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LINK Global Economic Outlook

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Abstract

Following another year of robust performance, world economic growth is moderating. Gross world product (GWP) is expected to increase by 3.2 per cent in 2007, decelerating notably from an estimated growth of 3.8 per cent in 2006. A slowdown has already manifested itself in the United States, the ripple effects of which are expected to drag the rest of the world. The international economic environment has in general been favourable towards the developing countries and the economies in transition, but the increased volatility in international prices of primary commodities and in equity prices of emerging market economies, as witnessed periodically during 2006, could be an early warning. The global economic outlook encompasses a number of downside risks: a burst of the housing bubble in the United States, as well as in a few other economies; another surge in oil prices triggered by shocks to global oil supply; a precipitous drop in the prices of other primary commodities; an abrupt adjustment in the ever-widening global imbalances; the lingering risks of a global pandemic of avian influenza; and the complicating geopolitical situation. Macroeconomic policies worldwide should therefore aim at reducing the global imbalances while the world economy is still in a relatively strong position, in order to mitigate some of these risks and to minimize the costs were some of these events to materialize. In this context, the present report reiterates the need for international policy coordination.

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Introduction

The following 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 15 October 2006. The major global assumptions underlying the forecast are set out in the box below. Most of the LINK Country Reports, which contain detailed country forecasts and policy analyses submitted by the national LINK centres, are available on the websites of both the United Nations and the University of Toronto.[1]

The present report summarizes the main short-term prospects for the global economy in 2007 and discusses the major risks and policy challenges in that regard.

Major assumptions for the baseline global economic forecast for 2007

The United States Federal Reserve (Fed) is expected to maintain the Federal Fund interest rate at 5.25 per cent until mid-2007 and to reduce the rate by 50 basis points in the second half of 2007; the European Central Bank (ECB) is expected to raise its policy rate by another 25 basis points over the course of the rest of 2006, bringing it to a level of 3.5 per cent, and to maintain that rate for 2007; the Bank of Japan has ended its policy of quantitative targeting for monetary policy, and is expected to keep the policy interest rate at 0.25 per cent for the rest of 2006, but to raise the rate gradually by 100 basis points in 2007.

The assumptions regarding fiscal policy in individual countries are based mainly on official budget plans or policy statements. In general, fiscal stance worldwide is expected to remain at the same level as in 2006.

The price of Brent crude oil is expected to average US$ 60 per barrel in 2007, down from an estimated average of US$ 64 per barrel for 2006.

The prices of most non-oil commodities are expected to decline moderately in 2007, within a range of 5-10 per cent.

The United States dollar is expected to depreciate against most other major currencies in 2007. The dollar/euro exchange rate is expected to average 1.35 for 2007, compared with an estimated 1.27 in 2006; the yen/dollar exchange rate is expected to average 105 for 2007, compared with an estimated 115 in 2006.

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

Overview

As 2006 draws to a close, the world economy is likely to register another year of robust growth. More importantly, 2006 marks at least three consecutive years in which many developing economies have grown at their strongest pace in decades, with a number of the least developed countries (LDCs) improving their prospects for fulfilling the Millennium Development Goals. The year has, however, also featured increased volatility in a number of market indicators for developing countries, especially in equity prices and the prices of primary commodities, although such volatility was transient and did not impact significantly on the growth of these economies. Moreover, the underlying momentum of the global economic growth seems to have been tapering off during the second half of the year, and the moderation is expected to become even more noticeable in the outlook for 2007. According to the baseline LINK forecast, the growth of gross world product (GWP) is projected to be at about 3.2 per cent for 2007, decelerating by about a half of one percentage point from 2006 (see table 1).

The employment situation has improved worldwide during 2006, but the growth of employment is still noticeably weaker than the growth of output, particularly in many developing countries, where high unemployment and underemployment remain a key policy challenge. Meanwhile, inflation has edged upward in most economies, due largely to higher energy prices, but the inflation outlook remains tame and stable.

The slowdown so far has been most obvious in the United States, particularly in its housing sector. At issue are to what extent the cooling down of the decade-long housing boom will lead a broad downturn in the United States, and, more crucially, to what extent the weakening economy of the United States will cause a slowdown in the rest of the world. In the baseline outlook, a measurable slowdown is expected in the United States, as the growth of household spending will be curtailed notably in response to the sliding housing sector. Worldwide, some optimistic views hold that the recent strengthening of the economies in Europe and that of Japan should be able to fill the gap left by the United States, thereby achieving a successful rotation of the engines for the global growth. The LINK outlook, however, takes a less sanguine perspective: the growth in both Europe and Japan is expected to decelerate, the slowdown in the latter being more pronounced as the external sector remains an important factor for Japan's growth.

A growth deceleration is also expected to be discernable in the developing countries and the economies in transition, to varying degrees, across countries and regions. The boom in the group of developing countries over the past few years seems to have become increasingly endogenous within the group: namely, propelled by a rapid industrialization and growth of modern services in China, India and a few other large developing economies. Nevertheless, the growth of many other developing countries remains highly sensitive to the economic fluctuations in the major developed countries. A large number of developing countries, especially those in Africa and Latin America, continue to be highly dependent on the production/exports of primary commodities, and the major developed countries still account for the lion's share in the global demand for these commodities. Indeed, the influence of China, as well as India, on the growth of other developing countries has increased, but even these large developing economies are not

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

	Observed		October 2006 forecast [a]		Change from October 2005 forecast for 2006
	2004 [b]	2005 [b]	2006	2007	
Gross World Product (GWP)	4.0	3.5	3.8	3.2	0.8
GWP - PPP weighted	5.2	4.8	5.1	4.6	1.5
Developed economies	3.1	2.5	2.9	2.2	0.5
Canada	4.2	2.9	2.8	2.6	0.2
Japan	2.3	2.6	2.5	1.7	0.6
United States	3.9	3.2	3.2	2.2	0.1
European Union (EU25)	2.4	1.7	2.7	2.4	0.5
France	2.3	1.2	2.3	2.3	0.2
Germany	1.6	1.0	2.2	1.7	1.0
Italy	1.1	0.0	1.6	1.2	0.7
United Kingdom	3.3	1.9	2.6	2.7	0.3
Memo item: Euro Zone	2.0	1.4	2.5	2.2	0.6
Economies in transition	7.6	6.3	7.1	6.4	2.1
Russia	7.2	6.4	6.7	5.8	1.2
Developing countries and regions	6.9	6.4	6.5	5.9	1.4
Latin America and the Caribbean	5.9	4.5	4.9	4.1	0.8
Argentina	9.0	9.2	8.0	6.1	4.0
Brazil	4.9	2.3	3.3	4.1	-0.7
Mexico	4.2	3.0	4.0	2.0	0.5
Africa	4.8	5.4	5.5	5.6	0.1
North Africa	5.0	5.0	6.1	5.5	0.4
Sub-Saharan Africa [c]	5.7	5.9	5.9	6.6	0.6
Nigeria	4.0	6.9	5.1	6.0	-0.9
South Africa	3.7	4.9	4.2	4.1	-0.2
South and East Asia	7.8	7.5	7.4	6.9	1.4
China	10.1	10.2	10.2	8.9	1.4
India	8.5	8.0	7.7	7.9	0.9
Indonesia	5.1	5.6	5.3	6.0	0.0
Korea, Republic of	4.7	4.0	5.0	4.3	0.7
Malaysia	7.1	5.0	5.5	6.0	-0.1
Philippines	6.2	5.0	5.5	5.7	-0.2
Thailand	6.4	4.5	4.2	4.8	0.0
Western Asia	6.6	6.1	6.1	5.2	1.0
Oil-exporting countries	6.2	6.1	6.2	5.0	0.7
Oil-importing countries	7.2	6.1	6.0	5.6	1.3
Memo: World Export volume	10.2	7.4	10.1	7.8	2.7
Oil price (Brent, US$/pb)	38.3	54.4	65.9	60.0	6.6

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

immune to a slowdown in the major developed countries, as a large proportion of their exports still depend on the demand of the major developed countries.

A number of uncertainties remain in the outlook with downside risks for a scenario much worse than which is depicted in the baseline outlook. For instance, a possible burst of housing bubbles not only in the United States but also in a number of other economies, another surge in oil prices triggered by escalated geopolitical shocks, an abrupt adjustment in the large global imbalances, an overshoot in the tightening of macroeconomic policies and a sharper-than-expected reversal of the upward trend in the prices of many primary commodities could all lead to an exacerbation of the current apparently mild downshift in the world economy. More risks also remain outside of the economic domain, such as a global pandemic of avian influenza, and an escalation of geopolitical conflicts. Therefore, policymakers worldwide should be vigilant, and preventive policy actions should be taken to mitigate the consequences of these risks. For example, measures should be implemented to redress the large global imbalances while the world economy is still relatively strong. In this context, the present report would reiterate the need for international policy coordination so as to guide a stable global rebalancing.

International economic environment for developing countries

The international economic environment for the developing economies and the economies in transition, as measured by trends in international prices of primary commodities, the costs of external financing, capital flows and trade flows, remains favourable by historical standards, but some of these indicators have certainly shown increased volatility during 2006. Equity markets in many emerging market economies experienced considerable turmoil during May-June of 2006, along with a significant drop in the prices of many primary commodities. Although the turbulence was short-lived and most markets quickly recovered, both emerging market economies and international investors should stand reminded of the risky nature of these markets. In the outlook for 2007, the developing countries and the economies in transition should be more cautious about the possible deterioration of their international economic environment: as global demand moderates, the prices of many primary commodities are expected to soften and capital flows may become less robust; moreover, the risks for a disorderly adjustment in the global imbalances remain high, and the emerging market economies would suffer a disproportionately large impact from such adjustment, should it occur.

The growth of world *merchandise trade* in volume has been robust during 2006, increasing at a pace of approximately 10 per cent. The strength in global trade has been broad based, but most Asian economies continue to lead the dynamism in global trade, with the exports of both China and India increasing at an annual pace of about 20 percent. Many developing countries in Africa and Latin America have also managed to expand their exports at double-digit rates, thanks to strong global demand for raw materials. Oil-exporting countries have continued to experience large increases in their export revenues, but in volume terms, the growth has been flat, as global oil demand has been growing at a pace slightly above 1 per cent during 2006. Exports of the major developed countries have also been robust, driven by global demand for capital goods, as business investment in many countries continues to recover from the low levels experienced since the last downturn at the beginning of the century. For example, the volume of exports of the United States has accelerated to a growth of about 10 per cent, its strongest pace in many years, with exports of capital goods growing at about 14 per cent. In the outlook, the growth of global trade is expected to moderate in 2007 to about 8 per cent for the year.

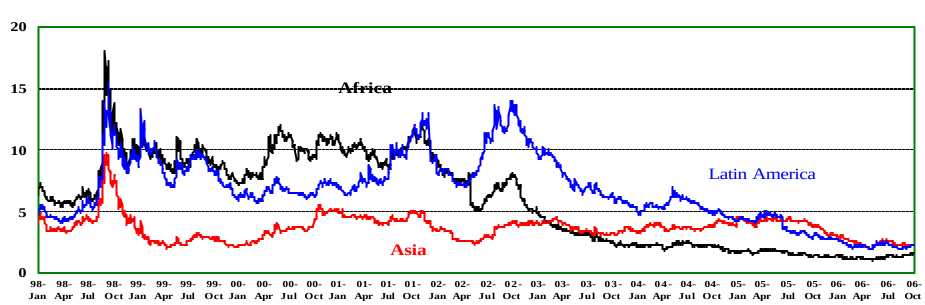
The world trading system suffered a serious setback during 2006 as the *multilateral trade negotiations* under the Doha Round in the World Trade Organization (WTO) were suspended in July. Earlier, the Sixth WTO Ministerial Conference that took place in Hong Kong Special Administrative Region (SAR) of China at the end of 2005 had achieved some modest results. For example, an agreement was reached to eliminate all forms of agricultural export subsidies by the end of 2013; developed countries agreed to provide duty-free and quota-free market access for products originating from the LDCs by 2008; and 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 benefit from WTO agreements and to cope with short-term adjustment costs associated with trade liberalization. However, further negotiations reached an impasse when no compromise could be made among major parties on export subsidies and domestic supports in the agricultural sectors. While various attempts to restart the negotiations continue, given the political constrains in a number of major countries, the feasibility of a breakthrough in the short-run to complete the Doha Round as planned is very limited. Meanwhile, various regional free trade arrangements and bilateral negotiations are mushrooming, intensifying the risk for an increasing fragmentation of international trade rules. As a result, this would not only inject additional inefficiencies into the international trading system, but would also complicate the effective enforcement of international trade agreements. So far, the setback in the world trading system has not generated any visible adverse impact on international trade flows, but it may have created the potential for more trade conflicts in the future.

The *terms of trade* have continued to improve during 2006 for many commodity-exporting developing countries, as they have done for four consecutive years. Despite a drop of about 30 per cent from their peak in August, oil prices have still increased by about 20 per cent on average from the level of 2005. The prices of base metals and minerals have increased even more on annual average. Only the prices of a few beverage and food commodities have experienced some moderation. However, the increased volatility in these prices during 2006, as indicated by a sharp decline of 20-30 per cent in the prices of many commodities in May-June and more periodic retreats in the second half of the year, might be the harbinger for a further reversal in these prices in the outlook. A strong demand for primary commodities stemming from the robust growth in China, India and some other developing countries, combined with a tight supply capacity in some commodities, has been the key factor behind the increases in these prices over the recent years, but there have also been other factors, such as heightened geopolitical uncertainties and market speculations. In the outlook, the terms of trade for many commodity-exporting countries are expected to deteriorate somewhat in 2007, as oil prices are expected to register an average decline of about 8 per cent and the prices of a number of other commodities are also expected to weaken.

Capital flows to emerging market economies have, as anticipated, moderated during 2006, and a further dwindling in the volume of the net inflows to this group of countries is expected in 2007. Having peaked in 2005, a major part of the slowdown has been due to a reduction in net borrowing from commercial banks and from the bond market. Many of these economies took advantage of very favourable market conditions during the previous year to pre-finance obligations due in 2006. A number of countries have also been buying back their bonds while some have repaid short-term bank loans. On the other hand, flows of foreign direct investment (FDI), which accounts for a large share of capital flows to emerging market economies, have continued to increase, but remain concentrated in a handful of emerging market economies, with China receiving more than one quarter of these flows. Meanwhile, official flows to this group of countries have continued to be largely negative as a result of increased net repayments to official creditors from a number of these countries, led by Russia and some economies in Latin America. In the outlook, net private capital flows to emerging markets will likely decline in 2007. Part of the decline will reflect the reduced demand for external financing, as many of these economies have been running current account surpluses for a few consecutive years and have accumulated foreign reserves, thus becoming less dependent on international capital, at least cyclically in the short run. The anticipated decline is also partly based on the outlook for a moderation in global growth, along with an expected gradual reduction in global liquidity.

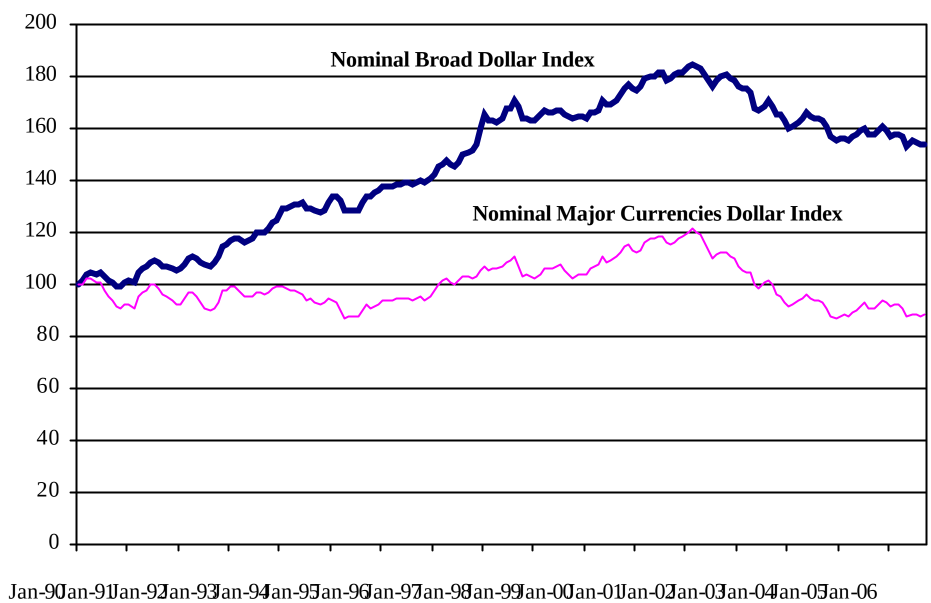
The *external financing costs* for emerging market economies remain low--abnormally so according to many analysts: the spreads in the Emerging Markets Bond Index (EMBI) reached all-time lows in the first quarter of 2006 and have since increased only slightly (see figure 1). Meanwhile, the benchmark interest rates underlying the external financing costs for emerging market economies are also low, despite a continuous monetary tightening in the United States to raise short-term policy interest rates over the past two years. There was a spike in the long-term benchmark interest rates during the first part of 2006, but since then interest rates have moved lower. As a result, the yield curve of the interest rates on the benchmark United States Treasuries is inverted. Such favourable external financing conditions may not be sustainable, however, as monetary tightening in major economies will likely reduce global liquidity, and the ever-growing current-account deficit of the United States will eventually induce higher benchmark interest rates.

Figure 1. Yield spreads of Emerging Market Bonds
(percentage points)



Volatility has also increased in the currency *exchange rates* for many emerging market economies vis-à-vis the United States dollar during 2006, even though on the year-over-year basis these currencies have appreciated by only about 2 per cent against the dollar on average (see figure 2). The currencies of these economies continued the trend of appreciation against the dollar at the beginning of 2006, but most – particularly those of energy- and commodity-exporting countries – reversed sharply by 10-20 per cent during the second quarter. Most of the currencies have since resumed their trend towards appreciation against the dollar. The exchange rates among the major currencies have also experienced periodic volatility during 2006. The dollar depreciated against the euro but appreciated against the Japanese yen. In the outlook, the dollar is expected to continue the trend of depreciation against most other currencies. The risk for a sharp depreciation of the dollar in association with an adjustment of its large current-account deficit has increased: since 2002, the trend of the depreciation of the dollar has been interspersed by periodic rebounds as the differentials in the interest rates and gross domestic product (GDP) growth rates among the major economies have been in favour of the dollar, thereby offsetting the depreciation pressures stemming from the concerns about the current-account deficit; but in 2007 these favourable differentials for the dollar are expected to narrow substantially.

Figure 2. Exchange rate index for the United States



Source: United States Federal Reserve Board.
Note: Major Currencies Index include currencies of most developed countries, while Broad Currencies Index also include currencies from emerging market economies

Many developing countries have continued to accumulate *foreign exchange reserves* during 2006. After totalling about 2 trillion of Special Drawing Rights (SDR) by the end of 2005, foreign exchange reserves for developing countries as a whole are estimated to have increased by another SDR 300-400 billion by the end of 2006, led by Asian economies: China's foreign exchange reserves are expected to surpass $1 trillion (or about SDR 700 billion at the exchange rate between the SDR and the dollar as of October 2006). In the outlook, the pace of reserve accumulation in developing countries is expected to slow in 2007. The increased foreign exchange reserves have made many developing countries less vulnerable to, or in better position to deal with, certain external shocks, such as deterioration in the terms of trade, reversal of capital inflows and speculative attacks on their local currencies; however, a paradox is that the mirror image of the accumulation of foreign exchange reserves by developing countries has been the widening of the external account deficit, as well as the increased net debt position, of the reserve currency issuing countries—in this case, mainly the United States. In other words, more accumulation of foreign exchange reserves in developing countries is correlated with less sustainability of the external deficit of the United States, thus weakening the value of the dollar and eventually destabilizing the world economy as whole—Triffin's dilemma for the international monetary system. This paradox also implies that accumulation of more foreign exchange reserves can make individual developing countries less vulnerable to idiosyncratic shocks only, but not to global systemic shocks such as an abrupt adjustment of the external deficit of the United States and a large devaluation of the reserve currency per se.

Prospects for economic growth by major economies and regions

Among developed economies, growth in the *United States* has moderated significantly during the second half of 2006, and the weakness will likely linger into 2007. GDP is expected to grow at the subdued pace of 2.2 per cent in 2007, notably lower than the 3.2 per cent estimated for 2006 and markedly below potential growth. While a sharp downturn in the housing sector has been the major drag, indicators for the labour market and manufacturing sector also have sent the signal for a broader deceleration in the economy recently. On the other hand, corporate finances are healthy and the policy space for macroeconomic stimuli is available when necessary, so the current moderation is not expected to degenerate into a recession. Nevertheless, downside risks do exist. Given the negative saving rate of households, a deeper-than-expected fall in house prices could lead to much weaker consumer spending, as well as to weaker import demand, which in turn could trigger an abrupt adjustment in the enormous external deficit of the United States, not only resulting in a possible contraction in its domestic economy but also derailing the world economy as a whole.

Despite some notable deceleration after the first quarter of 2006, economic growth in *Japan* remains robust by the standards of a matured developed economy, particularly in view of a sustained expansion since 2003 of an average rate of 2.5 per cent. Moreover, recent growth has been driven largely by domestic demand, rather than by net exports. While private consumption is now being buttressed by employment growth, which has in turn boosted household economic confidence, business investment is being strengthened by higher profits and the recent fall in oil prices. In the outlook, however, the economy is forecast to have a pronounced slowdown, as growth will drop from the rate of 2.5 per cent in 2006 to a rate of 1.7 per cent in 2007. The slowdown will be led by an expected weakening in external demand, especially from the United States, but some downward adjustment in consumption spending is also expected along with a continued withdrawal of liquidity by the central bank, as well as restrictive fiscal policy.

Growth in *Western Europe* has greatly exceeded expectations in 2006, leading to upward revisions for most countries in the region. GDP in the euro area is expected to grow by 2.6 per cent, the fastest since 2000. Outside the euro area, rates of growth are expected to be strong as well. This good performance has been anchored by healthy domestic demand, particularly investment expenditure, net exports having made only a minor contribution. Despite strong export performance, import growth was equally robust. However, exports were an important source of strength for investment expenditure. A slowdown in activity is expected for 2007, with GDP growing by 2 per cent, owing to a confluence of factors: external demand is expected to slow; the strengthening of currencies will hamper exporters; fiscal positions are expected to tighten; and monetary policy will also be tighter. On the other hand, growth is expected to have some support from consumption, as continuing moderate employment growth coupled with some increase in real wages boosts income.

The eight new European Union (EU) members have maintained strong momentum in 2006, with GDP accelerating. Poland has registered a strong recovery, the Czech Republic and Slovakia have achieved record high growth, and the Baltic States have experienced an exceptionally strong performance. These economies have benefited from a broadly favourable external environment: an upturn in Western Europe and easy access to foreign financing, despite a brief period of financial-market turbulence in May-June of 2006. In addition to an impressive performance in the external sector, the contribution of domestic demand to growth has become more important for Central European economies. In Poland, for example, stronger consumption and investment, along with net exports, have supported the recovery. Public investment projects and strong FDI, including reinvested earnings, have buttressed investment throughout the region. EU-accession-related activities have contributed to the development of infrastructure in Hungary and Slovakia. In the Czech Republic and Slovakia, the automotive industry has become the major driving force. In the Baltic States rising real wages and improved labour market conditions have supported strong demand, and exceptionally strong growth in consumer credit, including mortgage lending, has led to a housing boom. In the outlook, some slowdown is expected for 2007, due to the implementation of a fiscal adjustment package in Hungary, along with monetary tightening and a possible moderation of growth in the Baltic States. Specific challenges for this region are related to the increased competition from Asian products at all levels of production chain, and the risks include a slowdown in Western Europe and fiscal imbalances in Central Europe.

In other developed economies, weakening exports to the United States will likely drag the growth of *Canada* somewhat, but business investment and private consumption should remain robust. Similarly, growth in Australia is expected to be solid, balancing between robust domestic demand and a drag in net exports partly because of the adverse effects of a stronger currency. In *New Zealand*, economic growth is expected to exceed the previous forecast for this year owing to the stimulating effects of fiscal policy as well as the positive impact of the external sector, although household spending remains weak.

Economic performance in the *Commonwealth of Independent States* (CIS) has maintained its strong pace in 2006, largely due to high international prices of, and strong external demand for, oil, gas and metals. In addition, domestic demand has continued to grow, underpinned by robust household consumption as result of increased real incomes almost everywhere in the region and strong recovery of investments, in particular in the oil-exporting countries. While private capital inflows have contributed to the strong economic performance in the Russian Federation and Kazakhstan, official financing and remittances remain an important source of growth for smaller economies, such as Georgia and Moldova. The buoyant regional growth in 2006 largely reflects the acceleration in the Russian Federation, the strong rebound in Ukraine and the rapid pace of the economies in Central Asia. In contrast, some small oil-importing countries showed only moderate growth. In the outlook, robust regional growth is expected to continue in 2007, but to moderate from the pace of 2006. Some major downside risks include the high reliance on exports, and, in particular, on a handful of primary commodities. Moreover, capital inflows to the CIS countries and remittances to the non-oil exporting countries create inflationary pressure and also contribute to the appreciation of the national currencies. Therefore, these countries need to diversify their economies and improve the competitiveness of the non-oil sector.

Growth in *South-eastern Europe* regained dynamism during 2006 as GDP accelerated to 5.6 per cent. The upturn in Romania has been particularly strong. Robust domestic demand has generated large external imbalances in the region. Despite measures to curb private credit growth and cool down domestic demand, household and corporate borrowings remain strong, boosting both residential and business investment. Supported by strong FDI inflows, modernization of production bases has continued in the region. In the outlook, growth is expected to maintain the same pace in 2007, with the possibility of some moderation if real wage growth slows and further policy restrictions on domestic credit are adopted. Investor confidence likely will obtain a boost from the forthcoming accession of Bulgaria and Romania to the EU and this will also facilitate external trade and accelerate absorption of EU assistance. The large external deficits remain a key downside risk.

Among developing countries, GDP growth in *Africa* has continued to exceed expectations, reaching almost 5.5 per cent in 2006. Many countries in Africa have sustained a relatively strong recovery since 2003, driven by increasing hydrocarbon export earnings, vibrant global demand for, and favourable international prices of, some non-oil commodities vigorous domestic demand, and markedly growing FDI flows and donor support. On the other hand, protracted civil unrest and political disturbances, adverse weather conditions, and decreased tourism revenues continue to hamper economic growth in a number of African countries. In the outlook, the region’s GDP growth is expected to expand by 5.6 per cent in 2007, roughly the same pace as in 2006, as private and public consumption gather speed, investment for the expansion of productive capacities and infrastructure development continues, and new mines and oil fields come on stream in many countries. The outlook is subject to political and economic downside risks. Continued political tensions and/or civil unrest in Chad, the Côte-d’Ivoire, the Darfur region of Sudan and the Democratic Republic of Congo could have spillover effects on neighbouring countries, weakening their growth prospects. Meanwhile, a worse-than-expected slowdown in the rest of the world could significantly hamper the region’s prospects, as export growth remains a key growth engine in the continent.

Growth in *East Asia* has continued to be buoyant in 2006, with the acceleration in China setting the pace for the region, not just by driving up the average, but also by generating positive regional spillover effects. While China posted a growth of over 10 per cent, the other economies in the region have also performed strongly, driven both by strong external demand for their exports and by a recovery of domestic demand in most countries. This growth momentum slowed during the second half of the year as a result of tightening measures to take effect in China and weakening global cycle of electronic products. As these trends are set to continue, the region is headed for a growth slowdown in 2007, to a more sustainable yet still strong pace. Some downside risks for the region include a potential return to more protectionist trade policies in the region's main export destinations, a further increase in oil prices and avian influenza, in addition to a possible disorderly unwinding of the global imbalances. As China becomes increasingly important for East Asian economies, should the growth of China fall, the drag for the region could be severe.

Growth in *South Asia* has remained strong in 2006, despite a slight moderation from the previous year. India has largely maintained a brisk pace, driving the regional average. The other economies have also continued growing at above-trend rates, with the smaller economies of Bangladesh, Sri Lanka and Nepal accelerating owing to a sustained rebound in the agricultural sector, and – in the case of Nepal – the cessation of violence since April 2006. In 2007, average regional GDP growth is expected to slow further, as most countries have reached their cyclical peak and in line with the anticipated slowdown in global growth. The Islamic Republic of Iran will likely experience deceleration by almost one percentage point because of the expected decrease in oil prices. In contrast, Nepal is likely to experience further acceleration in the form of a peace dividend, while India is expected to reach similar growth rates as in the previous two years. The downside risks for the region include a further increase in the level and volatility of oil prices and an epidemic outbreak of avian influenza. Political and geopolitical uncertainties also pose risks for several countries, such as the international tension around the nuclear issue of the Islamic Republic of Iran, an escalation of the civil conflict in Sri Lanka or a reversal of the peace process in Nepal. In addition, the region remains vulnerable to the vagaries of the monsoon and to the potential recurrence of natural disasters.

Increased oil revenues have once again buoyed growth in *Western Asia* during 2006, particularly in the oil-exporting countries. The decline in oil prices in the latter half of the year will impact GDP growth prospects for 2007, but growth is still expected to remain at a strong pace. Increased output in the non-oil sector, particularly petrochemicals, is expected to contribute to growth in the region in the outlook as production continues to shift from more costly facilities in the developed economies to Qatar, Oman, Kuwait and the United Arab Emirates. Oil revenue will, however, continue to drive private consumption and spur private investment in the real estate and equity markets. The oil-importing economies will feel the spillover effects through increased aid, labour remittances and tourism, but these channels are becoming somewhat weakened. Growth will slow for the oil importers from an estimated 6.3 per cent in 2006 to 5.5 per cent in 2007, with the momentum in the service sector and domestic construction projects continuing to provide some support. Although the region's overall macroeconomic performance puts it in a better position for a downturn in the oil market, the more diversified economies would be better placed should these prices drop. The asset bubbles in oil-exporting countries pose key risks for the region. Meanwhile, the region's economies are particularly subject to geopolitical uncertainties.

Growth in *Latin America and the Caribbean* has been solid during 2006, owing to both strong external and domestic demand. GDP is estimated to have grown by 4.9 per cent, which is better than the earlier forecast. While the South American countries as a group continue to lead the region's growth, the northern countries of Mexico and Central America have started to catch up, broadening the growth throughout the region. The growth estimate for Brazil has recently been downgraded as a result of a weaker-than-expected manufacturing sector and exports. The rest of the South American subregion is performing better than expected, led by Argentina and the Bolivarian Republic of Venezuela. Mexico's prospects have also improved, private and public consumption having accelerated and real investment having increased, supported by strong public investment in an electoral year. The growth in the region is expected to slow down in 2007, but only gradually. The region's external sector remains vulnerable, presenting some downside risks. A larger-than-expected slowdown of the United States economy would directly hamper the exports of Mexico and Central America. A number of small oil-importing economies in Central America continue to be adversely affected by high oil prices. Moreover, the region will also be particularly susceptible to higher interest rates in global capital market.

The outlook for employment and inflation

The global employment situation has shown some improvement in 2006, as robust economic growth has stimulated job creation in some regions of the world. Job growth, however, has not been commensurate with the high rates of GDP growth recorded in the world economy, particularly in the developing economies, suggesting various structural issues that are weakening the nexus between GDP growth and employment generation.

In most of the developed economies, the unemployment rates have declined in 2006, although these rates may mask some structural problems in the labour market. For example, the rate of unemployment in the United States has decreased to a five-year low of 4.6 per cent, but this is partly the result of a decline in labour force participation. Additionally, employment growth in the United States has in the past few years been concentrated in only three sectors of the economy – namely, healthcare, housing and government – while other sectors have recorded job losses. In the outlook for the United States, employment growth in 2007 is expected to be more sluggish, and the unemployment rate may rise. In Western Europe, the unemployment rate continued its downward trend in 2006, reaching the level achieved during the last cyclical nadir in 2001. In 2007, employment growth should remain steady and the unemployment rates could decline further, although only moderately. Meanwhile, labour market conditions have improved in almost all the new EU-8 countries, most notably in Poland. The improvement is, however, largely cyclical, except for some structural improvement in the Baltic States. Increased migration to the EU-15 countries has also alleviated the unemployment rate in the EU-8 countries. As more Western European countries are opening their labour markets for the EU-8 countries, this trend is expected to continue. The continued economic recovery in Japan has also resulted in a fall in the unemployment rate. Labour markets in Australia, Canada and New Zealand are in good shape.

Despite a robust GDP growth in the developing countries, growth of employment has not been sufficient to substantially lower unemployment rates. The economic revival in Africa is being driven mainly by capital-intensive sectors, such as the oil and mining sectors; there are minimal backward and forward linkages with the rest of the economy, thus limiting the impact on reducing high unemployment and underemployment. As growth prospects improve, the increased size of and participation in the labour force have also held unemployment rates from falling in some African and Latin American countries, although the formal employment in Latin America has increased. In East Asia, with the exception of Hong Kong SAR, Taiwan Province of China and Singapore, unemployment rates have remained entrenched and in many cases have increased. Even China's spectacular economic growth has not managed to improve some of the country's unemployment problems because of rapid structural changes and the reforms of the State-owned enterprises. Similarly, in South Asia, unemployment remains high, as the formal sector is unable to absorb the rapidly growing labour force. Meanwhile, there is a mismatch in the labour market in terms of skills, leading to high unemployment, particularly among educated youth. The unemployment rate in West Asia, in the double digits, is also stubbornly entrenched. The employment situation in the region will continue to be exacerbated by the growing number of young people entering the labour market as well as the lack of employment opportunities for the domestic workforce as foreign workers represent 80 per cent of the private-sector labour market.

Among the economies in transition, in South-east Europe, unemployment continued to decline in Bulgaria and Croatia, but in many of the former Yugoslav countries, unemployment rates remain stubbornly high, despite progress in the post-conflict reconstruction. In the CIS countries, unemployment rates remain stubbornly high and are accompanied by shortages of labour in specific sectors. However, some progress has been achieved in Kazakhstan and the Russian Federation due to dynamism in the construction sector and increased migration inflows.

Headline *inflation* rates have edged up notably in a majority number of countries during 2006, but in most cases they have been caused by the direct impact of 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. There have also been some growing concerns about the inflation implications of rising labour costs and the tightening rate of capacity utilization, mostly in major developed economies, but inflation expectations, as measured by various surveys and market indicators, remain stable. In the outlook, inflation is expected to moderate along with a slowdown in the global demand.

Among developed economies, inflation in the United States accelerated notably in the first half of 2006, but has since stabilized. While the headline inflation rate is running above 3 per cent for 2006, the core inflation measures, excluding the prices of food and energy, have all also been above 2 per cent, and are thus beyond the commonly perceived comfort zone for the Federal Reserve. Falling energy prices in the later part of 2006 have eased some inflation concerns, but the rise in labour costs is becoming a new concern. However, inflation expectations remain stable, as measured by the spread between the yield on the 10-year Treasury and that of the Treasury-Inflation-Protected-Securities of the same term, at a little above 2 per cent. In the euro area, the Harmonised Index of Consumer Prices (HICP) has remained well above 2 per cent for a large part of 2006, while core inflation has been much lower, but also drifting upwards. The main impetus to the inflationary surge has been the rise in oil prices, but so far there is minimal evidence of pass-through effects into the general price level or into inflationary expectations. Inflation concerns have most recently also stemmed from some estimates that GDP might have grown above potential and that the rate of unemployment might have approached the so-called non-accelerating-inflation rate of unemployment (NAIRU). In the outlook, inflation is expected to moderate in both the United States and the euro area, but to remain above 2 per cent. In Japan, a continued recovery in domestic demand has finally pushed the economy out of deflation. In the outlook, inflation measures are expected to be above zero in 2007.

Inflation remains stable in most developing countries and economies in transition. A number of these economies have experienced a higher rate of inflation during 2006, but in most cases it was mainly due to the direct effects of higher oil prices, with limited second-round effects. Only several economies have encountered significant inflation pressures, caused by country-specific factors. In Africa, inflation for the region remains low, except in a few countries, where sharp increases in consumer prices have resulted from food shortages, currency depreciation, and/or an immediate pass-through of higher imported-oil prices to consumers. Inflation has been below 5 per cent for most East Asian economies, except Indonesia, where a removal of subsidies in oil prices in late 2005 has caused a significant rise in consumer prices. In China, contrary to some concerns about overheating, inflation has been running only above 1 per cent. Inflation in South Asia has edged up only slightly. In West Asia, while a few oil-importing countries have seen a rise in inflation, inflation pressure has also built up in oil-exporting countries due to the significant increase in oil revenues which have fuelled wage increases. Only a couple of economies in Latin America have registered inflation rates above 10 per cent; the rest all about 5 per cent. Inflation in most economies in transition remains close to 10 per cent, higher than other regions, but no escalation. The inflation outlook for most developing countries and economies in transition remains benign in 2007, particularly in view of an expected softening of oil prices.

Macroeconomic policy stance and implications

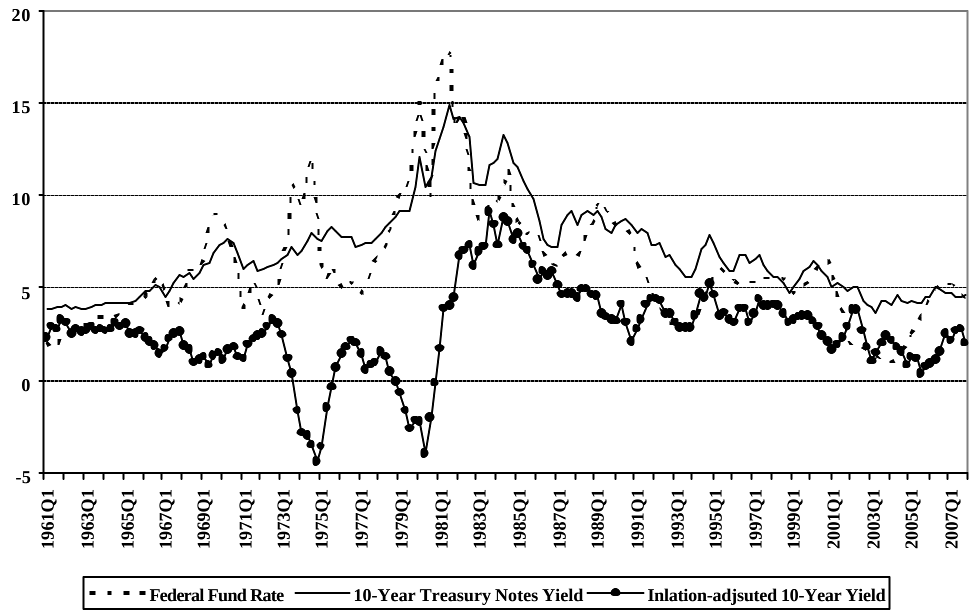
On the macroeconomic policy front, 2006 has been characterized by a general trend of monetary tightening, as the central banks of many economies have continued to raise interest rates to withdraw liquidity from the world economy (see table 2). The monetary policy stance, however, remains accommodative in most economies, and the benchmark interest rates in world capital markets are still relatively low compared with historical averages in either nominal or real terms (see figure 3). Another feature of the year has been a notable improvement in the fiscal position of a large number of countries, mainly coming from stronger-than-anticipated government revenues due to robust economic growth. In the outlook, macroeconomic policies are expected to face more challenges. As the cyclical expansion of the world economies tapers off, central banks will likely face competing demands. On one hand, monetary stance is required to remain accommodative in order to prevent the expected slowdown from deteriorating too far but, on the other hand, inflation pressures may continue to linger as a result of the multi-year expansion phase in the business cycle, requiring further monetary tightening to curb inflation. Meanwhile, as growth is expected to moderate, further cyclical improvement in fiscal revenues will weaken, and in some countries structural problems in government finance remain difficult to deal with.

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

	October 2006	Change from Jun 04 (bp)	Direction in recent change
Australia	6.00	75	+
Brazil	14.25	-175	-
Canada	4.25	225	+
Chile	5.25	350	+
China	6.12	81	+
Czech Republic	2.50	25	+
Hong Kong SAR	6.75	425	+
Hungary	7.75	-375	+
India	6.00	150	+
Indonesia	10.75	341	-
Japan	0.25	25	+
Korea, Republic of	4.50	75	+
Malaysia	3.50	80	+
Mexico	7.00	50	-
New Zealand	7.25	150	+
Norway	3.00	125	+
Philippines	7.50	75	+
Poland	4.00	-125	-
Slovakia	4.75	-25	+
South Africa	8.00	0	+
Sweden	2.50	50	+
Switzerland	1.75	125	+
Taiwan Province of China	2.63	125	+
Thailand	5.00	375	+
Turkey	17.50	-450	+
United Kingdom	4.75	25	+
United States	5.25	425	+

Source: JP Morgan Chase Bank.

Figure3. Nominal and real interest rates of the United States



Source: Global Insight

Monetary policy

In the developed economies, after a tightening cycle of two years to raise the interest rate of the Federal Fund to 5.25 per cent, the Federal Reserve Board (Fed) of the United States has decided to hold the interest rate steady since August 2006. Such a decision was made amid the competing readings of continued inflation pressures and the signals of weakening demand, as well as by taking into account the lagged cumulative effects of previous monetary tightening. In the outlook, the Fed is expected to hold the Federal Fund rate at 5.25 until mid-2007, to be followed by a cut of 50 basis points. In contrast, the European Central Bank (ECB) remains in the midst of a tightening cycle with the aim of bringing policy to a more neutral stance. It had raised its main policy interest rate to 3.25 per cent by October 2006, a cumulative 125 basis points since late 2005. Headline inflation has continued to run higher than the ECB target, GDP growth seems to have been at a pace greater than some estimates of potential growth, and the unemployment rate is believed to be close to some estimates of the NAIRU. Given all this, the ECB is expected to raise interest rates to 3.5 per cent in the outlook. During 2006, the Bank of Japan (BoJ) raised interest rates from 0 per cent to 0.25 per cent, beginning to normalize the level of interest rates after five years of the unorthodox monetary expansion aimed at fighting deflation. In the outlook, the BoJ is expected to raise interest rates by 100 basis points in 2007, although policy makers will remain cautious and move only gradually in tightening monetary policy.

Most developing countries and economies in transition have also been tightening monetary policy, gradually and by various measures, including by raising policy interest rates and increasing reserve requirements on demand deposits. In addition, the appreciation of currencies in a number of countries in this group has also worked to tighten monetary conditions.

In Africa, monetary policies continue to be cautious, to some extent countering an expansionary fiscal stance. In East Asia, while China and a couple of other economies are expected to tighten further in 2007, the monetary tightening in most other economies may have peaked. In South Asia, after a continued tightening in 2006 in most economies, except in the Islamic Republic of Iran, the central banks will remain vigilant, as the relatively low real interest rates imply more room for tightening. Monetary stance will remain accommodative in West Asia, with ample liquidity. Most Latin American economies have been reducing interest rates from relatively high levels, but currency appreciation in the region has offset some of the effects of lower interest rates on overall monetary conditions. In most economies in transition, monetary conditions are lax, featuring rapid growth of credit and relatively low real interest rates.

Fiscal policy

Fiscal policy stance varies considerably among developed countries, although fiscal positions in most of these economies have improved notably during 2006 because economic growth has been stronger than what was assumed in the budget. In the United States, revenues have increased so strongly that the federal budget deficit narrowed measurably during 2006. In the outlook, higher taxes will still be needed eventually to keep the deficit under control, but some of the tax reduction measures will not expire as scheduled. Fiscal stance is expected to remain modestly stimulatory. In Europe, deficit-to-GDP ratios are improving faster than anticipated, but pressure remains for countries with large deficits, especially those that are close to or exceed the target of 3 per cent as defined in the Stability and Growth Pact. While Germany has set the value-added-tax (VAT) increase at percentage points in 2007, Italy is under acute pressure for consolidation to set for a more restrictive fiscal policy. The overall fiscal policy stance in Europe will be moderately restrictive, but countries with balanced or positive budget positions have more leeway. Some cyclical improvement has been recorded in the fiscal balances of the eight new EU economies. While the budget deficit of Hungary is estimated to exceed 10 per cent of GDP in 2006, the deficits in the other countries are consistent with the Stability and Growth Pact. Japan's fiscal policy remains focused on reducing the deficit in the primary budget, both through tax increases as well as spending cuts.

Among the developing countries and the economies transition, fiscal policy stances are even more divergent, although most oil-exporting countries, as well as other commodity-exporting countries, have witnessed a significant improvement in their fiscal balance position, resulting from higher revenues, although such improvement may largely be cyclical. In Africa, fiscal policies have been relatively expansionary in many countries. Fiscal positions are in surpluses or small deficits in many African countries, mainly reflecting some improvement in domestic revenue collection and significant current grants. Public spending, in particular capital spending, has increased. In East Asia, fiscal policy in China, Taiwan Province of China and Malaysia will continue to be expansionary, as these economies plan to increase social and development spending; the rest of the economies in the region are expected to run a neutral fiscal policy. In South Asia, a broadly expansionary fiscal policy during 2006 is expected to continue in 2007. To ensure fiscal sustainability, most Governments aim at broadening the tax base, while also introducing selected tax increases in order to increase revenues. In West Asia, while the oil-exporting economies have continued to increase both fiscal surpluses and government expenditure, most oil-importing countries in the region are largely in fiscal deficit. In Latin

America, government expenditure has been kept in check in contrast to a robust increase in government revenues. A number of countries are in sizeable primary surplus, although the debt-to-GDP ratio remains above 50 per cent in several countries. A generally improved fiscal position in many CIS economies and South-east European countries are running budget surpluses or modest deficits.

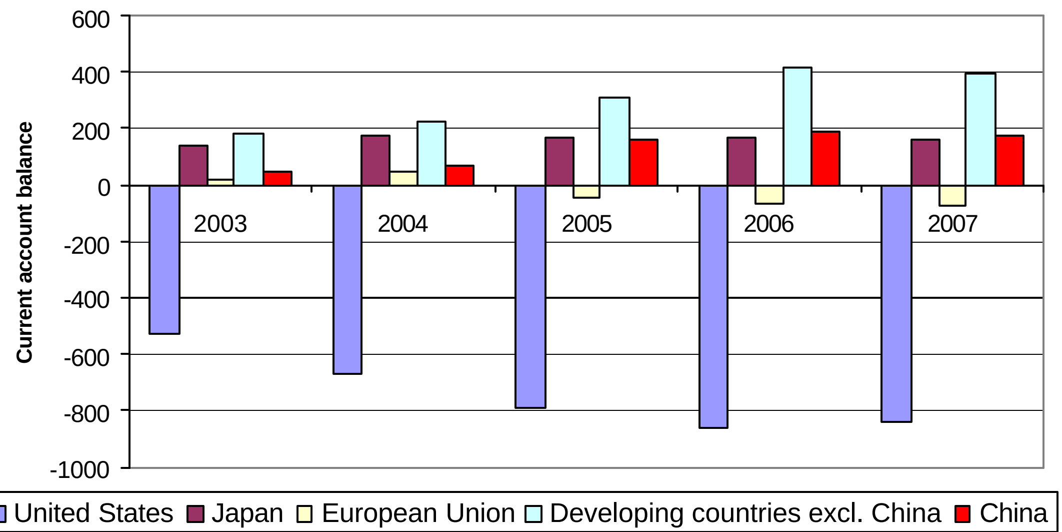
Uncertainties and risks

The outlook for the global economy encompasses a number of uncertainties and downside risks. A possible disorderly unwinding of the large global imbalances, the likelihood of a burst of the housing bubbles in a number of countries and the uncertainties around oil prices are among the major concerns. The risks for an outbreak of avian influenza and unpredictable geopolitical shocks are also not negligible.

Global imbalances

Current-account imbalances across countries have further widened during 2006. The deficit of the United States is estimated to rise to about $870 billion by the end of 2006, an increase of $80 billion from the previous year (see figure 4). Meanwhile, the deficits of a few other developed countries, such as Australia, Spain and the United Kingdom of Great Britain and North Ireland, have also become more substantial, either in terms of the level or relative to the size of these economies. Developed economies as a whole are running a current account deficit of above $600 billion. While Germany has maintained a sizeable surplus of about $120 billion, the euro area as a whole is in a balanced position. Japan’s surplus remains the largest among developed countries, at $170 billion.

Figure 4. Current Account Imbalances



Most developing regions are running surpluses, with the surplus in the group of oil-exporting countries increasing the most in 2006 and estimated to reach $500 billion. The surplus in developing Asia remains above $200 billion, concentrated almost exclusively in China, Hong Kong SAR and Taiwan Province of China. Latin America has managed to run a surplus for an unprecedented four consecutive years, while Africa is also in a small surplus. While the surplus in the CIS group has surpassed $100 billion, mainly because of the Russian Federation, the group of other economies in transition in Europe is running a sizeable deficit.

From the perspective of international trade, the widening global imbalances during 2006 have been, to some extent, correlated with the further price increases in oil and other commodities. For example, oil imports of the United States have increased by about $70 billion in 2006 over the previous year, accounting for more than the total increase in its trade-account deficit.

In the United States, the worsening current-account deficit has mainly been reflected in a widening of the private savings gap, as the deficit in the government account has improved by $50 billion, or 0.4 per cent of GDP, during 2006. The household saving rate has dwindled further to -0.6 per cent of disposable income, while business investment has accelerated slightly to offset a decline in residential investment.

Worldwide, the phenomenon of a pervasive "investment anaemia" underlying the global imbalances, as delineated in the previous LINK Global Economic Outlook and *World Economic Situation and Prospects 2006*, has improved only slightly. Among developed countries, investment accelerated moderately in both Europe and Japan during 2006 by about 1-2 percentage points from the previous year, but the growth rates of investment in most developed countries remain below the average rates of the late 1990s.

Some improvement in investment has been witnessed in developing countries, but the trend is divergent across countries. In East Asia (excluding China), a decline in the investment rate was the most evident in the years after the Asian financial crises of the late 1990s. The recent cyclical recovery has tightened capacity utilization rates in manufacturing to the highest degree in the post-crisis period, suggesting that investment outlays should recover. However, the investment recovery has not taken place consistently in the region. For example, a steady increase in equipment and machinery investment rates since 2001 has continued in Thailand (at least up to mid-2006), but the investment rate remains 10 percentage points below the pre-crisis level, even though the utilization rates have regained their pre-crisis levels. In the Republic of Korea and Taiwan Province of China, the situation is even worse. Private investment in Republic of Korea has remained depressed despite the fact that profit rates have returned to their high levels of the mid-1990s. Investment rates in Taiwan Province of China have also failed to catch up with the recovery in operating surplus rates. This investment weakness in some Asian economies can be partly explained by the ongoing relocation of production bases from these economies to China, and partly by a possible improvement in capital productivity, but its consequence for the long-run potential growth in the these economies and the implications for the adjustment of the global imbalances are worth noting. China, on the other hand, has continued to register strong investment growth in 2006, at a rate of about 15 per cent in real terms. Among other developing regions and the economies in transition, investment growth has further strengthened in most oil- and commodity-exporting countries, fuelled by increased revenues and driven by the strong demand for infrastructure and new production capacity. The investment rate in many of the LDCs remains too low to boost sustained high growth.

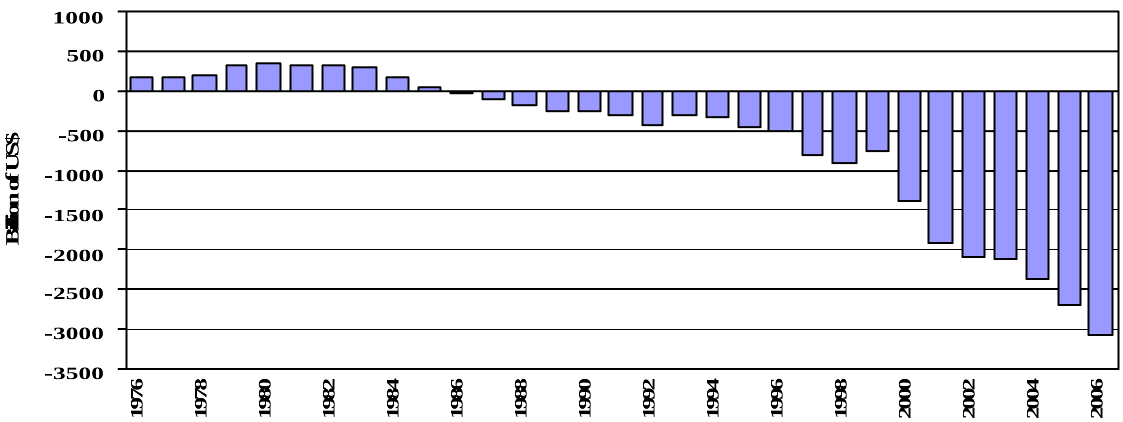
As a result of the widening current-account deficit, the indebtedness of the United States has deepened, further threatening the sustainability of the global imbalances. While the data for 2006 are not available yet, the latest official release for the net international investment position of the United States for 2005 could be used as a reference point for assessing development in 2006.[2]

By the end of 2005, United States-owned assets abroad were about $10 trillion (measured at current cost), while foreign-owned assets in the United States were about $12.7 trillion, recording -$2.7 trillion as the net international investment position of the United States, or about 22 per cent of its GDP for the year. A change of -$333 billion was added to the net international investment position during 2005, in comparison with a current-account deficit of $790 billion recorded in the same year. The difference between the increase in the net indebtedness of the United States and its current-account deficit reflects, aside from statistical discrepancies, valuation adjustments in both the United States-owned assets abroad and the foreign-owned assets in the United States related to, among others, exchange-rate changes and appreciation/depreciation of stocks. In recent decades, such valuation adjustments would almost always be in favour of the United States, making the annual change in the net debt position of the United States measurably smaller than the amount of the current-account deficit. The net debt position has, however, been on the rise over years along with the growing current account deficit. Against this backdrop, given the estimate of the current-account deficit at about $870 billion in 2006, and taking into account the exchange rate changes and the relative performance among major financial markets during 2006, the net international investment position of the United

[2] United States Bureau of Economic Analysis (2006) *Survey of Current Business*, multiple issues

States will likely worsen by some $400 billion by the end of 2006, to reach over $3 trillion (see figure 5).

Figure 5. United States net international investment position (1976-2006)



Source: United States Bureau of Economic Analysis up to 2005 and LINK estimate for 2006.

While the United States-owned assets abroad largely take the form of direct investment, stocks and bank and nonblank claims, a sizable share of the foreign-owned assets in the United States are allocated in holdings of the United States treasury securities. For example, by the end of 2005, United States-owned direct investment abroad was about $2.5 trillion while the foreign counterpart was about $1.9 trillion. A similar pattern has likely been maintained during 2006, as a number of countries with current-account surpluses have continued to accumulate foreign reserves. The share of the United States dollar was about 66 per cent of world total official reserves by the end of 2005; this share may have lowered slightly during 2006 as anecdotal evidence indicated downward adjustments in the dollar-denominated reserves in some countries.

In the baseline outlook for 2007, the global imbalances are expected to reduce, albeit only slightly. With the growth in the United States expecting to moderate more than that of other major economic regions, its current-account deficit is expected to narrow slightly from an estimate of $870 billion in 2006 to $840 billion in 2007. A continued cooling in the housing sector in the United States will likely curb household spending and raise savings, while an expected depreciation of the dollar is expected to boost exports of the United States and to restrain its imports. Meanwhile, the assumption of lower oil prices in the baseline for 2007 would also work to ameliorate the deficit of the United States.

Notwithstanding the expected reduction in the global imbalances for 2007, the risks of a disorderly adjustment have not dissipated. For example, since the differentials in growth rates and interest rates across major economies regions are expected to bring an unfavourable change the United States dollar vis-à-vis other major currencies, a self-fulfilling sell-off of the dollar in foreign exchange market could trigger a financial crisis and lead to an abrupt adjustment of the global imbalances.

In order to reduce such risks, international organizations, including the United Nations, the International Monetary Fund (IMF) and the World Bank, have reiterated the needs for international policy coordination as a means of implementing a set of economic policies in both the deficit and surplus economies. However, with the exception of some small progress in strengthening multilateral surveillance and multilateral consultation at the IMF, no other concrete actions have taken place. Although there seems to be a number of formidable obstacles to such policy coordination, history shows that the potential costs of inaction, or a delayed action, could be consequential.[3]

Impact of oil prices

Oil prices have been on a steady uptrend over the past few years, but the volatility seems to have notably increased during 2006. For example, the price of Brent crude reached a record high of $78.69 per barrel on 8 August 2006, but has since dropped by about 30 per cent, to below $60 per barrel in late October.

In general, a tight worldwide oil production and refinery capacity, coupled with a solid global oil demand, has been the fundamental factor behind the uptrend in oil prices. Increased, and yet capricious, geopolitical tensions are among the major factors driving the volatility. This situation will likely remain, and therefore, oil prices are expected to stay on an upward, albeit, highly volatile trend. Oil prices could drop further should the ongoing moderation in world economic growth develop into a “hard-landing”. Meanwhile, the Organization of Petroleum Exporting Countries (OPEC) has recently decided to reduce production quotas by about 1 million barrels per day to prevent the prices from falling further.

Unlike the two previous oil crises of the 1970s and the 1980s, higher oil prices have thus far not resulted in any significant contraction for the world economy. There are two main reasons. First, there has not been any large-scale curtailment in global oil supply as experienced in those two episodes, and despite the increased fears for supply disruptions, global oil production thus far has continued to grow in recent years; and second, strong economic growth underlying the higher demand for oil has compensated for the negative welfare effects of higher oil prices.

While most oil-importing countries will face pressures from higher oil prices, special attention should be paid to the implications of higher oil prices for the group of low-income oil-importing countries. The weight of net oil imports in these countries varies, but in some cases it has reached over 40 per cent of total imports. Low-income net oil-importing countries are especially vulnerable to higher oil prices, as they are in general characterized by a higher energy intensity of GDP than high-income countries. This is coupled with a relatively higher dependence on oil as a source of primary energy.

More directly, higher oil import bills can crowd out other import demand. As the price elasticity of oil demand is generally low in the short- to medium-term, the increased oil bill must be matched by a reduction of demand for other goods and services. This has led a number of

[3] Chapter II of the forthcoming *World Economic Situation and Prospects 2007* will focus on the obstacles to and the options for international policy coordination.

low-income countries to curtail other, non-oil imports. For example, during 2003-2005, countries like Bhutan, Guyana, Lesotho, Mauritania and Myanmar cut non-oil imports by more than 10 per cent of GDP.

Many countries have tried to protect domestic consumers from higher oil prices through subsidies, price controls or other compensatory measures. As oil prices stay high, these countries lack the means to avoid the pass-through of higher international oil prices to domestic prices as fiscal positions continue to deteriorate. The subsidies reduce the fiscal space for other essential public expenditures and this could jeopardize the necessary investments towards the achievement of the MDGs.

The poor in these countries will be hurt by the rising cost of living or less employment opportunities. Household survey data show that people in the lower income quintiles have suffered larger income losses because of higher oil prices than higher income groups. In India, Ghana, Guatemala, Nepal, South Africa and Viet Nam, for instance, it has been found that the welfare losses caused by higher oil prices have been, on average, four times higher for the poorest households, compared with the richest ones.

The recent decline in oil prices seems to have allayed the fears of an oil crisis and some analysts have even started to talk about the benefits of lower oil prices. The LINK baseline outlook, however, remains cautious about the impact of oil prices. First, if oil prices stay between $50 and $60 per barrel, they would continue to be a burden, rather than a boon, for many oil-importing countries, particularly those low-income developing countries. Second, although the international prices have declined by 25 per cent from the peak, the prices of oil products facing consumers in many countries have not declined accordingly, especially in those countries that have high taxes on oil products, or substantial government subsidies or strict control on domestic oil prices. For these economies, the recent decline in oil prices will have minimal positive impact on consumer spending. Third, even for those countries in which the latest decline in oil prices have immediately translated into a decline in the prices of oil products facing consumers, such as in the United States where the gasoline prices have recently dropped by 20-30 per cent, the positive effects of lower oil prices on household spending should not be overestimated. The less the consumers pay on gasoline now as compared to a few months ago does not necessarily lead to increases in household spending on other goods and services. Instead, households would simply not have to dig into their savings to cover their energy bills. In other words, lower oil prices would most likely lead to a replenishment of savings, rather than to higher spending. In general, as indicated by many studies, the relationship between oil prices and economic growth tends to be asymmetric: higher oil prices would usually forebode a slowdown in growth, but lower oil prices alone would not predict a stronger growth to follow. In this sense, the recent decline in oil prices could be an indication of the slowdown in global demand to come (among other factors, such as an improvement in geopolitical uncertainties) rather than a rescue to avert the slowdown.

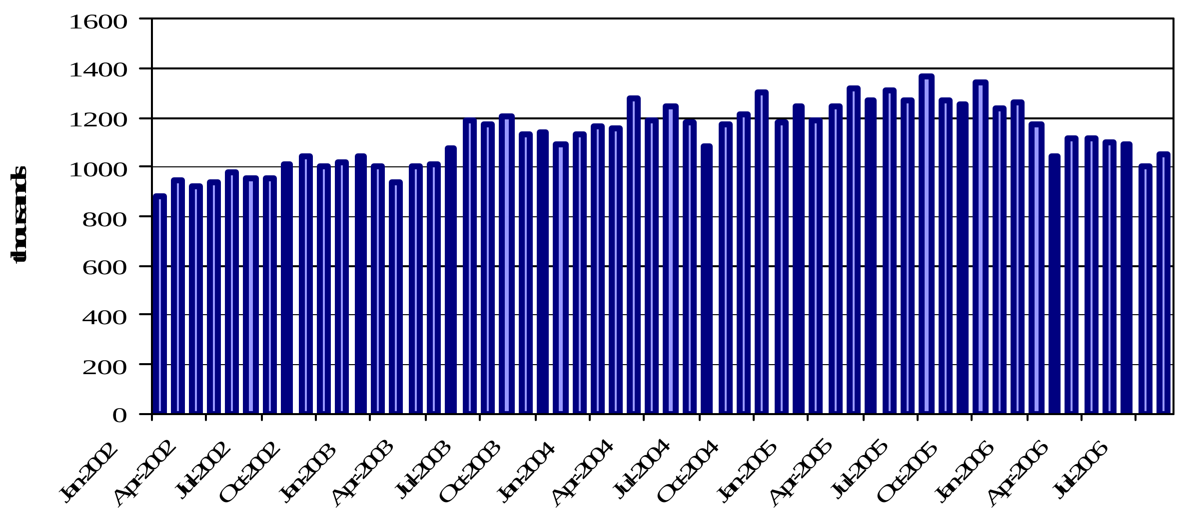
Reversal of the housing boom

A number of economies have experienced a substantial appreciation in housing prices over the past 10 years. For example, housing prices have increased by about 100 per cent in the United

States, 150 per cent in Spain, 200 per cent in the United Kingdom, and 300 per cent in Ireland. 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. While the housing boom has contributed, in varying degree, to the robust growth of these economies, a drop in housing prices would work conversely. The notable growth moderation in Australia and the United Kingdom a year ago was unambiguously attributable to a cooling down of the housing sector.

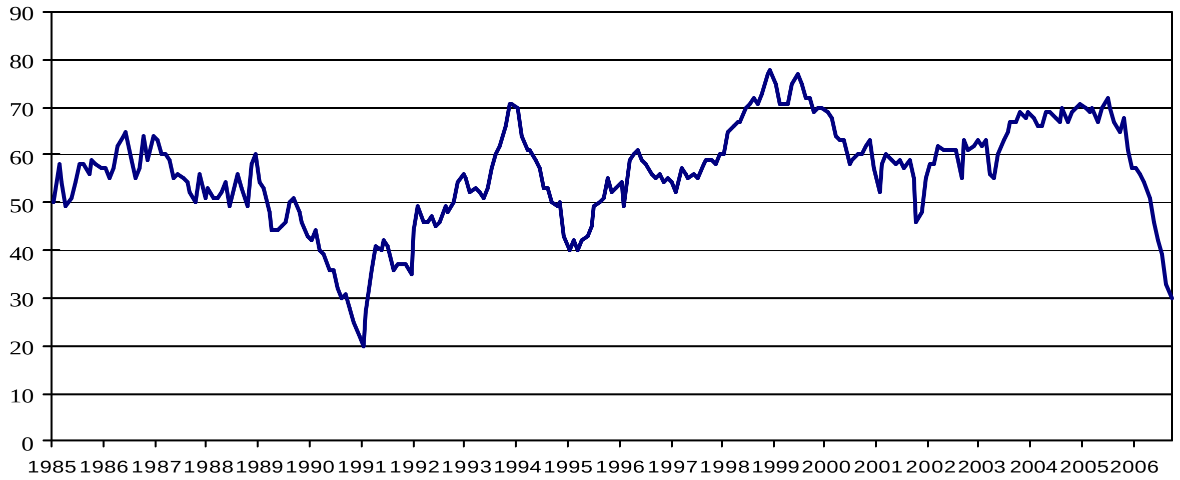
The slowdown in the trend of various measures of the housing sector in the United States has accelerated during the course of 2006, despite some month-to-month variation in the data. For example, new home sales, which had been on a steady rise for several years, declined in 2006 by about 20 per cent from the level of 2005 and dropped to the level of 2003 (see figure 6). Existing home sales have also dropped by more than 10 per cent. Nationwide, the inventory of unsold homes, both new and existing, has risen from a four-month supply to a seven-month supply, and the trend continues to rise. In response to the weakness in the housing market, the homebuilding industry has cut production substantially. The levels of housing permits and starts are running about 20 percent below that of the previous year. Additionally, the inventory of unsold new homes have risen by more than 40 per cent above the level of 2005, homebuilder's confidence has dropped to the lowest level in 15 years according to the survey by the National Association of Homebuilders (see figure 7).

Figure 6. New Home Sales in the United States(seasonally adjusted annual rate)



Source: United States Census Bureau.

Figure 7. Housing Market Index in the United States
(seasonally adjusted)



Source: National Association of Home Builders

So far, the adjustment in the level of house prices has been fairly modest, but the rate of deceleration in the prices has been salient. According to the Office of Federal Housing Enterprise Oversight (OFHEO) home price index, house prices turned from an average annual gain of about 10 per cent in the past few years to a slight decline in the second half of 2006. Meanwhile, for the first time in 11 years, median sales prices of existing homes registered a decline in August of 2006 from year-ago levels.

Further weakening of the housing sector is expected for the United States in the outlook. While the piling up of the inventory of both unsold new homes and existing homes for sale augurs a further weakening in sales and construction, the extent of the overvaluation in housing prices implies more room for the prices to drop. Since 1997, housing prices in the United States have appreciated by about 80 per cent in real terms (adjusted by inflation rates) in comparison with a real appreciation of just 10-20 per cent in booms of earlier years, leading to deterioration in housing affordability.

Meanwhile, a few positive factors may continue to support the housing sector from falling into a full-scale crisis. The interest rates on mortgages are still low by historical standards. Further, although 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, the banking sector in general is in good shape, particularly in contrast to the situation of the savings-and-loans crisis of the late 1980s and early 1990s. Finally, the delinquency rates on mortgage loans are still low. Therefore, the baseline outlook is for a continued weakening in the housing sector with moderation in the prices. Nonetheless, the risk for a much steeper decline in housing prices cannot be precluded.

The impact of the unfolding housing slowdown on the economy will be mainly through household spending. The housing sector is one of just a few industrial sectors that have created a sizeable number of new jobs in the last few years. The wealth effects and the impact on consumer confidence are also important. In the past few years, there has been an increase in mortgage equity withdrawal to finance consumption spending. The annual amount of mortgage equity withdrawal had increased from a very small amount in the late 1990s to more than $600 billion in 2005, accounting for over 6 per cent of disposable income. Although not all of the withdrawal was directly used to finance household spending, it has been a crucial factor for the resilient consumption growth, and the drop in the household saving rate, which now has become negative. This trend is reversing, as mortgage borrowing slowed since the peak of the housing market in 2005 and mortgage equity withdrawal declined to about $300 billion in 2006. So far the impact on the consumption and saving rates has been small leading to some complacency, but the negative wealth effects on household spending will likely become more evident when housing prices actually start to decline.

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 housing prices and global imbalances. A number of economies that have seen substantial appreciation in housing prices are also running large external deficits (relative to their GDP) and experiencing a decline in household savings to very low levels. In this regard, the housing boom in those countries has been to some extent financed by borrowing from the high-savings countries running external surpluses. Therefore, a burst in housing prices is likely to lead to an abrupt and contractionary adjustment of the global imbalances.

An alternative scenario

To illustrate the implications for world economic growth if some of the downside risks were to materialize the LINK forecast also includes a pessimistic scenario. In this scenario a burst of the housing market bubbles (especially in the United States, but also possible in a number of other economies), an abrupt adjustment of the large global imbalances, and a supply-side shock to drive oil prices higher are simulated.[4]

The key assumption of this scenario is a collapse of the house market in the United States. Specifically, it is assumed that in 2007 house sales would be about 15 per cent and housing prices 9 per cent lower than in the baseline.[5] Such a dramatic fall in the housing sector is expected to erode the confidence of consumers and investors, not only in the United States, but also in the rest of world. As a result, a dwindling domestic demand of the United States would be accompanied by a recoiling of the willingness in the rest of the world to hold the financial assets of the United States, pushing interest rates on the dollar denominated assets higher by about 200 basis points than in the baseline. At the same time, the United States dollar would depreciate against other currencies in a magnitude larger than in the baseline. Further, the scenario also

[4] As the LINK modeling system is under overhaul, this scenario is simulated by using some of the existing LINK country models, particularly the GlobalInsight model for the United States, along with an updated trade matrix and some other approaches of estimation; therefore, the results, particularly the results for developing countries and the economies in transition, could have a large margin of errors, with a likelihood of underestimating the size of the international multiplier effects.

[5] See GlobalInsight *U.S. Executive Summary*, September 2006, for more details.

assumes that oil prices, which retreated in the second half of 2006, would resume an upturn to surge to $85 per barrel, as compared with the price of $60 per barrel in the baseline.[6]

As shown in table 3, a confluence of a deeper housing slump, higher interest rates, a lower dollar exchange rate and higher oil prices would send the economy of the United States into a mild recession in 2007, compared with the moderate growth of above 2 per cent in the baseline.

The housing slump in the United States as assumed in this scenario would be equivalent to an annual decline by about 20 per cent in residential fixed investment. A sharper reversal in the housing boom would depress household spending. In this scenario, mortgage equity withdrawal would wilt amid falling house prices, rising interest rates and tightening scrutiny for the mortgage loans. The precise impact of falling house prices on consumer spending remains an issue of debate among economists, but the pessimistic scenario suggests that growth of household consumption would come to a standstill, while under the booming house market private consumption increased by more than 3 per cent growth over the past few years. Business investment would still increase in this scenario, partly because most American companies are in good financial condition owing to the high profitability over the past few years, but at a much lower pace than in previous years.

The weakening of household consumption and business investment would translate directly into a curtailment in the import demand of the United States, which would be further aggravated by the income/price effects of the dollar depreciation vis-à-vis other currencies. In this scenario, real imports of the United States would register an annual decline of 2 per cent, in comparison with growth of about 6 per cent in previous years.

Weaker demand in the United States would be transmitted through trade linkages to the rest of the world. As the imports of the United States account for about 16 per cent of total world trade, a deceleration in its real import demand by about 8 per cent would lead to an immediate slowdown in the exports of other countries by about 2 per cent on average. The direct impact would be felt strongest by those countries that have a large share of their exports in the market of the United States, particularly Canada, China and Mexico. In addition to the direct impact of the reduced import demand from the United States, economic growth in the rest of the world would also suffer from the adverse effects of the higher oil prices and the dollar depreciation. Through the international linkages, the initial shocks would feed back and forth across countries and the overall effects on the world economy multiply.

As also shown in table 3, in this scenario world economic growth would drop by about 1.6 percentage points as compared to the baseline. In Europe and Japan, GDP growth would decrease by about half a percentage point lower than in the baseline. Despite the recent strengthening of domestic demand in both Europe and Japan, economic growth still relies importantly on export performance. In this regard, the expectation of some analysts that these

[6] In contrast to the situation of the past few years when higher oil prices were mainly driven by stronger-than-expected global oil demand while global oil supply continued to grow by more than one million barrel/day annually, this scenario assumes the higher oil prices would be driven by a supply-side shock, namely, a rise in the prices along with a reduction in global oil supply by 1 million barrel per day.

economies could smoothly take over the role as the engine of global growth from a weakening in the economy of the United States seems to be overly optimistic.

Table 3. An alternative outlook for the world economy in 2007

(Percentage annual growth rate)

Selected indicators	**Alternative**	**Baseline in comparison**
World output growth	1.5	3.2
Developed economies	0.8	2.2
United States	-0.3	2.2
Euro	1.6	2.2
Japan	1.1	1.7
Developing economies	3.5	5.9
China	6.2	8.9
Economies in transition	5.4	6.4
World trade growth (volume)	4.8	7.8
Oil prices (US$ per barrel)	85.0	60.0
US dollar exchange rate index (annual percentage change)	-17.0	-7.0
Interest rate on 10-year US treasury	6.5	4.5
US Current Account balance ($billion)	-785	-840

Source: Project LINK

Growth in developing countries would expect to drop by 2.5 percentage points in this scenario. While some oil-exporting countries would continue benefiting from higher oil prices, the gains would be much smaller than in the previous years because the volume of oil demand would decline in this scenario. On the other hand, oil-importing countries would suffer not only from higher oil prices but also from reduced demand for their exports. Unlike in the past few years when the prices of many non-oil commodities rose along with higher oil prices so as to offset the impact of higher oil prices for a number of oil-importing developing countries, the prices of many non-oil commodities would drop as the overall global demand weakens in this scenario. Meanwhile, there would be significant negative wealth effects of a depreciated United States dollar for many developing countries with large amounts of dollar-denominated reserve assets.

How China (and to a lesser degree, India) would fare in this scenario is particularly interesting, in terms of whether the country could buffer or would rather magnify the ripple effects of an economic slowdown in the United States. China has constantly gained a market share in world trade, expanding its exports above 20 per cent since its accession to the WTO in 2001. Its exports account for about 9 per cent of the world total. Meanwhile, with a relocation of manufacturing bases from other countries to China, and along with China's own industrialization, its demand for energy and primary commodities has become increasingly important in determining the trends in the prices of these commodities as well as the economic growth of countries exporting those commodities.

China's exports, although quite diversified across all regions, remain highly correlated to the demand of the United States, as well as to other major developed economies. In this alternative scenario, in addition to directly reducing the demand from the United States, China's exports would also be adversely affected by an appreciation of the renminbi (RMB) stronger than originally built in the baseline: 10 per cent against the United States dollar. As a result, China's export growth would be lowered by about 10 percentage points, compared with the baseline, i.e. down from the annual growth of 15 per cent in the baseline forecast to a pace of 5 per cent in the pessimistic scenario. However, such a large deceleration in its export growth alone would have relatively small impact on China's GDP growth. China's exports have grown at a much faster pace than other GDP components, except fixed investment, with the ratio of exports-to-GDP standing at above 40 per cent, but the net contribution of exports to GDP growth is not as high as this ratio would imply. About 60 per cent of China's exports are categorized as "processing trade", namely, processing imported intermediate goods for exporting, with the value-added contributed by China in those manufactured and assembled goods to be exported accounting for a small share. Meanwhile, in China's domestic economy, a dominant proportion of the fixed investment is allocated to infrastructure and housing, rather than to the exporting sector. As shown in the table, China's GDP growth could be 2 to 3 percentage points lower in this scenario. China's import demand would fall in similar magnitude as exports, largely because of the nature of the processing trade. This in turn would harm exports of intermediate goods by many other Asian countries that are part of the same global production chain. In short, China's external sector would show considerable weakening in this scenario. Its domestic demand could still continue to expand, which would provide a bit of a cushion for commodity-exporting countries and could prevent a steep fall in the demand for and prices of primary commodities. On the other hand, a large appreciation of the RMB as assumed in this scenario could heighten the risks for China's banking, financial and real estate sectors, and other challenges the economy is facing may also lead to a domestically generated weaker growth, but the implications of these factors are not considered in this scenario.

The global imbalances would improve slightly in this scenario, as the current account deficit of the United States would reduce by $50 billion as compared to the baseline. The reduction in nominal value of United States imports would be much smaller than in real terms, partly because of the "J-curve" effects of the dollar depreciation in the short run and partly because of the higher oil prices assumed in this alternative scenario. Meanwhile, as there would be no policy stimulus assumed in the rest of the world to counter the weaker demand in the United States, there is no additional export growth to contribute to the reduction of the United States current-account deficit.

In the pessimistic scenario, the macroeconomic policy stance in all the economies is assumed either to remain at the baseline level (if those policy variables are exogenous in the country models) or to change according to the endogenous rules built in the models. If instead more policy stimuli were assumed, the slowdown in the global economy could be less significant. In the short run, however, policymakers in the major economies are expected to continue their more conservative policy stance in the pessimistic scenario, especially because of inflationary pressures from the assumed higher oil prices which would make central banks in the major economies reluctant to reverse their tightening monetary policy stance. On the fiscal front, many countries, including China and other emerging market economies, do have room for more stimuli, but such effects would hardly be shown in the short run because of the general nature of a slow process in stipulation and the implementation of extra fiscal stimuli (beyond the built-in automatic stabilizers).

The pessimistic scenario assumes a double negative shock in the form of a housing market collapse and higher oil prices. In contrast, without the assumption of a shock on global oil supply, oil prices would fall in response to a lower global growth. Nonetheless, also in this case the negative impact on world economic growth of a burst of the house market bubble in the United States would remain substantial. With lower oil prices, central banks would have more room for cutting interest rates, and households would be less pinched, but as mentioned in the section on oil prices, lower oil prices would not necessarily lead to more consumer spending on other goods and services, instead, household would more likely use the extra income from the lower oil prices to replenish their negative saving rates—which had been the result of the higher oil prices and housing boom in the previous years.

In summary, although the probability for this more pessimistic scenario to occur is lower than for the baseline, most assumptions in this scenario are not unrealistic and are in the order of magnitude of similar events in the past. Moreover, given the insufficient sense of urgency among policy makers in the major economies to redress the global imbalances, this alternative scenario of a notable downturn in the world economic growth could well develop into a much worse scenario of a global recession along with a destabilization of financial markets if the global imbalances unwind in a disorderly fashion and without internationally concerted macroeconomic policies.