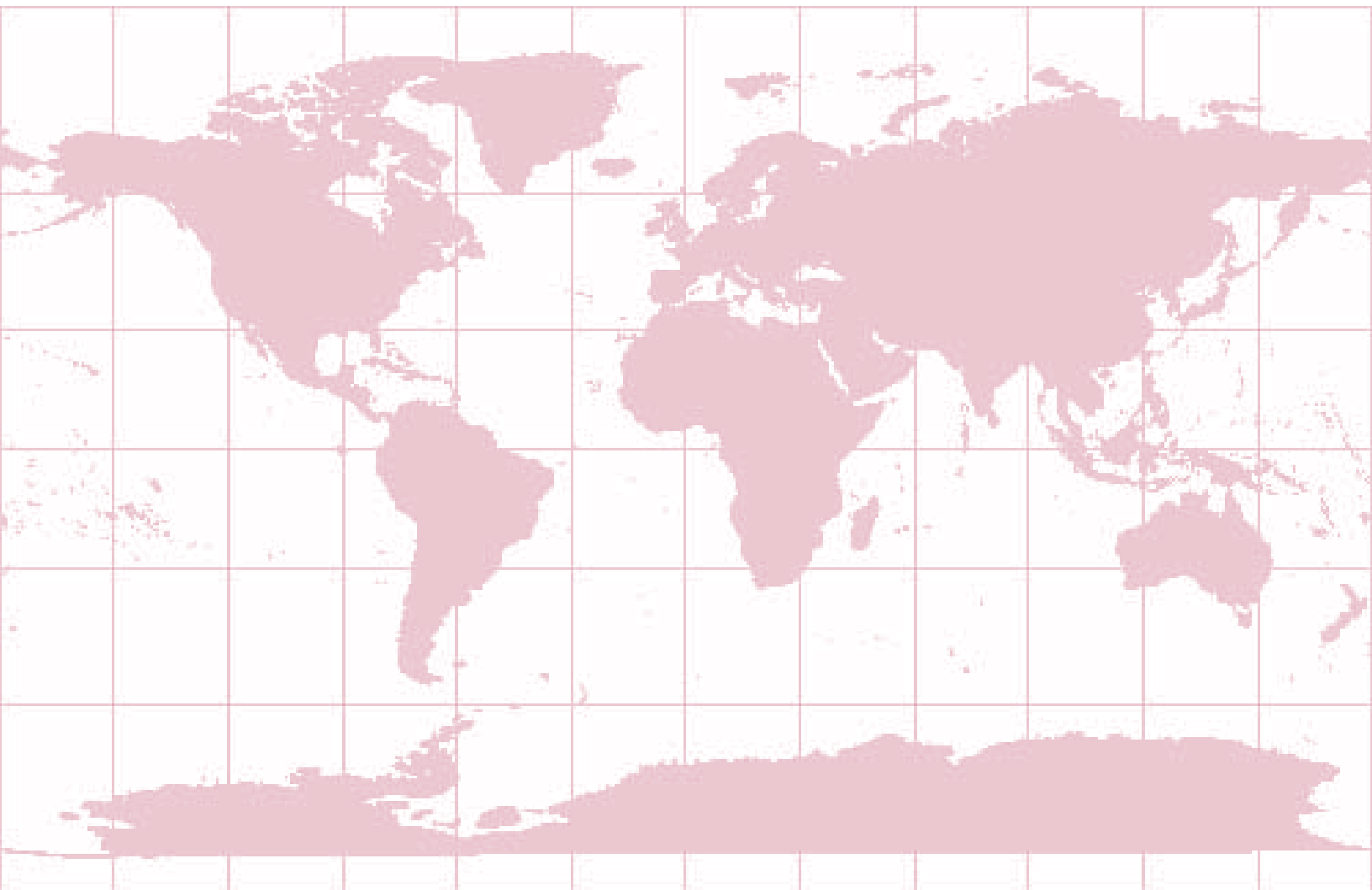


World Economic Situation and Prospects 2006



United Nations
New York, 2006

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Chapter IV

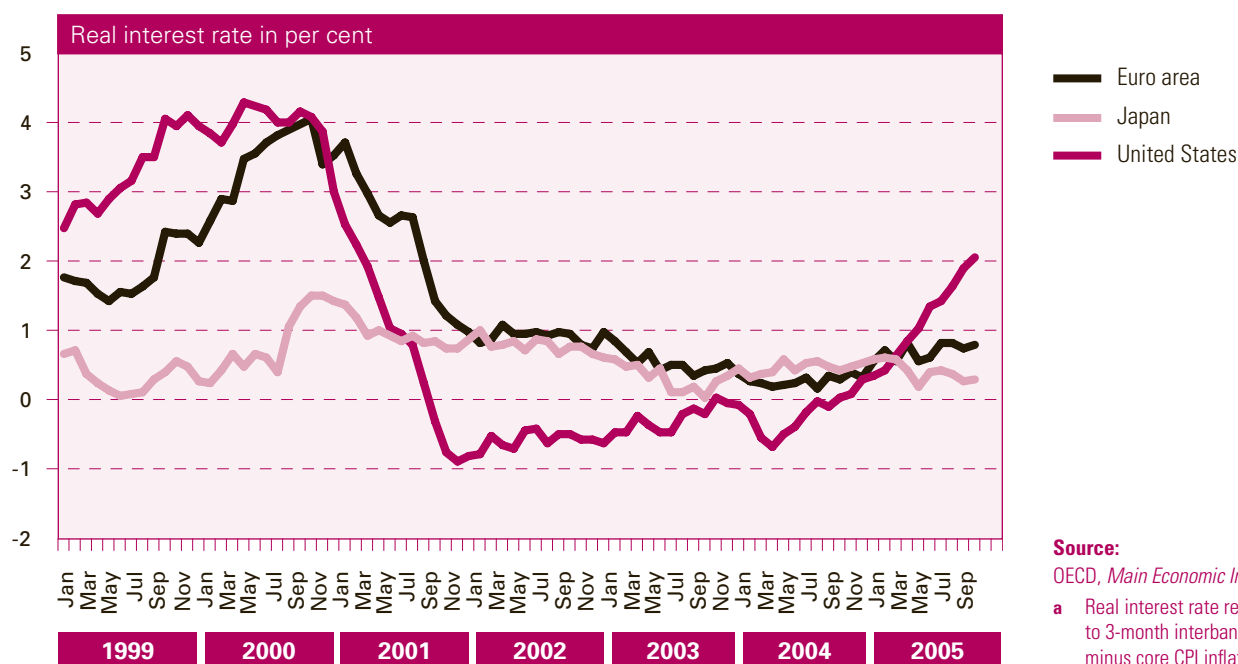
Regional developments and outlook

Developed market economies

Across the developed economy region gross domestic product (GDP) growth rates decelerated in 2005, partly because of the surge in energy prices during the year, as well as the hurricanes that hit the United States of America, and partly because of a natural moderation from above-trend growth in 2004 for some countries, in tandem with the gradual removal of policy stimulus. There were positive developments, however, in the form of still modest, but continuing growth in Japan suggesting a convincing end to its long period of stagnation. On the other hand, growth remains weak in the euro area. The rate of expansion of investment spending has been slow in most countries in the region, despite the favourable financing conditions and strong corporate profits for a number of years. A key to the expected growth performance in 2006 will be a significant pick-up in investment.

Inflationary pressures increased with the surge in oil prices, but to date there is little evidence of second-round effects through wage and price mechanisms. The era of zero or negative real interest rates, however, is coming to a close, as some central banks are well on the way to a neutral policy stance, while others are beginning to shift from an accommodating to a restrictive stance (see figure IV.1).

Figure IV.1.
Real interest rates^a in the euro area, Japan and the United States: January 1999-October 2005



The large macroeconomic imbalances remain and in some cases are increasing and not expected to shrink significantly in the outlook. The exchange-rate movements that accelerated at the end of 2004 and that were expected to lead to some diminution of the imbalances had a negligible effect and have since reversed. Thus it is increasingly likely that progress on adjusting the imbalances will be achieved only through a broader macroeconomic policy framework (see chapter I).

North America: imbalances and risks increase

The growth moderation in the economy of the United States during 2005 is expected to continue into 2006. GDP is forecast to grow by about 3 per cent in 2006, slightly lower than the pace estimated for 2005, but noticeably lower than the 4.2 per cent registered in 2004 (see table A.1). The economy has slowed with the maturing of the economic cycle, but the two devastating hurricanes along with the associated spikes in energy prices have also affected growth. Additionally, the economy is increasingly showing a number of structural weaknesses, as indicated by the extremely low household saving rate and the large and growing external deficit. Growth will continue to be supported by low interest rates, good corporate profitability and the improving labour market; however, risks are growing towards the downside.

Two large hurricanes
reduced GDP growth

The two large hurricanes, Katrina and Rita, led to a catastrophic loss of human life and devastating structural damage, but the impact on GDP growth, while significant, was more modest. The negative effects on economic growth were concentrated in the short run. The economy-wide effects came from the vital features of the Gulf of Mexico as a centre for energy production and supply and as a major harbour for exports and imports. In the aftermath of the hurricanes, energy prices surged: while the prices of crude oil and gasoline retreated in the subsequent months, the price of natural gas remained high. Consumer confidence was also significantly affected. The overall impact of the hurricanes was estimated to have reduced GDP growth by about 0.5 of a percentage point for the second half of the year.¹ Rebuilding in the region is expected to stimulate growth in 2006, including an estimate of federal government spending of about \$100 billion spread over the next few years, plus some private investment.

Consumption is
expected to moderate

Resilient household spending has been the key to the growth of the United States for the past few years, but has led to the average household savings rate falling below zero in 2005, for only the second time since the Second World War. With employment and real wages growing at only a modest pace in the past few years, an important source for financing household spending has been the strong housing market. Wealth effects from the appreciation of house prices have stimulated household spending while reducing the saving rate, as households refinance their mortgage loans and withdraw equity to finance current spending. It is estimated that about 30 to 40 per cent of the increase in household consumption has been financed by equity withdrawal in the past few years.² To some extent, the wealth effects also

¹ See Global Insight, *U.S. Economic Outlook*, monthly, various issues (2005).

² See Alan Greenspan and James Kennedy, "Estimates of Home Mortgage Originations, Repayments, and Debt On One-to-Four-Family Residences", *Finance and Economics Discussion Series*, No. 41 (Washington, D.C., Federal Reserve Board, 2005) and Remarks by Chairman Alan Greenspan, *Mortgage banking*, to the American Bankers Association Annual Convention (Palm Desert, California, 26 September 2005).

explain the smaller-than-expected impact of higher oil prices on household spending thus far: while the share of household disposable income spent on energy has increased markedly in the past two years (to about 6 per cent, the highest in two decades), consumers have managed to cope with the higher energy bill through withdrawing equity and lowering savings, instead of curtailing their spending on other goods and services. Such spending behavior is, however, expected to change as house prices are cooling off and interest rates are moving upward. A downward shift in household spending was already evident in the last quarter of 2005, with the growth of real private consumption moderating markedly. Although some specific factors were behind the recent moderation, such as the phase-out of automobile promotional sales and the spike in energy prices, the growth of private consumption for 2006 as a whole is expected to be significantly lower than that of the previous years.

In contrast to consumption expenditure, business investment is expected to strengthen somewhat. Over the past five years since the bursting of the information and communication technology (ICT) bubble, business capital spending in the United States has been low, registering an outright decline in two of those years, compared with an average rate of increase of about 10 per cent in the late 1990s. Nevertheless, an end to the investment anaemia as discussed in chapter I could be in sight. Some cyclical recovery in business investment seems to have gathered momentum in the past two years, particularly in information-processing equipment. Corporate financing conditions have improved markedly, with corporate earnings growing at double digits for the past few years. Those factors, together with favourable business surveys and strong factory orders, presage a further strengthening in business capital spending in 2006. The post-hurricane rebuilding will also give some impetus to business investment.

Employment has gradually improved during 2005. Even abstracting the displacement of labour caused by the hurricanes, however, the average increase in payroll employment is still below the pace necessary to accommodate the natural growth of the labour force and thus maintain a stable unemployment rate. Although the unemployment rate has retreated to about 5 per cent by the end of 2005, down from 5.5 per cent in 2004 (see figure IV.2), most of the improvement reflects a decline in the participation rate. In addition, employment in the manufacturing sector continued to diminish, remaining about two million persons lower than the level registered in 2000. According to the outlook, the moderate rate of employment growth is expected to continue, with the unemployment rate stabilizing at about 5 per cent (see table A.7).

Headline consumer price index (CPI) inflation moved upward measurably in 2005, reaching 3.5 per cent on average, mainly owing to the spikes in energy prices. At 2.2 per cent, the core inflation rate is much lower. While the pass-through of higher energy prices has been limited to date, the pressure on producers to raise prices of final goods has been mounting noticeably, particularly in the last quarter of 2005, and the core CPI rate is estimated to have risen by more than a half percentage point compared with the previous quarter. Inflation expectations remain well anchored. A competitive international and domestic environment continues to contain the pricing power of firms, although labour seems to bear a larger proportion of the squeeze than capital, as indicated by the mediocre growth of wages. The outlook foresees a retreat in the headline inflation rate in 2006 (see table A.4) as the effects of the spikes in energy prices abate, but core inflation is expected to continue to rise slightly.

The external sector has improved in terms of real exports growing faster than real imports during 2005, for the first time in a decade. Real exports have gained momentum since the second half of 2005, driven especially by foreign demand for capital goods. In value terms, however, the current-account deficit widened further to about \$800 billion in 2005,

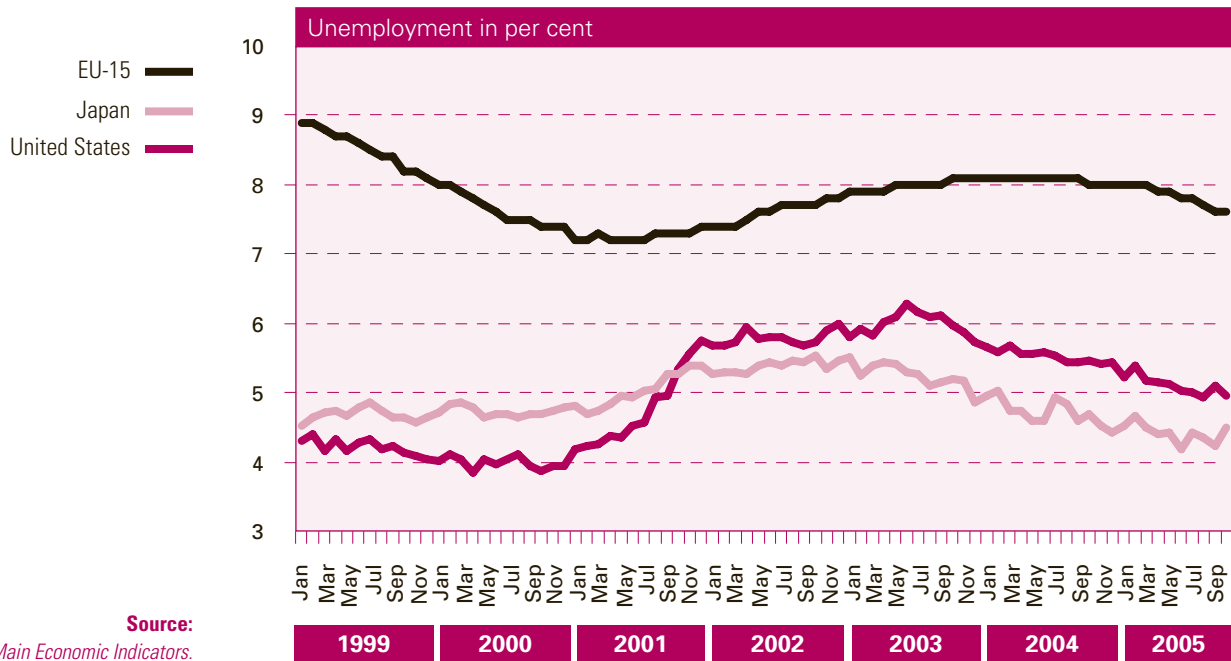
Business investment is expected to be on a more positive trend

Employment continues to strengthen but at a very modest pace

Inflationary pressures remain, but pass-through is limited so far

Exports pick up, but the current account is expected to deteriorate further

Figure IV.2.
**Standardized rates of unemployment in the EU-15,
 Japan and the United States: January 1999–October 2005**



Source:
 OECD *Main Economic Indicators*.

an increase of more than \$100 billion from the previous year, with a large proportion of the increase owing to the higher bill for oil imports. Robust export performance is expected to continue, but with total exports being only half the value of total imports, the deficit will continue to expand unless import demand were to slow down significantly.³

Monetary policy
 is challenged by
 conflicting pressures

Since mid-2004, the United States Federal Reserve (Fed) has gradually raised its policy interest rate—the federal funds rate—by more than 300 basis points to 4.25 per cent. The effects of the monetary tightening have, however, not been fully channelled into the economy, as long-term interest rates determined in capital markets have not moved in tandem, leaving the long-term financial costs for consumers and businesses at the same level as a year earlier. Monetary policy is increasingly challenged by the potential inflationary risks from greatly elevated energy prices, with core inflation rising. The inflationary risk is balanced, however, by downside risks to output and employment, particularly if the housing market were to react sharply to further tightening (or if long-term rates were to more fully reflect the previous degree of policy tightening). The Fed is expected to raise the federal funds rate to 4.5 per cent in early 2006.

Fiscal policy was
 neutral to restrictive in
 2005, and is forecast
 to be marginally
 expansionary in 2006;
 the budget deficit will
 remain high

Fiscal policy became much less stimulatory in 2005 than in the previous few years, or even became restrictive if measured by such indicators as “fiscal impulse”, with government expenditure growing more slowly than GDP and government revenue growing faster. As a result, the budget deficit fell by about one percentage point of GDP from the previous year, to 2.5 per cent of GDP. Given a planned increase in government spending for the reconstruction in the aftermath of the hurricanes, fiscal policy is expected to be slightly more expansionary in 2006, with the deficit increasing modestly. The policy debate will continue to be focused on long-term fiscal sustainability, particularly with the looming pressures on entitlement programmes arising from the retirement of the baby-boom generation.

³ See chapter II for a more detailed discussion of trade prospects.

Major downside risks for the economy of the United States are associated with the future developments of house prices and energy prices in the context of the stretched indebtedness of the household sector, the protracted huge external deficit for the economy as a whole, and the gradual tightening of monetary conditions (see chapter I for a more detailed discussion of downside risks).

Bucking the trend of modest deceleration in the United States, as well as in the world economy, the Canadian economy has notably strengthened in the course of 2005 from the earlier soft patch. High primary commodity prices and a relatively accommodating monetary stance have buttressed strong growth in domestic demand. As a net energy exporter, the Canadian economy on balance gains from the higher energy prices, despite some adverse effects of the higher prices on consumer spending. GDP growth is estimated to be 2.7 per cent for 2005, near potential growth, and a similar pace is forecast for 2006 (see table A.1).

Employment growth has been robust, driving the unemployment rate to below 7 per cent, the lowest in a decade. The inflation rate has been on a modest rise, as the average annual rate of CPI inflation has moved upward to 2.2 per cent in 2005 from 1.8 per cent in the previous year. The inflation outlook remains within the upper bound of 1-3 per cent, the target range of the Bank of Canada. Monetary policy remains accommodative, with the real short-term interest rate slightly above zero. Fiscal policy is expected to remain neutral. With a modest budget surplus, the Canadian Government is adhering to its plan of steadily reducing the debt-to-GDP ratio.

Downside risks predominate

Canada picks up

Developed Asia and the Pacific: ending deflation in Japan

The Japanese economy has sustained an expansion, however modest, for about four years. Despite a notable deceleration in the second half of 2005, GDP growth is estimated to have reached 2 per cent for the year, and a similar rate is forecast for 2006 (see table A.1). Cumulative gains in corporate profits from earlier years have finally spread to household income, leading to a gradual strengthening in domestic demand. The prolonged adjustment in excess capacity and employment by many firms has in the end produced results, as various measures of corporate profitability have finally surpassed the heights recorded before the decade-long stagnation. Progress continues in corporate financial restructuring, with non-performing loans declining.

A crucial turning point has been reached, and the protracted adjustment pressures in the corporate sector and the financial system have finally dissipated. Firms have almost resolved their problems of excess in debt, employees and capacity. The associated problem of large non-performing loans in the financial system has nearly been worked out. Corporate profitability has improved substantially. Japanese firms have experienced remarkable growth in cash flows over the past few years. Business fixed investment has been increasing modestly, but remains weak relative to the growth of corporate savings, leading to increased private-sector savings surpluses. Firms have been using financial surpluses to increase spending on land purchases, dividend payments, buy-backs of own shares, loans repayments and mergers and acquisitions. The latest business survey indicates that many firms still appear cautious about accelerating inventory and capital investments in response to increases in sales and production. In the outlook, business investment is expected to pick up.

Corporate sector restructuring advanced; investment spending is yet to pick up

Consumption spending remains subdued but underlying driving factors are improving

Growth is less dependent on external demand

Positive inflation is expected

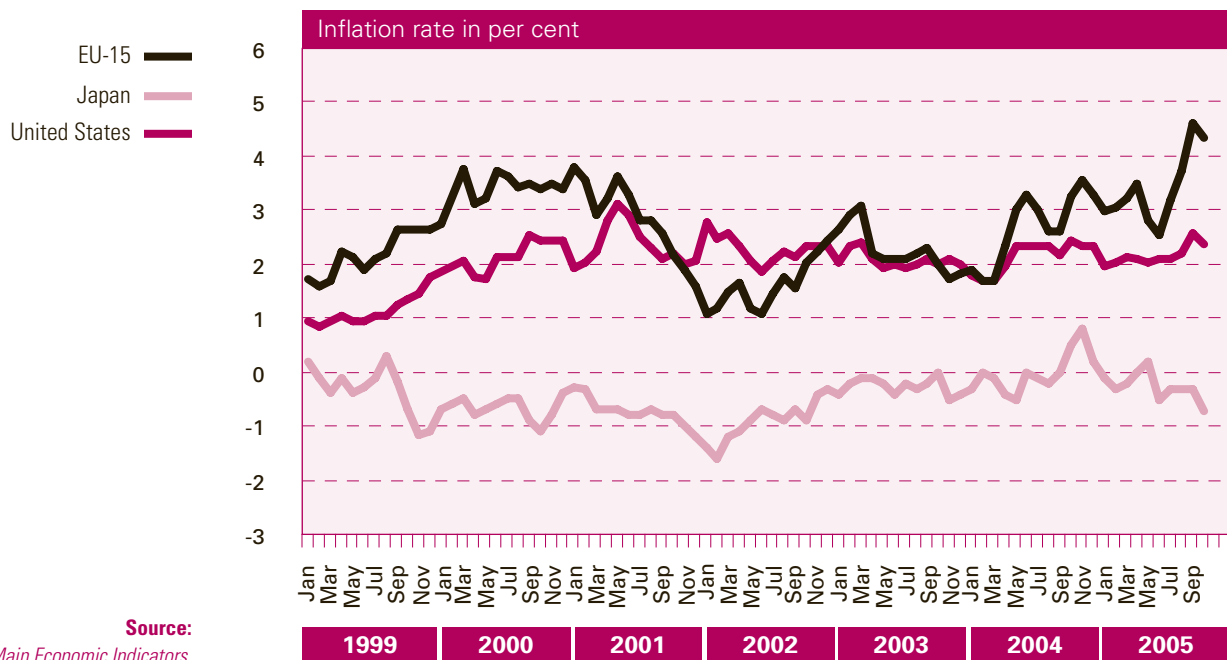
The strength of the corporate sector is steadily spreading to the household sector. In particular, improvements in the employment and income situation are becoming more apparent. Firms had been placing priority on restraining labour costs, but their stance has gradually changed: employment has picked up, with the ratio of part-time workers to regular employees starting to decline; bonus payments have recorded relatively high increases; and regular compensation has started to increase, though at a slow pace. With the improvement in employment and remuneration, household income is likely to continue to grow moderately, supporting the already evident rise in private consumption.

The contribution of the external sector to GDP growth has become less significant recently, with the growth of real exports moderating notably during 2005. A lacklustre global demand for ICT related goods in the early part of the year and a moderation in the growth of China's import demand have been the main causes. Real imports have been rising steadily owing to increased domestic demand. Despite this lessening dependence on the external sector for growth, solid external demand from Japan's major trade partners, particularly, the United States and China, remains important for sustaining growth.

Japan has experienced a protracted deflation for more than seven years, but the pace of decline in the core CPI has recently slowed considerably (see figure IV.3). The year-on-year changes in the CPI are expected to turn positive and to remain so in 2006. The pace of GDP growth in Japan in the past two years was considered to be above its potential rate, reducing the output gap that had opened up in the late 1990s. The impact on prices, however, has remained small. A decline in wages and a rise in productivity over the previous few years had driven down unit labour costs and contained pressures on prices. Unit labour costs are unlikely to increase in the near future because rising productivity will still tend to hold them down despite the recent recovery in wages. Higher oil prices in the past few years seemed to have had only a marginal effect on prices, as the Japanese economy is highly energy-efficient

Figure IV.3.

**CPI inflation in the EU-15, Japan and the United States:
January 1999-October 2005**



Source:

OECD *Main Economic Indicators*.

compared with other major economies. Stock prices have been strong in Japan, and land prices in some parts of Tokyo and other major metropolitan areas have also started to rise, reflecting to some extent an upturn in expectations of investors about the economy.

For about four years, the Bank of Japan (BoJ) has adopted an unorthodox framework of monetary policy aimed at eradicating deflation. The framework consists of two components: the provision of liquidity to the money market so that the outstanding balance of current accounts at the BoJ exceeds the amount of required reserves; and a commitment to continue the quantitative easing until the year-on-year rate of change in the core CPI registers zero per cent or higher on a sustainable basis. This policy has maintained short-term interest rates at zero per cent and longer-term interest rates stable at low levels. Along with the expectation for the annual change of the CPI to turn positive, the present monetary policy framework is likely to be phased out in the course of 2006. The monetary authorities are expected to proceed prudently, taking into account developments in economic activity and prices, as well as in financial market conditions.

Fiscal consolidation will continue in 2006 in order to curb the rise in the large public debt, in line with the medium-term goal of reaching a zero primary balance in 2010. The target is mainly to be reached by expenditure cuts, including reduction of public investment, reductions in subsidies, as well as through a rewinding of tax cuts introduced in earlier years and an increase in the value added tax. Structural reforms will likely continue.

Downside risks include a further increase in oil prices, even though the economy has not been overly affected by the higher oil prices. Fiscal consolidation to reduce the large public debt remains difficult, with downside risks to growth. Consequently, monetary policy should continue to maintain an accommodative position until the economy solidly extricates itself from the protracted deflation.

Both Australia and New Zealand experienced a notable slowdown during 2005, although this was attributable to different factors. A sharp cooling in the housing boom has contained growth in Australia, while in New Zealand the slowdown has been concentrated in sectors exposed to the appreciation of the currency. In the outlook, growth in Australia is expected to stabilize at about 3 per cent, but a further deceleration in New Zealand will be most likely. In both economies, large current-account deficits encompass some risks, with some adjustment already occurring in Australia and problems looming in New Zealand.

A booming housing sector had been the key factor for Australia's economic performance for many years. During this period, households increased consumption expenditure faster than income, either by reducing discretionary savings or by borrowing against the equity in their home. This phenomenon was particularly evident in 2002 and 2003. Since then, however, average house prices have not risen. As a result, consumption and borrowing have slowed noticeably as households have become more cautious. The downturn in the housing construction cycle has also been dampening household spending. On the other hand, growth in household income and spending continues to be supported by strong growth in employment and real wages, and by recent tax cuts. In contrast to the household sector, business-investment spending has been expanding rapidly, stimulated by the high level of commodity prices, and has been particularly strong in the mining sector and in resource-related manufacturing and infrastructure projects.

In New Zealand, the housing boom continues, but house prices seem to have reached unsustainable levels. This condition has been accompanied by an extremely low savings rate. With rising interest rates, many households, already spending over half of their disposable income on servicing their mortgages, are potentially at risk and are vulnerable if property prices were to fall. Additionally, high interest rates have attracted international hot money and induced an appreciation of the currency and a widening of the external imbalance.

Monetary Policy:
unorthodox measures
to combat deflation
are expected to be
gradually phased out

Fiscal consolidation
is to continue with
the aim of primary
balance by 2010

Risks remain

**Australia and
New Zealand slow
down in 2005**

Western Europe: a weak recovery in 2005

Recovery in Western Europe is weaker than expected

Growth diverged in the euro area

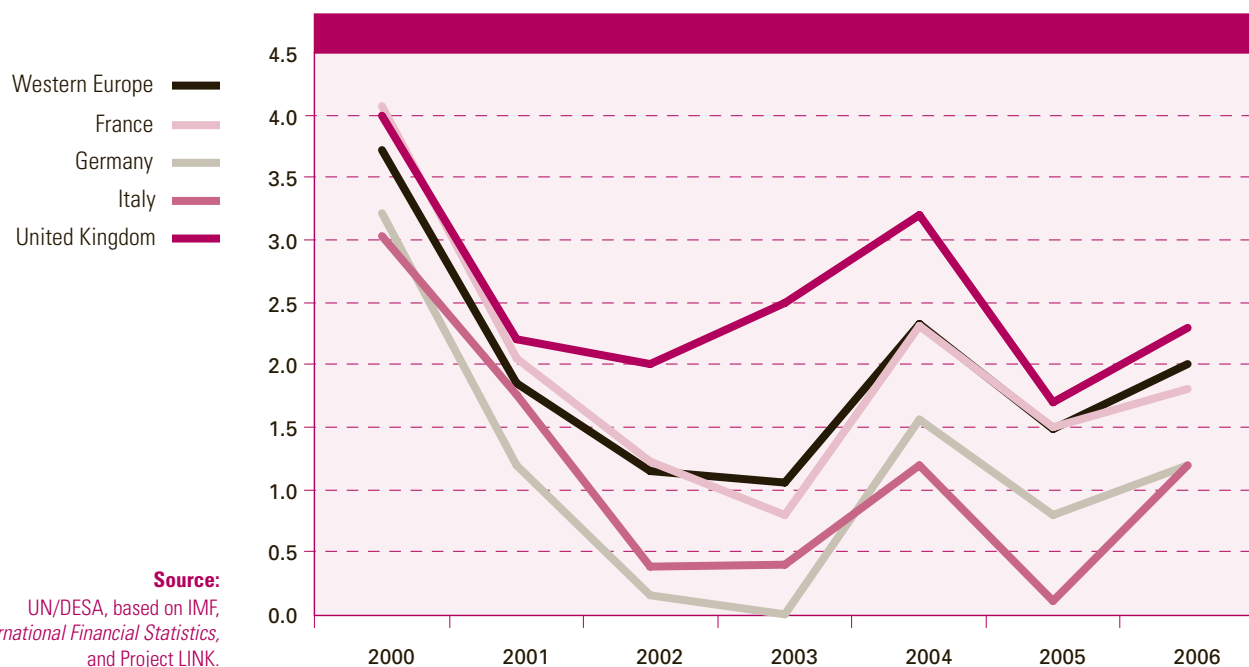
The modest recovery in Germany is driven by exports

The recovery in Western Europe was weaker than expected in 2005. Economic growth was dampened by high oil prices, cautious spending behaviour by private households and moderate investment by the business sector. Exports were the most dynamic component of demand. For the area as a whole (20 countries), real GDP rose by 1.5 per cent compared with the preceding year. In the euro area, average annual economic growth was only 1.3 per cent in 2005, which is significantly below the estimated growth of potential output, itself quite moderate at 2 per cent (see table A.1). As a result, the gap between potential and actual output widened further. A direct consequence of the low growth of potential output is that new adverse shocks always risk pulling down the economy of the euro area to near stagnation.

Annual GDP growth rates of the member countries of the euro area continued to diverge significantly in 2005 (see figure IV.4) with below average growth in Germany (0.8 per cent) and Italy (0.1 per cent) and a somewhat stronger performance of 1.5 per cent in France. The variations in growth performance can be traced back to the differential strength of domestic demand and changes in net trade. In Germany, the moderate recovery continues to be driven by exports, on the back of strengthened international competitiveness. The weak growth performance reflected stagnating domestic demand, in particular private consumption, so that the increase in real net exports accounted for all of the average annual economic growth in 2005. In sharp contrast, in France and Italy, the deterioration in international competitiveness dampened exports with the consequence that changes in real net exports subtracted from economic growth. This reduction was more than offset, however, by the rise of domestic demand (which was only moderate in Italy). Outside the euro area, in the United Kingdom of Great Britain and Northern Ireland, annual economic growth slowed down to only 1.7 per cent in 2005, the lowest increase over the past ten years. The low increase re-

Figure IV.4.

Annual rates of real GDP growth in Western Europe: selected countries, 2000-2006



Source:

UN/DESA, based on IMF, *International Financial Statistics*, and Project LINK.

flected a weakening growth of all major components of final domestic demand, notably a softening expansion of private consumption owing to the moderating house-price increases. Changes in net trade were broadly neutral to economic growth in 2005.

In the rest of Western Europe, robust domestic demand continued to yield well-above-average rates of growth in Spain and Ireland in 2005, although at a slower pace than that of the late 1990s. The oil sector is providing a boost to growth in Norway. Denmark and Sweden are also estimated to grow faster than the Western European average. At the other end of the spectrum, Portugal remains severely constrained by fiscal difficulties, while the Netherlands continues to suffer from weak private consumption, as well as from the very slow growth in the German economy, its main trading partner (see table A.1).

Against the backdrop of a continued favourable international environment and supportive financial conditions, economic growth in Western Europe is expected to accelerate slightly in 2006. For the whole area, real GDP is forecast to increase by 2.0 per cent compared with 1.5 per cent in 2005. In the euro area, the average annual growth rate of real GDP is forecast to be 1.9 per cent in 2006.

The strengthening economic expansion over the course of 2006 will be driven largely by a pick up in fixed investment. Business spending on new equipment is projected to pick up following subdued growth in 2005, which was partly owing to sluggish domestic demand and ample spare capacity. Continuing corporate restructuring of balance sheets and the uncertainties associated with the rapid exchange-rate movements and surging oil prices also likely played a role. The restructuring is well advanced, however, and the uncertainties regarding exchange rates and oil prices have receded. Business investment will continue to be supported by strong corporate profitability, favourable financing conditions and robust growth of foreign demand, but the acceleration of investment activity will also continue to be limited by the ongoing moderate expansion of private consumption, the major domestic expenditure item. The slow growth of consumption reflects largely the situation in labour markets, where minor increases in employment have offset the wage restraint yielding modest gains in labour incomes and in real disposable household incomes. Household precautionary savings will, moreover, remain high in the face of lingering labour-market risks and uncertainties about the outcomes of the reforms of pension and health systems. Exports will therefore continue to be the major driver of economic activity in the euro area and Western Europe at large. Changes in real net exports are expected to make only a small positive contribution to growth in 2006.

In the euro area, weak growth in Germany and Italy (1.2 per cent in both cases), which account for some 45 per cent of euro area GDP, will continue to weigh on the overall economic performance of the area in 2006. In France, real GDP is forecast to increase at a somewhat stronger rate of 1.8 per cent. As in 2005, growth in Germany will rely to a large extent on favourable changes in net trade, whereas in France and Italy net exports will continue to make a negative contribution to growth. Outside the euro area, economic growth in the United Kingdom is forecast to accelerate to an average annual rate of 2.3 per cent in 2006, which is broadly in line with trend output. After a long period where growth was dominated by domestic demand, net trade is expected to make a small positive contribution to growth, a pointer that growth in the United Kingdom has become more balanced than in recent years.

The forecast for Germany is subject to particular uncertainty, because it remains to be seen what impact the agreed economic programme of the new grand coalition Government will have on business and consumer sentiment and economic activity. Only a limited growth stimulus can be expected from a €25 billion spending programme on innovation and

Business investment is expected to carry growth in 2006

Growth remains weak in Germany and Italy into 2006

investment that will be spread over a period of four years. Some stimulus to private consumption in 2006 can be expected from the likely bringing forward of expenditures in anticipation of the sharp rise in value added tax at the beginning of 2007, which, in turn, will tend to dampen private consumption during 2007.

Inflationary pressures are expected to remain subdued

In 2005, sharply rising energy prices drove headline inflation in the euro area above the ceiling of 2 per cent established by the European Central Bank (ECB). Core inflation declined, a pointer to the absence of demand pressures on non-energy product prices. Labour costs increased only slightly and there are no indications for second-round effects in price and wage setting to compensate for the rise in energy prices. Inflationary expectations, as gauged from 10-year index-linked bonds, have remained stable at close to 2 per cent. Forecasts are for headline inflation to fall back below 2 per cent during 2006. The outlook for inflation is similarly favourable in the United Kingdom, where inflation moved above the central target of the Government of 2 per cent in 2005 (see table A.4).

There are no significant improvements in the labour market

Despite the moderate rate of economic growth, employment edged up further in Western Europe in 2005. In the euro area, it rose by about 1 per cent, but this outcome was influenced by government measures in some countries that aimed at boosting part-time employment and self-employment. The average annual rate of unemployment in the euro area rose slightly to 8.9 per cent. Looking ahead, employment growth is expected to strengthen moderately in 2006 and the unemployment rate will decline to an annual average of 8.7 per cent.

ECB maintains an accommodative policy stance...

Against the backdrop of sluggish economic activity, monetary policy in the euro area had been on hold since June 2003, when the ECB lowered its main refinancing rate to 2 per cent. But concerns about the potential inflationary consequences of the ample liquidity supply and possible lagged effects of the sharp rise in energy prices on price and wage setting, led the ECB to raise interest rates by 25 basis points in early December 2005. The marked depreciation of the euro against the dollar since May 2005 could have also played a role. In the run-up to this decision, the ECB had stepped up considerably the use of moral suasion to signal its readiness to raise interest rates "at any time".

...and should remain accommodating

Despite this move, the monetary policy stance remains accommodating. The increase in official interest rates was anticipated by market participants, as reflected in a significant steepening of the money-market yield curve in October and November 2005. This partly offset the easing of overall monetary conditions on account of the weakening of the euro. In the medium term, the ECB will be looking to bring short-term rates to a neutral position, as the United States Federal Reserve has been doing since July 2004, and there is some probability of a further modest increase in interest rates in the course of 2006. But, given the fragility of domestic growth forces in the euro area, it is expected that this policy change will be very slow to materialize. The risk of accelerating inflation appears to be low, suggesting there is scope for continuing the wait-and-see policy until the recovery is more firmly established. Chapter I of this report argues why the ECB should maintain an accommodative stance in the interests of stimulating growth and in the context of adjusting global imbalances.

In the United Kingdom, the stronger than anticipated economic slowdown in the first half of 2005 led the Monetary Policy Committee of the Bank of England to reduce the bank lending rate in August 2005. With inflation forecast to remain close to the central target of 2 per cent and economic growth expected to return to trend in 2006, it can be assumed that interest rates will not be cut further in 2006.

The rapid expansion in money supply in the euro area over the past years has been associated with strong growth of private sector credit, especially mortgages for house purchases by private households. With the major exception of Germany, low interest rates

have spurred housing investment and house prices have risen to elevated levels. The dynamism of the real estate market contrasts with the relative sluggishness of private consumption and suggests that the transmission of monetary policy stimuli to private consumption via housing market dynamics is weaker in the euro area than in other economies, such as the United Kingdom or the United States (see box IV.1).

In the face of moderate growth forces, the aggregate fiscal policy stance in the euro area was broadly neutral in 2005. The overall actual government budget deficit edged up slightly to 2.9 per cent of GDP. Fiscal policy is expected to maintain a broadly neutral stance in 2006 also. In five economies (France, Germany, Greece, Italy and Portugal), overall budget deficits are projected to remain above the 3 per cent threshold established in the Stability and Growth Pact. Outside the euro area, in the United Kingdom, which is at a more advanced stage of the business cycle, the government is expected to continue the tightening of fiscal policy that started in 2005.

Risks to the outlook in Western Europe are tilted mainly to the downside. They are related to the possibility of a further pronounced rise in oil prices, a disorderly unwinding of global imbalances and an associated renewed strong appreciation of the euro and a sharper increase in long-term interest rates in the case of a more pessimistic assessment of inflation prospects in financial markets. A potential upside factor could be a stronger than expected response of business investment to rising activity levels in the presence of continued favourable financing conditions and strengthened corporate balance sheets. A sharp fall in house prices from their current elevated levels remains another major downside risk in the United Kingdom and some other western European economies (France, Ireland and Spain).

The moderate strength of recovery limits the scope for fiscal consolidation

Risks to the outlook are tilted to the downside

The new EU members: dynamic but uneven growth

Economic activity in most of the new EU members from Central Europe and the Baltic region (EU-8) preserved its dynamism in 2005, but the pace of growth was uneven across countries. Aggregate GDP in the region grew by some 4 per cent in 2005, down from 5.1 per cent in 2004. The lower average growth reflects mainly the economic slowdown in Poland. Performance in the other economies was mixed, with growth in the Baltic States outpacing the rest of EU-8. The slowdown in some of the new members is mainly due to stagnating import demand by the EU-15 and to the fact that the one-off effect of the EU accession has been consumed.

Aggregate GDP growth is expected to accelerate to about 4.3 per cent in 2006 (see table A.1), driven by stronger exports, ongoing long-term investment projects, EU aid and a temporary boost to public consumption preceding upcoming elections.

In 2005, the expansion of economic activity in the EU-8 region was driven mainly by external demand, reversing the pattern of growth that had prevailed in the previous years. GDP growth was supported by a combination of strong exports and slowing imports, largely offsetting a declining growth contribution of domestic demand. Given the continuing expansion of FDI-dominated production capacity—for example, in the automotive industry in the Czech Republic and Slovakia—exports are set to remain buoyant in 2006 as well. Import growth has become less dynamic, reflecting weaker growth of consumer and investment expenditure; however, it may accelerate if domestic demand picks up.

Following an upward adjustment in prices related to the EU accession, disinflation resumed in Central Europe. Apart from the sharp increase in energy costs in 2005, there was little change in domestic core inflation in the EU-8, as labour-cost pressures were low.

Expansion is driven by external demand

Disinflation resumes in Central Europe

Box IV.1

The role of housing markets in the transmission of monetary policy

Weak economic performance and diverging views about the adequacy of the monetary policy stance of the European Central Bank (ECB) have propelled the debate over the strength of monetary policy transmission in the euro area. Recent empirical estimates^a suggest that the size and timing of the response of overall output and prices to monetary shocks in the euro area and the United States are rather similar. Significant differences emerge, however, with respect to the composition of the output response: the role of household consumption in driving output changes has been found to be much greater in the United States than in the euro area. There is also evidence that the transmission of monetary policy in the United Kingdom of Great Britain and Northern Ireland is generally stronger than in the euro area, particularly with respect to the consumption channel.^b

There are various explanations for the apparent weak impact of monetary policy shocks on private consumption in the euro area, but increasing attention has recently been paid to the role of housing markets. The monetary transmission through the housing market works as follows: monetary shocks determine changes in the market interest rate; the interest rate affects housing prices, which in turn influence consumption via a wealth effect. Assuming that monetary authorities are equally able to determine interest rates, differences across countries in the strength of those links will depend on: (i) the extent to which interest-rate changes pass through to housing prices; and (ii) the size and speed of the response of private consumption to the housing price fluctuations, in other words, the strength of the wealth effect.

Data for the economies of the OECD^c indicate that there is a positive correlation between changes in house prices and household consumption expenditures practically everywhere. But this correlation is much lower in the large European continental economies (France, Germany and Italy) than in the United States, the United Kingdom and several of the smaller European Monetary Union (EMU) member States. This lower correlation is mirrored by marginal propensities to consume out of housing wealth being significantly lower in France, Germany and Italy than in the other high-income OECD economies. In a similar vein, there is evidence that the pass-through of interest rate changes to housing prices is greater (and more rapid) in the United Kingdom, the United States and other OECD economies than in France, Germany and Italy.

The root cause of those differences seems to lie in the differential degree of development of the mortgage markets and hence in the ability of homeowners to borrow against housing wealth. In the United Kingdom and the United States (but also in many smaller Western European economies) mortgage markets are offering a larger variety of products to serve a broad range of potential borrowers than in France, Germany and Italy. As a result mortgage debt ratios tend to be higher in the former economies. This higher stage of development also results in lower housing transaction costs. The upshot is that withdrawal of housing equity (that is, the amount of liquidity that the household sector extracts from the housing market) and the refinancing of mortgages are easier in the United Kingdom and the United States, thus making the effect of interest-rate changes on private consumption stronger.^d

Industrial economies have been experiencing a rapid pace of financial innovation, in particular more flexible refinancing terms, on the one hand, and increased consumer access to unsecured credit, on the other hand. A key question is thus how these structural changes are affecting the monetary policy transmission via housing prices. On the one hand, easier access to unsecured credit should relax credit constraints and thereby reduce the responsiveness of consumption to changes in the value of collateral, including house values. On the other hand, more flexible refinancing terms for mortgages should increase the elasticity of consumption with regard to changes in housing prices. Which of the two effects prevails is then an empirical question.^e

In any case, the development and structure of the housing and mortgage markets are important in determining the strength of monetary policy transmission. The liberalization of mortgage markets and the elimination of regulations and transaction costs that reduce the extent of capital gains will improve the scope for housing equity withdrawal and hence strengthen the housing channel of monetary policy transmission. To prevent the emergence of financial instability problems, however, liberalization should be accompanied by improved surveillance and regulatory procedures.

^a See, for example, I. Angeloni and others, "The output consumption puzzle: a difference in the monetary transmission mechanism in the euro-area and the U.S.", *European Central Bank Working Paper* No. 268 (Frankfurt, September 2003).

^b H.M. Treasury "EMU and the Monetary Transmission Mechanism" (2003), available from www.hm-treasury.gov.uk.

^c P. Catte and others, "Housing markets, wealth and the business cycle", *OECD Economic Department Working Paper* No. 394 (Paris, OECD, June 2004).

^d On structural aspects of housing markets in the EU see European Central Bank, "Structural factors in the EU housing market", March 2003, available from www.ecb.int/pub.

^e K. Aoki and others, "Houses as Collateral: Has the Link between House Prices and Consumption in the U.K. changed?", The Federal Reserve Bank of New York, *Economic Policy Review*, No. 8, pp. 163-177 (2002).

The ongoing gains in labour productivity have also helped contain cost pressures, and hence rises in domestic prices. Slower nominal wage growth, increasing productivity and stronger retail competition, following the abolishment of the remaining trade restrictions with the EU, should sustain low inflation for the forecast period.

Labour market developments in the new EU member States were on average favourable in 2005, but the positive changes were marginal (see also box IV.2). Moderately positive rates of employment growth were accompanied by a slight decrease in the unemployment rate in most countries. This was the case in Poland, the largest economy in the region: for the first time in years, there was a notable decline in the rate of unemployment (see table A.7). In 2006, employment growth might slow down relative to 2005, reflecting the deceleration in the rate of output growth in 2005.

Macroeconomic policies have been broadly supportive of growth. In most EU-8 countries, better than expected fiscal outcomes and low inflationary pressures have allowed the central banks to preserve accommodating monetary conditions. With inflation down, interest rates were reduced in Central Europe in an attempt to stave off further currency appreciation. Fiscal deficits are likely to either decline or remain unchanged in 2006 throughout the EU-8. The upcoming elections in the Czech Republic, Hungary and Slovakia, however, may be associated with some spending hikes. Fiscal consolidation, related to the medium-term goal of the European Monetary Union (EMU) entry, will therefore be delayed in a number of member States; and fragile fiscal positions pose certain risks for Central Europe, where budgets are under pressure from social spending and the co-financing of EU-related projects.

The growth in trade throughout the region began to taper off in mid-2005 from the more robust pattern in the previous year. Nevertheless, export growth remained strong, as the countries increased their share in the EU market and continued to diversify their trade. Although the aggregate merchandise trade deficit of the EU-8 shrank compared with 2004, current accounts remain under the pressure of profit repatriation by foreign investors. The EU-8 continues to attract relatively large capital inflows, including significant levels of FDI, averaging 5 per cent of their aggregate GDP.

The principal downside risks to the outlook include a delayed recovery in the euro zone and significantly higher than expected energy prices. The most pressing policy challenges facing the larger new EU States in Central Europe are to achieve sustainable fiscal consolidation and to continue with the implementation of structural reforms for job-creating growth.

Economies in transition

After an exceptionally good economic performance in 2004, growth in the economies in transition moderated in 2005 but still preserved its dynamism and continued to outpace that of the world economy, albeit at a lower rate than in the previous two years (see table I.1). This outcome reflects strong growth in both subregions. In the CIS region, growth was supported by higher commodity prices, in particular for oil and gas, metals and agricultural products, and by domestic demand. In South-eastern Europe, growth was helped by the prospects of EU accession for three countries in this region (Bulgaria, Croatia and Romania) (see figure IV.5). With a strong pace estimated at 6.0 per cent on average in 2005, growth is set to stay robust, stabilizing at about 5.9 per cent in 2006.

Notwithstanding the heterogeneity among economies in transition, growth has become less divergent in the past few years after the initial rebound following the transitional

Unemployment rates decreased slightly in most countries

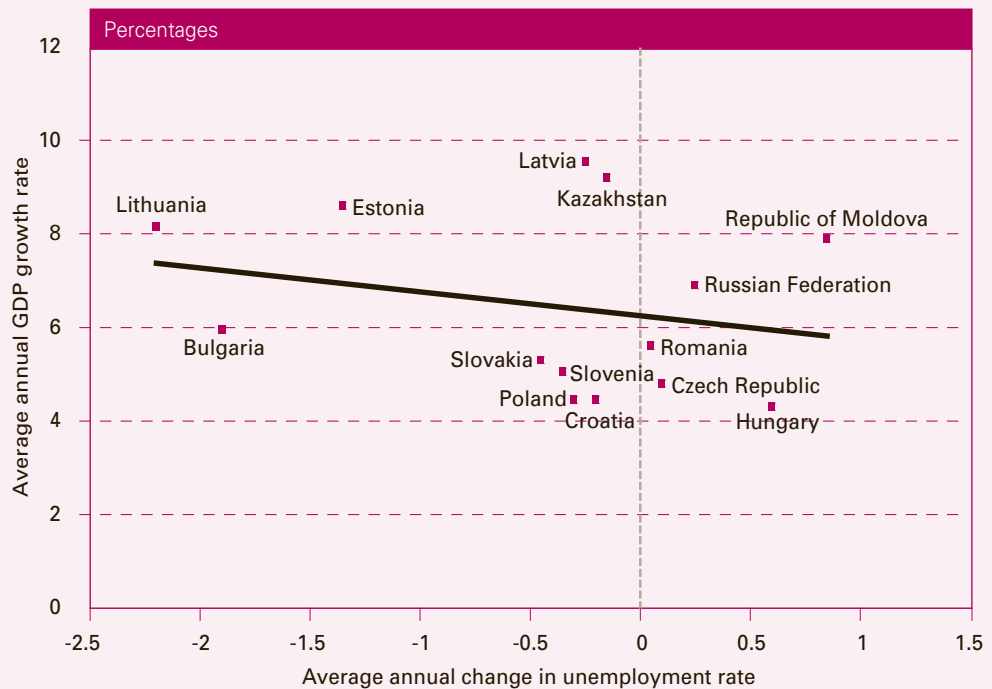
Macroeconomic policies have been supportive of growth

Box IV.2

Economic growth and labour market outcomes in Eastern Europe and the CIS

A strong pace of economic activity is often regarded as the best way to stimulate the growth of employment. Indeed, the figure below, based on recent data for a group of Eastern European and CIS economies, indicates that the changes in their unemployment rates correlate negatively with the corresponding rates of GDP growth. This correlation does not appear to be particularly strong, however, suggesting that cyclical expansions *per se* may not be sufficient for a sustained improvement in labour market outcomes in these economies. Their recent experience also suggests that a stronger focus on labour market policies and reforms may be required to strengthen labour market performance.

Economic growth and changes in unemployment in selected Eastern European and CIS economies, 2003-2005



Source:
UN/ECE Statistical database.

Several factors seem to have weakened the association between aggregate output growth and labour market outcomes in Eastern Europe and the CIS. First of all, employment data indicate that employment fluctuations have been only mildly pro-cyclical or even acyclical in some economies, and generally less volatile and more persistent than output fluctuations. This might suggest widespread labour hoarding, implying that employment responses to output cycles are smooth and occur with a longer lag. Second, economic expansion in many countries has taken place in sectors that are not labour-intensive, particularly in the commodity-exporting CIS economies. Expansions driven by extractive industries that use relatively low labour inputs cannot be expected to generate much growth in total employment and/or reduction in unemployment. Third, labour mobility across sectors of production and regions is still relatively low in most of these economies, implying a low degree of labour redeployment from declining to expanding sectors or

Box IV.2 (cont'd)

regions. This, in turn, tends to push up unemployment, especially to the extent that the economic restructuring and transformation involves “creative destruction” and hence the clustering of job opportunities in a few sectors and regions.

Last but not least, the data seem to suggest that labour markets have been relatively more responsive to GDP growth in countries that have made more progress in enterprise and labour market reforms: countries with more responsive labour markets, such as Bulgaria, Estonia, Lithuania and Slovakia, are situated on the left side of the chart. Thus, active restructuring of inefficient firms, in particular, firms inherited from the era of central planning, reduces the incidence of labour hoarding which, in turn, facilitates the transmission of labour demand associated with output growth into net job creation. The existing labour-market rigidities, (such as entry and re-entry barriers and skill mismatches) in these emerging market economies contribute to raising the average duration of unemployment and create the potential for hysteresis effects. Removing or reducing the rigidities contributes to greater responsiveness of employment to output growth.

All this evidence tends to suggest that a more proactive government stance on labour market policies could have a beneficial effect on the labour market outcomes in Eastern Europe and the CIS. Thus, devoting more resources to training and retraining programmes, job search and job placement assistance, and possibly subsidized employment, could help reduce the existing labour market rigidities. Measures to improve transportation infrastructures and develop housing markets, and international cooperation on legislation to liberalize cross-border labour movements, could facilitate labour mobility. Finally, public policies supporting the development of services that strengthen economy-wide productivity growth and the competitiveness of the economy at large (such as telecommunications and financial services) will at the same time have a positive labour market effect, especially in those countries where there is a high concentration of economic activity in extractive industries. Such policies facilitate the diversification of the production structure, help domestic producers endure the real appreciation of the exchange rate and hence create the basis for a sustained increase in labour demand.

slump. This pattern, however, is changing: differences between the growth rates within the economies in transition, as well as within the CIS region, have started to widen in 2005 (see table A.2). In contrast, growth among the countries of South-eastern Europe is converging—a pattern which is likely to continue, underpinned by foreign direct investment (FDI) and export expansion in the short run.

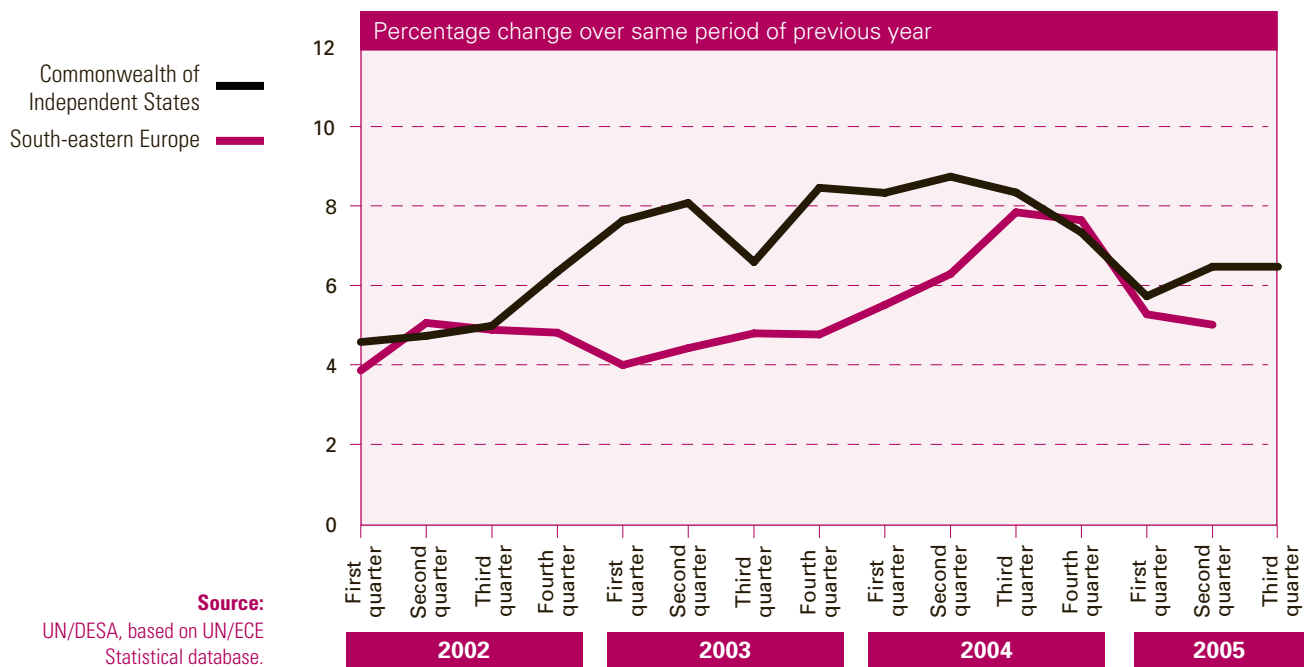
South-eastern Europe: dynamic growth continues but at a slower pace

Economic growth remained robust in South-eastern Europe in 2005 with aggregate GDP increasing by some 5 per cent. A slowdown from 6.5 per cent registered a year earlier reflected a base-year effect, as well as some constraints imposed on growth by strong currencies. In addition, the agricultural sector was affected by recent floods. Strong growth in this subgroup is expected to continue in 2006, albeit at a slightly lower rate of 4.4 per cent (see table A.2).

The EU accession candidates (Bulgaria, Croatia and Romania) continued to benefit from rising investor and consumer confidence, reflected in a solid inflow of FDI, continued restructuring and expansion of export-oriented production capacity and improved financial intermediation. Economic consolidation gained momentum in the remaining part of South-eastern Europe, combining successful post-conflict reconstruction and further macro-economic stabilization.

EU accession candidates benefit from a solid flow of inward FDI

Figure IV.5.

Quarterly changes in real GDP in South-eastern Europe and the Commonwealth of Independent States, first quarter 2002-third quarter 2005

Aggregate output in this subregion is likely to continue to grow at a relatively fast pace in 2006, although implementation of some corrective policies to prevent overheating may slow growth, mostly affecting private consumption. Investment is expected to remain strong, as privatization programmes continue to attract FDI. There is also an important number of ongoing public investment projects.

Growth is driven by robust domestic demand

In 2005, growth in South-eastern Europe continued to be driven mostly by robust domestic demand, fuelled by a boom in private credit. Total exports from the subregion increased by about one fifth in dollar value, although some labour-intensive industries faced increasing competition from Asia. A number of bilateral agreements facilitated intraregional trade. Import growth was even stronger, reflecting booming domestic credit and imports of machinery to upgrade the capital stock. As a result, trade deficits continued to widen.

Disinflation continues

In most of the South-eastern European economies, disinflation continued in 2005, reflecting a further tightening of the macroeconomic stances and low levels of domestic cost pressures (see table A.5). Growing competition in local markets has prevented the passing of demand pressures onto domestic prices. Those effects are likely to carry on in 2006.

Labour market performance within the region is divergent

The labour markets in the EU accession candidate countries benefited in 2005 from the expansion of economic activity in 2004 and some progress in labour market reforms, which is likely to continue in 2006. The rest of South-eastern Europe was characterized by very high unemployment and persistently feeble employment growth. Ongoing enterprise restructuring and the structural nature of unemployment suggest no major improvement in the labour-market situation in those countries in 2006 (see table A.8).

Current-account imbalances widened ...

Large current-account deficits widened further in several economies in the region in 2005, mostly reflecting the dynamics of the merchandise trade deficits, explained in part by strong currencies and rising energy prices. Rising domestic demand, outpacing output,

and, in some cases, inflows of speculative capital and/or increased private foreign borrowing further contributed to the widening of the external deficits. Nevertheless, FDI inflows continued to increase in the region, especially for the EU accession countries.

The policy response to those deficits is complicated, since higher interest rates may induce even larger inflows of speculative capital. The authorities resorted in 2005 to various types of credit restrictions and tighter bank regulations in an attempt to cool down the credit boom and foreign borrowing. Further liberalization of the capital account should be expected, however, over the longer-run.

The main risks to the outlook are related to the excessive reliance on domestic demand as a source of growth. Policies should target expanding export-oriented sectors in order to reduce the external deficit. Attempts to curb these deficits via fiscal restraint may have negative implications for economic activity.

... with complications for policy

The CIS: strong growth prevails despite some slowdown

The pace of economic expansion in the CIS region slowed in 2005, after two years of exceptionally strong growth: aggregate GDP increased by just over 6 per cent in 2005, down from 7.6 per cent in 2003 and 7.9 per cent in 2004 (see table A.2). This outcome reflected a deceleration of growth in the two largest economies, the Russian Federation and Ukraine, where the deceleration was particularly pronounced. The smaller economies fared better, with the notable exception of Kyrgyzstan. Regional GDP growth is forecast to stay robust in 2006, maintaining the same pace as in the previous year.

External factors were generally supportive of growth in 2005, with oil and gas prices reaching new highs, but there were adverse developments as well. Worsened conditions for exporters in the global markets for metals, in particular steel and steel products, and sharply lower cotton prices exerted a negative influence on the economies specializing in those commodities. Domestic demand remained the main driver of economic expansion in the CIS countries. Robust consumer demand played a key role, while fixed investment was less dynamic in the larger economies of the region. Imports were strong, fostered by robust domestic consumption and the ongoing appreciation of real exchange rates.

Export performance is mixed, while strong domestic demand drives growth

Despite favourable prices, export growth decelerated owing to a temporary slowdown in the growth of oil production in the Russian Federation, the result of supply constraints. The deceleration coincided with a sharp deterioration in the export performance of Ukraine. Those two factors explain why external demand negatively affected GDP growth for the region at large. In the outlook, domestic demand is anticipated to continue to drive growth in 2006, as private consumption grows rapidly on account of expectations of continued growth of real incomes and wages, and investment picks up in many CIS countries, boosted by government support to new investment projects.

Despite a notable deceleration in the Russian Federation in the first quarter of 2005, growth picked up at a rate of 6 per cent throughout the rest of the year. A slightly lower rate is forecast for 2006. Robust domestic demand was the main driving force in 2005 and is expected to remain so in the forecast period. In particular, domestic consumption expanded further, owing to continued strong growth in real incomes and wages, underpinned by increasing social expenditures and growing employment, and benefiting from increased bank lending to households. In addition, fixed investment rebounded after a relative moderation in the first quarter of 2005 and is expected to strengthen further throughout 2006, stimulated

Strong growth continues in the Russian Federation

by the newly established Investment Fund. In the near future, investment levels and output growth are expected to be sustained at high levels in Azerbaijan and Kazakhstan, thanks to the further development of the hydrocarbons sector.

Despite strong growth, improvements in labour markets remain elusive

As with other emerging market economies in Eastern Europe, labour demand responded with a lag to aggregate output dynamics in the CIS countries, suggesting a relatively high degree of labour hoarding (see box IV.2). Therefore, there was only a limited amelioration of the employment situation, even in countries that experienced high rates of economic growth. In the oil-exporting countries, employment increased only marginally compared with the rate of output growth and unemployment rates did not decrease significantly. The other CIS countries achieved even lower rates of employment expansion. The prospects for a visible improvement of the situation in the labour market hinge upon the growth performance in labour-intensive sectors, such as services, and the facilitation of intraregional labour mobility through the establishment of an adequate legal framework and social policies.

Inflationary pressures remain a concern

Inflation accelerated further in most CIS countries during 2005. The main factors underlying this trend were the generally expansionary stance of fiscal policies, fast rising consumer demand and rising energy costs. In many CIS economies, the official year-end inflation targets for 2005 were revised upward, particularly in the Russian Federation and Ukraine. Industrial producer prices continued to surge in 2005, albeit at a slower rate than in the previous year. Given the inherent inertia, a further rise in inflation cannot be excluded in some of the countries in the region in the short run. Limiting the increases in tariffs on gas, electricity, rail transport and houses, as well as lowering barriers for food imports, however, is likely to keep inflationary pressures down in 2006 in some of the largest economies, including the Russian Federation. Curtailing further inflationary pressures would require a more comprehensive policy approach and a major policy effort towards fiscal consolidation.

Macroeconomic policies face conflicting policy goals

Macroeconomic policies were generally supportive of growth in 2005, continuing a pro-cyclical fiscal policy stance and expansionary monetary policy by the governments of the primary commodity-exporting countries. High oil prices have exacerbated the old dilemma faced by monetary authorities in the oil-exporting CIS countries, as they attempt to target two monetary goals simultaneously—inflation (seeking price stability) and the exchange rate (preventing excessive real appreciation)—using only one instrument, namely, intervention in the foreign-exchange market. Given the persistently large current-account surplus and some fiscal loosening, the management of excessive liquidity is even more complicated in the Russian Federation. A higher degree of exchange-rate flexibility may be required to prevent inflation from becoming entrenched. The rapid credit expansion and growing foreign liabilities in the private sector are further risks that need to be closely monitored.

Most energy and commodity exporters achieved significant merchandise and current-account surpluses and sizable increases in their foreign exchange reserves. Those trends should persist as oil prices remain high in 2006. The remaining CIS countries are likely to continue to rely on external finance in order to cover moderately sized current-account deficits.

There has been effective management of oil revenues through stabilization funds

The management of the booming oil revenues has been reasonably prudent and the stabilization funds functioned efficiently. In the Russian Federation, the expansionary effect of high oil prices was significantly contained through changes in the tax system during 2005. A further relaxation of the fiscal stance, however, could increase the vulnerability of public finances to external shocks. Further fiscal expansion is expected in a number of economies, including the Russian Federation, as governments seek to stimulate economic activity further. Given the generally low domestic supply responsiveness, however, a significant part of the stimulus is likely to leak into higher imports.

Looking forward, the major risks for the CIS economies are rising inflationary pressures, volatility of commodity prices, particularly for oil, gas and steel, as well as continuing real exchange-rate appreciation and rising production costs. Those potential risks should be addressed through consistent monetary and fiscal policies. In addition, these countries face the challenge of creating appropriate conditions for increased business investment in order to address the erosion of competitiveness and to broaden the basis of economic expansion beyond the current narrow specialization in a handful of commodities.

Risks include rising inflation and volatile commodity prices

Developing economies

The overall benign international economic environment supported economic growth in developing countries, which reached 5.7 per cent in 2005 after having recorded 6.6 per cent in 2004. The slowdown—albeit moderate—was present in most regions and related to the deceleration in the global economy because of the maturing of its cyclical recovery (see chapter I). Owing to increased globalization and economic integration, external demand conditions are becoming progressively relevant for growth in developing countries, while domestic demand remains constrained or subdued in many economies.

Africa was the exception to this general deceleration in developing countries, as the region was able to maintain its economic performance thanks to favourable conditions in agriculture and higher prices and volumes for the main exports of the region. Equally important, the group of least developed countries (LDCs) was also able to sustain fast rates of growth, which were above the average for developing countries for the fifth consecutive year (see table A.3). The overall outcome was, however, mostly owing to very fast growth in the new net fuel exporters in this group and in countries recovering from conflict. Given the particular circumstances underlying this growth performance, sustained high growth is not guaranteed.

The outlook for oil-importing developing countries remains positive, despite the fact that the expected persistence of high oil prices will negatively affect their terms of trade and put stronger upward pressure on inflation rates. In 2006, developing countries are expected to keep up the current rate of growth and expand output by 5.6 per cent.

Africa: GDP growth continues to be robust

Africa's real GDP is estimated to have grown by 5.1 per cent in 2005, roughly the same rate that was achieved in 2004. Steady growth in the latter half of the 1990s and the relatively high rates of growth recorded over the last five years confirm the continued recovery of African economies (see table A.3). Growth in 2005 was underpinned by the same factors that drove growth in 2004. The agricultural sector had a good overall performance, which benefited Africa in the aggregate, although several countries suffered from drought and other setbacks, such as the locust invasion in West Africa in 2004 that affected crop yields in 2005. Continued progress in macroeconomic and structural reforms, including the unification of foreign exchange markets and better public expenditure and financial management, and a high degree of macroeconomic stability in a large number of countries encouraged economic activity and improved economic welfare. Parliamentary and presidential elections in Burundi and Liberia, and the signing of a peace agreement in the Sudan, improved the growth prospects of those countries and underscored recent gains made throughout Africa in strengthening civil and political governance.

The near-term outlook
is also favourable...

The region also benefited from a supportive international economic environment. Higher oil prices and buoyant world market prices of some of Africa's main non-fuel, primary export commodities contributed to growth in export earnings and GDP. Increased FDI and official development assistance (ODA) inflows and a reduction in the stock of debt were also factors supportive of growth. Growth is expected to be sustained at 5.5 per cent in 2006. The favourable factors underlying the current growth performance are unlikely to change substantially in the outlook, despite some risks discussed below.

GDP expanded robustly in North African countries in 2005, except in Morocco, owing to the poor performance of its agricultural sector and a contraction in textile and clothing exports. Increased oil and gas exports (in both value and volume) underlined Algeria's GDP growth. Windfall earnings from higher oil prices led to large current-account and fiscal surpluses (estimated at 22.2 and 11.7 per cent of GDP, respectively) and allowed for a reduction in external indebtedness. Algeria continued with its reform efforts, aimed at attracting FDI in telecommunications, power and water industries and generating faster employment creation in other sectors of the economy by diversifying away from the oil and gas sector. Egypt's GDP growth in 2005 was largely explained by the rise in oil prices, strong performance in the services sector and an increase in domestic demand following the reduction of customs duties and income tax rates.

Economic growth in sub-Saharan Africa (excluding Nigeria and South Africa) averaged 5 per cent in 2004 and 2005 and is expected to remain at roughly the same rate, possibly with a slight acceleration, in 2006. Most countries in this subregion will achieve GDP growth rates in the range of 3 to 7 per cent. Oil-exporting countries such as Angola and Chad grew at double-digit rates in 2005 (and the Sudan at a slightly lower rate of 7.0 per cent) as a result of higher export volumes and stronger domestic spending. Mauritania will also join the group of fast-growing economies in the region when new oil fields come on stream in 2006.

Nigeria's GDP growth decelerated in 2005 (see table A.3), but increased oil and gas export revenues enabled the country to run a current-account surplus. Part of the increase in revenues is being used to upgrade infrastructure in order to lay a solid foundation for future growth. Additionally, agriculture has been the focus of recent policy measures to promote economic diversification and the revitalization of sectors other than the hydrocarbons sector.

South Africa's GDP grew by 5.0 per cent in 2005, driven mainly by growth in real domestic expenditure owing to rising real incomes, low interest rates and moderate inflation. Strong global demand boosted exports, although the current account remained in deficit because of faster import growth. The high unemployment rate (officially reported at 26.5 per cent) remains a major challenge and was further complicated in 2005 by a large influx of illegal and unskilled workers from neighbouring countries and a large outflow of skilled workers constituting a "brain drain" to the rest of the world.

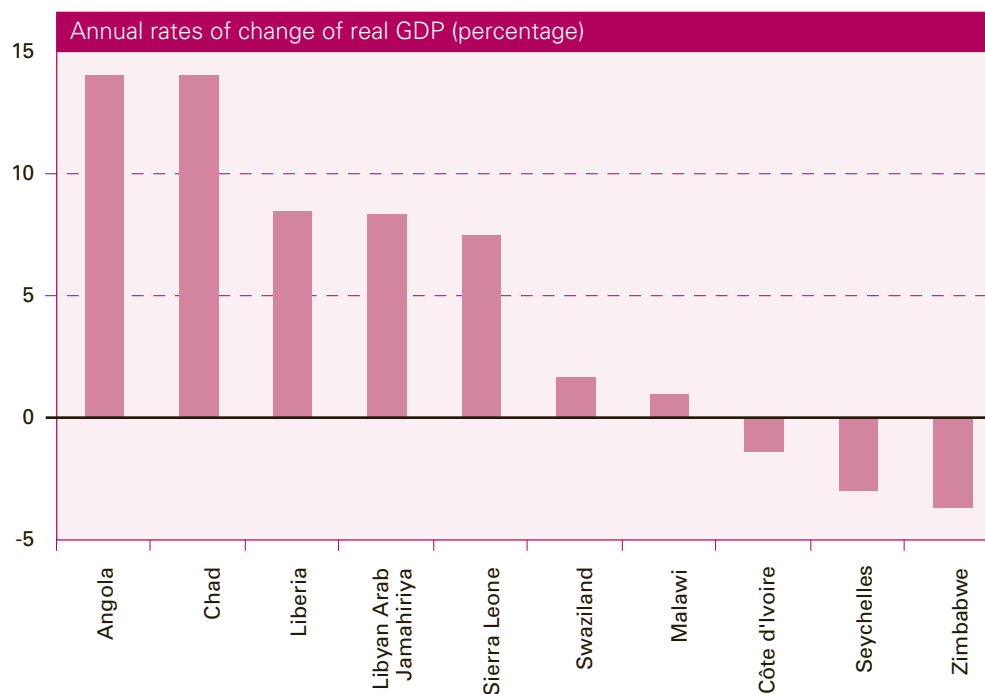
Côte d'Ivoire, Seychelles and Zimbabwe were the only African countries where GDP contracted in 2005 (see figure IV.6). Economic decline in Côte d'Ivoire and Zimbabwe was associated with political instability and civil unrest, while the economy of the Seychelles contracted as the result of weak domestic demand and decreased tourism revenues.

Despite the overall benign external environment, there was a decline in manufacturing output in countries heavily dependent on textiles and clothing exports, owing to the end of the Agreement on Textiles and Clothing (ATC) in January 2005 and increased competition from low-cost producers in China and other Asian countries (see chapter II). For example, from January to September 2005, the value of sub-Saharan African textile and ap-

...but conflicts and
weak domestic demand
continue to constrain
growth in a few
countries...

...and the end of the
ATC took a heavy toll
on textile exports and
formal employment in
some countries

Figure IV.6.
Real GDP growth in Africa: the five fastest and five slowest performers in 2005



Source:
UN/DESA.

parel exports to the United States dropped by 11 per cent compared with the same period in 2004.⁴ Thousands of jobs were reportedly lost in Lesotho, Madagascar, Malawi, Mauritius, Swaziland and South Africa as a result of the contraction of the textile sector, with little opportunity for the displaced workers to be absorbed in other sectors of the formal economy.

Fiscal policies remained cautious in Africa, as reflected in the generally low fiscal deficits (and surpluses in a few countries). South Africa, for instance, maintained an ongoing policy of moderate fiscal expansion that focused on programmes aimed at improving government services and infrastructure for the poor and increasing employment opportunities through public works projects. Public expenditures also increased, albeit less than revenues, in countries that benefited from higher oil export earnings, with Algeria and Nigeria as cases in point.

Monetary policies remained relatively tight in most countries. Some oil-producing countries used monetary policy tools, including sterilization and credit controls, to avoid excess money-supply growth and to dampen inflationary pressures.

Africa's average inflation remained at low double-digit rates in 2005 (see table A.6). Increased inflationary pressures, however, were recorded in countries such as Ghana, Guinea, Malawi, Zambia and Zimbabwe that faced currency depreciation and/or the immediate pass-through of higher imported oil and food prices to consumers.

The commitment of Africa to economic and political reforms was further underscored as 23 African countries have signed up for the African Peer Review Mechanism (APRM) as of November 2005. The main objective of the APRM exercise is to encourage

Fiscal and monetary policies were generally cautious in Africa

There exists a stronger commitment to better political and economic governance

⁴ Exports include Generalized System of Preferences (GSP) and African Growth and Opportunity Act (AGOA) provisions. See United States International Trade Commission, Sub-Saharan Africa: "U.S. exports, imports, GSP imports, AGOA imports, by major commodity sectors, annual and year to date" (January-September 2005), available from http://reportweb.usitc.gov/africa/by_country_agoa.jsp.

integrity and transparency in political and economic governance of individual countries and thereby secure the confidence of external development partners and foreign investors in the sustainability of African reform efforts. It is hoped, in particular, that the APRM process will eventually confirm Africa as a desirable destination for FDI. In 2005, the first stage of APRM reviews was conducted for two countries (Ghana and Rwanda).

The external debt situation of Africa improved in 2005—and is expected to improve further in 2006—owing to higher export earnings, continued debt relief and more active debt management. The G-8 proposal to write off multilateral debt owed by the heavily indebted poor countries (HIPC), emanating from the July 2005 Gleneagles Summit, is expected to facilitate long-term debt sustainability in many African countries if commitments are met (see chapter III). The decision of Algeria, Nigeria and other African oil-producing countries to use their windfall oil earnings to repay some of their debt ahead of schedule also enhanced their debt sustainability.

Many challenges remain ahead

Despite the relatively positive aggregate economic performance, African economies are faced with fundamental challenges that require attention if better and faster growth is to be achieved in the future. The aggregate rate of growth has remained below 7 per cent, which the Economic Commission for Africa (ECA) and the World Bank estimate as the minimum average rate at which sub-Saharan African countries need to grow in order to achieve the first Millennium Development Goal of halving poverty on the continent by 2015.⁵ Thus far, increased growth seems to have had a limited effect on poverty reduction. In fact, growth has largely concentrated in relatively capital-intensive sectors with little spillover effects on employment creation and on the rest of the economy. Moreover, its benefits have been unequally shared owing to the pattern of income distribution of the region (Africa is the region with the second highest inequality in the world after Latin America). In addition, pandemics such as HIV/AIDS and malaria continue to exert tremendous pressure on Africa's productive resources, which might impose additional constraints on the long-term growth prospects of some of the more seriously affected countries.

Adverse external shocks, conflicts and poor weather conditions are the major risks to continued strong growth

There are a number of downside risks to economic growth in 2006. First, prolonged high oil prices over the next one to two years will have a stronger inflationary impact on most African economies. Despite the higher oil prices, many countries registered terms-of-trade gains owing to increased commodity prices (particularly minerals and base metals) and lower prices of imported manufactures, thus offsetting inflationary pressures until recently. Price gains of some commodities, however, weakened in 2005 (see chapter II). Many net fuel importers will therefore be hit if oil prices remain high. This additional burden could be severe since, in some countries, oil imports account for up to 50 per cent of their total import bill. Second, a possible disorderly adjustment of the current-account deficit of the United States (see chapter I) could seriously undermine exports and growth in many African countries, as this might entail a significant depreciation of the dollar and contraction of United States imports. Third, African countries will face increased competition in global markets for textiles and apparel from lower-cost producers as the impact of the elimination of the ATC continues to unfold. Fourth, continued tensions in Côte d'Ivoire, the Ethiopian-Eritrean border, the Darfur region of the Sudan and Zimbabwe are a source of great concern and could jeopardize progress made in reducing conflicts and improving civil and political governance in a large number of African countries in recent years. Fifth, the eventual reduction and/or removal of market-distorting subsidies on agricultural products—within the framework of

⁵ United Nations Economic Commission for Africa, *Economic Report on Africa 1999, The Challenges of Poverty Reduction and Sustainability* (May 1999), available from http://www.uneca.org/eca_resources/Publications/ESPD/economic_report_1999.htm#ii, and World Bank, *Can Africa Claim the 21st Century?* (Washington, D.C., World Bank, 2000).

WTO negotiations—may benefit some African agricultural exporting countries in the long-run, provided they are able to compete in global markets. Many net food importers, however, are likely to suffer from higher food prices in the short term. Finally, African economies remain vulnerable to weather shocks, and the projected increased growth rate would have to be revised downwards if bad weather were to seriously affect the agricultural sector.

East Asia: solid growth amidst increased downside risks

East Asia's GDP growth is estimated to have reached 6.7 per cent in 2005, supported largely by China, whose rate of GDP growth surpassed 9 per cent in the year. GDP growth decelerated in the majority of the economies in the region. Besides higher oil prices, the region has been confronted with several non-economic shocks, with the recent outbreak of avian influenza remaining a source of concern. Average regional growth is anticipated to continue at the current rate in 2006 (see table A.3), albeit less divergent across the region owing to a variety of factors, including the expectation of a continued stable performance of the economy of the United States, the largest destination of the region's exports, expectations of a continued turnaround in the economic performance of Japan and the bottoming out of the global electronics cycle.

As in 2005, China is expected to drive economic growth in East Asia as well as that of the global economy in 2006. The GDP growth of China, however, is anticipated to slow down but still remain robust at above 8 per cent. This deceleration is expected to take place following the implementation of measures by policy makers to cool off investment in key sectors with excess capacity (for example, steel and cement manufacturing, consumer electronics and real estate). Imports of raw materials and manufactured components for domestic consumption are anticipated to decelerate. Conversely, imports of services will rise as China seeks to improve its underdeveloped service sector. Exports will continue to support growth in view of the only limited currency appreciation brought about by the change in the exchange-rate regime (see chapter I), the competitive level in labour costs of China as well as increasing labour productivity. Economic restructuring through disinvestment of public enterprises—particularly in the banking sector—is likely to intensify in 2006, thus potentially bringing efficiency gains to the entire economy.

The situation in China's banking sector has improved, based on a fall in the amount of non-performing loans, which was largely owing to write-offs and the recapitalization of banks. It is less clear, however, whether processes of risk assessment and risk management have been strengthened enough to avoid a renewed increase in non-performing loans in the future. The increased presence of foreign banks in the Chinese banking sector could have a positive effect in this regard, as it is likely to lead to the establishment of improved management and governance practices. Conversely, stock markets remain surrounded by uncertainties regarding future government action with respect to its shares in firms listed on the stock exchange. In addition, bond markets require further reform and deregulation so that economic fundamentals and market perceptions could have a greater role in determining prices and yields.

Although modest, the slowdown of the Chinese economy will be felt by the economies of the region that trade heavily with China. Growth in Hong Kong Special Administrative Region (SAR) of China is expected to decelerate in 2006, despite the potential boost to the economy stemming from the likely influx of tourists from the mainland and elsewhere to the Disneyland that opened for visitors in September 2005. In the case of the Republic of Korea, faster growth in 2006 will be based on sustained growth in private consumption as well as positive impetus from increased trade with a recovering Japanese economy.

Despite a slowdown in 2005, regional economic growth is expected to remain well supported

Economic policies will slow the economic expansion of China

China's financial sector remains in need of further reforms

The performance of the economy of China will have mixed effects on other economies in the region

An upturn in the global electronics cycle and tourism create upside potential for economic growth in the region

The expected upturn in the global electronics cycle will contribute to faster growth in the region. Accordingly, Taiwan Province of China and Malaysia are both likely to see a moderate acceleration in their rate of GDP growth in 2006. Similarly, exports of high-tech products will continue to support the economic expansion of Singapore.

As in the case of Hong Kong SAR, tourism will be an important driver of economic growth in Thailand, especially after the slump in tourist arrivals in 2005 in the aftermath of the tsunami disaster. Increased tourist arrivals combined with further fiscal stimulus coming from enhanced public expenditures on large infrastructure projects will lead to faster growth in the country in 2006. As in other countries relatively dependent on the tourist sector, however, a severe outbreak of avian flu poses a significant downside risk to this outlook (see box IV.3).

External imbalances are accompanied by an investment shortfall

The export orientation of the region has contributed to the generation of current-account surpluses since it recovered from the 1997 crisis. Lately, however, current-account surpluses have declined largely owing to higher oil prices, especially in such economies as the Republic of Korea and Taiwan Province of China, which are fully dependent on oil imports to cover demand. Against the backdrop of persistent trade imbalances, evidence of “investment anaemia” is well pronounced in many East Asian economies (see chapter I). Several governments in the region are reluctant to stimulate domestic investment because it was precisely excessive investment, particularly in real estate, that triggered the financial crisis in the previous decade. Thus, any adjustment is likely to take place only slowly.

Increasing inflationary pressure ...

Despite higher oil prices, inflation rose marginally in the region (see table A.6). Inflationary pressures were muted—until the second quarter of 2005—owing to the use of subsidies by several governments, which kept a lid on domestic fuel prices. Yet, oil subsidies eventually became unsustainable as they implied a heavy fiscal burden and had to be phased out. Accordingly, the region has experienced renewed inflationary pressures. In the outlook, the extent of the impact of higher oil prices on inflation, however, will depend not only on the monetary policy stance (see below) but also on exchange-rate movements, as oil prices are quoted in United States dollars. Despite current trends, the dollar is expected to continue to fall against East Asian currencies in 2006. Thus, the appreciation of Asian currencies is likely to alleviate potential inflationary pressures coming from higher oil prices.

... will imply a further tightening bias in monetary policy

Low interest rates prevail in most countries of the region, but monetary policy has been tightening in response to inflationary pressures as discussed above. This stance will continue in 2006, especially in Malaysia and Taiwan Province of China, where real interest rates are negative. Notable exceptions to this trend are likely to be Indonesia and the Philippines, where interest rates are already higher than the regional average and have dampened private consumption and its contribution to GDP growth.

Lower oil subsidies will support fiscal consolidation

Fiscal policy in the region is expected to be generally cautious, with the leading economies (except China) continuing to use a moderate amount of fiscal stimulus to promote growth. An important determinant of fiscal positions, however, will be the policy responses of individual countries to higher oil prices. In the case of Thailand, for instance, the elimination of oil subsidies in July 2005 is likely to narrow the budget deficit sufficiently to allow the release of funds for large infrastructure projects. The phased elimination of oil subsidies in Indonesia, Malaysia and Viet Nam is also likely to reduce the fiscal deficit, although by a smaller margin. In the Philippines, on the other hand, the primary policy response to higher oil prices has been to use administrative methods such as curtailing working hours to cut fuel consumption. Given that in the past such measures have largely failed to reduce fuel consumption, the Philippines is likely to be saddled with a higher fiscal deficit in 2006.

Box IV.3

Avian influenza: worries in Asia^a

Avian influenza was first identified over 100 years ago: since then, the disease has been reported at irregular intervals in all regions of the world. In addition to the current outbreak in Asia, recent epidemics have occurred in Hong Kong in 1997-1998 and 2003, in the Netherlands in 2003, and in the Republic of Korea in 2003.

Once domestic birds are infected, avian influenza outbreaks can be difficult to control and may cause major economic damage to poultry farmers in affected countries, since mortality rates are high and infected fowl generally must be destroyed—the technical term is “culled”—in order to prevent the spread of the disease.

The outbreak is caused by the highly pathogenic H5N1 strain of the virus. Recently, outbreaks of avian influenza in poultry, associated with the H5N1 virus have been reported from Croatia, Kazakhstan, Romania, the Russian Federation, Turkey and Ukraine. Migratory wildfowl have been identified as viral carriers: it is thought that they may be responsible for this spreading pattern of infection. By early December 2005, 137 human cases—all in South-East Asia and China—had been reported. These sporadic infections have mainly occurred among persons who have close contact with live poultry or poultry products. Seventy ended in deaths.^b

Avian influenza is very different from seasonal influenza which occurs each year, is transmitted between humans, and usually causes a mild illness. It can have severe consequences—and even death—usually among older people. But, the H5N1 virus is coming under close scrutiny because of the possibility that it might undergo genetic change and be capable of direct transmission from one person to another. This could well trigger the next human influenza pandemic.

East and South-East Asia has suffered significant human and economic losses owing to the present outbreak. Small and medium-sized farmers, whose stocks are often not insured and who have no alternative sources of income, have been hit the hardest. Overall, 140 million birds have been destroyed so far. Poultry meat imports from affected areas were prohibited in many countries. As the size of the poultry sector ranges from 0.6 per cent of GDP in Thailand and Viet Nam to over 2 per cent of GDP in the Philippines, a fall in poultry output by 15 per cent, as has already been the case in Viet Nam, can imply a reduction in GDP by up to 0.3 per cent.^c Across the region, the total losses from the damaged poultry sector amounted to about \$10 billion by the end of 2005.

The estimates of deaths from a possible global pandemic of highly pathogenic avian influenza depend on several factors including the assumptions on timing, morbidity and mortality rates as well as the availability and efficacy of control measures such as vaccination or drugs. It is difficult to give any precise estimates of potential numbers of deaths from the next pandemic. Experience with the severe acute respiratory syndrome (SARS) outbreak in 2003 suggests, however, that the reaction to pandemic risk could result in major consequences for economies and societies. The economic losses associated with an avian influenza pandemic could well amount to \$200 billion in just one quarter, with the Economic and Social Commission for Asia and the Pacific (ESCAP) region bearing most of the brunt. This corresponds to 2 per cent of world GDP.^d The impact on some specific sectors, however, could be catastrophic. Tourism, one of the industries to be potentially affected by an outbreak, accounts for over 9 per cent of GDP in East Asia and about 11 per cent in South-East Asia. As in the SARS outbreak, significant economic costs may arise in the form of people trying to avoid personal contact in order to reduce the risk of infection and/or from psychologically-induced effects, affecting overall consumer and investor confidence and therefore resulting in reduced spending.^e

Countries are adopting a two-pronged strategy to address threats caused by influenza. This involves steps to control the outbreaks in the poultry populations thus minimizing the chance of spread to humans, and preparation of a comprehensive multisectoral plan to tackle a possible pandemic. Despite measures to control the disease among poultry, countries face considerable challenges, including slow and/or absent reporting of cases, which makes surveillance difficult; financial and technical constraints confronting small, often poor, breeders; overall lack of resources in countries to implement comprehensive plans; and difficulties in stockpiling antiviral medicines.

In this regard, regional and multilateral cooperation has a vital role to play, also with respect to the adoption of measures that ensure access to the required medicines by the poor. Sharing information through a regional forum as well as ensuring transparency in coordinating responses to a possible pandemic is also vital. Last but not least, the most important element remains sustainable funding. Donors and affected countries have been discussing ways of financing the enormous cost of the contingency plans. Regional arrangements such as the creation of an Asia-Pacific health emergency fund to deal with such health emergencies, including establishing and financing a regional stockpile of lifesaving medicines, are worth serious consideration.

^a Based on ESCAP, *Socio-Economic Policy Brief*, Issue No. 1, October 2005, available from <http://www.unescap.org/pdd/publications/se%5Fbrief/1.pdf>.

^b WHO, “Cumulative Number of Confirmed Human Cases of Avian Influenza A/H5N1 reported to WHO”, available from http://www.who.int/csr/disease/avian_influenza/country/cases_table_2005_12_09/en/index.html.

^c World Bank, *East Asia Update* (November 2005), available from <http://siteresources.worldbank.org/INTEAPHALF-YEARLYUPDATE/Resources/EAP-Brief-final.pdf>.

^d Ibid.

^e Canada/Department of Finance/Economic Analysis and Forecasting Division, “The Economic Impact of an Influenza Pandemic”, 28 November 2005 (mimeo).

Downside risks include protectionist trade measures, speculation in the housing market, large build-up of currency reserves, higher oil prices and avian flu

The forecast for the region is subject to some risks and uncertainties. First, the surge in garment exports from China following the abolition of the ATC has led to emergency safeguard measures by the EU and the United States (see chapter II). The emergence of these and other protectionist measures is of particular concern to East Asia owing to its dependence on trade for economic growth. Second, low interest rates, particularly on mortgages, have led real estate prices to soar to record levels in several economies. This development is a source of concern for policy makers in such countries as Malaysia and Thailand, where a real estate bubble was an important catalyst of the 1997 financial crisis. Careful surveillance by central banks is needed in order to minimize the potentially destabilizing effects of unsustainable lending against real estate. A third potential risk is the high accumulation of foreign exchange reserves in China, the Republic of Korea and Taiwan Province of China. A sizable portion thereof corresponds to inflows of portfolio capital, which are highly volatile and, hence, a possible source of macroeconomic instability, although the higher level of currency reserves also serves as a shield against such negative effects (see chapter I). Moreover, holding the accumulated currency reserves could also imply additional costs (owing to asset value losses) in the case of a depreciation of the United States dollar. Fourth, prospects of higher oil prices are an adverse risk confronting the region. Policy responses—whether in the form of incentives to divert production away from fossil-fuel-intensive processes, raising taxes to discourage consumption, or continuing with subsidies to avoid burdening firms with higher input costs—will ultimately depend on the constraints stemming from the macroeconomic fundamentals of each country. Finally, concerted efforts are required to contain the outbreak of avian flu currently affecting some of the regional economies in order to avoid the loss of human life and the economic costs that would be associated with a more widespread pandemic.

South Asia: a sustained broad-based growth

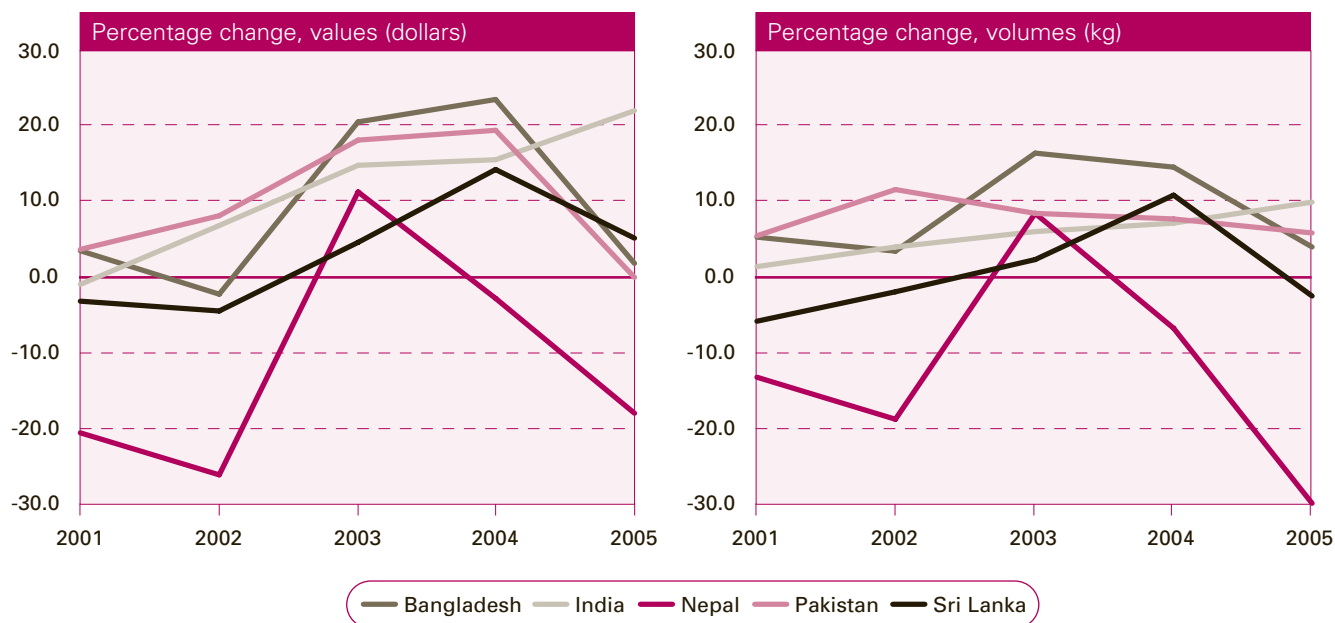
South Asia is on track for sustained healthy growth in 2005 and 2006

After posting an average GDP growth rate of 6.7 per cent in 2004, the region was on track to reach a similar result of about 6.5 per cent in 2005, sustained by normal monsoon rains and strong domestic demand. Continuing reforms and structural changes that have accompanied increasing integration of the region into the global economy will contribute to sustaining growth of 6.4 percent for 2006 (see table A.3), albeit with diverging trends across countries. After two consecutive years of high growth, Pakistan is expected to slow down slightly and the Islamic Republic of Iran is likely to be hit by falling oil production owing to a deterioration in production facilities. The rest of South Asia is expected to post constant or accelerated GDP growth in the coming year.

The textiles sector and services are contributing to strong growth

Growth was broad based in 2005, as normal monsoon rains in most countries allowed the agricultural sector to recover from its lacklustre performance in 2004, while industrial growth and the services sector remained strong. One important driver of manufacturing growth and investment is the textiles and ready-made garment (RMG) industry, particularly in Bangladesh, India, Pakistan and Sri Lanka. The exports of those countries held up after the termination of the ATC (see chapter II, and figure IV.7), rebutting earlier fears of disruptive crises, especially in Bangladesh. While tourist arrivals in Sri Lanka increased by around 10 percent over 2004, earnings from tourism were down, indicating that a large number of arrivals were business travellers and relief workers rather than leisure travellers. Conversely, Nepal suffered from a continuing downturn in tourist arrivals, which is not expected to improve until the political situation stabilizes. Moreover, the country suffered from insufficient rainfall in 2005 and a decline in RMG exports.

Figure IV.7.
Growth in textile and clothing exports from selected South Asian countries to the European Union and the United States, 2001-2005^a



Sources: Eurostat; IMF, *International Financial Statistics*; United States Department of Commerce.

^a Growth for 2005 refers to the first three quarters over the same period in 2004.

India maintained a strong economic performance in 2005, driven largely by the manufacturing sector, owing to booming domestic demand for consumer goods as well as infrastructure development. There has been a strong response by the business community to the opportunities created by an expanding domestic market as the middle class grows—thus sustaining consumption demand—infrastructure bottlenecks started to be addressed, and prospects for exports remained positive. The “Building India” programme, which comprises investments totalling \$40 billion over a four-year period starting in 2005, will add impetus to demand for industrial goods over the medium term.⁶ The services sector also performed well, supported by the continued strong growth of information technology (IT) services as well as tourism and tourism-related activities. Agriculture remains dependent upon monsoon rains, but there has been a return to near normal harvests, which contributed to growth in the year.

The impact of the October 2005 earthquake in South Asia was felt largely in Pakistan, resulting in massive human losses, devastation of dwellings and infrastructure. GDP growth is likely, however, to decrease by less than half a percentage point in fiscal year 2005-2006, since no major industries are located in the affected area, and contributions to the agricultural or services sectors of the national economy are small. Over the medium term, reconstruction activities and investments are expected to offset the negative impact on GDP. Owing to the vast amount of resources needed for relief and reconstruction, an adverse impact on the national budgetary position is expected in the near term, part of which may be financed through ODA pledged during an international donor conference in November (overall, \$4 billion were pledged in loans and \$2.2 billion in grants). Also, inflationary pres-

Domestic demand is a key driving force behind robust growth in India

The October 2005 earthquake will have a limited impact on the growth of Pakistan

⁶ Asian Development Bank, *Asian Development Outlook 2005 Update* (Manila, ADB, 2005), available from <http://www.adb.org/documents/books/ado/2005/update/ADU2005-Full.pdf>.

tures may increase from supply bottlenecks (for example, in non-tradable reconstruction materials).

Regional unemployment remains high

Despite sustained growth, unemployment remains a problem in the region. While official unemployment rates fell slightly in the Islamic Republic of Iran and in Pakistan, they remain stubbornly high in all countries. With a rapidly growing workforce, the formal sector is not able to absorb all job seekers who enter the labour market. Unemployment is highest among the young, and especially among educated young people—who are less likely to be absorbed by the informal sector.

Inflationary pressures are fuelled by increasing pass-through of high international oil prices...

High growth rates were accompanied by strong inflationary pressures in most of the economies of the region, with consumer price inflation rising to 6.5 per cent in 2005. Country-specific drivers of inflation were high food prices (as in Bangladesh and Sri Lanka), as well as strong private-sector credit expansion and increases in property prices. The real estate sector is believed to be overheated in many cities of both India and Pakistan. In addition, price levels were rising in all net oil-importing countries as Governments allowed international oil price increases to feed through to domestic fuel prices in 2005. Earlier subsidies had by then become unsustainable as they increasingly stretched public finances and distorted market signals. The oil price hike, however, has not yet been entirely passed on to consumers, and further adjustments are likely in 2006.

...triggering further cautious monetary tightening

In order to keep inflation in check, monetary policies continued the tightening trend, raising key policy rates in several steps throughout 2005, and taking measures to rein in monetary expansion. Given that real interest rates still remain comparatively low, the measured tightening is expected to continue into 2006. Only the Islamic Republic of Iran is avoiding monetary tightening, in order to further strengthen private consumption and investment, particularly in the agricultural sector where lending interest rates have become negative. Inflation posted an annual rate of 13.5 per cent in 2005, the highest in the region.

Government spending on infrastructure and human development will increase

There has been a renewed focus in national budgets on development of infrastructure and the provision of health and education services in order to accelerate growth, resulting in expansionary fiscal policies in many parts of the region. As the imposition of new taxes in the near term will be difficult, and privatization of State-owned enterprises is stalling in all countries but Pakistan (and, to a lesser extent, India), these initiatives are likely to weigh on the region's fiscal deficits, unless they can be financed through improved revenue collection.

Most countries face—sustainable—current-account deficits...

Unlike East Asia, most economies in South Asia face current-account deficits, caused by increased expenditure on oil imports and by strong import demand. Increased private savings are mostly channelled into domestic private investments through the financial system, as visible from the strong demand for private credit for emerging business opportunities in industry and services, as well as the strong increase in home loans in many parts of the region. Consequently, there is only a small ex post gap between private savings and investment. As a percentage of GDP, current-account deficits remain within acceptable limits, owing to the continuing flow of remittances from South Asians working overseas. In the case of India, service income also remains strong thanks to buoyant IT and back-office service exports. Apart from the net oil exporter, the Islamic Republic of Iran, only Bhutan and Nepal posted current-account surpluses, as official and private transfers sufficed to offset the merchandise trade deficit.

...while capital inflows remain strong, bolstering foreign exchange reserves

There has been a rise in portfolio capital flows to emerging markets (see chapter III) and South Asia has not been an exception, facilitating India's stock market to rise by 17.6 per cent in dollar terms since December 2004. Those inflows are also partly responsible for the growth in India's foreign exchange reserves to \$143 billion by October 2005, covering

around nine months of 2006 imports of goods and services. In contrast, the Islamic Republic of Iran experienced increased capital outflows since the elections in mid-2005, accompanied by a decline of more than 20 per cent in the stock market. Gross official reserves in most countries are at healthy levels, with the lowest relative levels in Bangladesh and Sri Lanka, where reserves cover 2.6 and 3.3 months of imports, respectively. Most currencies, except the Bangladeshi taka, are expected to appreciate in real terms against the United States dollar in 2006. On the back of continued strong capital inflows, the Indian rupee is expected to appreciate also in nominal terms.

Finally, while security concerns persist across the region, Indian-Pakistani relations appear to be continuing to thaw slowly. In case the political momentum is maintained in 2006, both countries stand to gain economically through mutually beneficial trade, particularly in energy and water resources.

Provided the political and security situation in the region remains stable, a major downward risk for the region is a further increase in international oil prices, raising fiscal and inflationary pressures as well as current-account deficits. Insufficient monsoon rains could also undermine the optimistic growth prospects by hurting agricultural growth and hence rural incomes and consumption. In addition, the region remains prone to natural disasters with potentially large disruptive effects on economic activity.

A further increase in international oil prices is the major downward risk

Western Asia: boom conditions persist amidst uneven growth

The Western Asian region continued to enjoy a general economic bonanza stimulated by booming oil revenues in 2005, largely a result of surging prices. The region is estimated to have grown by 5.3 per cent in 2005, with oil-exporting countries enjoying a continued expansion at 5.9 per cent, and oil-importing countries posting a somewhat lower rate at 4.6 per cent. With oil prices expected to stay high, momentum is seen as remaining strong in the outlook, and the region is expected to expand a further 5 per cent in 2006 (see table A.3).

The boom is especially benefiting the oil-exporting economies of the Gulf Cooperation Council (GCC),⁷ through rising trade surpluses and fiscal expenditures, along with growth in asset prices and credit to the private sector, that stimulate consumption and investment.

Despite suffering from falling terms of trade, oil importers in the region have benefited from spillover effects emanating from the oil boom, as workers' remittances from the Gulf and increased intraregional tourism flows supported demand expansion, particularly in the Syrian Arab Republic and Jordan. Jordan has also benefited from inflows of capital and skilled labour from Iraq, as many Iraqis flee their country.

Turkey registered exceptionally fast growth in 2004 based on strong consumer and investor confidence as the country continued its recovery from the 2001 crisis. Rapid expansion of domestic credit and a strong external sector were also a factor. Growth, albeit still robust, dropped to more sustainable levels, reaching 4.6 per cent in 2005 as growth of private consumption and investment moderated and net exports became increasingly negative. In the outlook, Turkey is expected to grow by around 5.3 per cent in 2006, with all demand components (private and public consumption and investment and exports) growing at healthy rates. Large trade and current-account deficits, high interest rates and an appreciated real exchange rate, however, remain a concern in the medium run. In Israel, the economic momentum of the

The region continued to benefit from booming oil revenues in 2005, and momentum remains in the outlook

Intraregional remittances and tourism flows support demand in oil-importing countries

Growth in Turkey stays high, but the current-account deficit raises concern

⁷ The Gulf Cooperation Council consists of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.

In Iraq and the Occupied Palestinian Territory, progress is stalled by acute conflict

Unemployment in the region remains high, and growth is doing little to bring it down

Political conflict further complicates progress on the unemployment front

Inflationary pressures are on the rise region-wide

last two years continues, despite some signs of softening in the manufacturing export sector in 2005, whereas tourism and other services increased their contribution to overall growth.

Conditions are strikingly different in the economies of the region afflicted by severe political conflict or insecurity. In Iraq, pervasive violence, weak rule of law and severe energy shortages continue to seriously undermine economic activity and exacerbate unemployment and poverty. Despite some relief brought about by debt cancellation by the Paris Club of bilateral creditors of about \$35.7 billion, available resources are dwarfed by the sheer magnitude of the reconstruction needs. Economic growth in the Occupied Palestine Territory (OPT) is estimated to have reached 2.5 per cent in 2005, down from 6.1 per cent in 2003, but slightly recovering from the meagre 1.6 per cent in 2004.⁸ Output growth in recent years constitutes a weak recovery from a severe economic decline in 2001 and 2002. Calculated in constant United States dollars of 2000, GDP per capita in 2005 was 15 per cent lower than the level attained in 2000. Low growth of domestic output and restrictions on labour mobility and trade continue to contribute to high poverty rates. Remittances from Palestinians residing abroad provide a significant and stable compensatory source of income to support livelihoods in the OPT. The wage bill of the Palestinian Authority (PA), the largest employer in the OPT, grew substantially in 2005. The PA is thus faced with a major fiscal problem with the budget deficit expected to increase to \$900 million in 2006.

Higher growth has done little to dent high unemployment rates in Western Asia. The region's unemployment rate is currently estimated at around 15 per cent, with youth unemployment reaching well over 20 per cent. This is largely the result of rapid population growth, an increasing female participation rate and a large supply of temporary extraregional immigrant labour in the oil-exporting economies of the Gulf. Oil-exporting economies typically face segmented labour markets and a structural mismatch between the demand for labour and the characteristics of the domestic labour force, resulting in significant unemployment rates for nationals coexisting with the employment of large volumes of immigrant labour. In Bahrain and Saudi Arabia, Governments have recently enacted labour "nationalization" policies by setting limits on hiring immigrant workers. It is not clear, however, how effective such policies will be in redressing the labour-market mismatches.

The open unemployment rate of the Syrian Arab Republic was above 12 per cent in 2004. This rate is likely to have increased further, along with greater demands on the scarce social welfare resources, following the forced return of workers from Lebanon. Unemployment rates in Iraq and the OPT are currently estimated at about 27 per cent. Conversely, labour-market conditions continued to improve in Israel, with the unemployment rate declining to 9 per cent in 2005, down from 10.4 per cent in 2004 (see table A.9).

Strong expansion of both domestic liquidity and private sector credit are stoking inflationary pressures throughout the region. The average inflation rate in the region (excluding Iraq) is estimated at 4 per cent for 2005, with a slightly higher 4.1 per cent expected for 2006 (see table A.6). In many countries, however, official inflation indicators are believed to significantly underestimate current inflation levels.

In the United Arab Emirates, heavy expatriate demand for housing and strong activity in the construction sector have also contributed to rising inflationary pressures, with housing rental costs having increased between 20 to 40 per cent in 2005, whereas prices of

⁸ A recent report by the IMF, although acknowledging enduring poverty and lower nominal per capita income, estimated faster GDP growth for the period 2003-2005 (see IMF, *Macroeconomic Developments and Outlook in the West Bank and Gaza*; Ad Hoc Liaison Committee Meeting, London 14 December 2005). The IMF estimates are based on rather optimistic assumptions regarding developments in the OPT.

building materials are also estimated to be growing strongly. In Iraq, general disruption and supply shortages in key sectors of the economy have pushed the inflation rate to an estimated level of around 34 per cent in 2005, with very limited progress in cutting inflation expected for 2006, if any. Inflation in Turkey was on track to easily meet the central bank's target of 8 per cent by the end of 2005. In Israel, inflation edged up towards the upper end of the target of the Central Bank during the second half of 2005.

Monetary policy in most of Western Asia is subject to maintaining fixed or semi-fixed pegs to the United States dollar, in many cases supported by surpluses in the current and capital accounts and the accumulation of international reserves. Those policies have largely succeeded in supporting domestic growth while keeping inflation rates within reasonable levels, despite the recent increase in inflationary pressures. Both Israel and Turkey maintain floating exchange rates; while Israel's monetary policy continues to be generally accommodative, real interest rates are still high in Turkey as the country's central bank has been following a cautious stance and giving priority to meeting its inflation target. Nominal interest rates, however, declined along with inflation.

With international oil prices about 42 per cent higher than in 2004 on average, the combined nominal oil export revenues of the region are estimated to have reached almost \$300 billion in 2005. Given current assumptions for international oil prices in 2006, and the fact that many oil-producing countries are close to capacity, combined oil export revenues of Western Asia can be expected to stay at roughly similar levels in 2006.

Fiscal expansion in the GCC countries is taking place despite relatively prudent budgetary stances by Governments, which since 2003 have been saving a significant share of their revenues. Available estimates indicate that Governments in the region are saving about 70 per cent of additional oil revenue in the current oil price cycle,⁹ a significantly larger share than in the oil shocks of the 1970s and 1980s. Saved funds are being invested in regional and international capital markets, for example, through national investment and oil stabilization funds. Bahrain, Kuwait, Oman and Qatar are cases in point. Some countries are using windfall gains to reduce high public debt levels, as is notably the case in Saudi Arabia. Additionally, there is evidence that saved funds are being invested in a more diversified range of assets compared with the previous oil price shocks,¹⁰ including private and treasury bonds, portfolio equities and private equity. Moreover, investment opportunities at the regional level, notably in stock markets and the real estate sector, are also absorbing part of these flows while concerns of a possible bubble in these sectors have increased (see box IV.4).

Current fiscal policies in the region are consistent with conservative budgetary assumptions for oil prices, which were within a range of \$21 to \$27 per barrel for 2005, far below their average level in the year. Lagged expenditures of accumulated fiscal surpluses are expected to provide considerable economic momentum for these economies in 2006 and beyond, thus helping offset the significant deceleration of oil-revenue growth currently expected in the outlook.

Fiscal consolidation and the reduction of public debt-to-GDP ratios remain a key priority in some of the oil-importing countries, namely Israel, Jordan and Lebanon. In the case of Lebanon, financing conditions have deteriorated in 2005 as a result of the heightened political uncertainty, whereas in Israel the Government continues to implement restrictive measures to reduce the fiscal gap.

Monetary policies in the region continue to be largely growth-supportive, but disinflation is still a key priority in Turkey

Oil revenue is estimated to reach \$300 billion in 2005-2006

Oil exporters are saving a large share of the windfall and investing in diversified portfolios

Saved funds will support fiscal expansion in 2006 and beyond

Fiscal consolidation is still a priority in some countries

⁹ International Monetary Fund, "Regional Economic Outlook, Middle East and Central Asia Department" (September 2005).

¹⁰ Bank for International Settlements, *The Quarterly Review* (December 2005).

Asset price bubbles and an end to the oil boom are significant risks in the outlook

The economic outlook of the region is subject to risks in the medium run. The risks largely stem from the vast savings surpluses fuelling booming real estate and financial markets in many countries of the region (see box IV.4). Those markets may well collapse following a substantial correction in oil prices. Productive diversification is still modest, particularly in the oil-exporting countries, and the economies of the region continue to be strongly oil-dependent, therefore, vulnerable to oil-market conditions. This dependence is particularly relevant at present since many see current oil prices driven to a significant extent by speculative factors, estimated to account for between \$15 and \$20 out of the current price of a barrel of crude. Thus any major shifts in oil supply or demand could cause speculative expectations to reverse and eventually result in substantial declines in oil prices.

Box IV.4

Oil windfall, booming stock markets and real estate sectors: is there a bubble on the way?

Booming oil prices since 2003 and the surge in revenues that have come along with them have induced euphoria for domestic investment throughout the Western Asian region. This has translated into a considerable measure of speculative activity in both capital and real estate markets leading to steep increases in asset prices.

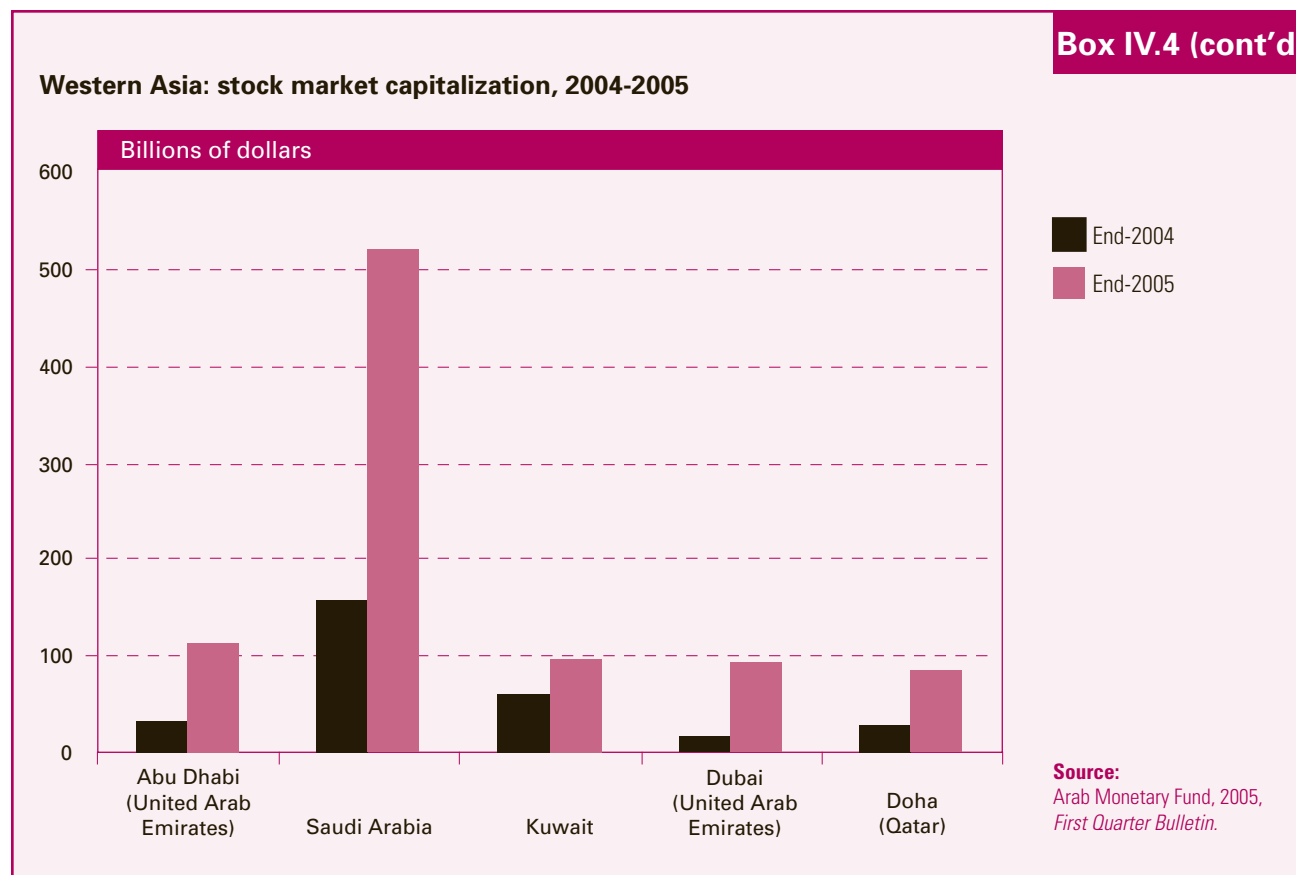
The growth in market capitalization, especially in the Gulf oil-exporting countries, seems to be related to the strong expansion of liquidity and the associated surge in demand for stocks and securities. These were a result of both booming oil revenues and the repatriation of capital flows by Arab investors following more restrictive requirements for portfolio investments in the United States after the attacks of 11 September 2001.

The combined market capitalization of the nine major stock markets in Western Asia surged 205 per cent from \$317.6 billion at the end of 2003 to \$968.2 billion by the end of the second quarter of 2005. The markets of Abu Dhabi and Dubai were the fastest-growing in the region. Market capitalization in Saudi Arabia, the largest in the region, jumped by 229 per cent between end of 2003 and the second quarter of 2005 (see figure below).

Higher oil prices, however, were not the only factor underpinning these developments. In the Amman Stock Exchange, for instance, trading was boosted by a significant inflow of capital originating in Iraq. Massive capital flight from Iraq was initially prompted by the general confusion and chaos following the fall of the regime of Saddam Hussein, and then reinforced by the ensuing period of serious violence and uncertainty. A considerable share of these capital outflows have been invested in the economies of Jordan, Lebanon and the United Arab Emirates, particularly in the real estate sector and financial markets, thus contributing to the surge in asset prices in those markets.

An unprecedented surge in investment in real estate development has also taken place in the region. In many countries, the real estate boom has been compounded by the absence of alternative investment opportunities with an appropriate profitability-risk mix. The latter is mainly a result of largely undiversified economic structures, low competitiveness of the domestic industry owing, inter alia, to relatively high labour costs, restrictive regulations and lack of a transparent and open general business environment.

As many episodes in the global economy have clearly shown, investment surges in asset markets can take prices beyond their long-run sustainable levels, thus creating a risk of bubble-bursting that can have very damaging consequences both for the financial sector and the real economy. While it is unclear whether prices in certain asset classes in Western Asia are already beyond those levels, the recent surges in prices do indicate that they may be approaching unsustainable levels, particularly in view of associated risks. For example, an unexpected and significant decline in oil prices, a crisis in a major regional market, or the accumulation of significant levels of unsold housing units or vacant rental units in real estate markets are all factors that could provoke shifts in investor sentiment and potentially damaging reversals in market conditions.



Latin America and the Caribbean: export-led growth

Latin America and the Caribbean continued to benefit from a favourable external environment. The GDP of the region is expected to expand by about 4 per cent in 2006, similar to the economic performance in 2005, but well below that of 2004 when growth reached 5.6 per cent (see table A.3). Despite the slowdown, the cumulative increase in GDP per capita would be around 10 per cent during 2004-2006, well above welfare improvements of the recent past. The moderation of the average growth performance was largely due to what is happening in the two major economies, Brazil and Mexico. High interest rates weakened domestic demand in Brazil. This was also the case in Mexico, but its growth performance was affected more importantly by slower export growth. In contrast, fuel and mining exporters such as Chile, Colombia, Peru, Trinidad and Tobago and Venezuela (the Bolivarian Republic of) sustained good macroeconomic performances in 2005. Growth decelerated in Ecuador—another fuel exporter—reflecting domestic factors, such as the end of the stimulus provided by the construction of the new oil pipeline and lower than expected oil production caused by a lack of investment over the past decade.

Since the 1980s, economic growth has been mainly export-led in most countries of the region. This trend has continued in recent years. In 2004 and 2005 the rate of growth of the volume of exports from the region was slightly above the world average (see table A.17)

and more countries are diversifying into industrial manufactures and non-traditional products, beyond the customary raw materials. This upswing in exports has been reinforced by more flexible exchange-rate systems that have resulted in steady depreciations in real terms until 2004, when compared with the averages observed in the 1990s. More recently, however, the exchange-rate based gains in competitiveness have been partially offset by renewed tendencies towards currency appreciation (see chapter I).

Terms of trade continue to improve...

Increased Asian demand for primary products from the region has contributed to an improvement in the terms of trade of the region. Such gains differ widely, however, among countries. Net fuel exporters, such as Bolivia, Colombia and Venezuela (the Bolivarian Republic of), and to a lesser extent, Ecuador and Mexico, benefited from higher oil prices. Chile and Peru improved their terms of trade thanks to record levels of prices for metals and minerals, which compensated for the higher cost of oil imports. On the other hand, higher fuel costs worsened the terms of trade of Central America and the Caribbean. The Bolivarian Republic of Venezuela's provision of oil at preferential terms has attenuated part of the negative impact in the latter region.

... while dependence on external financing is reduced

Buoyant trade has allowed economic growth to be accompanied by current-account surpluses. The region as a whole has been running savings surpluses for three consecutive years. Low international interest rates have kept debt-servicing costs down. In addition, country-risk ratings are at their lowest levels of the past 15 years for most countries. Furthermore, the region's debt-to-export ratio has dropped considerably, along with a significant reduction in short-term debt as a proportion of total external debt. Several Caribbean countries form an exception as their debt-to-export ratios continue to be critically high.

Export growth is concentrated in South America

South American countries accumulated the bulk of the regional trade surplus through the strong rise in export values, despite a boost in imports due to greater economic activity. In contrast, in Mexico and Central America the merchandise trade deficit widened because of the loss of export buoyancy owing to competition from China in the United States market, combined with the appreciation of the peso in Mexico and the higher oil import bill for the Central American countries. Surpluses on the services account and substantial inflows of worker remittances were not enough to offset the deficit in merchandise trade in this subregion (see figure IV.8). A similar situation arose in the Caribbean countries, which also recorded negative current-account balances, except Trinidad and Tobago, whose exports climbed by over 20 per cent, mainly as a result of the increase in oil prices.

Capital flows are bolstering reserves...

Although most countries have official flexible exchange-rate regimes, central banks have been intervening in foreign exchange markets (especially in South America, with the exception of Chile), purchasing foreign exchange and increasing their international reserves in an effort to maintain exchange-rate stability, attenuate the recent appreciation or build up foreign reserves (see chapter I). The region as a whole has increased its reserves on average by around 1.5 per cent of GDP per annum over the past three years. Available reserves now cover eight months worth of imports, up from five months in 2002.

...and increasing revenues improve fiscal balances

Most countries are taking advantage of the favourable economic environment to fortify their fiscal balances. Brazil's primary surplus continued to improve in 2005 owing to higher revenues, mostly from direct taxation. Part of this increase is also attributed to an improvement in the efficiency of tax collection. This revenue has contributed to reducing public debt, although it still weighs around half of the GDP of Brazil. Interest payments remain high, however, at around 7 per cent of GDP as domestic interest rates are still up. Similarly, the Argentine primary surplus was helped by the strong growth in revenues, which was mostly

due to increases in revenues from personal and corporate income and value-added taxes. As a result, the public debt burden of Argentina was reduced to 70 per cent of GDP in June 2005, which is about half of the ratio in 2002. Next to primary surpluses, the restructuring of the external debt was a crucial factor in bringing down the debt-to-GDP ratio. The debt restructuring was accepted by the majority of the bond holders in March 2005, which included large value discounts and maturity period extensions. A strong recovery of the economy helped the negotiation which included GDP-linked bonds and demonstrated the trust of the debt holders in the recovery of Argentina. Furthermore, on 15 December 2005, Argentina announced its intention to make an early repayment of the entire outstanding obligations to the IMF.

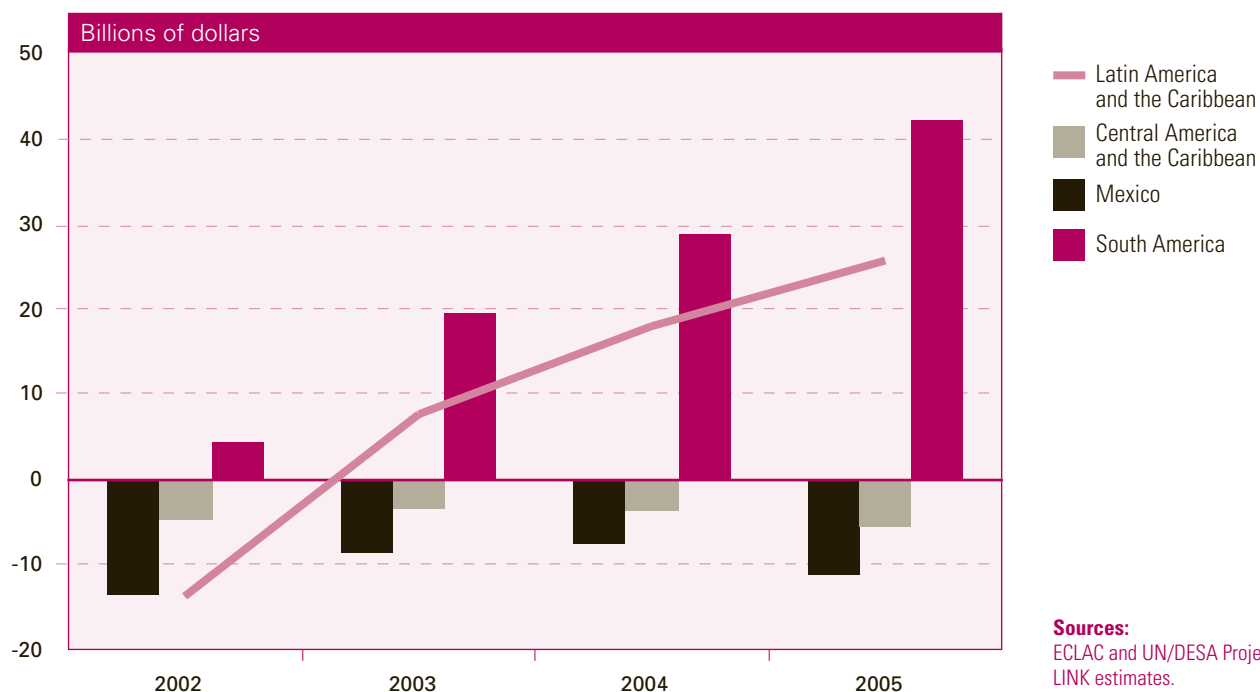
Windfall gains from higher export commodity prices have helped a great number of countries to improve their fiscal balances, allowing also for greater expenditures. Part of the oil export revenues of the Bolivarian Republic of Venezuela have been earmarked to a special fund directed to help the needy cover their health and education costs. Chile increased its public surplus for a second consecutive year thanks to greater copper and tax revenues and high growth. Chile follows a structural budget rule, requiring the Government to have a surplus of at least 1 per cent of GDP while calculating mineral resource revenues at the average medium-term copper price and measuring GDP by its trend-level growth. The Copper Stabilization Fund is to smooth government revenue over time.

Although external demand was a major source of growth in the region, domestic demand is also picking up, though at a slower pace than output growth. The relatively slow rise in private consumption, combined with fiscal austerity and the effect of improved terms of trade and remittances, has boosted national savings to the equivalent of 21.4 per cent of GDP (in 2000 dollars), which represents an increase of 3.4 percentage points of GDP over the average of the 1990s. Also, the investment rate of the region is up, apparently putting an end to the investment anaemia in previous years. Investment growth is estimated to have out-

Favourable conditions have strengthened domestic demand and unemployment is reduced

Figure IV.8.

Latin America and the Caribbean: current-account balance, 2002-2005



paced GDP growth in 2005 and the gross investment rate is estimated to have increased from 18.6 per cent to 19.6 per cent of GDP from 2004 to 2005. Yet, the upward trend is not uniform across the region. Investment rates are still virtually stagnant in Brazil and Mexico. The average is mainly pushed up by strong investment growth in Chile, Colombia and Venezuela (the Bolivarian Republic of), riding high on booming commodity prices. Investment growth has also been strong in Argentina since the recovery from the deep economic crisis at the beginning of the century. The recovery in investment has been concentrated in construction and manufacturing of machinery and equipment. Investment in the production of tradable goods has been favoured by the relative stability of the Argentine peso.

Employment has gradually improved and contributed to the modest recovery of domestic demand mentioned above. The open unemployment rate reached 9.3 per cent in 2005, the lowest rate since 1997 and one percentage point lower than in 2004. Estimated projections suggest the poverty incidence for the region has fallen from 41.7 per cent in 2004 to around 40 per cent in 2005.

Inflation was reduced through stricter monetary policies in some countries...

Average weighted inflation for the whole region reached a little over 6 per cent at the end of 2005, down from 7.4 per cent in December 2004. This result mainly reflected trends in the two largest economies of the region (Brazil and Mexico). In those countries, monetary authorities followed stricter inflation-target objectives after 2003, complemented by a more austere fiscal policy. Recently, inflationary pressures brought about by higher oil prices have been offset by currency appreciation. During the latter half of 2005, monetary policy eased in those countries as inflation remained under control.

...but it increased in others

In other countries (especially those in Central America and the Southern Cone) inflation rates for 2005 were higher owing to increased oil prices, higher prices of some industrial manufactures, and higher transportation costs. Inflation in Argentina was around 10 per cent in 2005, as prices of tradables rose with economic activity and the money supply was buoyed by an expansion of international reserves. Capital inflows, the current-account surplus, and active buying of dollars (only partially sterilized) have increased reserves as the monetary authority pursues prudential objectives.

Risks are present from both changes in the external situation themselves and...

Downside risks to the outlook of the region may come from the same international macroeconomic situation underpinning the positive performance. Of particular concern are the possible negative effects of a disorderly adjustment of the global imbalances on reducing the external demand for exports from the region and rising international interest rates (and the impact of the latter on financial inflows, the cost of debt servicing and risk ratings of countries). External demand will also depend on the sustainability of demand by China for the exports of the region. However important this demand is for export growth, Latin America needs to focus on speeding up its efforts to diversify and increase the value added of its exports in order to achieve faster and sustained rates of growth in the future.

...possible domestic problems brought about by appreciation of the currencies

Domestic risk factors include the challenges to domestic policies posed by appreciating exchange rates that can, on the one hand, compromise export growth, particularly of manufactures, and, on the other hand, support fast growth in import demand. In such a context, the trade balance surplus the region sustained in the past three years could quickly disappear, thus increasing, once again, one of the main vulnerabilities of the region, that is, its dependence on external finance. Policy measures adopted to restrain currency appreciation, such as intervention in foreign currency markets, however, could generate additional inflationary pressures (as liquidity increases) or widen the quasi-fiscal deficit (if intervention is sterilized), thus creating tension with other macroeconomic policy objectives (see chapter I).