 is expected to stabilize at a lower but more sustainable pace.

South Asia witnessed strong economic growth at the beginning of 2004, with the performance of India, Pakistan and Sri Lanka surpassing expectations, and Pakistan anticipated to surpass the earlier forecast for 2004 as a whole. Agricultural growth in the region is not as good as in 2003 when there was exceptionally good weather. The main drivers of growth in 2004 are services and the industrial sector, with services playing a key role in India, Nepal and Sri Lanka, and industrial growth leading in Pakistan. On the other hand, growth in Bangladesh, for example, may have to be downgraded due to the adverse effects of the end of the Agreement on Textiles and Clothing (ATC) and flood damage. The external sector has been very vibrant in most economies, with both exports and imports growing at a double-digit pace. Inflationary pressures have picked up throughout the region and monetary tightening is anticipated for most economies. Fiscal policies in the region remain expansive, with a trend towards improved revenue collection and more emphasis given to developmental and social spending. Throughout the region, the internal political situation remains a concern, with civil conflict flaring up in some areas and political dissonance hampering reform processes.

West Asia has experienced mixed fortunes: higher oil prices, together with increased oil production, have brought an unexpected windfall of oil revenue to the region, but the deteriorating security situation in Iraq and the ongoing conflict between Israel and Palestine continue to have adverse effects on the region. Most oil-exporting countries have improved their fiscal and external balances substantially, but growth in oil-importing countries is mixed. Increased remittances have benefited Jordan and Lebanon while a recovery in the high-tech sector has accelerated growth in Israel. The economic improvement in Iraq has been dilatory, with oil production and exports increasing very slowly. Political and economic normalization in the country is likely to require both a longer time and more resources than anticipated. More generally, geopolitical uncertainty will continue to cast a shadow over the economic prospects of the region.

The economic performance of the *Latin American and Caribbean* region has been slightly better than expected, suggesting an upward revision of the growth previously projected for 2004, although downside risks exist as well. Strengthened external and domestic conditions have supported broader-based growth. Greater external demand, particularly from the United States, has boosted growth in such economies as Mexico and the Central American region (with the exceptions of Haiti and the Dominican Republic, which are struggling to extricate themselves from political and economic crises). Sustained favourable export commodity prices, especially for metals, will also continue to benefit exporters in the Andean region. Oil prices have also favoured the region's exporters, especially Venezuela, whose high growth also reflects the normalization of its oil production after a setback in 2003. Unprecedentedly, in recent memory, the region is registering a second consecutive year of current-account surplus, albeit small. Foreign investment is also returning, although mostly to Mexico. While external demand explains most of the growth, consumption has recovered somewhat although investment remains weak. Many economies in the region have room to ease monetary policy and an increased degree of flexibility in their fiscal management. Inflationary pressures from higher fuel prices are under control, but unemployment remains one of the biggest challenges. Although growth rates were better than expected during the first half of the year, they largely reflected post-crisis recovery in some countries so that growth is likely to slow down to more normal levels. In addition, there remain concerns about the external debt renegotiations of Argentina, and Mexico continues to face increasing international competition in the market of the United States.