Global Economic and Monitoring Unit
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LINK Global Economic Outlook

May 2006

Abstract

After the notable slowdown in late 2005, the beginning of 2006 has seen a sharp rebound in a number of major developed economies, while many developing countries maintain their momentum of solid and broad growth. A measurable moderation is, however, expected in the second half of 2006, and world gross product (WGP) is expected to register a growth rate of 3.6 per cent for the year as a whole, the same pace as in 2005 and marginally higher than what was projected at the beginning of the year in the ***World Economic Situation and Prospects 2006 (WESP)***. The breadth of good performance in developing countries seen in 2004-2005 where about half of the 107 developing countries for which data are available registered per capita growth above 3 per cent, while only a dozen or so experienced a decline, should continue in 2006. The international economic environment for developing economies and economies in transition, as measured by such indicators as the international prices of commodities, the costs of external financing, capital flows, and trade flows, is also very favourable. However, in the outlook, this environment is expected to deteriorate somewhat: monetary conditions in major economies are tightening, with investors becoming more risk-averse, real interest rates in global capital markets are rising, and the global imbalances are still widening, which may lead to a disorderly adjustment and instability for global currency and financial markets. The outlook is clouded by a number of risks: the large global imbalances remain the major source of uncertainty for the stability of the world economy; the persistence of higher oil prices may feed more fully into general prices; the cooling off in the housing sector in a number of economies may pose risks to consumer spending; rising interest rates worldwide may slow growth more than expected; the avian influenza may turn into a pandemic; and geopolitical uncertainties have the potential to weigh on investment behaviour.

United Nations

Global economic outlook 2006

Introduction

This global economic forecast was prepared by staff of the Development Policy and Analysis Division of the United Nations Department of Economic and Social Affairs based on inputs from national LINK centres and information from other sources as of 24 May 2006. The major global assumptions underlying the forecast are set out in box 1 below.

Box 1

Major assumptions for the baseline global economic forecast for 2006

After raising its main policy rate to 5.0 per cent in May 2006, the United States Federal Reserve (Fed) is expected to maintain this level for the rest of the year. The European Central Bank is expected to raise its policy rate by 50 basis points over the course of 2006, bringing it to a level of 3 per cent by the end of the year. The Bank of Japan has ended its policy of quantitative targeting for monetary policy, but is assumed to maintain its zero interest policy throughout the remainder of 2006. The assumptions regarding fiscal policy in individual countries are based mainly on official budget plans or policy statements. In general, fiscal policy worldwide is expected to be less expansionary in 2006 than in the previous year, with the exception of a few economies. The price of Brent crude oil is expected to average US$ 61 per barrel in 2006, up from an estimated average of US$ 56.5 per barrel for 2005. After another bout of $US depreciation in the first half of 2006, the dollar-euro exchange rate is expected to remain stable for the rest of the year, giving an average of $US 1.25 per euro for the year as a whole. The yen-dollar rate is expected to average yen 115 per dollar in 2006.

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

Overview

The world economy started 2006 on a strong note. While a number of major developed economies managed to rebound from the notable slowdown in late 2005, many developing countries maintained the momentum of a solid and broad growth. A measurable moderation is, however, expected in the second half of 2006, with the annual growth of world gross product (WGP) for 2006 as a whole at about 3.6 per cent (see table 1),[1] the same pace as in 2005 and marginally higher than what was projected at the beginning of the year in the *World Economic Situation and Prospects 2006* (*WESP)*. A number of downside risks have heightened most recently and they will weigh on the world economy in the near to medium future. The large global imbalances remain

1 The global projections are based on the weighted average of projected individual country growth rates using the GDP valued in 2000 dollar prices for each country. Other global projections, such as those by the International Monetary Fund, use GDP valued at purchasing power parity dollars. When using those weights the United Nation's global forecast for world economic growth would be 4.8 per cent for 2006.

Table 1.
Growth of world output, 2001-2006

Annual percentage change	2001	2002	2003	2004	2005[a]	2006[b]	2006[g]
World output[c]	1.6	1.9	2.8	4.1	3.6	3.6	3.3
of which:							
Developed economies	1.2	1.3	2.0	3.2	2.7	2.7	2.5
North America	0.8	1.7	2.7	4.2	3.5	3.1	3.1
Western Europe[d]	1.9	1.2	1.2	2.4	1.6	2.3	2.1
Asia and Oceania[e]	0.7	0.4	2.0	2.3	2.7	2.8	1.9
Economies in transition	5.7	5.0	7.0	7.6	6.3	6.0	5.9
South and Eastern Europe	4.8	4.8	4.6	6.6	4.6	4.8	4.4
Commonwealth of Independent States	6.0	5.1	7.6	7.8	6.8	6.3	6.2
Developing economies	2.7	3.9	5.2	6.9	6.1	6.2	5.6
Africa	3.6	3.3	4.7	5.0	5.3	5.9	5.5
East Asia	4.5	6.9	6.8	7.9	7.3	7.3	6.5
South Asia	4.1	5.6	7.0	7.0	6.7	6.3	6.4
Western Asia	-0.3	3.0	4.7	6.5	5.1	5.2	5.1
Latin America and the Caribbean	0.3	-0.8	2.0	5.8	4.5	4.6	3.9
Other groupings							
Landlocked countries	5.6	4.5	4.6	6.1	7.2	6.8	..
Least developed countries	6.5	6.3	6.7	6.7	6.9	7.3	6.6
Small island developing states	0.5	3.4	2.8	5.7	5.9	5.5	..
Sub-Saharan Africa[f]	4.8	3.9	3.4	5.7	5.5	6.6	5.3

Soure: Department of Economic and Social Affairs of the United Nations Secretariat (UN/DESA).

a Partly estimated.
b Updated forecasts in May 2006, based in part on Project LINK, an international collaborative research group for econometric modeling, coordinated jointly by the Economic Monitoring and Assessment Unit of the United Nations Secretariat and the University of Toronto.
c 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.
d EU-15, EU-10, Iceland, Norway, Switzerland.
e Japan, Australia and New Zealand.
f Excludes Nigeria and South Africa.
g Forecast released in January 2006 in the World Economic Situation and Prospects 2006.

the primal uncertainty for the stability of the world economy, but other sources of uncertainties are not negligible, such as the persistence of higher oil prices, the cooling off in the housing sector in a number of economies, the risk of the avian influenza turning into a pandemic, and the rising interest rates worldwide, as well as some geopolitical uncertainties.

One salient feature in the global economic expansion of the past two years has been the improvement in the breadth of growth performance among developing countries: a large number of developing countries have registered solid growth.[2] As shown in table 2, during 2004-2005 about half of the 107 developing countries for which data are available managed to register per capita growth above 3 per cent, which by rule of thumb is considered to be the threshold of growth for a developing country to reduce poverty meaningfully. Meanwhile, only about a dozen

2 See the forthcoming *World Economic and Social Survey 2006* for a comprehensive analysis of the growth divergence among the world economies in the past four decades.

Table 2.
Frequency of high and low growth of per capita output, 2003-2006

	Number of countries monitored	Decline in GDP per capita				Growth of GDP per capita exceeding 3 per cent			
		2003	2004	2005[a]	2006[b]	2003	2004	2005[a]	2006[b]
		Number of countries							
World	159	27	16	14	6	64	85	88	84
of which:									
Developed economies	33	5	1	2	0	9	16	12	13
Economies in transition	19	0	0	1	0	16	18	18	19
Developing countries	107	22	15	11	6	39	51	58	52
of which:									
Africa	51	12	10	10	5	20	19	25	19
East Asia	13	0	1	0	0	6	11	11	11
South Asia	6	0	0	0	0	5	5	5	5
Western Asia	13	4	2	0	1	5	6	6	6
Latin America	24	6	2	1	0	3	10	11	11
Memorandum items:									
Least developed countries	41	10	11	7	5	18	15	19	15
Sub-Saharan Africad	44	12	10	9	5	15	15	19	13
Landlocked developing countries	26	4	4	5	1	12	10	13	12
Small Island developing states	17	4	4	3	1	2	6	7	6
	Share[c]	Percentage of world population							
Developed economies	15.4	1.9	0.0	1.1	0.0	1.3	6.8	1.5	1.6
Economies in transition	5.6	0.0	0.0	0.1	0.0	4.7	4.8	5.1	5.1
Developing countries	79.0	7.1	2.0	1.6	0.8	60.1	66.4	68.0	65.2
of which:									
Africa	13.5	2.3	1.1	1.6	0.4	6.8	6.2	9.9	6.8
East Asia	30.8	0.0	0.0	0.0	0.0	27.8	30.3	30.2	30.1
South Asia	23.3	0.0	0.0	0.0	0.0	23.2	23.3	23.4	23.5
Western Asia	2.9	0.8	0.6	0.0	0.3	1.6	1.8	1.7	2.1
Latin America	8.6	3.9	0.2	0.0	0.0	0.7	5.0	2.9	2.9
Memorandum items:									
Least developed countries	10.7	1.9	1.4	0.6	0.6	6.8	7.5	8.0	6.6
Sub-Saharan Africad	8.4	2.3	1.1	1.1	0.4	3.5	4.7	5.2	3.6
Landlocked developing countries	5.1	1.6	0.7	0.6	0.2	1.3	2.1	2.9	1.6
Small Island developing states	0.8	0.2	0.2	0.0	0.0	0.0	0.1	0.3	0.3

Source: UN/DESA, 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 Percentage of world population for 2000.
d Excludes Nigeria and South Africa.

developing countries experienced a decline in per capita GDP during 2004-2005, the smallest number in decades. Such a trend is expected to remain in 2006.

The international economic environment for developing economies and economies in transition, as measured by such indicators as the international prices of commodities, the costs of external financing, capital flows, and trade flows (see table 3), is generally very favourable. In the outlook, however, such an environment will deteriorate somewhat: monetary conditions in major economies are tightening, investors are becoming more risk averse so that real interest rates in global capital markets are rising, and the global imbalances are still widening, which may lead to a disorderly adjustment and instability for global currency and financial markets.

The growth of world *merchandise trade* has stabilized at a moderate annual pace since 2005, but is still at 7 to 8 per cent. The exports of developing countries continue to grow faster than those of developed countries, thereby increasing their share in the world market. This increase is particularly evident for some of the most dynamic developing countries, such as China and India, whose exports are growing at an annual rate of 20 per cent or more. An expected rebound of business investment in many countries from the weakness of the past few years may lead to increases in global demand for capital goods, thereby raising the exports of major developed countries such as the United States and Germany. Meanwhile, continued robust growth in a few large developing countries should sustain strong international trade flows of energy and primary commodities.

Table 3.
Indicators of the international economic environment, 2000-2005

	2000	2001	2002	2003	2004	2005[a]	2006[b]
World trade merchandise							
Growth of volume of world exports (per cent)	10.8	-0.9	3.0	6.4	11.0	7.1	7.0
Value of exports from developing countries (billions of dollars)	1913.6	1797.5	1938.4	2285.5	2876.9	3524.8	3911
United States trade deficit ($billions)	378	362	421	496	516	726	752
World prices							
Oil (Brent) ($ per barrel)	28.3	24.4	25	28.9	38.3	54.43	63
Non-fuel commodities (Index: 2000=100)	100	96	97	105	126	141	..
Manufactures (Index: 2000=100)	100	98	98	107	115	118	..
Real prices of non-fuel commodities (Index, 2000=100)	100	98	99	98	110	119	..
Exchange rate of US dollar							
Nominal trade-weighterd index (January 1997=100)	119.4	125.9	126.7	123.2	113.6	111.56	..
Euros per dollar	1.09	1.12	1.06	0.89	0.81	0.80	0.78
Yen per dollar	107.8	121.5	125.4	115.9	108.2	110.2	110.0
Financial flows to developing countries ($billions)							
Net transfer of resources	-192.4	-163.6	-215.6	-302.1	-374.0	-483.4	..
Official development assistance	53.8	52.4	58.3	69.1	79.6	106.5	..
Net direct investment	140.8	152.8	114.4	134.4	153.7	172.1	..
Global interest rates (per cent)							
LIBOR interest rate	6.6	3.7	1.9	1.2	1.8	3.8	..
Spread on developing country bonds (percentage)	7.5	8.4	7.8	5.6	4.4	3.0	..

Sources: DESA, based on Project LINK and international sources.

a Partly estimated.

b Forecast, based in part on Project Link.

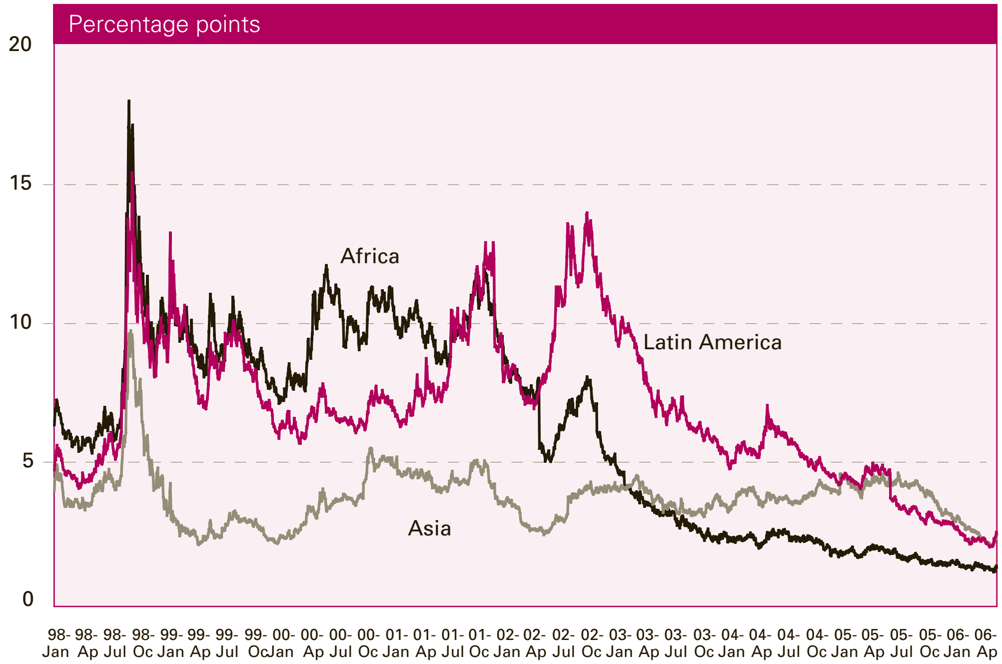
The momentum of international trade in the future will depend in part on the progress in *multilateral trade negotiations*. The Sixth WTO Ministerial Conference in Hong Kong (SAR) of China at the end of 2005 achieved modest results. An agreement was made to eliminate all forms of agricultural export subsidies by the end of 2013, in a progressive manner. Developed countries agreed to provide duty-free and quota-free market access for products originating from the LDCs by 2008. This would apply to all products, except that the preference-giving countries will get the flexibility to exclude up to 3 per cent of the number of products originating from LDCs. Another decision was made to eliminate all forms of export subsidies for cotton by developed countries in 2006 and to grant duty- and quota-free access for cotton exports from the LDCs. The Conference also recognized the importance of Aid for Trade to help developing countries, particularly the LDCs, to improve supply-side capacity and trade-related infrastructure in order for them to implement and benefit from WTO agreements and to cope with short-term adjustment costs associated with trade liberalization. A more concrete agenda was set for further negotiations, to complete all the items on the Doha agenda by the end of 2006. Progress in the early part of 2006 has, however, been disappointing: the negotiations at the WTO failed to meet the deadline of April 30 for establishing modalities for Agriculture and Non-Agriculture Market Access, as a result of persistent disagreement among the member countries.

The *terms of trade* continue to improve for many commodity-exporting developing countries. Oil prices, which more than doubled over the past two years, climbed further during the early part of 2006, surging to $75 per barrel in mid-April. While the prices of precious metals have approached their highest levels in decades, the prices of base metals and minerals have also continued on the upward trend of the past few years. Only the prices of a few beverage and food commodities have experienced some moderation. At issue is the sustainability of the upward trend in the prices of most commodities. A strong demand for primary commodities stemming from the robust growth in China, India and some other developing countries and tight supply capacity in some commodities have been the key factors behind the increase in these prices over the recent years, but there have also been other factors beyond the economic fundamentals, such as the heightened geopolitical uncertainties and market speculation. These non-economic factors have made the prices more volatile than otherwise and led to an inefficient allocation of resources for both the producers and the users of primary commodities. In view of the past history of high volatility in commodity markets, primary commodity exporting countries should be vigilant about the risk of a sharp reversal in prices.

Private capital flows to emerging market economies were strong in 2005, and the momentum continued in the early part of 2006, but a certain degree of moderation is expected in the outlook, particularly in non-FDI flows, as most of the favourable conditions that bolstered capital flows over the past two years seem to have been phasing out. Despite buoyant private capital markets, the net transfer of financial resources to developing countries is increasingly negative; there is a rising flow of capital—net of interest and other investment income—moving from developing to developed countries. Net transfers are still positive for sub-Saharan Africa, but declining. This flow of resources from poor to rich countries has increased over the past ten years. The widening external deficit of the United States is absorbing the major share of those transfers.

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 (see figure 1). The current level of spreads, however, may not be sustainable, as debt ratios in some countries are high. More importantly, a noticeable spike in the benchmark long-term rates of the United States treasuries in March-April 2006 may be worth noting. During the past two years when the United States Fed raised the policy interest rates by about 400 basis points, long-term interest rates stayed unusually low, leading to a flattened yield curve, which was considered

Figure 1.
Yield spreads for developing countries, January 1998-April 2006



Source:
J.P. Morgan Chase.

a "conundrum" by some analysts. In March-April 2006, however, interest rates of the long-term United States treasuries moved up by about 50 basis points, to push the rates to the highest level in 4 years. The factors behind the recent increases in the long-term interest rates seem far beyond the concerns about higher inflation. For example, a comparison of 10-year yields on Treasuries and 10-year Treasury Inflation Protected Securities shows only one third of the recent rise in long-term interest rates could be attributed to a higher inflation expectation, while the rest reflected an upward adjustment in investors' assessment of other risks in the future. One of these risks is the possibility for an abrupt adjustment in the global imbalances. The current levels of long-term interest rates are still not high by historical standard, but the recent move indicates once again that international investors' risk aversion can change quickly.

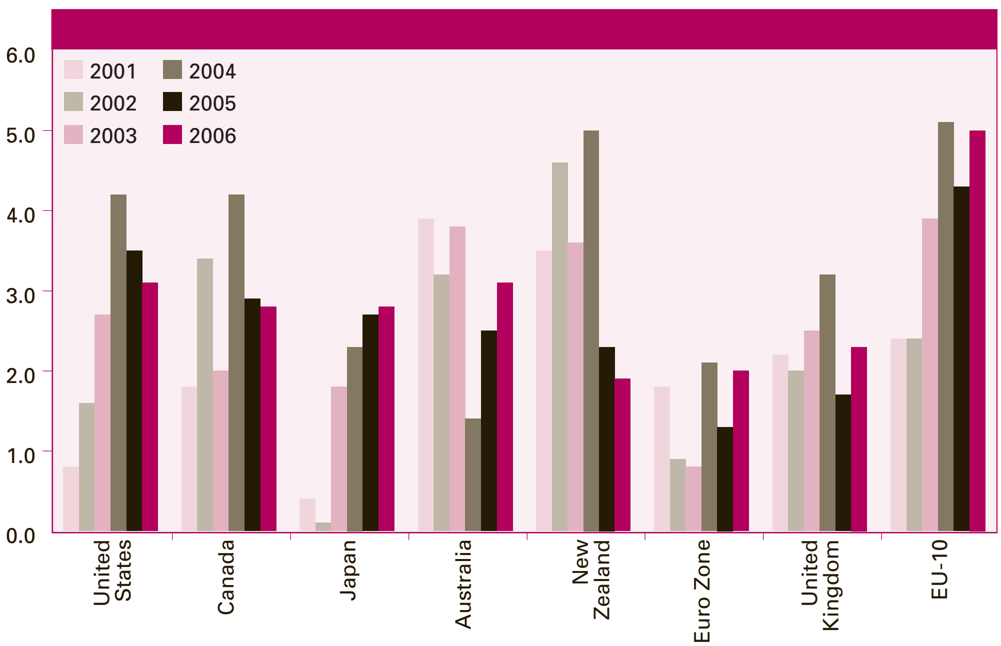
Official Development Aid (ODA) has recently increased in nominal terms, but the amount of aid received by the LDCs in recent years, excluding resource flows for emergency assistance, debt relief and reconstruction, was only marginally higher than that of a decade ago. In 2005, some progress was made in official development cooperation. The international community reiterated that improving the quality of aid is as important as mobilizing more aid. Meanwhile, developing countries, particularly in Africa, have continued their efforts to forge a multi-actor and multi-dimensional partnership with the developed countries, focusing on efforts towards capacity building, establishing and maintaining peace and security and building an enabling climate for business investment. Yet, many more efforts are needed for donor countries to live up to the commitments made at the 2005 World Summit.

A few more countries have reached the completion point in 2005 under the *Heavily Indebted Poor Country* (HIPC) Initiative, with its implementation continuing to progress slowly. As a result of debt relief under the HIPC Initiative, most debt indicators of developing countries have improved, including the debt-service ratios.

Regional outlook highlights

Among *developed countries* (see figure 2), the economy of the *United States* is increasingly challenged by a number of structural macroeconomic weaknesses, despite exceptionally strong growth in the first quarter of 2006. Growth of private consumption is expected to slow considerably in the face of higher energy prices, rising interest rates and a cooling housing market. On the other hand, a continued modest improvement in employment could prevent household spending from experiencing an excessive retrenchment, and the prospects for business investment remain robust, buttressed by record corporate profits and ample cash positions. While the baseline outlook for GDP growth remains at about 3 per cent for 2006 as a whole, major downside risks exist: a larger-than-expected decline in house prices and/or further substantial increases in energy prices, for example, would lead to a much more severe downward adjustment in private consumption, which in turn, given the protracted large external deficit, could cause an abrupt adjustment in its current account imbalance, derailing not only the growth of the United States but also the growth of the world economy.

Figure 2.
Annual rates of GDP growth in selected developed countries, 2001-2006



Source: UN/DESA, based on OECD and Project LINK.

The growth prospects for *Western Europe* have improved, but only marginally. GDP growth in the euro area is forecast to be about 2 per cent for 2006, a slight upward revision from the *WESP 2006*. A number of leading indicators are positive, with industrial confidence climbing steadily, particularly in Germany, and consumer confidence also improving, although less robustly. Investment is expected to be the major driver of growth, and will be supported by increased rates of capacity utilization, robust export demand, improved corporate balance sheets, and continuing favorable financing conditions. Real interest rates both long and short-term remain historically low, and the gradual return of policy to a more neutral level is not expected to have a major impact in the near term. Household consumption has been weak, but is expected to recover gradually over the year, supported by moderate growth in employment, but dampened by higher oil prices. Government spending will be unable to add much to growth at the aggregate level due to severe fiscal constraints in most of the major economies.

For the group of *new EU members*, broad-based growth is expected to continue in 2006. More contribution from domestic demand is expected in Central Europe, in spite of slower real wage growth. In the Czech Republic and Hungary, a reduction in the income tax and pre-electoral spending will provide some boost to private consumption, while in Poland consumption will be supported by lower interest rates, an improving employment situation and higher real wages. Foreign direct investment flows are expected to continue throughout the region, and public investment projects associated with the utilization of the EU funds will also contribute to growth. Some moderation of domestic demand is expected in the Baltic States, where growth will likely decelerate somewhat, remaining nevertheless robust, driven by strong exports and double-digit investment rates.

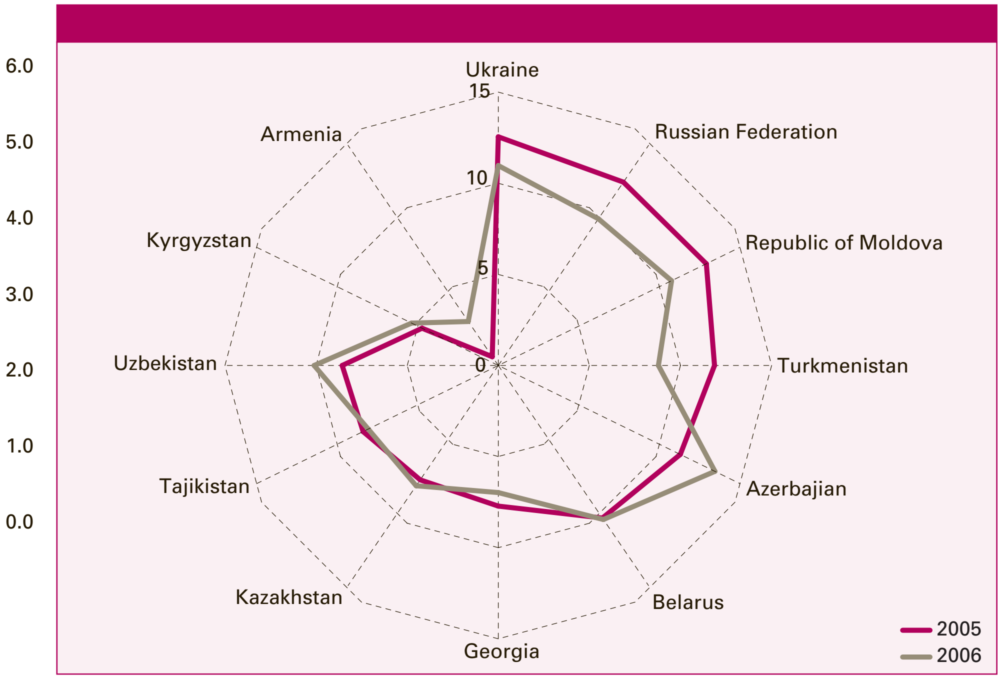
Japan's economic expansion continues at a stronger-than-expected pace. While the export sector remains an important source for growth, domestic demand has strengthened, supporting the overall economic expansion. Business investment is expected to pick up, as corporate profitability improves significantly. More progress has been made in restructuring the corporate sector and financial system to reduce non-performing loans, and bank lending has stabilized after declining for years. Household consumption, which had lagged in the recovery of the previous years, has finally strengthened. With further improvement in wages and employment, growth in household consumption is expected to continue. On the other hand, some drag will come from the public sector, as the government aims at further fiscal consolidation through spending cuts and the reversal of previous tax cuts. Meanwhile deflation, which the economy has been mired in for a number of years, is expected to end in 2006, as prices, including property prices, are recovering.

Among *other developed economies*, the Canadian economy will maintain a growth near its long-run potential pace of 3 per cent, supported by the strong external demand for and higher prices of commodities, and improvement in employment. Australia also continues to benefit from a strong external demand, offsetting to some extent the weak private consumption due to a slowing housing sector and higher energy costs. In contrast, growth in New Zealand is expected to decelerate significantly due to a falling net immigration after the boom in the previous years and the tighter monetary policy stance.

Among the *economies in transition*, growth in the *Commonwealth of Independent States* (CIS) is expected to remain robust, above 6 per cent, benefiting from higher commodity prices, in particular for oil, gas and metals. Private consumption is boosted by rising wages and pensions, underpinned by fiscal stimuli and credit expansion. Investment also picks up, largely in oil-exporting countries. A certain moderation in growth is expected in the Russian Federation, as a result of rising production costs, the continued real appreciation of the ruble, and inadequate investment levels. In Ukraine, after a sharp deceleration in 2005, political and economic uncertainties continue to weigh on the growth prospects. By contrast, growth in a few CIS economies in Central Asia is outperforming the regional average by a large margin, for example, Azerbaijan by over 20 per cent boosted by strong exports of oil and Armenia near 10 per cent driven by rapid expansion of construction and private consumption. Major risks for the region include the building up of inflation pressures (see figure 3), the volatility in commodity prices and the continued real appreciation of the currencies.

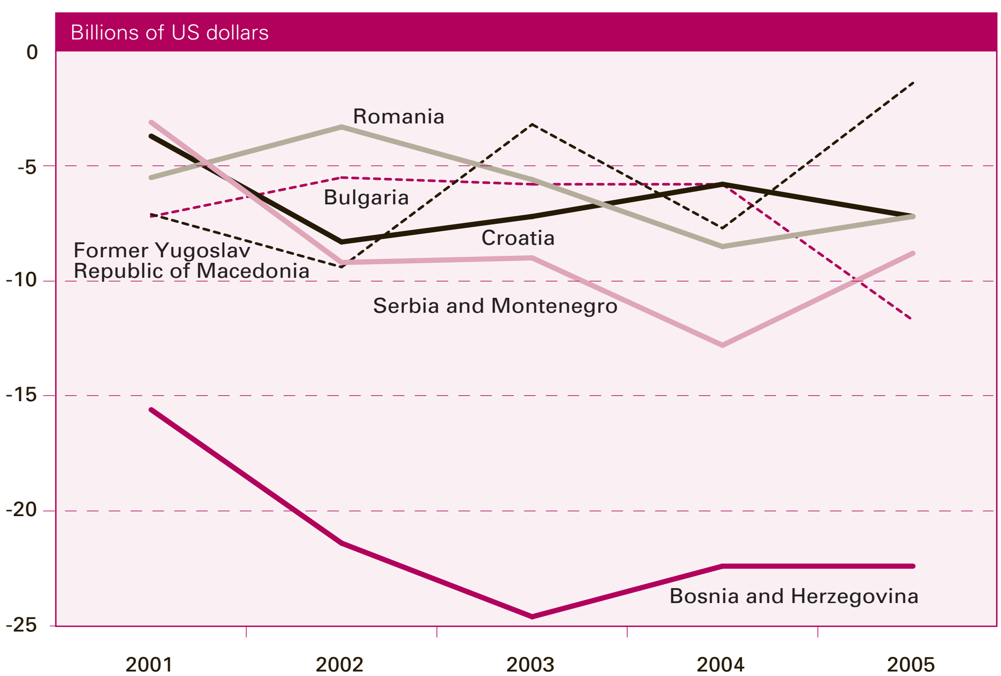
For the rest of the economies in transition, *Southeastern Europe* is expected to grow by about 4.8 per cent in 2006. Some slowdown is possible in private consumption in response to policy measures adopted in the wake of escalating external imbalances (see figure 4) for cooling down private demand, while investment, including public investment supported by the

Figure 3.
Inflation rates of CIS countries



Source:
UN/DESA based on CISSTAT and Project LINK.

Figure 4.
Current-account balances of transition economies in Southeastern Europe, 2001-2005

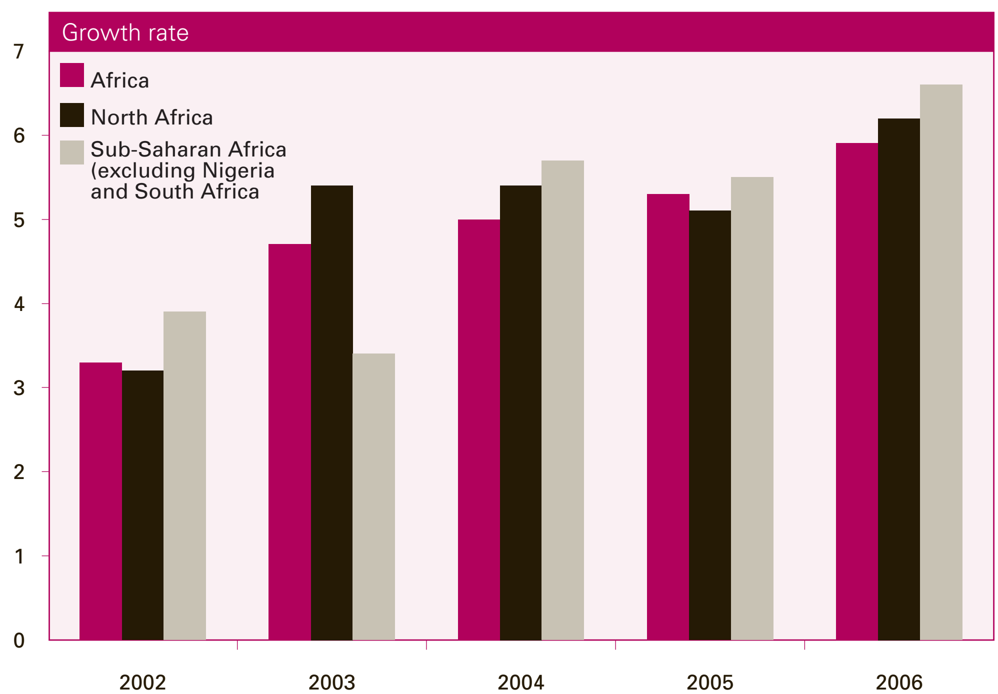


Source:
UNECE and national statistics.

EU pre-accession assistance for the candidate countries, should boost growth. Improvements in productivity will likely sustain a robust expansion in exports, although some adverse effects are expected from currency appreciation in some countries and from the phase-out of the multi-fiber agreement in the previous year—especially the increased competition from Asian textile products in the EU markets.

Among *developing countries*, growth in *Africa* will continue to expand by more than 5 per cent in 2006 (see figure 5), maintaining the momentum gained over the past three years. Many countries are expected to benefit from robust exports of oil and some non-oil commodities, buoyant domestic demand, as well as increased FDI flows and donor support in the form of ODA and debt relief. On the other hand, several countries will likely suffer from weak agriculture caused by adverse weather conditions in the last quarter of 2005 and the continuing decline in textiles and clothing exports. Growth in all Northern African countries is expected to accelerate in 2006. While continued strong hydrocarbon earnings will support public consumption and investment in Algeria and the Libyan Arab Jamahiriya, GDP in Egypt will be buttressed by export growth, private investment, and higher receipts from tourism and the Suez Canal. Morocco's GDP growth is also expected to recover from a severe contraction caused by inadequate rainfall in the previous year. In sub-Saharan Africa, excluding Nigeria and South Africa, growth is projected to be more than 6 per cent in 2006 (see more details in box 2 for the Least Developed Countries). South Africa's GDP growth will moderate slightly, although remaining strong, while Nigeria's growth will decelerate to about 5 per cent due to increased disruption in oil production, partly offsetting the relatively robust growth in the agricultural and manufacturing sectors.

Figure 5.
Growth of real GDP in Africa, North Africa and Sub-Saharan Africa, 2002-2006



Source:
UN/DESA based on Project LINK.

Box 2

Prospects for the Least Developed Countries

Many Least Developed Countries (LDCs) have sustained a strong growth, averaging more than 6 per cent per year, since 2001. Growth performance varied widely within the group, however. 15 LDCs (only 41 out of 50 LDCs have data to monitor) are expected to have per-capita GDP growth of 3 per cent or above in 2006, slightly down from 19 in 2005. Meanwhile, 5 LDCs are expected to suffer a decline in per-capita GDP in 2006 (see table 2). In 2005-2006, sustained high oil exports earnings and stronger public spending are expected to support strong GDP growth rates in a number of oil-exporting countries, such as Angola and Sudan. Some other LDCs are also expected to see terms-of-trade gains.

In the majority of the LDCs, however, economic growth depends significantly on agricultural production, which is vulnerable to weather conditions. Most LDCs enjoyed good harvests in 2005, with the exception of those affected by drought, food shortages and related inflationary pressures. Lesotho, Malawi, and Niger were hardest hit by drought and food shortages. The competitiveness of the manufacturing sector in most LDCs is weak, and, with a few exceptions, this sector contributes little to export growth. The loss of trade preferences associated with the Agreement on Textiles and Clothing (ATC) in 2005 hit some LDCs, including, Lesotho, Madagascar, and Malawi, hard. These effects will continue to be felt in 2006 in some countries. Bangladesh is an exception, and has been able to weather the shock well and managed to expand textile production and exports. The most vulnerable LDCs are the net-oil-importing countries, which suffer from high oil prices, do not gain from higher, non-oil primary commodity prices and have limited access to external financing. Those and other adverse factors have constrained economic growth in countries such as the Central African Republic, Eritrea, Guinea, Guinea-Bissau, and Togo.

Political stability and sound macroeconomic policies continue to be crucial for growth in the LDCs. Improved political and economic governance have directly contributed to sustained growth rates of above 5 per cent during the past three years in countries such as Cape Verde, Madagascar, Mozambique, Senegal, Tanzania and Zambia. Meanwhile, the ongoing civil conflicts in Côte-d'Ivoire (which is not an LDC) and the Darfur region of Sudan remain of great concern, not only because of the consequences for the inhabitants of those countries, but in view of the potentially destabilizing effects on neighboring countries. Increased tensions on the Chad-Sudan border, for instance, are partly responsible of the rapid deceleration of GDP growth in Chad in 2005-2006.

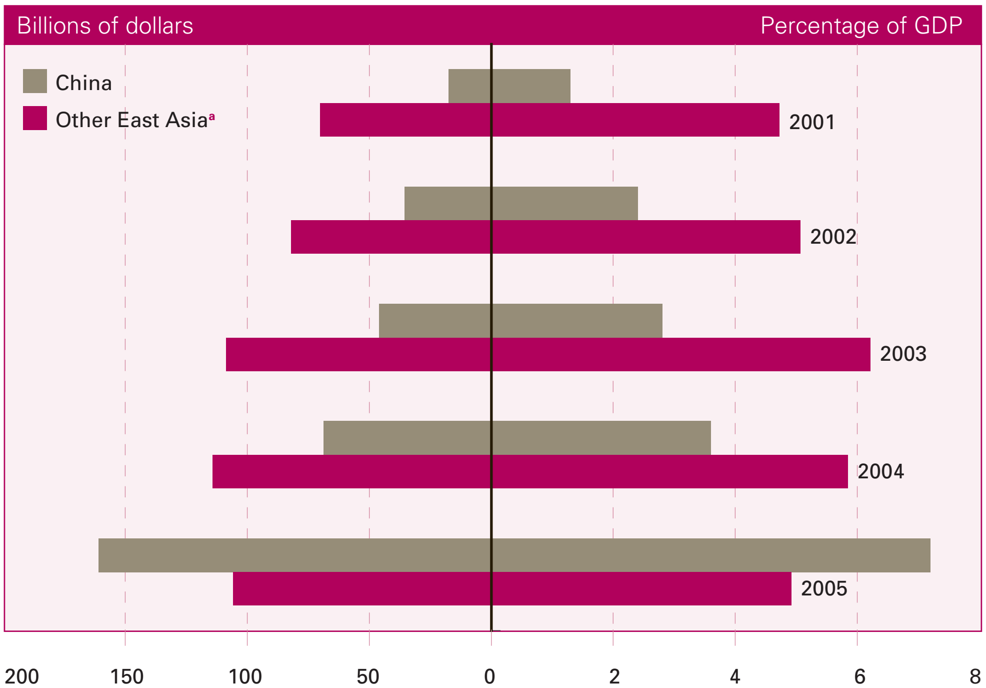
Many LDCs will continue to pursue relatively cautious monetary and fiscal policies. LDCs that experienced lower export earnings and higher import costs will have to rely on additional official development assistance (ODA) and debt-relief to avoid a major recession. The new plans announced by the European Union (EU) in 2005 to substantially increase aid flows to Africa and to improve the coordination of bilateral aid programmes and policies of member states, when fully implemented, are expected to enhance prospects for many LDCs in the region for achieving the Millennium Development Goals (MDGs). The recent decision to write off multilateral debt owed by heavily indebted poor countries is expected to facilitate the long-term debt sustainability in many LDCs.

Growth in *East Asia* is expected to maintain a strong momentum, above 7 per cent, led by China.[3] Along with some tightening measures to prevent the economy from overheating, China's growth in 2006 is expected to decelerate marginally. While investment will continue to

3 Compared with the *WESP 2006*, this document includes the revision of the Chinese GDP numbers as released by the Chinese authorities at the end of 2005.

post strong growth, private consumption is expected to strengthen, resulting from a number of policy initiatives to boost income and consumption in the rural area. Export growth is expected to remain high, only to slow somewhat from the pace of the previous year, and import growth is likely to accelerate, underpinning strong current-account positions in the region (see figure 6). A

Figure 6.
East Asia Current-account surplus, 2001-2005



Sources:
UN/DESA, based on IMF, *World Economic Outlook 2006* and national sources.

a Other East Asia in this case comprises Hong Kong Special Administrative Region (SAR), Indonesia, Republic of Korea, Malaysia, Philippines, Singapore, Taiwan Province of China, Thailand, and Vietnam.

continued upswing in global electronics demand will benefit the economies such as the Republic of Korea, Malaysia, Singapore, and Taiwan Province of China. Meanwhile, a pickup in tourism is expected to raise growth in Thailand only slightly above its post-tsunami performance in 2005, as planned large public infrastructure spending will be delayed until the current political uncertainty is resolved. Hong Kong (SAR) is expected to register a slight slowdown, owing to the maturing of its economic cycle. In light of the increased regional and international incidence of the avian influenza since the beginning of 2006 (see box 3), the risk of further outbreaks among poultry and humans and the potential of a human pandemic should not be underestimated. Other downside risks for the region also include more protectionist trade policies in the region's main export destinations.

South Asia will continue a strong growth in 2006, above 6 per cent, only slightly below the previous year. India is expected to experience a moderate cyclical downturn, as is Pakistan, which posted record growth in the fiscal year ending June 2005. Growth in the Islamic Republic of Iran in 2006 is likely to surpass the pace of last year, due to increased public spending. As in 2005, growth in 2006 will be broad based across economic sectors, although agricultural output growth in most countries will likely slow after the rebound in 2005, except in Bangladesh, where agricultural growth is expected to recover from last year's severe flood damages. Industrial production and the services sector will remain buoyant throughout 2006. Domestic demand will continue to be driven by private consumption demand and public investment. Many governments are planning significant infrastructure investments, and post-tsunami

Box 3

Risks of a global influenza pandemic

In the first four months of 2006, 63 new cases of human infections with avian influenza were reported, 39 of them fatal. Total mortality has thus risen to 122 since the first recorded outbreak of the A (H5N1) strain of the virus in Hong Kong (SAR) in 1997.[a] In addition to the increased number of human infections, the incidence of the virus in animals has also spread geographically, reaching South- and Central Asia, as well as Europe and Africa.

If avian influenza remains in its essence a bird disease, the economic impact will be limited to the poultry sector, as well as upstream and downstream industries. A larger risk is, however, that the virus could mutate to become efficiently transmissible in human-to-human contact[b], resulting in large social and economic costs at a global scale. According to the World Health Organization, the world is closer to a pandemic now than it has been since 1968.[c]

To assess the potential economic impact, several studies have drawn on past experiences with Severe Acute Respiratory Syndrome (SARS) in 2003 and with the three influenza pandemics of the twentieth century (in 1918/19, 1957/58, and 1968/69). These estimates of economic costs vary in a large range between 0.1 and 10 per cent of GDP in the year of the pandemic, depending on underlying assumptions and types of models (see table). One general perception is, however, that any economic downturn will be only of short duration, as production, consumption and investment are likely to rebound quickly after the pandemic.

On the supply side, absenteeism—owing to illness, the need to care for relatives, and/or the fear of being infected—in combination with reduced labour productivity[d], is likely to have a sharp, but temporary impact on economic activity. Only to a limited extent will this be mitigated by the possibility for telecommuting. The absolute number of possible deaths, which has been estimated to lie between five and 150 million worldwide, might also affect GDP in the longer term, through its effects on the labour force and dependency ratios.

Demand side factors, while also temporary, are even harder to estimate, as they are largely subject to psychological responses. Drawing on the experiences with SARS, most studies assume that demand side effects will be more severe than the supply side effects, as households would forego or hold back consumption, either for lack of income or for fear of contagion in public spaces. Investment is also likely to be postponed until the end of the pandemic. Meanwhile, substitution effects would benefit certain business sectors at the expense of others.

Prevention of influenza pandemic: The prevention of an influenza pandemic as well as its containment, should one occur, should be considered as a global public good. Once the virus becomes efficiently transmissible between humans, it will not stop at national borders. Efforts to contain the virus at its source, by culling infected poultry and taking follow-up measures to keep the virus from spreading to other animals or humans, are essential to decrease the risk of a dangerous mutation. In addition to purely humanitarian concerns, it is therefore in the international community's own best interest to assist poor countries in preventing and controlling outbreaks.

Owing to technical constraints and the limited scale of vaccine production, it will take several months after the first outbreaks to develop an effective vaccine, and more time to produce an adequate supply for the world's population.[e] Early quarantine measures and travel restrictions, as well as targeted treatment with antiviral drugs can buy valuable time for generating such a vaccine. This could help to attenuate at least the second wave of the pandemic (past pandemics have typically occurred in two or three distinct waves over time).

Therefore, international cooperation and technical and financial assistance are essential. Preparedness and contingency planning is needed at the global, national, and local level, in the

a World Health Organization, as available from http://www.who.int/csr/disease/avian_influenza/country/cases_table_2006_05_8/en/index.html (accessed May 9 2006).

b The A(H5N1) influenza virus already fulfills two out of three prerequisites for the start of a pandemic: It is a novel virus, to which the general population has no or little immunity; and it is able to replicate in humans and causes serious illness. The third prerequisite is efficient human-to-human transmission, which it could acquire either through mutation (antigenic drift) or through a gene-swap with a human influenza virus (antigenic shift). See for example World Health Organization: "Avian influenza: assessing the pandemic threat". WHO/CDS/2005.29 Available from http://www.who.int/csr/disease/influenza/H5N1-9reduit.pdf (accessed April 12, 2006).

c World Health Organization (2005): Avian Influenza: assessing the pandemic threat. WHO/CDS/2005.2. Geneva, January. Available from http://www.who.int/csr/disease/influenza/H5N1-9reduit.pdf (accessed May 09 2006).

d Labour productivity is expected to decrease because of a likely reduction in other essential production inputs.

e While a prototype vaccine can be developed based on a subtype of the virus, it will have to be adjusted to the exact characteristics of the yet unknown mutated version in order to be effective.

Box 3 (cont'd)

Table
Percentage points of GDP growth decline in year of pandemic

Study[a]	Region	Scenario	Demand-side effect	Supply-side effect	Total effect
ADB	Asia	Mild	2.3	0.3	2.6
		Severe	6.5	0.3	6.8
CBO	US	Mild	0.5	1.0	1.5
		Severe	2.0	3.0	5.0
CDF	Canada	Mild	0.0	0.1	0.1
		Moderate	0.1	0.2	0.3
		Severe	0.4	0.3	0.7
		Ultra	0.4	0.5	0.9
Brookings	US (and other countries, not reported here)	Mild	0.0	0.6	0.6
		Moderate	0.2	1.2	1.4
		Severe	0.4	2.7	3.0
		Ultra	0.8	4.8	5.5
BMO NB	Global	Mild	0.5	1.0	1.5
		Severe	2.0	3.0	5.0
GI	Global	Mild			1-2
		Moderate			3-4
		Severe			4-5
		Ultra			6-10

Source: Based on BMO Nesbitt Burns (March 2006), UN Staff research.

a Detailed references for Studies:

ADB: Bloom, Erik, Vincent de Wit, and Mary Jane Carangal-San Jose (November 2005): Potential Economic Impact of an Avian Flu Pandemic. Asian Development Bank, ERD Policy Brief No. 42.
CBO: Congressional Budget Office (December 2005): A Potential Influenza Pandemic. Possible Macroeconomic Effects and Policy Issues.
CDF: Canadian Department of Finance, Economic Analysis and Forecasting Division (February 2006): The Economic Impact of an Influenza Pandemic. Mimeo.
Brookings: McKibbin, Warwick, and Alexandra Sidorenko (February 2006): Global Macroeconomic Consequences of Pandemic Influenza. Brookings Institution and Lowy Institute for International Policy.
BMO NB: Sherry Cooper (March 2006): The Avian Flu Crisis. An Economic Update. BMO Nesbitt Burns Special Report.
GI: Global Insight: World Overview, First Quarter 2006, pp 16 - 19.

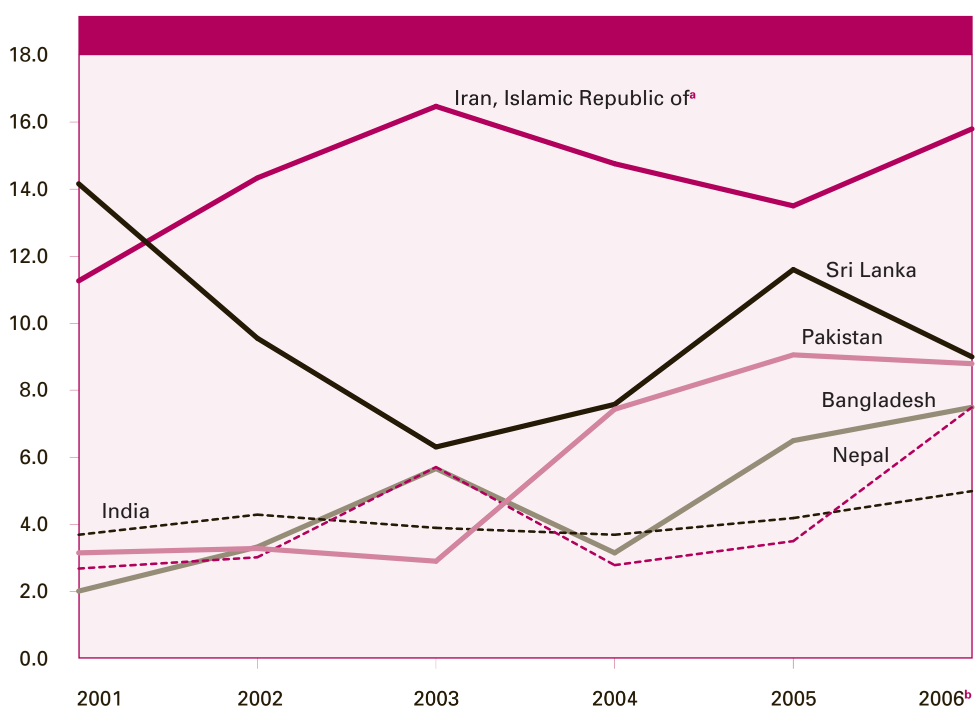
public and private sector. Surveillance measures, effective communication mechanisms, and quick response capacities need to be established, and healthcare systems must be prepared to handle peak numbers of patients. Increased international cooperation can also help to improve the process of vaccine development and the scale of production, and it can help to step up efforts to produce and distribute antiviral drugs.

Costly preparatory measures for an uncertain event can be hard to justify in the presence of competing budget pressures, but they will likely pay off in the medium term, even if the A (H5N1) virus does not trigger the next global influenza pandemic. Improvements in the vaccine production process and the enhancement of international surveillance and communication mechanisms are a case in point. They can help to fend off future pandemics triggered by different influenza strains, and contribute to fighting other global diseases or coping with natural disasters. These medium-term benefits add to the case for international cooperation and investment in pandemic prevention and preparedness.

reconstruction activities in Sri Lanka and the Maldives continue. Pakistan has also entered the reconstruction phase after the October 2005 earthquake. Private investment is also picking up in some countries, most notably in India, where sustained growth and reforms have contributed to a rise in investor confidence. Downside risks for the region, besides inflationary pressure (see figure 7) due to higher oil prices, as well as avian influenza, include the uncertainties around the international settlement of the nuclear issue in the Islamic Republic of Iran, and continued political instability in Nepal and Sri Lanka.

Growth in *Western Asia* continues to benefit from booming oil revenues. In the oil-exporting economies of the Gulf Cooperation Council (GCC), rising trade surpluses and fiscal expenditures, along with wealth effects from asset prices and ample credit to the private sector, have been stimulating consumption and investment. With oil prices staying at high levels, some countries, such as Saudi Arabia, have planned to increase investment in the oil sector and broad infrastructure, which will sustain strong growth in the outlook. For oil-importing countries in the region, despite suffering from falling terms of trade, these economies have benefited from spillover effects emanating from the oil boom, as workers' remittances from the Gulf have increased. A positive trend in intraregional tourism flows supported demand expansion, particularly in the Syrian Arab Republic, and Jordan. Jordan has also benefited from inflows of capital and skilled labour. Growth in Turkey is moderating from the exceptionally strong expansion of last year, but can still reach 6 per cent in 2006: domestic demand is strong, but the widening current account deficit is a challenge. For the region, in addition to the chronic, as well as new, geopolitical uncertainties, other downside risks are associated with the booming real estate and financial markets fueled by surging oil revenues, which could lead to a burst when oil prices reverse the trend.

Figure 7.
South Asia CPI inflation, 2001-2006



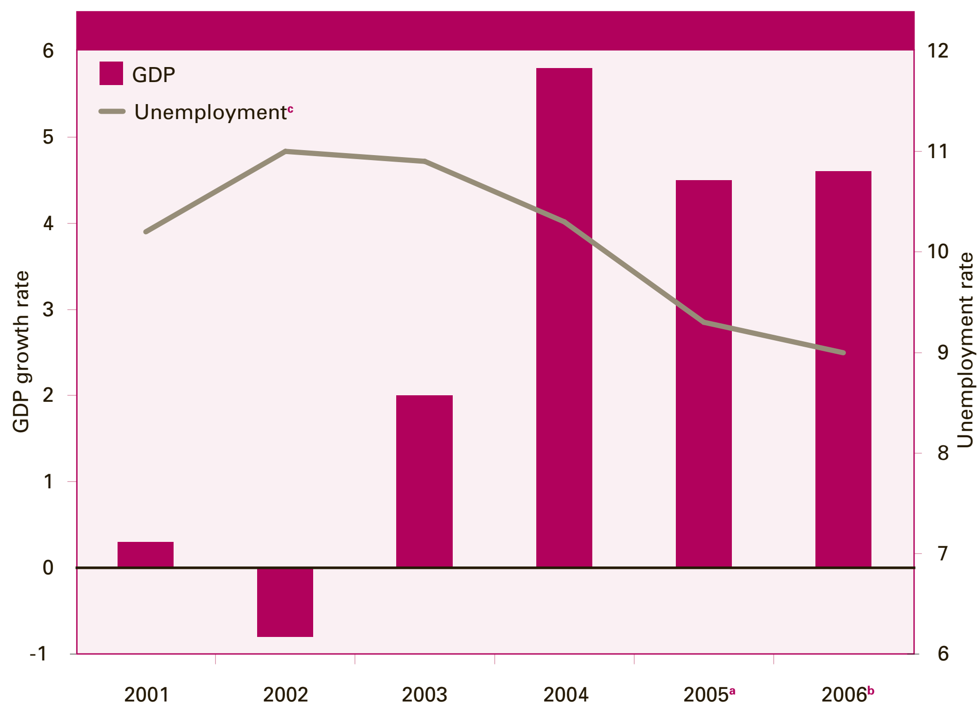
Source:
UN/DESA, based on IMF, International Financial Statistics.

a Data for Islamic Republic of Iran corresponds to fiscal years (beginning on March 21 of indicated year).

b Forecast, based in part on Project LINK.

The growth prospects for *Latin America and the Caribbean* have been upgraded slightly from the last forecast in *WESP 2006*, due mainly to improved conditions in Argentina, Brazil, Peru, Uruguay and Venezuela, delaying the previously anticipated mild slowdown. The improved outlook relies on both a continued favorable external environment and a strengthened domestic demand. This favorable conjuncture should help improve employment conditions as unemployment rates are expected to continue their steady decline reaching around 9% in 2006 (see figure 8). Monetary easing since the end of 2005 in the two largest economies, Brazil and Mexico, has helped revive real investment from contractions in the previous year. Investment has also accelerated in Argentina, especially in construction and commerce, boosting a higher-than-expected growth. Meanwhile, private consumption in the region has also gained momentum along with lower interest rates. Real import demand has also strengthened, but the unprecedented three-consecutive-year current account surplus of the region, will continue, due to the higher commodity export prices and strong demand from China and the United States. This has resulted in currency appreciation presenting policy challenges in several countries in the region. Despite salient progress made in reducing public debt, the debt-to-GDP ratio remains high in some countries, still vulnerable to deterioration in the international environment, such as higher interest rates in global capital markets and softening of commodity prices.

Figure 8.
Latin America and the Caribbean: GDP and Unemployment, 2001-2006



Source:
UN/DESA.

a Partly estimated.
b Forecast, based in part on Project LINK.
c ECLAC data from 2001-2005.

Key Issues in the Global Outlook

The *employment* situation worldwide is improving, but remains far from satisfactory. Employment creation has lagged behind output growth in the global recovery of the past few years. Despite some noticeable improvement most recently in 2006, unemployment rates in a large number of countries are still higher than their levels prior to the global downturn of 2000-2001. Many developing countries are also facing high levels of structural unemployment and underemployment, limiting the effectiveness of growth on reducing poverty.

A gradual recovery in employment continues in most developed countries. In the United States, the average monthly increase in wage employment has strengthened in 2006, with the unemployment rate dropping below 5 per cent. In Western Europe, unemployment rates are still about one percentage point above their low levels of 2001, but a gradual improvement is discernible. While the unemployment rate in Japan has been declining steadily, labour markets in Australia, Canada and New Zealand are exceptionally strong.

The unemployment situation in developing countries and economies in transition is more pressing, in both cyclical and structural terms. Official unemployment data, which often only cover urban areas, in general, underestimate by a large margin the severity of unemployment and, particularly, the underemployment situation in most developing countries. Nonetheless, even by this measure, only a small number of countries in Asia, Latin America and in the group of economies in transition registered a notable reduction in unemployment rates in 2005. Unemployment rates for most Asian economies are still above their levels prior to the Asian financial crisis of the late 1990s. In China and many Asian economies, where people in rural areas still account for a large share of the population, surplus labour and high rates of underemployment in the rural areas remain a long-term policy concern. In South Asia, for example, the formal sector is unable to absorb a rapidly growing workforce and unemployment is highest among the young—which is also the case for many other developing countries. Despite some improvement, unemployment rates in most Latin American countries and economies in transition are still high—near 10 per cent. Structural unemployment and underemployment problems are particularly acute in Africa despite its recent growth recovery. Official rates of unemployment are at 10 per cent or higher in some of these economies.

Headline *inflation* rates have edged up markedly in a majority of countries, driven mainly by higher oil prices. Core inflation rates, excluding such highly volatile components as the prices of energy and food, have been much more stable, indicating that the pass-through of higher oil prices into overall inflation is limited. Inflation expectations, as measured by various surveys and market indicators, remain tame.

Core inflation rates in most developed countries are between 1 to 3 per cent, within the bound of inflation targets set by those countries, although in some countries the rates are near the upper bound of the targets. A long period of deflation in Japan is expected to come to an end in 2006. Inflation is accelerating in some economies in transition, and more inflation pressures are building up in many developing countries, particularly the oil-importing countries. Inflation has decelerated in Latin America and also in Africa inflation rates have fallen in most countries, except in the case of a few countries where high inflation has more to do with structural problems than with the increase in oil prices.

A number of developing economies have contained the rise in domestic oil prices relative to the increase in international oil prices through various measures, including subsidies at the cost of putting pressure on fiscal balances. Such measures to smooth spikes in global oil prices can only be temporary, given the magnitude of the oil price increases and difficulties in sustaining large fiscal deficits. As these countries reduce these measures, a stronger direct impact of higher oil prices on inflation is expected, as is already the case in Indonesia and a few other economies.

Policy stance and policy implications

Current macroeconomic policy stance

Among the developed countries, the United States Federal Reserve Board has continued monetary tightening. The Federal Funds rate, after rising to 5 per cent by mid-2006 from one per cent two years ago, is expected to remain unchanged for the rest of the year. Despite the lackluster economic growth and generally fragile domestic demand in the euro area, the European Central Bank (ECB) has also raised interest rates in the euro area and is expected to raise rates by another 50 basis points over the course of 2006, indicating that the ECB's main policy concern has been focused on the inflation pressures from higher energy prices and/or that the ECB's estimate of the potential growth for the region is only near 2 per cent. The Bank of Japan has abandoned the policy framework of quantitative easing, as the long period of deflation in the economy is ending, but short-term interest rates will likely stay very close to zero for the rest of 2006.

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

Fiscal policies are more country-specific. Fiscal policy in the United States is expected to remain slightly expansionary because of the expected increase in government spending on post-hurricane reconstruction. Fiscal policies in the countries of the euro area will likely remain restrictive given the need to reach the targets established by the Stability and Growth Pact (SGP). Other European countries can maintain a neutral-to-mildly expansionary stance, while Japan is expected to continue its fiscal consolidation. Among the developing countries and economies in transition, most countries in Latin America, Africa and East Asia are likely to adopt more restrictive or cautious fiscal policies.

Policy coordination for global rebalancing

The current macroeconomic policy settings in the world economy lack concerted policy actions to redress the global imbalances. Coordinated global adjustment will require measures that will stimulate savings in the deficit countries and domestic demand in the surplus countries. The United States will need to stimulate household savings and reduce public dissaving, which may come at the cost of lower growth in the short run as the fiscal and monetary stimuli are reduced. Expansionary macroeconomic policies in the surplus countries may compensate for the growth loss and stimulate United States exports. In Europe, economic stimulus should come primarily from keeping interest rates down in an effort to stimulate private demand. Room for fiscal expansion is more limited in most countries. Yet more should be done to revitalize consumption and investment demand. Structural reform policies of recent years have thus far not been able to create such a stimulus. In Japan, continued financial sector reform and fiscal incentives to stimulate private investment demand should combine to reduce domestic savings and trade surpluses. Asian surplus countries should try to boost public and private investment rates, or, if these are considered sufficiently high such as in China, boost broad-based consumption demand, particularly through increasing wages and rural sector incomes.

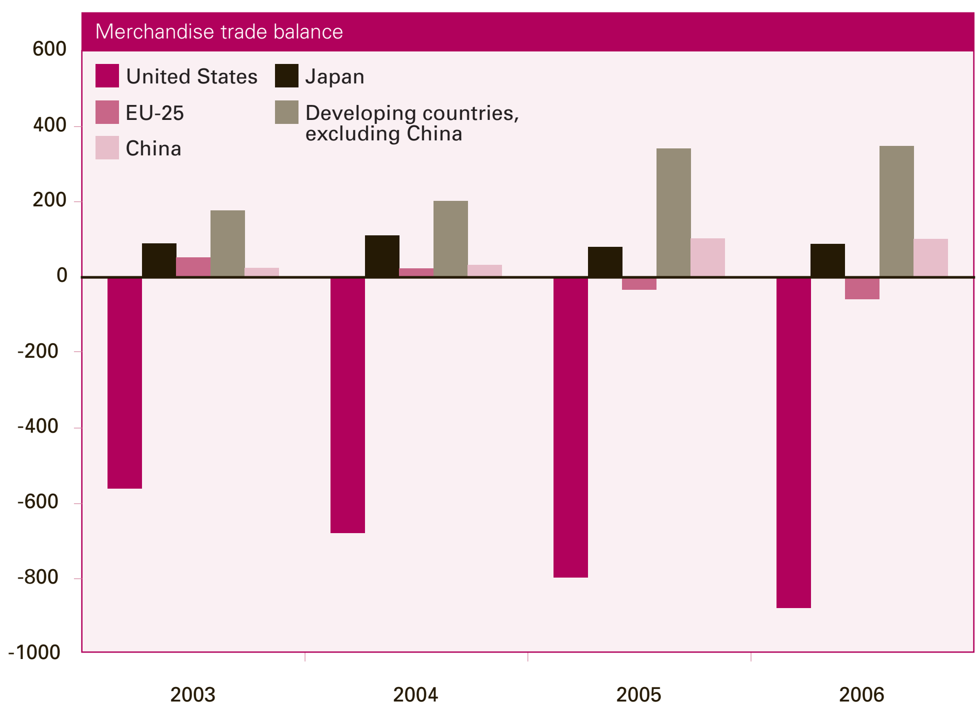
When implemented in a timely and coordinated fashion, a cooperative policy approach could avoid a contractionary and/or disorderly adjustment of the global imbalances. Such an approach would require a substantial degree of international macroeconomic policy coordination involving a much broader forum of countries than the major economies of the G-8.

Downside risks

Further deterioration in global imbalances

Global imbalances continue to widen in 2006 (see figure 9). The current-account deficit of the United States surpassed $800 billion in 2005 and is expected to exceed $900 billion in 2006. On the other hand, oil-exporting countries continue to experience increases in their surpluses, Asian economies as a whole appear to have stabilized their large surplus at the level of 2005, euro-area's external account is in balance, and the rest of European developed countries still have some surplus as a group.

Figure 9.
Global imbalances, 2003-2006



Source: Project LINK.

According to some analysts, global imbalances reflect a worldwide 'savings glut', as is evident from two concurrent trends: a number of countries with high savings rates, mainly in Asia, seem to have enlarged their positive saving-investment gaps over the past few years, and long-term interest rates worldwide have been at exceptionally low levels.[4]

However, both global savings and investment rates have been persistently on the decline since the 1970s, reaching an historical low point in 2002 and rebounding only slightly

4 See *WESP 2006* for more detailed discussion on the issue of global imbalances.

since. The increased saving-investment gaps in most countries running current-account surpluses are primarily due to a weakening of investment growth. Declining or stagnant investment rates also characterize recent trends in the dynamic Asian economies as well as other developing countries, with China being the only exception. Business investment, relative to GDP, is clearly below historical averages in the major economies, such as Germany, Japan and the United States, despite low interest rates and remarkably buoyant corporate profits and savings. Thus, instead of a global 'glut' in savings associated with the global imbalances, there is a global 'anaemia' in investment.

Meanwhile, the sustainability of the present global imbalances should not only be judged from the savings-investment and current account positions, but, more importantly, from the net foreign asset positions of the major economies. Net foreign liabilities of the United States have increased to over $3 trillion, about 25 per cent of its GDP. Normally, increases in the net debt ratio could trigger expectations of exchange-rate depreciation, and foreign investors will be less interested in holding assets of the debtor country, unless compensated through a higher interest rate. The case of the United States is not normal, however, due to the fact that United States dollar is the international reserve currency. Despite being the world's largest net debtor country, income earned on foreign assets held by United States agents is higher than what the country pays on its foreign liabilities. Rates of return on United States direct investment abroad appear to be substantially higher than on United States based assets. In addition, the depreciation of the dollar against other major currencies has increased the value of United States foreign holdings and contained the rise in the value of its liabilities. In the outlook, the net investment income balance of the United States may turn into to a deficit in 2006 as a result of the rising interest rates and more accumulation of foreign debt.

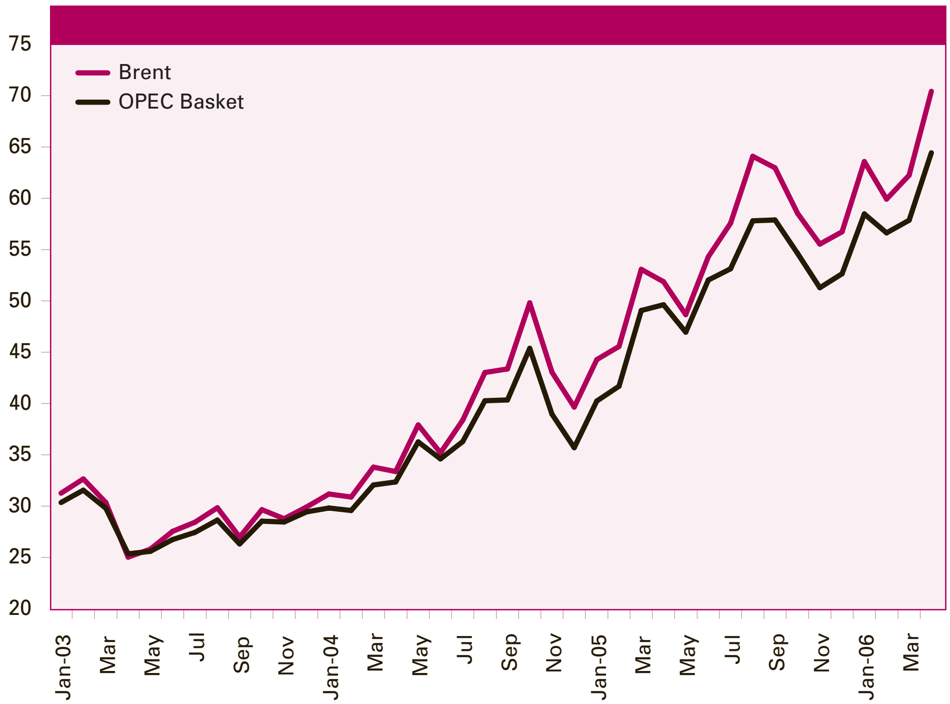
A large devaluation of the dollar would form the prelude to a disorderly adjustment of global imbalances, as it would undermine confidence in the dollar and likely trigger a swift retreat from dollar assets. A substantial devaluation of the United States dollar would also lead to significant negative wealth effects for many other developed and developing countries holding dollar-denominated assets, and depress aggregate demand in those countries and in the world economy as a whole. Therefore, restoring balance to the global economy solely through a major exchange-rate realignment seems neither an adequate nor an efficient path. After a rebound in 2005, the exchange rates of the United States dollar vis-à-vis other major currencies have resumed the depreciation trend in 2006. At the same time, the dollar has also continued to depreciate against the currencies in many developing countries.

While the baseline outlook assumes no abrupt adjustment of the global imbalances in 2006, there is a looming risk of a disorderly adjustment of global imbalances leading to a worldwide recession and destabilization of global financial markets. The worst-case scenario would be an abrupt retrenchment in the spending of households and businesses in the major deficit country, the United States, triggered by a sharp erosion of the willingness of the surplus countries to hold dollar-denominated assets and thereby continue financing the deficits of the United States. In such a scenario, the rebalancing would generate a substantial contraction, not only in the United States, but also in the world economy as a whole, accompanied by a precipitous change in exchange rates and a detrimental shock to financial markets.

Risks associated with oil prices

Oil prices, in terms of the price of Brent oil, surged to $75 per barrel (pb) in mid-April 2006, the highest level in nominal terms, although still about 10 per cent below the peak of 1980 when measured in comparable (real) dollar prices. While the increases in oil prices in the past few years

Figure 10.
Oil prices, January 2003-March 2006



Source: Project LINK.

since 2003 (see figure 10) could mainly be attributed to a stronger-than-anticipated growth in global oil demand, the further rise in oil prices since the second half of 2005 has largely been driven by factors associated with the uncertainties on the supply side. After an exceptionally strong increase in 2003-2004, growth of global oil demand since 2005 has slowed to the average pace of the past three decades. On the supply side, excess capacity in most oil producing countries remains limited. As a result, oil prices have been highly sensitive to any perceptible risks of possible disruptions in oil production. While the spikes in oil prices during the fourth quarter of 2005 were caused by the hurricane damages in the United States, the recent price surge in 2006 has been associated with the heightened geopolitical concerns about the situation in the Islamic Republic of Iran, Iraq and Nigeria. The impact of these concerns on oil prices was also exacerbated by speculation in the oil futures market.

Thus far, world economic growth has not been visibly affected by the higher oil prices because the recent upward trend in oil prices has not been accompanied by a major curtailment in oil supply. Negative welfare effects from higher costs for producers and consumers have been offset by the continued growth in income. Should the push no longer come from the demand side, but rather from restrictions on the supply side—as was the case with the oil shocks of the 1970s and early 1980s—world output growth could be substantially hurt. The risk of such a supply-side shock to oil prices is certainly present, given the current tightness in global oil production capacity, a result of under-investment in the energy sector over the past two decades. New investment plans and policy incentives to redress this situation have been announced in several oil-exporting countries, but these solutions will only raise production capacity in the medium term. Shortages in drilling equipment, technical personnel and service company capacity may impede capacity growth over the next two to three years. The significant upward movement in the prices of long-run oil futures reflects the expectation in the market that existing production capacity will remain constrained for some time to come. In the short run, major supply disruptions could well be caused by various unforeseen factors, including geopolitical tensions and natural disasters. Should such disruptions occur, a combination of much higher oil prices and the shortage of oil supply would choke off the world economic growth.

Burst of the housing market bubble

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

Part of the housing boom in recent years can be attributed to various country-specific features, but low interest rates and easier access to mortgage loans seem to be the common factors for most of these countries. Therefore, an increase in interest rates can lead to a flattening or reversal in the growth of house prices, turning the positive growth contributions of the housing sector into negative ones. As an example, the recent notable growth moderation in Australia and the United Kingdom of Great Britain and Northern Ireland was unambiguously attributable to a cooling down of the housing sector. Various leading indicators in early 2006 have also shown a slowdown in the housing sector in the United States. In the best case, a cooling off in the housing sector will only lead to a moderation in private consumption. Should house prices drop significantly, however, combined with a subsequent bank crises (mortgage loans account for a sizable proportion of total bank loans in some countries), as has happened in a number of countries in the past, the adverse impact on overall economic growth would be much larger.

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

Annex

Table A.1.
Developed economies: rates of growth of real GDP, 2001-2006

Annual percentage change[a]

	2001	2002	2003	2004	2005[b]	2006[c]
Developed economies	1.2	1.3	2.0	3.2	2.7	2.7
United States	0.8	1.6	2.7	4.2	3.5	3.1
Canada	1.8	3.4	2.0	4.2	2.9	2.8
Japan	0.4	0.1	1.8	2.3	2.7	2.8
Australia	3.9	3.2	3.8	1.4	2.5	3.1
New Zealand	3.5	4.6	3.6	5.0	2.3	1.9
European Union	1.9	1.2	1.2	2.4	1.6	2.3
EU-15	1.9	1.1	1.1	2.3	1.5	2.2
Euro Zone	1.8	0.9	0.8	2.1	1.3	2.0
Austria	0.8	1.0	1.4	2.4	1.9	2.5
Belgium	1.0	1.5	0.9	2.6	1.5	2.1
Finland	1.0	2.2	2.4	3.6	2.1	3.4
France	2.1	1.2	0.9	2.3	1.5	2.1
Germany	1.2	0.1	-0.2	1.6	0.9	1.8
Greece	4.6	3.8	4.6	4.7	3.7	3.2
Ireland	6.2	6.1	4.4	4.5	4.4	5.1
Italy	1.8	0.4	0.3	1.2	0.0	1.0
Luxembourg	1.5	2.5	2.9	4.5	3.8	3.0
Netherlands	1.1	0.1	-0.1	1.7	0.9	2.8
Portugal	2.0	0.5	-1.2	1.2	0.3	0.7
Spain	3.5	2.7	3.0	3.1	3.4	2.9
Other	1.9	1.9	2.3	3.1	1.9	2.5
Denmark	0.7	0.5	0.6	2.1	3.4	2.9
Sweden	1.1	2.0	1.7	3.7	2.7	3.7
United Kingdom	2.2	2.0	2.5	3.2	1.7	2.3
EU-10	2.4	2.4	3.9	5.1	4.3	5.0
EU-8	2.4	2.4	4.0	5.2	4.3	5.1
Czech Republic	2.6	1.5	3.7	4.6	6.0	6.1
Estonia	6.5	7.2	6.7	7.8	9.6	8.0
Hungary	3.8	3.5	2.9	4.2	3.2	4.5
Latvia	8.0	6.4	7.2	8.5	9.6	8.0
Lithuania	6.4	6.8	10.5	7.0	7.5	6.8
Poland	1.0	1.4	3.8	5.3	3.2	4.5
Slovakia	3.8	4.6	4.5	5.5	6.0	5.9
Slovenia	2.7	3.3	2.5	4.6	4.0	4.0
Other	3.0	1.9	0.7	2.3	3.4	2.9
Cyprus	4.1	2.1	1.9	3.8	3.8	3.4
Malta	0.3	1.5	-2.5	-1.5	2.5	1.5
Other Europe	1.7	0.6	0.4	2.4	2.7	2.2
Iceland	2.6	-2.1	4.2	5.2	6.6	4.6
Norway	2.7	1.1	1.1	2.8	3.7	2.3
Switzerland	1.0	0.3	-0.3	2.1	1.9	2.0
Major developed economies	1.0	1.1	2.0	3.2	2.7	2.7
North America	0.8	1.7	2.7	4.2	3.5	3.1
Western Europe	1.9	1.2	1.2	2.4	1.6	2.3
Asia and Oceania	0.7	0.4	2.0	2.3	2.7	2.8

Source: UN/DESA, based on IMF, *International Financial Statistics* and individual national sources.

a Calculated as a weighted average of individual country growth rates of gross domestic product, where weights are based on GDP in 2000 prices and exchange rates.

b Partly estimated.

c Forecasts, partly based on Project LINK.

Table A.2.
Economies in transition: rates of growth of real GDP, 2001-2006

Annual percentage change[a]	2001	2002	2003	2004	2005[b]	2006[c]
Economies in transition	5.7	5.0	7.0	7.6	6.3	6.0
South-eastern Europe	4.8	4.8	4.6	6.6	4.6	4.8
Albania	7.2	4.3	5.7	6.7	5.6	5.2
Bosnia and Herzegovina	4.5	5.3	4.0	5.7	4.5	5.2
Bulgaria	4.1	4.9	4.5	5.6	5.6	5.0
Croatia	4.4	5.2	4.8	3.8	4.3	4.3
Romania	5.7	5.1	5.2	8.3	4.1	4.8
Serbia and Montenegro	5.5	3.8	2.1	8.0	5.5	5.2
The former Yugoslav Republic of Macedonia	-4.5	0.9	3.4	4.1	4.0	4.0
Commonwealth of Independent States	6.0	5.1	7.6	7.8	6.8	6.3
Net fuel exporters	5.6	5.0	7.3	7.2	7.1	6.7
Azerbaijan	9.9	10.6	11.2	9.5	26.4	28.0
Kazakhstan	13.5	9.8	9.3	9.4	9.4	8.5
Russian Federation	5.1	4.7	7.3	7.2	6.4	6.0
Turkmenistan	4.3	0.3	3.3	5.0	9.6	5.0
Uzbekistan	4.5	4.2	4.4	4.5	7.0	6.0
Net fuel importers	7.9	5.6	9.1	11.2	4.9	4.3
Armenia	9.6	15.1	13.9	10.0	13.9	7.5
Belarus	4.7	5.0	7.0	11.0	9.2	8.5
Georgia	5.2	5.4	11.6	7.7	9.0	6.5
Kyrgyzstan	5.3	0.0	6.7	6.0	-0.6	4.5
Republic of Moldova	6.1	7.8	6.6	7.3	7.1	7.0
Tajikistan	10.2	10.8	11.0	10.6	6.7	7.5
Ukraine	9.2	5.2	9.4	12.1	2.6	2.2

Source: UN/DESA, based on data of Economic Commision for Europe (ECE).

a Calculated as a weighted average of individual country growth rates of gross domestic product, where weights are based on GDP in 2000 prices and exchange rates.

b Partly estimated.

c Forecasts, partly based on Project LINK.

Table A.3.
Developing economies: rates of growth of real GDP, 2001-2006

	2001	2002	2003	2004	2005[b]	2006[c]
Developing countries[d]	2.7	3.9	5.2	6.9	6.1	6.2
Africa	3.6	3.3	4.7	5.0	5.3	5.9
North Africa	3.5	3.2	5.4	5.4	5.1	6.2
Sub-Saharan Africa (excluding Nigeria and South Africa)	4.8	3.9	3.4	5.7	5.5	6.6
Net fuel exporters	3.0	3.4	6.2	5.3	6.3	6.9
Net fuel importers	4.2	3.3	3.5	4.7	4.5	5.0
East and South Asia	4.4	6.6	6.8	7.7	7.2	7.1
Net fuel exporters	3.9	6.5	6.4	5.2	4.8	5.0
Net fuel importers	4.5	6.6	6.9	8.1	7.5	7.4
East Asia	4.5	6.9	6.8	7.9	7.3	7.3
South Asia	4.1	5.6	7.0	7.0	6.7	6.3
Western Asia	-0.3	3.0	4.7	6.5	5.1	5.2
Net fuel exporters	2.6	2.1	5.1	6.0	5.4	5.6
Net fuel importers	-4.1	4.2	4.2	7.1	4.6	4.7
Latin America and the Caribbean	0.3	-0.8	2.0	5.8	4.5	4.6
South America	0.2	-1.9	2.1	6.9	5.1	5.1
Mexico and Central America	0.2	0.9	1.6	4.2	3.1	3.6
Caribbean	2.8	2.7	2.5	2.7	5.8	5.4
Net fuel exporters	-0.6	-3.0	2.5	6.7	5.4	5.0
Net fuel importers	1.4	1.9	1.4	4.9	3.4	4.1
Memo items:						
Least developed countries	6.5	6.3	6.7	6.7	6.9	7.3
East Asia (excluding China)	1.7	5.2	4.2	6.0	5.0	5.2
South Asia (excluding India)	3.4	6.5	6.7	5.4	4.8	5.0
Western Asia (excluding Isreal and Turkey)	2.7	2.2	5.0	5.9	5.2	5.4
Landlocked developing economies	5.6	4.5	4.6	6.1	7.2	6.8
Small island developing economies	0.5	3.4	2.8	5.7	5.9	5.5

Table A.3 (cont'd)

	2001	2002	2003	2004	2005[b]	2006[c]
Major developing economies						
Argentina	-4.4	-10.9	8.7	9.0	9.2	7.5
Brazil	1.3	1.9	0.6	4.9	2.3	3.7
Chile	3.4	2.2	3.7	6.1	6.3	5.7
China	8.3	9.1	10.0	10.1	9.9	9.6
Colombia	1.5	1.9	4.1	4.0	5.1	4.8
Egypt	3.2	3.1	3.2	4.2	5.0	5.4
Hong Kong SAR[e]	0.6	1.8	3.2	8.6	7.3	5.8
India	4.9	4.7	7.4	8.5	8.5	7.4
Indonesia	3.8	4.4	4.7	5.1	5.6	5.4
Iran (Islamic Republic of)	3.7	7.5	7.1	5.1	4.1	4.6
Israel	-0.3	-1.5	1.7	4.4	5.2	4.1
Korea, Republic of	3.8	7.0	3.1	4.6	4.0	5.1
Malaysia	0.3	4.4	5.4	7.1	5.2	6.0
Mexico	0.0	0.8	1.4	4.2	3.0	3.5
Nigeria	3.1	1.5	10.7	4.0	6.5	5.0
Pakistan	2.5	4.1	5.7	7.1	7.2	6.3
Peru	0.2	4.9	3.8	4.8	6.7	5.6
Philippines	1.8	4.3	4.7	6.0	5.1	5.5
Saudi Arabia	0.5	0.1	7.7	5.2	6.4	5.8
Singapore	-2.3	4.0	2.9	8.7	6.4	6.1
South Africa	2.7	3.6	2.8	3.7	4.9	4.6
Taiwan Province of China	-2.2	4.2	3.4	6.1	4.1	4.2
Thailand	2.1	5.4	6.9	6.2	4.5	4.6
Turkey	-7.5	7.9	5.8	8.9	4.6	5.3
Venezuela	2.8	-8.9	-7.7	17.9	9.3	6.7

Source: UN/DESA.

a 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.
b Partly estimated.
c Forecast, based in part on Project LINK.
d Covering countries that account for 98 per cent of the population of all developing countries.
e Special Administrative Region of China.