

World Economic Situation and Prospects 2007

Update as of mid-2007*



United Nations
New York, 2007

* The present document updates *World Economic Situation and Prospects 2007* (United Nations publication, Sales No. E.07.II.C.2), released in January 2007.

Macroeconomic trends in the world economy

1. After solid and broad-based growth for three consecutive years, world economic growth is moderating in 2007, in line with the early projection of *World Economic Situation and Prospects 2007*. The growth of world gross product (WGP) is expected to slow to a pace of 3.4 per cent for 2007 as a whole, down from 4.0 per cent, as recorded in 2006 (see table 1).¹ The slowdown is expected to stabilize in 2008 with a projected growth of WGP at 3.6 per cent.² The risks, however, are slanted on the downside.

2. The performance of the world economy over the past few years was indeed remarkably broad-based. During 2006, 96 out of a total of 159 countries for which recent data are available succeeded in increasing per capita output by above 3 per cent (see table 2). This group of strong performers included 63 developing countries.³ At the same time, the number of countries that registered a decline in gross domestic product (GDP) per capita fell to only nine, less than in previous years. The same table shows that, nonetheless, there were still 44 developing countries that had not managed to reach a growth rate exceeding 3 per cent in GDP per capita, including a large number of African countries, suggesting that economic development in those countries fell short of what would be needed to achieve the Millennium Development Goals.

3. One challenge for policymakers worldwide is how to sustain such a robust growth path for the world economy, and, more importantly, how to engender higher growth in more developing countries so as to secure the fulfilment of the Millennium Development Goals. Currently, the primary drag for the world economy is a notable slowdown in the United States of America, as its housing sector is falling into a substantial recession and business investment is weakening. Growth in other developed economies such as those of Europe and Japan appears to remain strong by the standards of those economies, but limited potential output growth in these other major economies constrains their role as the main engines of global growth. Growth in developing countries and the transition economies seems to have become more endogenously propelled within the group, driven in particular by China, India and a few other emerging economies. However, as many developing countries integrate further into the world economy, their economic prospects have become increasingly dependent on the international economic environment, which is still largely shaped by the economic performance and policies of the major developed countries. A further weakening of the housing market and related economic downturn in the United States would pose a downside risk to global growth and the prospects for developing economies. The most recent meltdown in sub-prime mortgage markets in the United States has heightened the probability of a longer and more pronounced decline in

¹ WGP growth is calculated as a weighted average of individual-country growth rates of GDP, where weights are based on GDP in 2000 prices and exchange rates. This may differ from WGP growth estimates of other institutions that use GDP weights in purchasing power parity (PPP).

² More detailed forecasts for 2008 can be found in the LINK Global Economic Outlook May 2007 at the website of the Department of Economic and Social Affairs (http://www.un.org/esa/progareas/macro_fin.html. Path: Project LINK).

³ As a rule of thumb, 3 per cent per capita income growth is sometimes seen as the minimum growth rate required to achieve significant reductions in poverty, even in the absence of income redistribution.

housing demand. Meanwhile, the risks to the growth and stability of the world economy posed by the large global imbalances have not receded, calling for internationally concerted policies to avert this danger.

Table 1
Growth of world output, 2002-2008
 (Annual percentage change)

	2002	2003	2004	2005	2006 ^a	2007 ^b	Revision ^c	2008 ^b
World output ^d	1.9	2.7	4.1	3.4	4.0	3.4	0.2	3.6
<i>of which:</i>								
Developed economies	1.3	1.9	3.1	2.4	3.0	2.3	0.1	2.5
Northern America	1.7	2.5	3.9	3.2	3.3	2.1	-0.1	2.8
Western Europe ^e	1.2	1.2	2.4	1.7	3.0	2.7	0.3	2.5
Asia and Oceania ^f	0.5	1.7	2.8	2.0	2.2	2.2	0.3	2.0
Economies in transition	5.1	7.2	7.6	6.6	7.5	7.1	0.6	6.7
Southern and Eastern Europe	4.2	3.4	4.5	4.4	5.0	5.0	-0.5	5.0
Commonwealth of Independent States	5.2	7.6	8.0	6.8	7.7	7.3	0.6	6.9
Developing economies	3.9	5.2	7.1	6.5	6.9	6.4	0.5	6.2
Africa	3.5	4.5	5.2	5.3	5.6	5.9	0.3	5.8
East Asia	6.9	6.8	8.0	7.6	8.1	7.5	0.5	7.3
South Asia	5.0	7.0	7.2	6.8	7.2	6.8	0.3	6.7
Western Asia	3.1	4.7	6.9	6.4	5.4	5.1	0.2	4.9
Latin America and the Caribbean	-0.5	2.2	6.1	4.8	5.7	4.8	0.6	4.4
<i>Other groupings</i>								
Landlocked countries	4.7	4.6	6.8	7.3	8.2	8.2	0.6	7.7
Least developed countries	6.3	6.5	7.9	8.2	6.6	7.0	-0.1	6.3
Small island developing States	3.4	3.1	6.0	6.6	7.9	6.1	1.0	5.3
Sub-Saharan Africa ^g	4.1	3.3	5.9	6.0	5.9	7.1	0.5	6.7

Source: Department of Economic and Social Affairs of the United Nations Secretariat.

a Partly estimated.

b Updated forecast in May 2007, based in part on Project LINK, an international collaborative research group for econometric

modelling, coordinated jointly by the Global Economic Monitoring Unit of the United Nations Secretariat and the University of Toronto.

c Change in percentage points from the forecast released in January 2007 in *World Economic Situation and Prospects 2007*.

d Calculated as a weighted average of individual-country growth rates of gross domestic product (GDP), where weights are

based on GDP in 2000 prices and exchange rates.

e European Union (including Bulgaria and Romania), Iceland, Norway and Switzerland.

f Japan, Australia, and New Zealand.

g Excluding Nigeria and South Africa.

Table 2

Frequency of high and low growth of per capita output, 2004-2007

	Number of countries monitored	Decline in GDP per capita				Growth of GDP per capita exceeding 3 per cent			
		2004	2005	2006 ^a	2007 ^b	2004	2005	2006 ^a	2007 ^b
		Number of countries							
World	159	14	14	9	7	87	90	96	95
<i>of which:</i>									
Developed economies	35	2	2	0	0	16	13	18	14
Economies in transition	17	0	1	0	0	15	15	15	17
Developing countries	107	12	11	9	7	56	62	63	64
<i>of which:</i>									
Africa	51	8	7	8	6	21	27	25	29
East Asia	13	1	1	0	0	11	11	11	11
South Asia	6	0	0	0	0	5	5	5	5
Western Asia	13	2	2	1	1	8	6	9	7
Latin America	24	1	1	0	0	11	13	13	12
<i>Memorandum items:</i>									
Least developed countries	39	8	7	7	5	15	19	16	21
Sub-Saharan Africa ^c	44	8	7	8	6	17	22	19	23
Landlocked developing countries	25	2	5	4	2	11	14	11	14
Small island developing States	17	4	1	1	0	6	8	10	10
	<i>Share^d</i>	<i>Percentage of world population</i>							
Developed economies	15.9	0.2	1.1	0.0	0.0	2.3	2.0	3.1	2.6
Economies in transition	5.1	0.0	0.1	0.0	0.0	5.0	4.9	5.0	5.1
Developing countries	79.0	1.5	1.3	0.9	1.0	68.7	67.6	68.2	67.7
<i>of which:</i>									
Africa	13.5	0.8	1.0	0.8	0.7	8.2	9.2	8.4	9.5
East Asia	30.8	0.0	0.0	0.0	0.0	30.7	30.7	30.7	30.7
South Asia	23.3	0.0	0.0	0.0	0.0	24.4	24.8	25.2	25.6
Western Asia	2.9	0.6	0.4	0.1	0.3	1.8	1.7	1.9	1.8
Latin America	8.6	0.1	0.0	0.0	0.0	5.1	3.1	4.3	2.9
<i>Memorandum items:</i>									
Least developed countries	10.4	1.0	1.1	0.6	0.7	7.3	7.7	6.3	7.4
Sub-Saharan Africa ^c	8.4	0.8	1.0	0.8	0.7	4.8	5.7	3.9	4.9
Landlocked developing countries	5.0	0.4	0.8	0.6	0.3	2.7	3.1	2.6	2.8
Small island developing States	0.8	0.2	0.0	0.0	0.0	0.3	0.4	0.5	0.5

Source: Department of Economic and Social Affairs of the United Nations Secretariat, including population estimates and projections from *World Population Prospects: The 2004 Revision, vol. I, Comprehensive Tables* (United Nations publication, Sales No. E.05.XIII.5).

a Partly estimated.

b Forecast, based in part on Project LINK.

c Excluding Nigeria and South Africa.

d Percentage of world population for 2000.

Outlook by region

Developed economies

4. GDP in the *United States*, among developed economies, is expected to grow at a sluggish pace of 2.1 per cent in 2007, a significant deceleration from the 3.3 per cent of 2006. The weakness is expected to be contained largely within the housing sector. Private consumption has remained resilient for now, but a weaker housing market and the high ratio of household debt to disposable income is expected to curb household spending in the outlook. Despite healthy corporate finances, business capital spending has weakened visibly in late 2006 and early 2007. Exports have strengthened and have allowed for a slight reduction in the large current-account deficit during 2006. The external deficit remains very large and pressure remains regarding a further and possibly abrupt depreciation of the exchange rate as confidence of international investors in the dollar erodes further. Meanwhile, productivity growth has decelerated, limiting the potential for further economic expansion.

5. Growth in *Japan* remains robust by the standards of a mature developed economy, particularly in view of a sustained expansion since 2003 at an average annual rate of 2.5 per cent. In the outlook, the economy is expected to expand by 2.1 per cent in 2007, compared with 2.2 per cent in the previous year. Solid corporate profits underpin investment in the replacement and expansion of production capacities, while improved conditions in the labour market are expected to buttress consumer confidence and household consumption. The external sector remains one of the main driving forces of growth, and a major downside risk therefore lies in a larger-than-expected downturn in Japan's major trade partners, such as the United States.

6. The outlook for *Western Europe* has been revised upward compared with the forecast of *World Economic Situation and Prospects 2007*. In the euro area, GDP grew by 2.7 per cent in 2006, marking the strongest growth performance since 2000. Exports and investment were the key driving force, but consumption expenditure, which had been a major drag to growth in the past, also contributed significantly. In the outlook, most leading indicators remain strong, but a number of factors are likely to restrain growth over the forecast horizon. First, the slowdown in the United States, coupled with the appreciation of the euro against the dollar, is likely to dampen export growth. Second, fiscal policy for the euro area as a whole is slightly contractionary, but more so in some of the largest economies, while monetary policy continues to tighten with current short-term rates now close to neutral and past increases have yet to fully feed through the economy. On the bright side, the near-term outlook is bolstered by the good carry-over from the recent growth momentum, by improvements in labour-market conditions, and by the particularly strong performance of the Germany economy. Outside the euro area, rates of growth are also expected to be strong. Growth is expected to slow only mildly to 2.5 per cent in 2007 for Western Europe as a whole.

7. The *new members of the European Union (EU)* maintained strong momentum in 2006, some of these countries having registered record-high growth rates for more than a decade. Robust domestic demand was the main driving force, although exports, especially of the automotive sector, contributed to growth four as well. Increased wages, a rapid expansion of consumer credit, including mortgage lending, improved employment conditions, a rise in purchasing power via appreciated currencies and continued foreign direct investment (FDI) inflows as well as EU aid have all supported robust consumption as well as investment. A strong recovery continued in Poland. Growth reached a record-high in the Czech Republic and Slovakia, and both Estonia and Latvia expanded at a double-digit growth rate. The economies of Bulgaria and Romania, which joined the Union at the beginning of 2007, also maintained robust economic growth. In the outlook, aggregate GDP of the region is expected to grow by 5.4 per cent in 2007, moderating slightly from the 5.9 per cent of 2006 in part because of fiscal consolidation in Hungary.

8. In respect of other developed economies, growth in the *Canadian* economy is forecast to moderate in 2007, partly as a result of the slowdown in the United States. Growth in *Australia* is expected to recover somewhat from the slow pace of the previous year, sustained by a strong external sector including favourable prices of the major commodities in its exports. Growth in *New Zealand* will remain under 2 per cent in the outlook.

9. *Employment* conditions have shown some improvement in developed economies. In the United States, the unemployment rate had dropped to 4.4 per cent by the first quarter of 2007, the lowest level in six years. The growth of payroll employment seems to have peaked in 2006, however, and is expected to slow during 2007. Consequently, the unemployment rate is expected to edge up to near 5 per cent by the year's end. Unemployment in the euro area also fell to the lowest level in more than a decade. The employment outlook remains positive throughout Europe as above-trend growth continues in Western Europe and the spillover impacts of labour-market openness benefit workers from the new members of EU. The unemployment rate in Japan has also been on a downward trend.

10. *Inflation* (as measured by the consumer price index) in the United States has been above 3 per cent for two years now, and unit labour costs have risen gradually. Inflationary expectations, as measured by the spread between the yield on the 10-year Treasury note and that of the Treasury Inflation-Protected Securities, have remained tame, however. In the outlook, inflation is expected to decelerate in 2007 to about 2 per cent. In Western Europe, inflationary pressures continue to be a concern for the monetary authorities. In the euro area, the Harmonized Index of Consumer Prices (HICP) registered 2.2 per cent in 2006, above the upper bound of the European Central Bank target of "less than 2 per cent". Headline inflation is expected to remain close to 2 per cent, but to fall slightly in 2007. In Japan, a continued recovery in domestic demand has finally pushed the economy out of its deflationary spiral and inflation indicators are expected to be above zero in 2007.

The economies in transition and developing countries

11. Among the economies in transition, which registered a robust growth of about 7.5 per cent in 2006, the momentum is maintained in The *Commonwealth of Independent States* (CIS). Firm prices of such commodities as oil, gas, metals and cotton continue to support the commodity-exporting economies. Rising real incomes continue to strengthen domestic demand throughout the region, with a strong pickup in investments. After a long period of underinvestment, gross fixed capital formation has rebounded at the pace of about 14 per cent on average for the region over the past year, amounting to over 50 per cent in Tajikistan and more than 30 per cent in Armenia and Belarus. In some countries, such as the Russian Federation, the increase in investment has already led to a notable rise in productivity. Sustained economic growth in the long run will require continued high investment growth in all CIS countries. In the outlook, strong consumption and investment demand are expected to offset some weakening of the external sector in CIS in 2007.

12. The economies in *South-eastern Europe* have preserved dynamism during 2006, as GDP growth exceeded 5 per cent. A similar growth performance is forecast for 2007, with strong domestic demand remaining the major driving force for growth. Despite increased FDI inflows to the region, for many countries production capacity remains limited. The goal of joining EU is helping to lock in prudent macroeconomic policies in these countries, regardless of their status in the EU accession process. Widening external deficits are a source of concern with respect to stable growth. The situation around Kosovo also poses some economic risks for the region.

13. Among developing countries, growth in *Africa* is expected to remain robust at a pace of about 6 per cent during 2007. Rising mining and hydrocarbon production, and increased public spending, especially on infrastructure, are expected to bolster growth. The strength of GDP growth in the region continues to stem largely from developments in a few big economies there, namely, Algeria, Egypt, Morocco, Nigeria and South Africa. All of these economies, except Morocco, will expand at almost 5 per cent or more in 2007. Elsewhere, African oil-exporting countries continue to grow strongly except Chad, where political tensions and the stagnation in oil production significantly impede economic activity. In comparison, growth in the oil-importing countries of the region is less robust on average, with a few exceptions. Meanwhile, political and social tensions have constrained economic growth in a number of African economies (see box I for more details on the outlook for the least developed countries).

14. Growth in *East Asia* accelerated to above 8 per cent in 2006, but some moderation is expected for 2007. Its largest economy of the region, China, posted GDP growth of 10.7 per cent in 2006, while most other countries in the region also registered an acceleration of their economic growth, with the exception of Indonesia and Viet Nam, which both witnessed a marginal slowdown. Exports remained the main driver of regional growth, while domestic demand also recovered in most economies. Not only was there strong global demand for the region's exports, but the buoyant Chinese economy

continued to gain in importance as an export destination for the other East Asian economies. This growth pattern in East Asia is expected to continue during the current year, although some tightening measures in China as well as the expected global deceleration in growth will lead to a slight slowdown in the region.

Box I

Prospects of the least developed countries

After maintaining strong momentum for six years, growth the least developed countries as a whole is expected to reach 7 per cent in 2007, up from the 6.6 per cent recorded in 2006, although the expected acceleration reflects mostly the increase in the growth of Angola and Equatorial Guinea.

In general, oil-exporting least developed countries continue to grow more strongly than oil-importing countries. With the notable exception of Chad, other oil-exporting economies, such as Angola and Equatorial Guinea, will expand at a brisk pace owing not only to rising oil productions and increased public spending but also to the remarkable performance of non-oil sectors such as mining and agriculture.

Some of the oil-importing least developed countries have also sustained relatively high GDP growth over an extended period of time. Owing partly to increasing aid and/or continued political and economic reforms, such countries as Cape Verde, Madagascar, Senegal, the United Republic of Tanzania and Zambia will continue to grow at almost or more than 6 per cent in 2007. Also, recovery is gaining traction in Nepal, where the still-fragile process of political reform and stabilization is under way and public spending is rising.

Less favourably, political and social tensions have constrained economic activity in Haiti, Chad and Guinea, while power outages have hampered the expansion of manufacturing output and economic activity in Benin and Togo.

Fiscal policies are expected be relatively expansionary as most Governments step up efforts to achieve the Millennium Development Goals and to invest in infrastructure. Despite an increase in public spending, especially in infrastructure and human capital, many least developed countries continue to post fiscal surpluses or moderate fiscal deficits, reflecting improved domestic revenue collection and increased current grants. Bangladesh, where the fiscal deficit is forecast to widen, is one of the few exceptions, however. Monetary policies will remain relatively tight, or at best neutral, as many countries try to limit the potential inflationary pressures associated with buoyant domestic demand and/or attempt to synchronize their monetary policies with those of countries whose currencies are used as pegs.

Many least developed countries have enjoyed preferential trade schemes in recent years, contributing to rising export earnings. The trade preferences have not, however, addressed some of obstacles that limit exports, such as overly complex rules of origin and quotas on products of interest to the least developed countries. More importantly, these schemes have underestimated structural supply constraints in these countries. Thus, harnessing potential benefits of trade preferences would require the international community to promote and to implement mechanisms through which to strengthen the production and trading capacity of the least developed countries.

15. *South Asia* maintained strong growth in 2006, but is expected to decelerate marginally in 2007. Growth in India will slow amid tight capacity, inflationary pressures and continued monetary tightening, while other economies are also forecast to slow from their peak performances in 2006. Nepal represents an exception, as the country is expected to continue its slow recovery in the context of a more stable political situation and increased development spending. In most economies of the region, growth in 2006 was broad-based across economic sectors, with a rebound in agriculture in most countries and buoyant manufacturing and services. In the outlook, world demand for the region's exports is expected to slow, but this will be partially offset by continued strong domestic consumption and investment demand.

16. Growth in *Western Asia* remained strong in 2006, as higher-than-expected non-oil production, most notably in the construction and finance sectors, offset lower oil revenues in the larger economies of Saudi Arabia and the United Arab Emirates. Disparities in economic performance remain significant in the region. Among the oil importers, for example, Lebanon is still recovering from the aftermath of the Lebanese-Israeli war as the economy contracted by about 3 per cent in 2006. The prospects for 2007 are expected to improve with the pledge of aid from the international community. Growth in Israel was stronger than expected in 2006, underpinned by resurgent export growth and a significant increase in private consumption. In Turkey, a considerable fall in private consumption led to a moderation in GDP growth, which still amounted to about 6 per cent in 2006. The country's prospects for 2007 are favourable, but clouded by the risk of increased tensions in the run-up to this summer's presidential elections which could trigger uncertainty and undermine economic stability. In the outlook, growth in the region is expected to remain at about 5.1 per cent.

17. Growth in *Latin America and the Caribbean* was above expectations in 2006. Increased income over the past three years has boosted domestic demand and the performance of the external sector remains robust. Notably, the region's largest economies (Brazil, Mexico and Argentina) performed better than expected. Mexico registered its highest growth in 2006 since 2000, owing to strong demand for construction and services which buffered the negative effects on exports of the slowdown in the United States economy. Economic growth in Mexico is expected to moderate in 2007, however, as the drag from the United States continues. Brazil also fared better than originally expected as a major revision of the system of national accounts revealed that both consumption and investment were stronger than expected, reacting to expansionary monetary policy, and that the share and growth of the services sector in GDP were substantially greater than expected. Domestic demand is expected to remain strong while net exports are expected to recover in 2007. Argentina seems to have graduated from its post-crisis recovery and it continued its strong growth performance supported by buoyant domestic demand, especially through increased investment in public infrastructure and private construction. Domestic demand has also been the main driving factor in the Andean economies, in addition to favourable terms of trade. In contrast, Chile's growth has been lower than expected because of unanticipated production losses in the mining sector owing to a collapse in a major mine as well as prolonged labour strikes. In the outlook for the region, the growth projection for 2007 has been revised upward from the

previous *World Economic Situation and Prospects* forecast, although growth will still be lower than in 2006.

18. *Employment* situations in the economies in transition and developing countries are mixed. Job growth remains limited in the CIS economies, despite several consecutive years of rapid growth in the region. Even in the economies with the most dynamic markets, such as the Russian Federation and Kazakhstan, unemployment has been reduced only marginally.

19. Employment growth in the developing countries has been particularly weak, despite robust economic growth. The employment situation has improved little in most African countries and unemployment rates for national workers in Western Asia remain at double-digit levels, partly owing to competitive foreign labour. In East Asia, unemployment rates in the newly industrialized economies decreased in 2006, but a further improvement in labour markets is not likely as overall economic growth in these countries is expected to slow. Improvements in the employment picture have been recorded in some economies in South Asia, such as Pakistan and Sri Lanka, but this masks the broader problem of underemployment. Job growth in the economies of Latin America and the Caribbean, compared with that of most other developing economies, has been relatively strong and employment indicators have improved, but vast informal sector employment and high levels of underemployment remain key policy concerns in these countries (see box II).

Box II

Growth of productive employment in developing economies

Employment-creation is generally weak in developing countries, even among those with relatively high GDP growth. For the period between 1990 and 2005, average GDP increased at an annual rate of about 5 per cent in developing economies. This relatively robust output growth has not, however, been accompanied by adequate employment growth, and unemployment rates among most developing countries either remained entrenched or increased over the period 1990-2005. In addition, a substantial share of employment in developing economies is of low productivity, as weak employment growth in the modern sectors results in workers' being pushed into low-productivity informal activities.

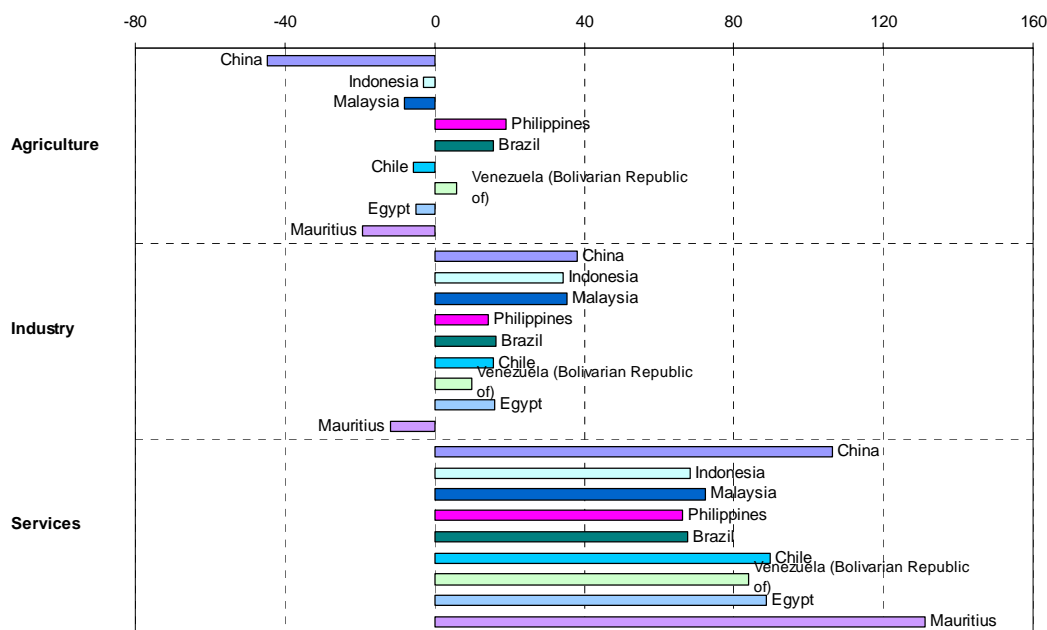
The table compares employment and productivity growth in selected developing countries. As indicated therein, only a couple of economies in the group, such as Malaysia and to some extent Mauritius, managed to have a good combination of adequate employment growth (relative to increases in labour force and population) and robust productivity growth. Structural changes seem to have played an important role in overall employment growth and labour productivity. The figure presents a decomposition of annual employment growth by the percentage contribution of the three main economic sectors, namely, agriculture, industry and services. Despite some country-specific variations, a general pattern emerges, which shows a low, and in many cases negative contribution of agriculture to total employment growth. The bulk of the observed job creation between 1990 and 2005 took place in the services sector, while industry accounted for only 15 - 35 per cent of employment growth in most countries.

Employment and productivity growth in selected developing countries, 1990-2005
(Percentage)

	<i>GDP growth</i>	<i>Employment growth</i>	<i>Growth in labour force</i>	<i>Change in employment relative to population</i>	<i>Growth in labour productivity</i>
China	10.3	1.2	1.1	-3.2	7.6
Indonesia	4.3	1.5	2.3	-5.7	2.8
Malaysia	6.4	2.9	2.9	-0.4	3.3
Philippines	2.9	2.6	3.1	-1.4	0.2
Brazil	2.5	2.6	2.5	1.7	0.6
Chile	5.8	1.9	2.5	0.2	2.8
Venezuela (Bolivarian Republic of)	2.4	3.5	3.5	5.3	-2.3
Egypt	4.1	1.8	3.3	-3.6	2.2
Mauritius	4.7	1.0	1.4	1.1	3.7

Source: UN/DESA, based on International Labour Office, LABORSTA database; and *Key Indicators of the*

**Employment growth in selected developing countries:
sectoral contributions (1990-2005)**
(Percentage of total employment growth)



Sources: UN/DESA, based on International Labour Office, LABORSTA database, and *Key Indicators of the Labour Market*, 4th ed. (Geneva, Internal Note: For all countries, the contribution of each sector to total annual employment growth over the entire period is presented in percentage, with the total contribution equaling 100 per cent. This is independent of the actual level of total employment growth, which varies among countries, as presented in the table. Data for the Bolivarian Republic of Venezuela and Egypt, until 2003.

In the East Asian economies, the decline in industrial output and employment during the crisis of 1997-1998 had pushed labour further into services and, in countries like Indonesia, even temporarily back into agriculture. After the crisis, the employment contribution of industry recovered somewhat, but generally remained below pre-crisis levels.⁴ Similarly, Latin America suffered several reversals in overall employment growth, and especially in industry, during the second half of the 1990s amid a series of crises. In the African economies, the growth in service employment has also increased relative to that in industry, which has remained relatively stagnant or has declined owing to increasing competitive pressures in manufacturing since the late 1990s.

The creation of more productive employment is important because it has the potential to induce sustainable growth by acting as a catalyst for lifting wages to more remunerative levels. This in turn could support an expansion of aggregate domestic consumption, leading to a virtuous circle from employment growth to income growth and to more employment growth. Recent data show that wage growth, though increasing, has been advancing at a comparatively moderate pace in some of the economies selected for this analysis. For example, in Malaysia and China, the increase in real wages has not led to their convergence to the level of advanced economies at a pace as fast as that of Hong Kong, Special Administrative Region of China, Singapore and the Republic of Korea in the earlier period. In Brazil, real wages in manufacturing have been stagnant, while in the Bolivarian Republic of Venezuela they have fallen since the 1970s relative to the advanced economies. As in other countries of Latin America and the Caribbean, weak growth in labour productivity during the period from the 1970s to the present did not allow for wage improvement, despite efforts by the Governments to increase the minimum wage.⁵ A key policy challenge is how to generate more jobs in highly productive sectors, while at the same time improving productivity in sectors where employment is currently being generated.

One effective way of diversifying the economy and increasing labour-intensive manufacturing has been through targeted sectoral policies promoting foreign direct investment (FDI). For example, in Malaysia, industrial and labour-market policies since the mid-1980s have worked well in promoting FDI mainly towards labour-intensive manufacturing and had resulted in the achievement of near full employment by the early 1990s.

Education and training programmes are also crucial for improving labour productivity, particularly in services, and providing workers with skills necessary for job changes in the economy. Malaysia initialized the transition towards a technologically more advanced economic structure with higher value added content by placing special emphasis on education and training so as to bolster human resources development. The recent emphasis on a knowledge-based economy has also supported the productivity growth in all sectors, most importantly the service sector. Mauritius, which set its sights on becoming a regional financial hub for Africa, has now spread into the area of information technology servicing supported by the implementation of the National Information Technology Strategy Plan 1998-2005. Having acknowledged its lack of skilled employment, the Government has made increasing skills and training in information technology a major policy focus.

⁴ In China, which was not directly involved in the Asian crisis, the poor industrial employment growth had been mainly owing to the restructuring and layoffs in State-owned enterprises during this period. During the first five years of the new millennium, however, industry's contribution to overall employment growth recovered to the level of the early 1990s

⁵ data for 2006 show signs of wage recovery in these two countries owing precisely to minimum-wage hikes

20. A large number of economies in transition and developing countries experienced higher rates of *inflation* during 2006, mainly owing to the direct effects of higher oil prices, except for a small number of economies that encountered significant inflation pressures caused by country-specific factors. In Africa, inflation remains moderate on average, but there were sharp increases in consumer prices in a few African countries, as a consequence of food shortages, currency depreciation and/or an immediate pass-through of higher imported-oil prices to consumers. In East Asia, inflation remained broadly subdued in 2006, at an average of 2.9 per cent. Only Indonesia registered an exceptionally high inflation rate of about 13 per cent, as a result of the lift in the control of domestic fuel prices in late 2005, but inflation has since been retreating. China has also seen notable increases in consumer prices in early 2007, mainly owing to food prices. Inflationary pressures in South Asia remained strong throughout late 2006 and in early 2007, with inflation running at an annual rate of about 10 per cent. The main contributory factors continue to be domestic fuel prices, owing to a reduction of subsidies in the oil-importing countries, as well as increases in food prices. In Western Asia, a few oil-importing countries have seen a rise in inflation, but inflation pressure has also built up in oil-exporting countries owing to wage increases and a rise in housing costs. Average inflation reached a historic low of about 5 per cent in Latin America, but it will be difficult for most countries to reach further disinflation. Although stable in general, inflation rates in most economies in transition remain higher than in other regions, and inflation pressures have re-emerged in some economies of the group.

The international economic environment for the developing economies and the economies in transition

21. The international economic environment for the developing economies and the economies in transition remains favourable by historical standards, but has shown increased volatility since mid-2006. Foreign-exchange and equity markets in many emerging market economies experienced considerable turmoil in mid-2006 and in the first quarter of 2007. Although most markets quickly recovered from the turbulences, both emerging market economies and international investors might do well to remind themselves of the risky nature of these markets.

23. World *trade* was growing at a robust pace of about 9 per cent in 2006 (see table 3) and the trade expansion has been broad-based. Asian economies continued to lead the dynamism in global trade, with exports of China and India increasing by about 20 per cent in real terms. Also, many developing countries in Africa and Latin America have managed to expand their exports at double-digit rates, owing to strong global demand for raw materials. Exports of the major developed countries have also been robust, driven by global demand for capital goods, as business investment in many countries continues to recover from the low levels experienced since the last downturn at the beginning of the century. In the outlook for 2007, growth of global trade is expected to moderate to about 7 per cent along with a notable slowdown in the import demand of the United States economy. To sustain the growth of world trade, more efforts are needed to move ahead with the *multilateral trade negotiations* under the Doha Round in the World Trade

Organization, which were suspended in July 2006 and are now in the process of being resumed. Moreover, to ensure the benefits of trade for developing countries, any final agreement of the Round should take sufficiently into account the development dimension, while the implementation of the Aid-for-Trade Initiative should be sped up.

Table 3
**Indicators of the international economic environment,
 2002-2007**

	2002	2003	2004	2005	2006 ^a	2007 ^b
World trade merchandise						
Growth of volume of world exports (percentage)	4.6	6.2	11.4	7.5	9.3	6.8
Value of exports from developing countries (billions of dollars)	2093	2460	3127	3819	4538	5014
United States trade deficit (billions of dollars)	492	560	676	791	844	780
World prices						
Oil (Brent) (dollars per barrel)	25.0	28.9	38.3	54.4	65.4	60.0
Agricultural commodities (index: 2000=100)	101	108	122	129	150	..
Mineral commodities (index: 2000=100)	87	98	137	173	278	..
Manufactures (index: 2000=100)	99	108	117	120	123	..
Real prices of non-fuel commodities (index: 2000=100)	98	97	108	118	150	..
Exchange rate of the United States dollar						
Nominal trade-weighted index (January 1997=100)	126.7	119.1	113.6	110.7	108.5	..
Euros per dollar	1.063	0.886	0.805	0.804	0.797	..
Yen per dollar	125.4	115.9	108.2	110.2	116.3	..
Financial flows to developing countries (billions of dollars)						
Net transfer of resources	-204.4	-298.9	-351.2	-533.3	-661.6	..
Official development assistance (ODA)	58.3	69.1	79.6	106.8	103.9	..
ODA excluding debt relief and emergency assistance	51.0	56.4	67.1	74.5
Net direct investment	123.8	145.0	144.6	210.4	188.8	..
Global interest rates (percentage)						
LIBOR ^c interest rate	1.8	1.2	1.6	3.6	5.2	..
US 10-year Treasury bill yield	4.6	4.0	4.3	4.3	4.8	..
Spread on developing-country bonds	7.8	5.6	4.4	3.2	2.0	..

Source: Department of Economic and Social Affairs of the United Nations Secretariat, based on Project LINK and international sources.

Note: Two dots (..) signify data unavailable.

a Partly estimated.

b Forecast, based in part on Project LINK.

c London Interbank Offered Rate (three-month).

23. The *terms of trade* continued to improve in 2006 for many commodity-exporting developing countries for the fourth consecutive year; however, the prices of most commodities are expected to moderate in the outlook for 2007, along with increased volatility. The *price of oil* in terms of Brent crude reached an unprecedented yearly average of \$65 per barrel in 2006, accompanied by high volatility, with prices ranging from a peak of nearly \$80 per barrel to a nadir of less than \$60 per barrel. Variable weather, supply restrictions of the Organization of the Petroleum Exporting Countries (OPEC), refinery outages, and geopolitical tensions in the Islamic Republic of Iran and Nigeria have been and will continue to be the factors weighing on both the supply and demand side that impact on price movements. Oil prices are expected to average \$60 per barrel for 2007, a drop of nearly 8 per cent from 2006. *Metal prices* surged by more than 50 per cent in 2006, but prices of copper and zinc have already been on a slide since mid-2006 and metal prices are expected to moderate in the outlook. *Prices of agricultural commodities* have been diverging notably, with the prices of maize and wheat increasing markedly and the prices of others flattening or even declining.

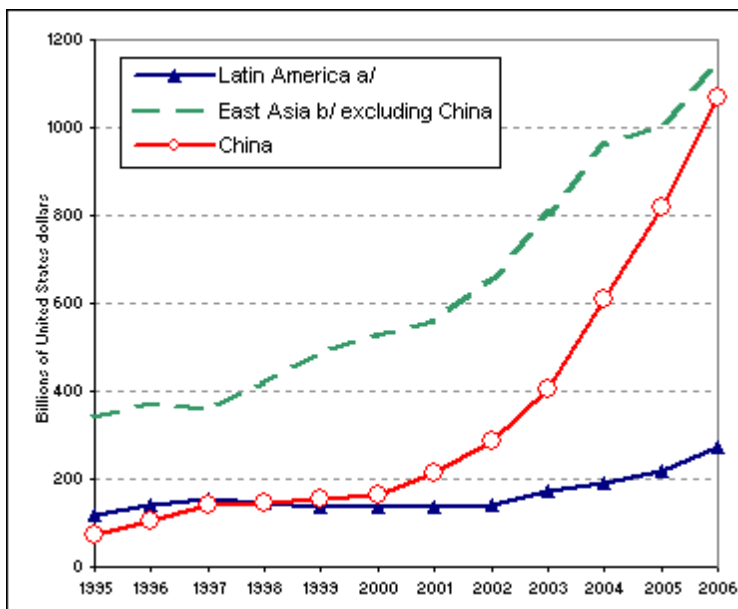
24. The *external financing costs* for emerging market economies remain low. The spreads in the Emerging Markets Bond Index (EMBI) stand at all-time lows in April 2007. Meanwhile, the benchmark interest rates underlying the external financing costs for emerging market economies are also low, despite monetary tightening in major developed countries over the past two years aimed at raising short-term policy interest rates. Such favourable external financing conditions may not be sustainable, as the persistent current-account deficit of the United States will eventually induce higher benchmark interest rates.

25. *Capital flows* to emerging market economies in 2006 were slightly lower than in the previous year. Many of these economies took advantage of very favourable market conditions during the previous year to pre-finance obligations due in 2006. FDI flows have continued to increase, although they are concentrated in a handful of emerging market economies. Official flows to this group of countries have continued to be largely negative as a result of increased net repayments to official creditors. In the outlook, net private capital flows to emerging markets will likely decline in 2007. Part of the decline will reflect the reduced demand for external financing, as many of these economies have been running current-account surpluses for several consecutive years and have accumulated vast amounts of foreign reserves, thus becoming less dependent on international capital, at least cyclically in the short run.

26. *Official development assistance* (ODA) declined in 2006, partly because the additional commitments made in 2005 were largely for debt relief and emergency assistance, and the lack of large debt-relief packages such as those approved in 2005 led to a fall of aid from Organization for Economic Cooperation and Development (OECD) countries by 5.1 per cent in constant dollars in 2006. The system of providing ODA has become increasingly complex and fragmented and is insufficiently coordinated. Moreover, the current governance of international aid is uneven and recipient countries have inadequate voice in the process. Aid is found to be significantly more volatile than fiscal revenue, and tends to be pro-cyclical on average. More substantial reforms of the aid architecture are needed to improve aid effectiveness.

27. The massive accumulation of *official reserves* by developing countries is continuing. As indicated by the figure, reserves surged in China to more \$1.2 trillion by the first quarter of 2007, and more reserves are also being accumulated by other East Asian economies and those in Latin America. While the amassed foreign-exchange reserves are providing a buffer against external shocks, they also entail a range of costs and challenges for these economies. At the policy level, the accumulation of currency reserves carries the potential of creating inconsistencies between the effects of interventions in the currency markets and monetary policy. Fiscal costs resulting from sterilization policy can also be sizeable, particularly when domestic interest rates are notable higher than the interest rates of the issuing countries of the reverse currencies. The financial losses in the value of the reserves for these developing countries would also be significant should the major reserve currency depreciate substantially. In addition, these countries are challenged with respect to efficiently managing the reserves.

Figure 1
International Reserve Accumulation in Emerging Market Economies, 1995-2006



Source: International Monetary Fund, International Financial Statistics.

a/ Including Argentina, Brazil, Chile, Colombia, Ecuador, Mexico, Peru and Venezuela (Bolivarian Republic of).

b/ Including Hong Kong Special Administrative Region of China, Indonesia, Malaysia, Philippines, the Republic of Korea, Singapore, Taiwan Province of China and Thailand.

28. Furthermore, the reserve accumulation by developing countries is the main mechanism through which they continue to make net resource transfers to developed countries. *Net outward transfers* by developing countries reached \$662 billion in 2006

and those by economies in transition \$125 billion. This trend has been continuing for a decade, raising questions about its sustainability as well as its implications for global equality.

Uncertainties and downside risks

29. The outlook for the global economy encompasses a number of uncertainties and risks. The downside risks to the outlook include a much more severe downturn than what the baseline is projecting in the ongoing correction of the housing sector in a number of economies, particularly the United States; a disorderly adjustment of the global imbalances; higher oil prices; the possible outbreak of avian influenza; and unpredictable geopolitical shocks. While all of these risks have been analysed and reported in the previous issues of *World Economic Situation and Prospects*, an update of the latest developments in the risks associated with the housing sector and the global imbalances is presented below.

Recession in the United States housing market

30. The downturn in the housing sector of the United States has accelerated since the second half of 2006. For example, new home sales had declined during 2006 by about 20 per cent and remained weak in the first quarter of 2007. Home builders have been aggressively curtailing construction and the inventory of unsold homes has risen steadily to levels more than double the average of the past decade. Average house prices had stagnated in 2006 and median house prices actually declined in early 2007.

31. The meltdown in the sub-prime mortgage market at the beginning of 2007 has further heightened the risks for a longer and deeper slump in the housing sector and for a possible spread of the weakness to the overall economy. The sub-prime mortgage market serves clients with poor credit histories or with insufficient financial resources. As house prices rose, the sub-prime mortgage market expanded rapidly in the past few years. An increasing number of mortgage loans had been made with high loan-to-value ratios, poor information about the borrower's financial condition, and lax assessments of the value of the homes to be financed. When house prices failed to appreciate, both delinquency rates and foreclosures increased sharply. In early 2007, data indicating that delinquency rates in the sub-prime market had risen to more than 13 per cent in the fourth quarter of 2006 set off a crisis among sub-prime lenders. While some of the lenders filed for bankruptcy, others sought buyers or closed operations.

32. So far, the financial stress has been limited to the sub-prime market only, which accounted for about 20 per cent of all mortgage originations over the last three years. Mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency. Meanwhile, there is no general credit crunch in the economy: credit spreads have widened outside of the mortgage market only slightly and the financial system at large is in much better shape than during

the last housing crisis in the late 1980s and early 1990s. Nevertheless, the problems in the sub-prime mortgage market have aggravated the near-term outlook for the housing sector. Delinquencies are expected to rise further and banks are tightening lending standards not only to sub-prime borrowers but also to other categories. As a result, sales and prices of houses will likely continue to be on a downward trend before the housing sector becomes stabilized.

33. The impact of the housing recession on the overall economy of the United States has so far been reflected mainly in the slump of construction, dragging down GDP growth by about 1 percentage point for the past year. Consumer spending has thus far not suffered any major setback. However, if there continues to be a deterioration in the housing sector along with a notable correction in house prices, both the wealth and income effects will become more significant, leading eventually to a retrenchment of private consumption.

34. In the baseline outlook, the correction in the housing sector of the United States is expected to continue during 2007 and to be of a magnitude similar to that of 2006, with another 1 percentage point of GDP to be trimmed. However, risks for a much more severe adjustment in housing prices are not negligible: since 1997, there has been an appreciation in housing prices in the United States of about 80 per cent in real terms (adjusted by inflation rates), compared with a real appreciation of just 10-20 per cent in previous booms, implying more room on the downside.

35. As illustrated by a simulated alternative scenario in the *World Economic Situation and Prospects 2007* (box I.2), a further weakening in the demand for residential homes by 15 per cent could slow the growth rate of the United States economy to 0.5 per cent, which would slow world economic growth to below 2 per cent.

Risks of disorderly unwinding in the global imbalances

36. After a further widening during 2006, current-account imbalances across countries are expected to narrow slightly in 2007. The deficit of the United States had risen to about \$860 billion by the end of 2006, or 6.5 per cent of its GDP, and is expected to fall to \$800 billion in 2007. Developed economies as a whole registered a current-account deficit of more than \$600 billion in 2006 and the deficit is expected to remain at this level in 2007, despite a sizable surplus in both Germany and Japan. Most developing regions are running surpluses. It was the surplus in the group of oil-exporting countries that increased the most in 2006, reaching about \$500 billion, but the surplus is expected to moderate in 2007 along with an anticipated decline in the average price of oil. The surplus in developing Asia exceeded \$200 billion, with China being the main contributor, and will remain on a similar scale in 2007. Latin America has managed to run a small surplus for an unprecedented four consecutive years, while Africa is almost in a balanced position. The surplus in the CIS group has surpassed \$100 billion, mainly because of the Russian Federation, but the group of other economies in transition in Europe is running a substantially large deficit relative to the size of their GDP.

37. Despite the small projected narrowing of the current-account deficit in the United States, the risks for a disorderly adjustment remain, as the indebtedness of the United States will continue to deepen. As a result of the chronic current-account deficits over the past decade, the net international investment position of the United States is estimated to have exceeded \$3 trillion by the end of 2006. Another deficit of \$800 billion in its current account will further add to the net debt position of the United States, making it less and less tenable.

International policy coordination for global rebalancing

38. An abrupt unwinding of the large global imbalances can significantly destabilize the global financial markets and substantially depress world economic growth. The challenge facing policymakers worldwide is to find an approach to achieving a benign adjustment of the global imbalances with the minimum adverse impact on the stability and growth of the world economy. In this regard, the United Nations, the International Monetary Fund (IMF) and the World Bank have alike reiterated the fact that there is a need for international policy coordination.

39. The unwinding of the imbalances would engender, ideally, combined measures in both the deficit and the surplus countries. For example, the United States should reduce its external deficit through fiscal consolidation, including tax reforms designed to encourage household saving, and the surplus economies in Asia and oil-exporting countries should stimulate their domestic demand by boosting public expenditure, while Europe could loosen monetary policy. Governments will also have to permit adjustment of the exchange-rate between the dollar and other currencies, including Asian currencies, but should not rely on exchange-rate realignment only.

40. If any of these policies were adopted individually, they could have undesirable implications for domestic economies and could create negative spillover effects for the rest of the world. No Government would be prepared to bear the costs of the policy initiatives needed to correct the global imbalances on its own. By contrast, an international cooperative policy strategy would allow each country to achieve a superior outcome with a reduction in the imbalances and a neutral net effect on economic growth. More specifically, cooperation would make use of the spillover effects of the policies of one country as an offsetting factor for the negative element of the adjustment policy of another country.

Develop a consensus on common goals through international consultations

41. The objective behind the multilateral consultations inaugurated by IMF in spring 2006 was to share information on and analysis of the global imbalances among all countries. According to IMF, these consultations would provide a “forum for debate” among parties to a common economic issue. The aim is to enable the Fund and its members to agree on policy actions to be undertaken to address vulnerabilities affecting

both individual countries and the global financial system. Members will exchange information and views, with IMF acting as an honest broker.

42. Even though participants at the 2006 round of multilateral consultations hosted by IMF stated their willingness to make policy pledges to reduce the imbalances, these discussions have not yet led to any results. The renewed discussions on revising the 1977 Decision on Surveillance over Exchange Rate Policies at IMF are taking place in the context of these imbalances. The shared responsibility over the global system's vitality and growth requires an approach that is even-handed. A shift to a compliance-based system, away from the current dialogue-and-persuasion approach, could exacerbate the inequities in the current approach whereby adjustment of domestic policies becomes the principally the duty of developing countries with limited regard to their specific circumstances and level of development. Improved surveillance should not entail the imposing by IMF of new obligations on members; rather, such surveillance should pay attention to the special circumstances of member countries, be even-handed and have the flexibility needed to evolve under changing conditions.

43. Guided by such principles, the multilateral consultations could develop into a new mechanism, replacing less representative consultation platforms such as the Group of Eight (G8). An advantage of such a new mechanism is that it could be designed specifically to address the problem at hand. It would possess the flexibility needed to address new issues and, at the same time, should have more legitimacy than that of consultations held by ad hoc groups of countries.

Enhance the context for mediation and the perceived legitimacy of the mediator

44. Mediation is unlikely to work when doubts exist regarding the impartiality of the mediator. In the present context, the problem stems from the fact that the United States and the euro area have more votes and more leverage in the Fund than other participants. Thus, reforming governance and representation in IMF, so that seats on the Executive Board and votes in the Fund better reflect twenty-first century realities is critical for enhancing the legitimacy of the Fund's mediation role. A first step in this direction was taken at the annual meetings of IMF and the World Bank in Singapore, where it was agreed to increase quotas and votes for four particularly underrepresented countries, namely, China, Mexico, the Republic of Korea and Turkey, and to raise the number of basic votes cast by every country (regardless of size) as a way of enhancing the voices of poor countries. More comprehensive governance reform is still required, however. There is a need for agreement on a new quota formula so that other rapidly growing countries can see that their problem of underrepresentation is addressed – and that such problems will continue to be addressed over time. There is also a need to update the composition of the Executive Board, where largely for historical reasons European countries occupy as many as 9 of the 24 seats (depending on whether Spain holds the chair of its largely Latin American constituency at any particular moment). Furthermore, there is the need for greater independence of management and staff to reassure all members that IMF advice is not unduly affected by political pressure from particular shareholders.

Address commitment problems by issuing multi-year schedules for policy adjustments

45. A gradual approach to adjusting the global imbalances may be preferable in that it would avoid shocking the economy with significant changes in fiscal, monetary and exchange-rate policies all at once. Such a gradual approach will likely be more reassuring to financial markets. Investors will be reassured only if the commitment to continued adjustment is credible, however. A small down payment on adjustment may not do much to reduce financial vulnerabilities if the markets doubt that Governments will follow up with additional instalments. If a Government is unconvinced of the need for adjustment, it may agree to token adjustments simply to get off the hook with its foreign partners, while having no intention of following up. There will be no perfect solution to politically grounded commitment problems, but a partial solution would be to publish a multi-year schedule for adjustment. Announcing specific targets, in the form of a schedule, and then not meeting them has costs in terms of reputation, as has specifying a series of policy actions and then failing to implement them. Commitments, in order to be credible, must be attainable and readily monitored, which requires that they should be explicit, measurable and public.

46. Governments already pre-specify schedules of actions in an effort to enhance the perception of commitment. One can imagine similar schedules emanating from the IMF multilateral consultations as discussed above. The “deliverable” from the consultations process (the “multilateral letter of intent”) should be a sequence of policy adjustments tied to a specific schedule, to be made public at the end of the multilateral round. In this regard, it will be important for any multilateral letter of intent to focus on a limited number of targets.

Initiate systemic reforms in the field of international monetary and financial affairs

47. In the long run, only deeper and more far-reaching reforms of the global monetary and financial system as a whole will be able to prevent a similar constellation of imbalances from arising again and to deal with the asymmetries that are currently inherent in the global adjustment mechanisms. As indicated, the current situation emerged partly because developing countries, following the financial crises of the 1990s, had seen it as necessary to accumulate international reserves as protection against renewed instability. Since the dollar was the leading reserve currency, this meant accumulating dollars, which in turn meant providing easy finance for the United States current account. Now that developing countries have augmented their dollar balances, they are reluctant to alter their reserve portfolios or the policies that facilitated the emergence of the United States deficit for fear of precipitating a fall in the dollar and inflicting capital losses upon themselves. As this situation allows the United States deficit to persist and the country’s foreign indebtedness to grow, the point would inevitably be reached where doubts about the sustainability of its debts induced reserve diversification and other policy adjustments by one creditor country, leading others to flee the dollar in order to avoid being left in an adverse situation.

48. This is an intrinsic problem in a system in which a single national currency is used to hold international reserves. A new, supranational currency based on the scaling up of special drawing rights would probably offer, through its emergence, the best solution to the problem of redesigning the global reserve system in a stable way; but this can only be a long-term option. A market solution is problematic, as it will likely not be smooth (that is to say, it will not occur without a collapse of the dollar and the disruption of financial markets). Therefore, a more immediate, pragmatic reform measure would be to promote an officially backed multi-currency reserve system. This idea should be as compelling as that of pursuing a multilateral trading system. Similar to multilateral trade rules, a well-designed multilateral financial system should create equal conditions for all parties and avoid unfair competition and an asymmetric burden-sharing of exchange-rate adjustments. It should also help to increase stability in the international financial system by reducing the likelihood of a crisis scenario where capital flight out of the major single reserve currency has potentially far-reaching repercussions throughout the global economy.