World Economic Situation and Prospects 2007

Executive Summary

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Executive summary

The global outlook

Slower global economic growth in 2007

After a solid and broad-based growth for three consecutive years, the world economy is expected to decelerate in 2007, with the growth of world gross product (WGP) moderating to a pace of 3.2 per cent, down from the estimated 3.8 per cent for 2006.[1] The economy of the United States of America will be the major drag for this global slowdown, as its growth is forecast to soften on the back of a weakening housing market to a rate of 2.2 per cent in 2007. No other developed economy is expected to emerge as an alternative engine for the world economy, as growth in Europe is forecast to slow to around 2 per cent and in Japan to below 2 per cent in 2007. There are, furthermore, substantial downside risks associated with the possibility of a much stronger slowdown of the United States economy.

Continued robust growth in developing countries

The developing countries and the economies in transition have continued their exceptionally strong economic performance during 2006, reaching average growth rates of 6.5 and 7.2 per cent, respectively. Growth is expected to remain robust in 2007, albeit with a mild moderation: 5.9 per cent for developing countries and 6.5 per cent for economies in transition. Among developing countries, sustained high growth in China and India has engendered more endogenous growth through increasing South-South trade and financial linkages. This is reflected in, among other things, continued strong demand for and higher prices of energy and primary commodities. Buoyant commodity prices benefit many developing countries and also the economies in transition, especially the Commonwealth of Independent States (CIS). The performance of the least developed countries also remains remarkably strong, averaging nearly 7 per cent in 2006. Growth in the poorest countries is expected to remain equally strong in 2007.

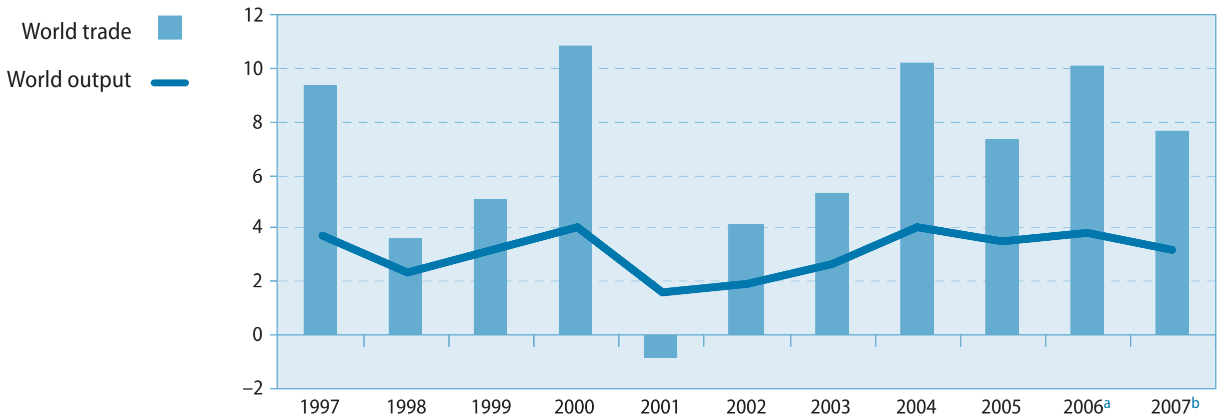
Notwithstanding the improvement in both their domestic economic conditions and stronger interregional linkages, most developing countries remain vulnerable to any slowdown in the major developed economies and to the volatility of international commodity and financial markets.

Insufficient employment growth

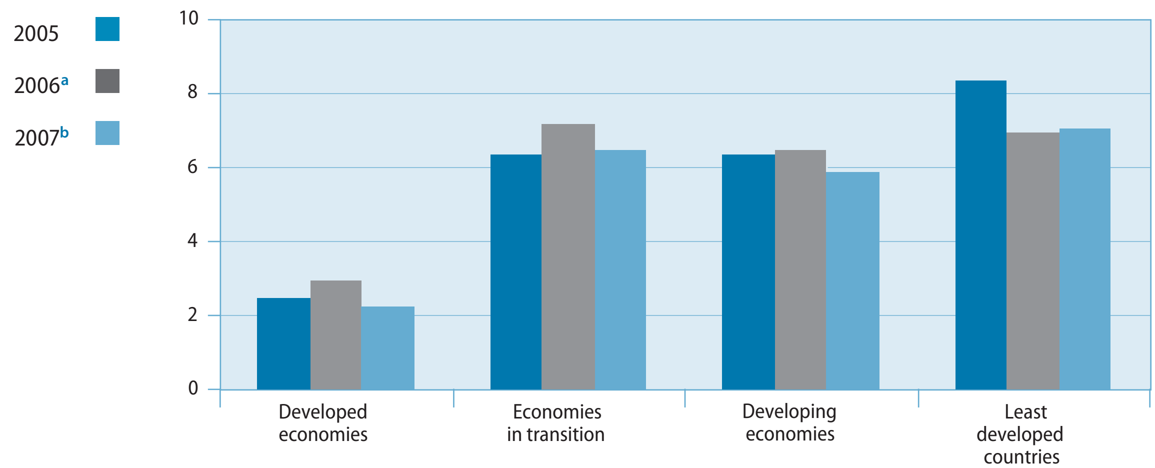
The strong growth performance of the world economy has also helped improve labour-market conditions in a large number of countries. In most developed economies, unemployment rates have declined in 2006. Nonetheless, and despite higher output growth, in important parts of the developing world, employment growth has not been strong enough to substantially reduce unemployment rates. Various factors may have impeded sufficient

1 In the United Nations estimates, the growth of world gross product (WGP) is calculated using country weights for gross domestic product (GDP) in dollars at market prices. When using purchasing power parity(PPP)-based weights, WGP growth would be 5.1 per cent for 2006 and 4.5 per cent for the forecast for 2007.

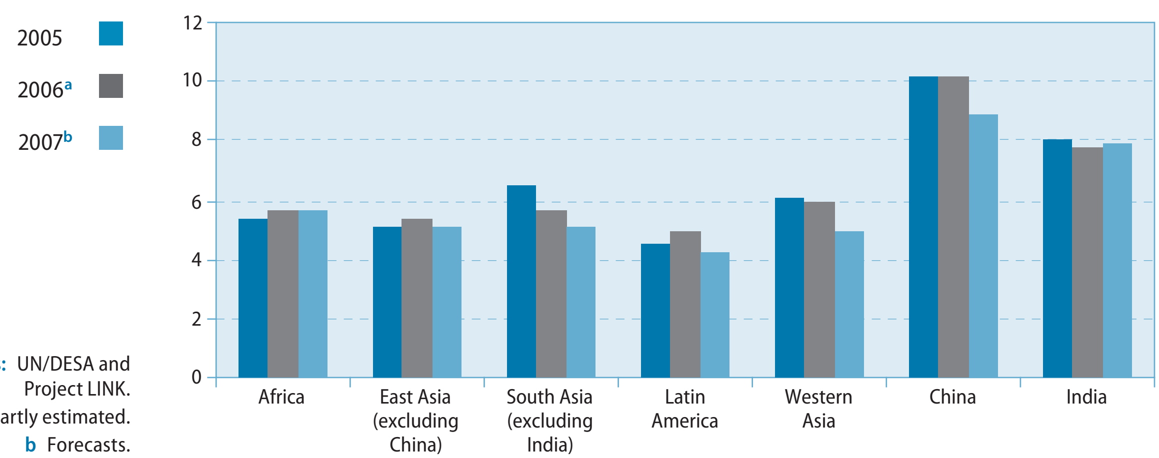
World economic growth expected to slow down, 1997-2007 (*annual percentage change*)



Growth in developing countries and economies in transition stronger than in developed countries (*annual percentage change*)



Moderation is anticipated in most developing-country regions (*annual percentage change*)



Sources: UN/DESA and Project LINK.
a Partly estimated.
b Forecasts.

job growth and/or reductions in unemployment, including the capital-intensive nature of commodity-producing sectors, which has generated most of the growth stimulus in Africa; strong increases in labour participation in both Africa and Latin America; and, in China, labour shedding resulting from the restructuring of State-owned enterprises, strong productivity growth and labour shifts out of agriculture. The situation is similar in the economies in transition, where unemployment rates generally remain high, despite solid economic growth for several consecutive years.

Benign inflation outlook

Headline inflation rates have risen in many economies in 2006, but most of the increase is attributable to first-round effects of higher oil prices. So far, there has been only limited pass-through of higher energy prices into core inflation. Inflationary pressures are expected to moderate in 2007 in view of the retreat of oil prices in the latter part of 2006, the expected slowdown in global economic growth and the tighter monetary policy stance in many economies. Exceptions include a few countries in Africa, which have experienced a sharp increase in inflation owing to food shortages, currency depreciation and/or stronger pass-through of higher oil prices to producers and consumers.

Uncertainties and downside risks

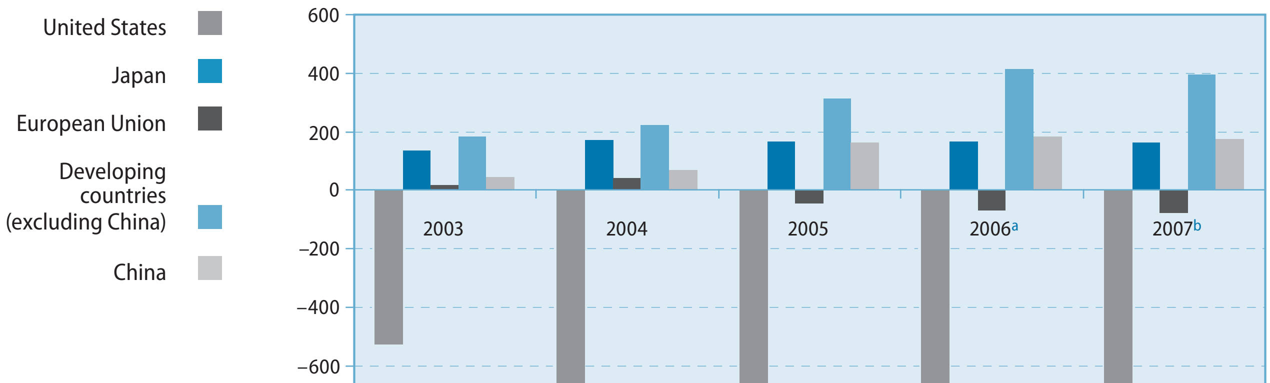
The risk of a further decline in house prices in the United States

The possibility of a more severe downturn in housing markets represents a significant downside risk to the economic outlook. A number of economies have witnessed substantial appreciation of house prices over the past decade, and the associated wealth effects have contributed to solid economic growth rates. A reversal of the process may thus lead to significant negative fallout for world economic growth. Various indicators measuring the performance of the housing market in the United States show a significant recession in activity in 2006—a reduction of close to 20 per cent in recent months. While the baseline forecast assumes a mild adjustment in the housing market, and hence a moderate slowdown in the economy, an alternative, more pessimistic scenario shows that a more severe decline in house prices in the United States would not only undercut its own growth to a pace below 1 per cent in 2007 but also substantially reduce economic growth in the rest of the world by more than one percentage point. In addition, a collapse of house prices in major economies would provoke a crisis in the mortgage markets and set in motion a deflationary adjustment in the global imbalances, enhancing the risk of a major upheaval in financial markets.

Challenges posed by persistently higher oil prices

Although oil prices have recently fallen significantly after reaching a historical high during 2006, they are forecast to remain high, but volatile, in 2007. The short-term prospect for oil prices is highly uncertain, however, owing to geopolitical tensions, new production capacities coming on stream and speculative demand. So far, higher oil prices have not had the same dampening effect on the world economy as they had in the previous episodes of comparable price movements. Among developing countries, oil exporters have benefited from the oil price increase. Buoyant non-oil commodity prices have offset rising import costs due to higher oil prices. A number of low-income, net oil-importing countries, however, did not see an improvement in their terms of trade and have been increasingly hurt

Current-account imbalances have widened further in 2006



Source: UN/DESA and project LINK.
a Partly estimated.
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by the impact of higher energy prices. These economies have had to reduce non-oil imports and have incurred higher fiscal burdens owing to attempts to protect consumers from higher oil prices through subsidies. Economic growth costs in these countries have already been substantial and are likely to increase as oil prices remain high and oil dependency is not reduced.

Risk of a disorderly adjustment of the global imbalances remains

Current-account imbalances across regions and countries have widened further in 2006, featuring the United States running a current-account deficit of close to $900 billion, matched by surpluses generated by Japan and Germany, and—most importantly—by developing regions and economies in transition, including the major oil exporters. As a result of its continued and widening current-account deficit, the indebtedness of the United States has deepened to a level which more seriously calls into question the sustainability of the current constellation of global imbalances. In 2007, the baseline scenario predicts a moderate reduction in these global imbalances as the slowdown in United States economic growth and the moderation in oil prices will generate a reduction in the import bill of the world's largest economy, while the expected depreciation of the dollar will stimulate exports and curb import demand. Nonetheless, the risk of a disorderly adjustment remains. Slow progress, if any, in the unwinding of the global imbalances will enhance the risk of a strong speculative wave towards dollar depreciation. Such exchange-rate depreciation could help reduce the external deficit of the United States, but given the dependence of global economic growth on demand stimuli from the world's largest economy, falling import demand in the United States would have further global deflationary repercussions. This, in turn, could quite easily unravel the momentum of economic growth in developing countries and jeopardize any further progress in poverty reduction. A hard landing of the dollar would further raise uncertainty among international investors and could upset financial markets.

Macroeconomic policy coordination

Why international macroeconomic policy coordination is needed

Existing national macroeconomic policy stances are not designed around the need for achieving an adjustment in the global imbalances. The current tendency towards more restrictive monetary and fiscal policies will have a dampening effect on demand in some of the surplus countries, such as Japan and Germany, making it more difficult for the United States to lower its external deficit through export growth. At the same time, the more expansionary fiscal policies conducted in some of the East Asian surplus countries seem insufficient either to compensate for such deflationary effects or to yield the necessary significant export growth for the United States economy, particularly in the absence of major exchange-rate adjustments.

A coordinated strategy, in contrast, could help avoid the negative growth effects and create confidence in the stability of financial and foreign-exchange markets. Cooperation would make use of the spillover effects of the policies of one country as an offsetting factor for the negative demand effects of the adjustment in another. Growth stimulus in Europe, Asia and the major oil-exporting countries, for instance, could then offset the initially contractionary effect of adjustment policies conducted by the United States.

Various proposals have been put forward as a framework for such policy coordination, including the idea of a new Plaza Agreement on specific policy measures aimed at reducing the imbalances. Despite the shortcomings of such an ad hoc initiative, it may well constitute the desirable second-best outcome in the absence of any more fundamental changes to the global monetary and financial system.

Obstacles to international policy coordination

International policy coordination faces a series of obstacles. These include, among other things, the fact that major stakeholders have different perceptions regarding the risks posed by the current situation. There are also disagreements on the current position of individual economies. In the case of the United States, for example, there are divergent views on how robust economic conditions will remain and whether current imbalances can continue to be financed without major disruptions in international financial markets. Similar uncertainty exists regarding the strength of China's economic growth in the near future and the capacity of Japan and Europe to increase their potential growth rates in the short-to-medium run. These obstacles are likely to be compounded by a problem of commitment to any negotiated international policy solution, as national policy makers may prefer that other countries bear the brunt of the adjustment or may feel constrained to follow through on their commitments because of domestic resistance. Furthermore, an effective solution of the existing imbalances requires sustained action over time, and Governments may find it difficult to credibly commit themselves for a prolonged period.

What can be done?

There are various forums in which such obstacles to international policy coordination could be overcome. An international consultation mechanism that includes an outside mediator such as the International Monetary Fund (IMF) could help generate consensus on the nature and extent of the current problems. Given the structure of the imbalances, such consultations should involve all major players and would thus have to include a fair representation of developing countries. Existing ad hoc platforms, such as the Group of Eight (G8) and other forums, are unsuitable in this regard. The broader-based multilateral surveillance mechanisms launched this year by the IMF are, in this sense, an important step forward. At the national level, countries should issue multi-year commitments for policy adjustment in an internationally coordinated framework. The announcement of internationally agreed but nationally specific targets, for example, would increase the credibility of national policies as Governments would run the risk of incurring reputation costs in the case of policy failure. Finally, only more far-reaching reforms of the global monetary and financial system will help to prevent a re-emergence of the imbalances seen today. A new, supranational currency should be considered a key element of a more structural solution, but this can only be a long-term option. The more immediate solution should be oriented towards developing a multi-currency reserve system. Structural solutions of this kind, aimed at promoting world economic stability, should be as compelling as the pursuit of a multilateral trading system.

International trade

Rapidly expanding trade flows

World merchandise trade has expanded at a rapid pace during 2006. The expansion is featured by a continued sizeable increase in the value of trade flows of both oil and non-oil commodities, mainly due to the higher prices of these commodities, and also by a notable increase in the volume of trade flows of capital goods driven by the recovery in global investment. Growth of the volume of world exports is estimated to be above 10 per cent in 2006, up from 7.3 per cent in 2005. The value of world exports has increased by about 16 per cent. Growth of world exports is more than twice that of world output, indicating a further deepening of global economic integration. In the outlook, however, the growth of world trade is expected to moderate to a pace of 7.7 per cent.

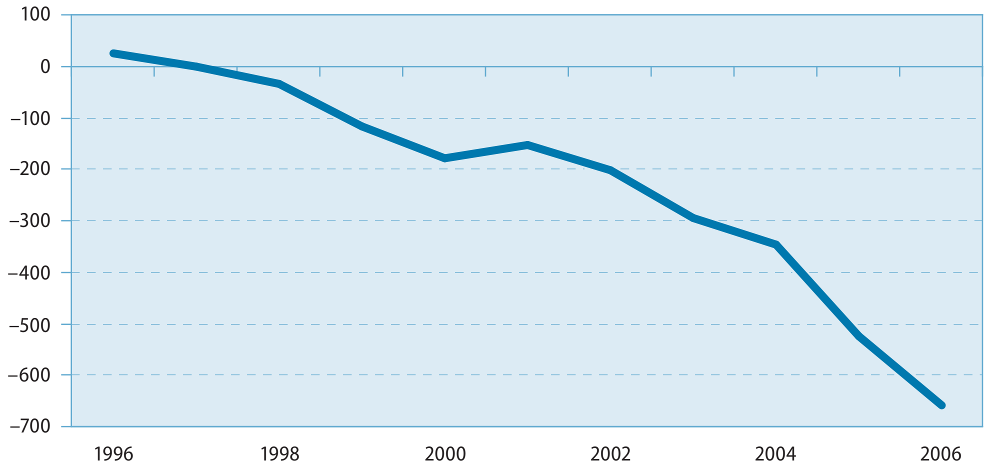
More volatile primary commodity prices

Despite a significant drop from their peak in August, average oil prices were up by 20 per cent for the year compared with the average for 2005. Prices of base metals and minerals have increased even more markedly. Only the prices of a number of beverage and food commodities have experienced some moderation. However, the prices of commodities became more volatile during 2006, and most of them experienced a significant drop in mid-2006. In the outlook for 2007, the prices of most commodities are expected to moderate.

Uncertain future of multilateral trade negotiations

Multilateral trade talks in the Doha Round were suspended in July 2006 owing to differences between major trading partners, especially in the area of agriculture and non-agricultural market access (NAMA), as well as to a more general sense that the economic and commercial benefits of any agreement would not outweigh the political costs of making additional concessions on issues often highly sensitive on the domestic political front. This represents a setback with respect to achieving the Millennium Development Goal of committing to an open and rule-based trading system. Furthermore, the proliferation of large numbers of bilateral and regional trade agreements has put the integrity of the multilateral

Increasing negative net financial transfers to developing countries and economies in transition, 1996-2006 (*billions of dollars*)



Sources: UN/DESA, based on IMF World Economic Outlook database, September 2006, and IMF Balance of Payments Statistics.

Note: Net financial transfers are defined as net capital inflows less net interest and other investment income payments to abroad.

trading system at risk. While there is currently no agreement on the next steps in the negotiating process, efforts have intensified in order to reach consensus on the resumption of the Doha Round.

The Aid for Trade Initiative

Lower tariffs and improved market access have been a strong focus of international trade negotiations. In practice, however, many developing countries, especially the least developed among them, have been unable to fully reap the benefits of improved trading conditions. For developing countries to strengthen their export performance, they need financial resources to remove supply-side constraints through investments in trade infrastructure, technology and institutions. The United Nations World Summit of September 2005 recognized this, and world leaders pledged to support and promote increased aid for building the productive and trade capacities of developing countries. Subsequently, the Aid for Trade Initiative was endorsed by the Sixth Ministerial Conference of the World Trade Organization (WTO). Further guidelines for the implementation of the Initiative have been prepared, but consultations regarding the resource requirements are still ongoing. WTO members generally consider that the work on the Initiative should continue, despite the current suspension of the Doha Round negotiations.

Finance for development

Lower, but still high, private capital flows to developing countries and transition economies

The level of net private capital flows to developing countries and transition economies in 2006 has been high in historical terms, though lower than levels recorded during the previous year. The financial-market turbulence in the second quarter of the year, the slowdown in net borrowing from commercial banks and bond creditors because of pre-financing of obligations due in 2006, and bond buy-backs have contributed to the moderation. Meanwhile, the external financing costs for emerging market economies remain low. The spreads in the Emerging Markets Bond Index (EMBI) reached all-time lows in the first quarter of 2006, then increased during the turmoil in the global markets in May-June; since then, they have tended to fall again. The benchmark interest rates underlying the external financing costs for emerging market economies are also low, despite a continuous monetary tightening in the United States. In the outlook for 2007, the level of net private capital flows to developing countries will remain high, although the risk of a slowdown in the global economy or significant tightening in liquidity in major developed countries could lead to a sharper contraction in such flows and to higher risk premia for developing countries.

Increasing foreign direct investment

Developing and transition economies play an increasingly important role as a source of global foreign direct investment (FDI) flows. The rapid industrialization in economies like China and India has led to policy-induced efforts to focus overseas investments on securing access to primary resources, while oil-producing countries have seen their investment position strengthened through higher oil revenues and strong growth rates. In this context, a sizeable portion of developing-country FDI has gone to other developing countries, broadening the range of potential sources of capital, technology and management skills for the receiving countries.

Yet, larger net transfers from poor to rich countries

Developing economies as a group, together with the economies in transition, ratcheted up their net outward transfers of financial resources to developed countries. Net transfers refer to net capital inflows less net interest and other investment income payments. Net transfers to sub-Saharan Africa have also become negative, it having been the only region with positive net transfers in previous years. This trend of poor countries financing rich countries has continued for a decade, raising questions about its sustainability. The building-up of official reserves has been a key mechanism through which these financial net transfers have occurred. Developing countries now own well over $3 trillion in foreign-exchange reserves, with China alone holding more than $1 trillion. The strengthened reserve positions have provided greater protection in dealing with external shocks emanating from volatility in world markets. The mirror image of the accumulation of reserves in developing countries is the widening external deficit of the world's major reserve currency country, the United States. Thus, while their current reserve position may have made them less vulnerable to idiosyncratic shocks, it does not insulate developing countries from more systemic shocks, such as an abrupt adjustment of the external deficit in the United States and a large devaluation of the dollar.

Increased, but still insufficient, official development assistance

Official Development Assistance (ODA) from OECD countries to developing countries rose to a record high of $106 billion in 2005. This total represents 0.33 per cent of the Development Assistance Committee (DAC) countries' combined gross national income (GNI), up from 0.26 per cent in 2004. The current projections are that total ODA by the DAC member States is expected to reach the target of $130 billion (0.36 per cent of the combined GNI of the DAC countries) set forth for 2010, although a steep climb in the flows is still required as the deadline approaches. It is important to note, however, that the recent increases in ODA have to a considerable extent been due to one-time effects such as debt forgiveness grants to Iraq and Nigeria. Given these one-off effects, donors will have to significantly increase aid in order to achieve the target ODA levels set by the internationally agreed development goals. In addition to these trends, aid from non-DAC sources has increased notably. Countries like China and India are among these "emerging donors" which have begun to contribute significant additional funding for development assistance.

Efforts to improve aid effectiveness and donor coordination need to remain centre stage as aid volumes rise and more donors enter the arena. Since maintaining taxpayer support in developed countries is critical, managing development aid in a way that delivers real results is a key condition for sustaining the momentum of aid volume increases. In addition, harmonization of development cooperation has become more complex with the increase in the number of players. In this regard, the call of the United Nations General Assembly to convene a Development Cooperation Forum in 2007 within the framework of the Economic and Social Council is timely, as this Forum has the potential to build political oversight over aid effectiveness among all donors with the broad participation of developing countries.

More debt-relief

The Heavily Indebted Poor Countries (HIPC) Initiative remains the primary international instrument for the provision of debt relief to low-income countries. The volume of debt relief has increased owing to both the progress made by eligible countries towards reaching the milestones of the HIPC Initiative process and the introduction of the Multilateral Debt Relief Initiative. However, a series of challenges remain, including increasing the resources effectively available for the implementation of poverty reduction programmes by HIPCs as well as the adoption of measures in order to avoid the re-emergence of unsustainable debt burdens.

First steps towards a reform of the international financial system

The global financial system has recently witnessed some steps towards farther-reaching reforms as well as new policy approaches. The IMF Board of Governors adopted a resolution on quota and voice reform, aiming, among other things, at quota increases for China, Mexico, the Republic of Korea and Turkey, which are the most clearly underrepresented countries in the organization. These changes, however, will not significantly alter the present balance of voting power within the IMF. Negotiations about farther-reaching quota and voice reforms are to take place in the coming years. In addition, the International Monetary and Financial Committee agreed on the need for a new framework to strengthen multilateral surveillance, and a new vehicle for multilateral consultations involving systematically important members and groupings was established to complement other surveillance approaches. The first round of consultations involving China, the euro area, Japan, Saudi Arabia and the United States will focus on reducing the global imbalances while maintaining robust economic growth. While these are steps in the right direction, reaching agreement on quota and voting power reform and on strengthened multilateral surveillance is only a first step towards broader-based consultation processes. Bolder steps need to be taken to establish a credible process of macroeconomic policy coordination under multilateral guidance in order to avoid a disorderly adjustment of the global imbalances and a major disruption in world economic growth.