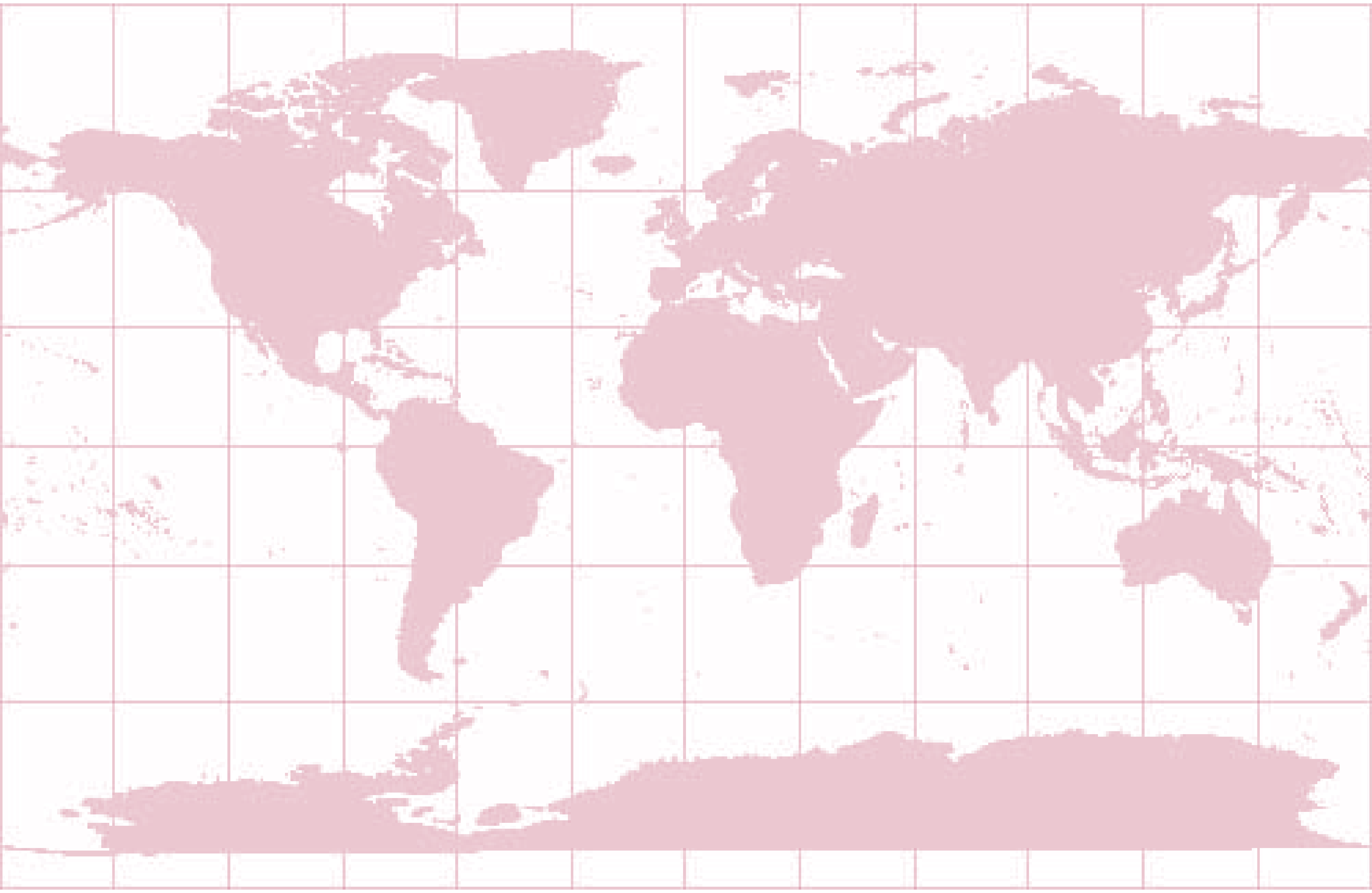
World Economic Situation and Prospects 2006



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This report is a joint product of the Department of Economic and Social Affairs (DESA), the United Nations Conference on Trade and Development (UNCTAD) and the five United Nations regional commissions (Economic Commission for Africa (ECA), Economic Commission for Europe (ECE), Economic Commission for Latin America and the Caribbean (ECLAC), Economic and Social Commission for Asia and the Pacific (ESCAP), and Economic and Social Commission for Western Asia (ESCWA)). It provides an overview of recent global economic performance and short-term prospects for the world economy and of some key global economic policy and development issues. One of its purposes is to serve as a point of reference for discussions on economic, social and related issues taking place in various United Nations entities in 2006.

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Executive Summary

The global outlook

Moderate world economic growth in 2006

World economic growth slowed noticeably in 2005 from the strong expansion in 2004. The world economy is expected to continue to grow at this more moderate pace of about 3 per cent during 2006.[1] This rate of growth is, nonetheless, the same as the average of the past decade. The United States economy remains the main engine of global economic growth, but the dynamic growth of China, India and a few other large developing economies is becoming increasingly important. Economic growth slowed down in most of the developed economies during 2005, with no recovery expected in 2006. Growth will moderate further to 3.1 per cent in the United States of America, while lacklustre performance will still prevail in Europe, with growth reaching a meagre 2.1 per cent in 2006. The recovery in Japan is expected to continue, albeit at a very modest pace of around 2 per cent.

Strong, yet insufficient growth in the poorest countries

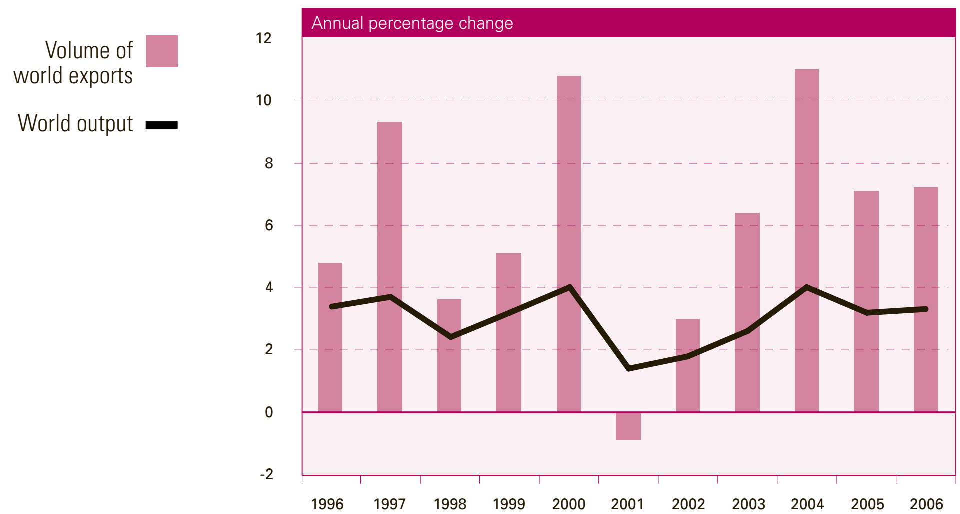
Generally, economic growth in most parts of the developing world and the economies in transition is well above the world average. On average, developing economies are expected to expand at a rate of 5.6 per cent and the economies in transition at 5.9 per cent, despite the fact that these economies may face larger challenges during 2006. While China and India are by far the most dynamic economies, the rest of East and South Asia is expected to grow by more than 5 per cent. Latin America is lagging somewhat behind, with growth of about 3.9 per cent, but African economic growth is expected to remain solidly above 5 per cent. Growing at 6.6 per cent, the least developed countries (LDCs) are faring even better, reaching the fastest average rate of growth they have had for decades. Even if these record levels are sustained, per capita income growth is still not strong enough in many of these countries to make sufficient progress towards the Millennium Development Goal of halving extreme poverty by 2015. Much of the economic buoyancy of developing countries has resulted from high export commodity prices, which may not be sustainable in the longer run. In contrast, developing countries and LDCs that are net importers of oil and agricultural products have been hurt by the high cost of oil and food imports.

Lacklustre employment growth worldwide

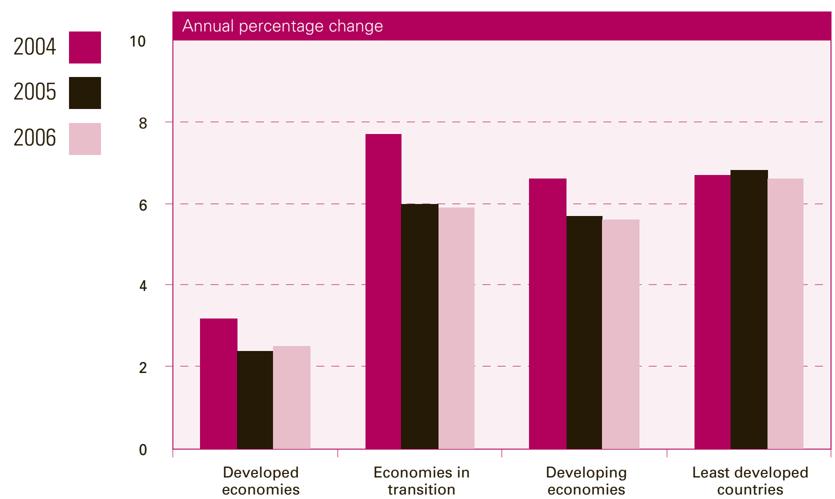
The employment situation worldwide remains unsatisfactory. The slowdown in growth partly explains this. More importantly, though, employment creation is falling short of the increment in labour supply in the majority of countries. Consequently, in a large number of countries, unemployment rates are still notably higher than the levels prior to the global downturn of 2000-2001. Despite strong growth performance, many developing countries continue to face high levels of structural unemployment and underemployment which limit the impact of growth on poverty reduction.

1 Growth is estimated at market prices. World output growth as measured with purchasing power parity-based weights is estimated at 4.3 per cent for 2005 and projected to reach 4.4 per cent in 2006.

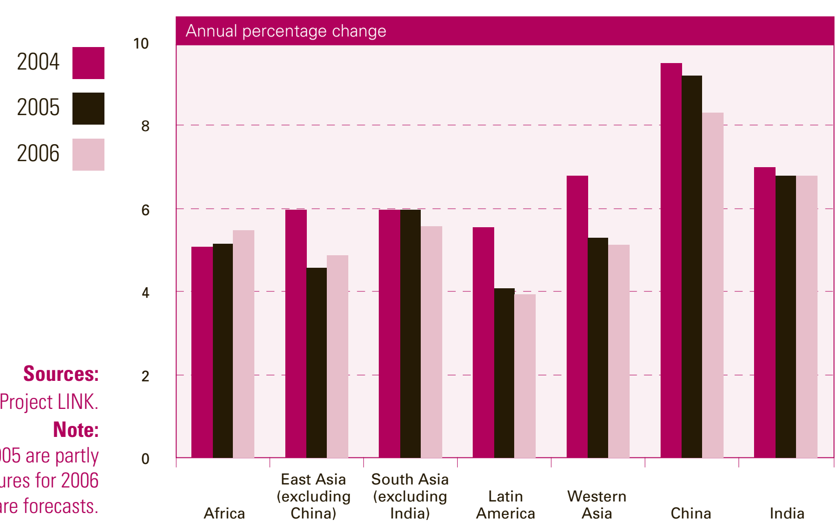
World economic growth slows down, but still robust for the decade



Growth in developing countries and economies in transition stronger than in developed countries



Slower growth in most developing-country regions, stronger growth in Africa



Sources: UN/DESA and Project LINK.

Note: Figures for 2005 are partly estimated. Figures for 2006 are forecasts.

Rising inflation, mainly due to oil price increases

Driven mainly by higher oil prices, inflation rates have edged up worldwide. Core inflation rates, which exclude such highly volatile components as the prices of energy and food, have been more stable, indicating that the pass-through of higher oil prices to overall inflation is limited. In most parts of the world, economic agents seem to expect inflation to remain low and stable. Worldwide inflation is forecast to remain tame during 2006. Nonetheless, certain inflationary pressures will need to be addressed, particularly if oil prices stay high.

The negative consequences of higher oil prices will be felt more

Higher oil prices are taking a greater toll in a growing number of oil-importing countries. Following the initial rise in oil prices, many countries adopted measures to protect domestic consumers by introducing or strengthening energy price controls and subsidies. These measures are becoming less and less viable as high oil prices persist and more of the price increases are passed on to consumers. For the longer run, policies in energy-importing countries should aim at improving their energy efficiency and at developing alternative energy sources. Oil-exporting countries continue to benefit from the higher oil prices, but at the same time the windfall gains from oil revenues are creating inflationary pressures and real exchange-rate appreciation. The macroeconomic policy challenge is to turn these gains into investments in future economic and human development.

Global imbalances constitute a downside risk

Global imbalances are widening further

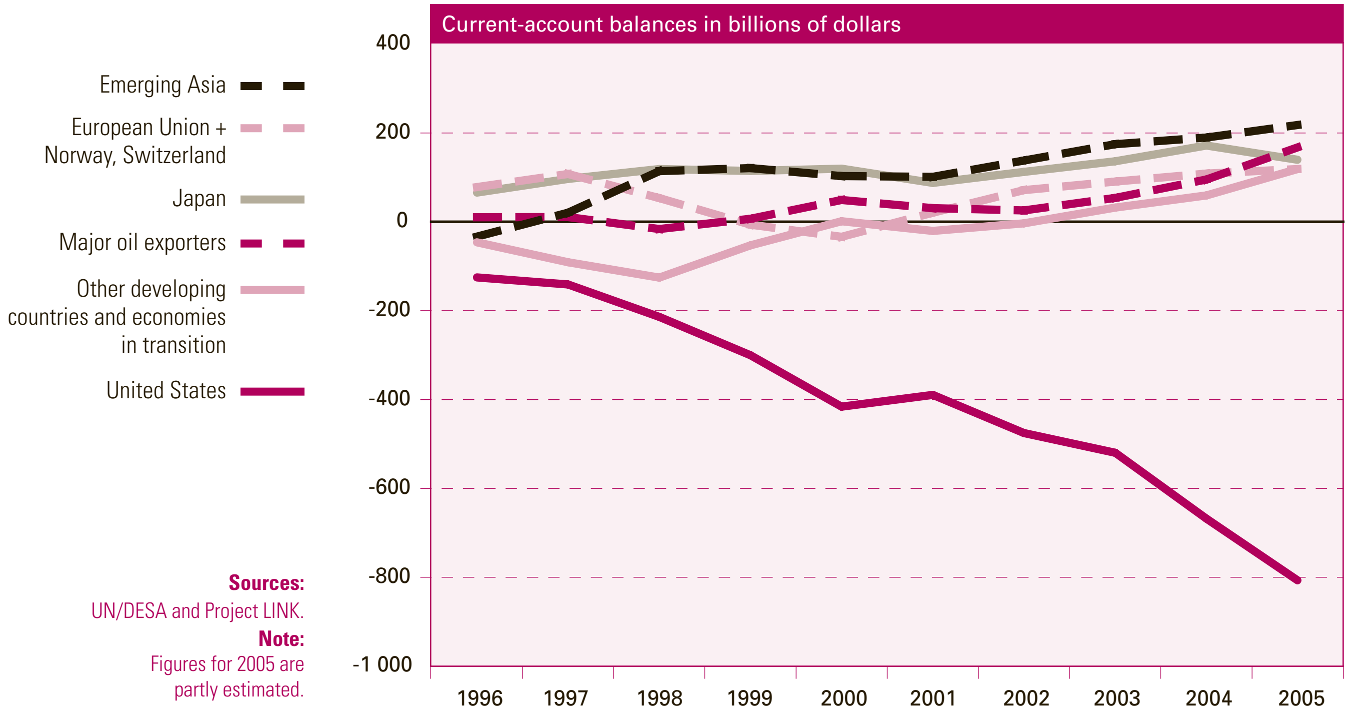
The projected growth and relative stability of the world economy are subject to some degree of uncertainty. The possibility of a disorderly adjustment of the widening macroeconomic imbalances of the major economies is a major risk which could harm the stability and growth of the world economy.

Global imbalances widened further during 2005. The current-account deficit of the United States surpassed $800 billion, matched by increased surpluses elsewhere, particularly in Europe, East Asia and oil-exporting countries. In several parts of the world, growing savings surpluses appear to be essentially caused by stagnating or reduced investment rates.

Investment has been 'anaemic' worldwide

The global investment rate has been on a long-term declining trend, reaching an historic low in 2002, with a very slight recovery thereafter, but remaining below 22 percent of world gross product. Accordingly, it may be inappropriate to speak of a "global savings glut", as some analysts have defined the macroeconomic condition of the world economy. Rather, investment demand has been "anaemic" in most of those countries running current-account surpluses, China being the notable exception among the largest economies. More specifically, since 2001, the growth of non-residential business investment has been remarkably weak in a large number of countries, regardless of their current-account balance position and despite

Widening global imbalances



Sources: UN/DESA and Project LINK.
Note: Figures for 2005 are partly estimated.

generally buoyant corporate profits and low interest rates worldwide. There are prospects that investment demand will pick up in 2006, which would strengthen economic growth. This will not take away the risk of a disorderly adjustment of the macroeconomic imbalances of the major economies, however.

Disorderly adjustment of global imbalances is a clear and present danger

Despite low interest rates worldwide and ample liquidity in global financial markets, there are strong reasons to be concerned about the sustainability of the global imbalances. The current-account deficit of the United States continues to increase at a rapid pace. The concomitant rise in the United States net foreign liability position could eventually erode the willingness of foreign investors to buy dollar-denominated assets. This could lead to a precipitous fall in the value of the United States dollar and an abrupt and disorderly adjustment of the global imbalances.

Exchange-rate realignment is not the solution

During 2005, exchange rates of the major currencies did not move in directions indicated by the global imbalances. The United States dollar rebounded strongly vis-à-vis the euro and Japanese yen. This has not helped to reduce the external deficit of the United States. In contrast, a depreciation of the dollar might achieve that, but, given the size and nature of the deficit, a very large devaluation would be needed. This in turn is undesirable, as orderly adjustment of the global imbalances should avoid a free fall of the dollar. A strong depreciation of the international reserve currency would imply large wealth losses for those holding dollar assets, undermining confidence in the dollar and triggering a swift retreat of foreign investors from such assets. The dollar did depreciate somewhat against the currencies of many developing countries during 2005, causing negative wealth effects, particularly for those holding large dollar reserves. None of this did much to prevent the global imbalances from widening, as was the case with the depreciation of the dollar against the euro and the yen in 2003 and 2004.

Policy dilemmas in managing exchange rates and reserves in developing countries

A number of developing countries have to deal with policy dilemmas in response to upward pressures on their exchange rates and increases in their foreign reserves. Many have opted for intervening in foreign-exchange markets to avoid further loss in competitiveness, while simultaneously undertaking active monetary policies to avoid that the expansion of the money supply due to reserve increases leads to inflationary pressures. Exchange-rate policies and management of reserves may face conflicting policy objectives. On the one hand, maintaining exchange-rate competitiveness is a crucial objective of macroeconomic policy in open economies and failure to do so can have important effects on economic growth and employment generation. On the other hand, the accumulation of reserves in these economies represents a transfer of resources to the countries issuing the reserve currencies at a price equivalent to the difference between the costs of their external borrowing and the (lower) returns from their holdings of foreign reserve assets. The challenge is to find the adequate balance between the desired degree of exchange-rate competitiveness and the cost of accumulating large foreign-exchange reserves.

Other downside risks

Oil prices are expected to remain high

The recent upward trend in oil prices has been mainly demand driven. As a consequence, the negative global welfare effects have been largely compensated by continued income growth worldwide. In the near term, though, the global oil market is expected to remain tight. Due to underinvestment in global oil-production capacity over the past decade, the oil market is nearing supply constraints. Oil prices should therefore be expected to remain high in the near future. Furthermore, they may prove highly vulnerable to shocks, such as natural disasters or terrorist attacks. World economic growth will be hit more severely if further oil price increases are caused by supply shocks, as was the case with the oil shocks of the 1970s and early 1980s. More recently, foreign direct investment (FDI) in the oil sector has increased worldwide and governments of many oil-exporting countries have announced new investment plans and production incentives. Over time, this should raise production capacity. If, in addition, oil importers take measures to reduce consumption of fossil energy structurally, the price of oil may come down in the medium run.

An end to the house price bubble?

A reversal in house prices in economies that have experienced substantial and prolonged appreciation in the value of houses could pose another downside risk to stable growth of the world economy. The booming housing sector has been a major driver of output growth in many of these countries, and significant wealth effects coming from housing appreciation have boosted household consumption. However, various housing indicators in these countries are at historical highs, and there are discernible signs of continuing speculative activities. A cooling of house prices will therefore lead to a moderation of overall economic growth, as already witnessed in Australia, the United Kingdom of Great Britain and Northern Ireland and several other European countries. Moreover, declining house prices will heighten the risk of default and could trigger bank crises. A number of these economies are also running large external deficits and have low household savings. A sharp fall in house prices in one of the major economies could, then, precipitate an abrupt and destabilizing adjustment of the global imbalances.

The cost of an avian influenza pandemic

The risks of an avian influenza pandemic should not be precluded. The recent outbreak of avian influenza in some countries has already caused significant economic losses and has claimed 70 lives worldwide. The world is not yet adequately prepared for an outbreak of pandemic proportions. The possible macroeconomic costs of such a pandemic could be enormous.

Policy challenges to address the global imbalances

International macroeconomic policy coordination is needed

To mitigate the risk of a disorderly adjustment in the global imbalances, the major economies should coordinate their macroeconomic policies over the medium run. It should be recognized that an orderly adjustment of the imbalances will take some time. This is so, firstly, because savings and investment patterns are not easily changed, and, secondly, because the adjustment of the widely divergent net foreign asset and liability positions will require a prolonged shift in the savings-investment balances of the major economies. Concretely, the adjustment will require measures that will stimulate savings in the deficit countries and investment, or, more generally, domestic spending in the surplus countries. More specifically, the United States should stimulate household savings and reduce public dissaving. Europe should keep interest rates down to stimulate private demand as room for fiscal expansion seems limited in most countries. More efforts should be made to revitalize investment, which the structural reform policies of recent years have failed to achieve. In Japan, financial sector reform should con-