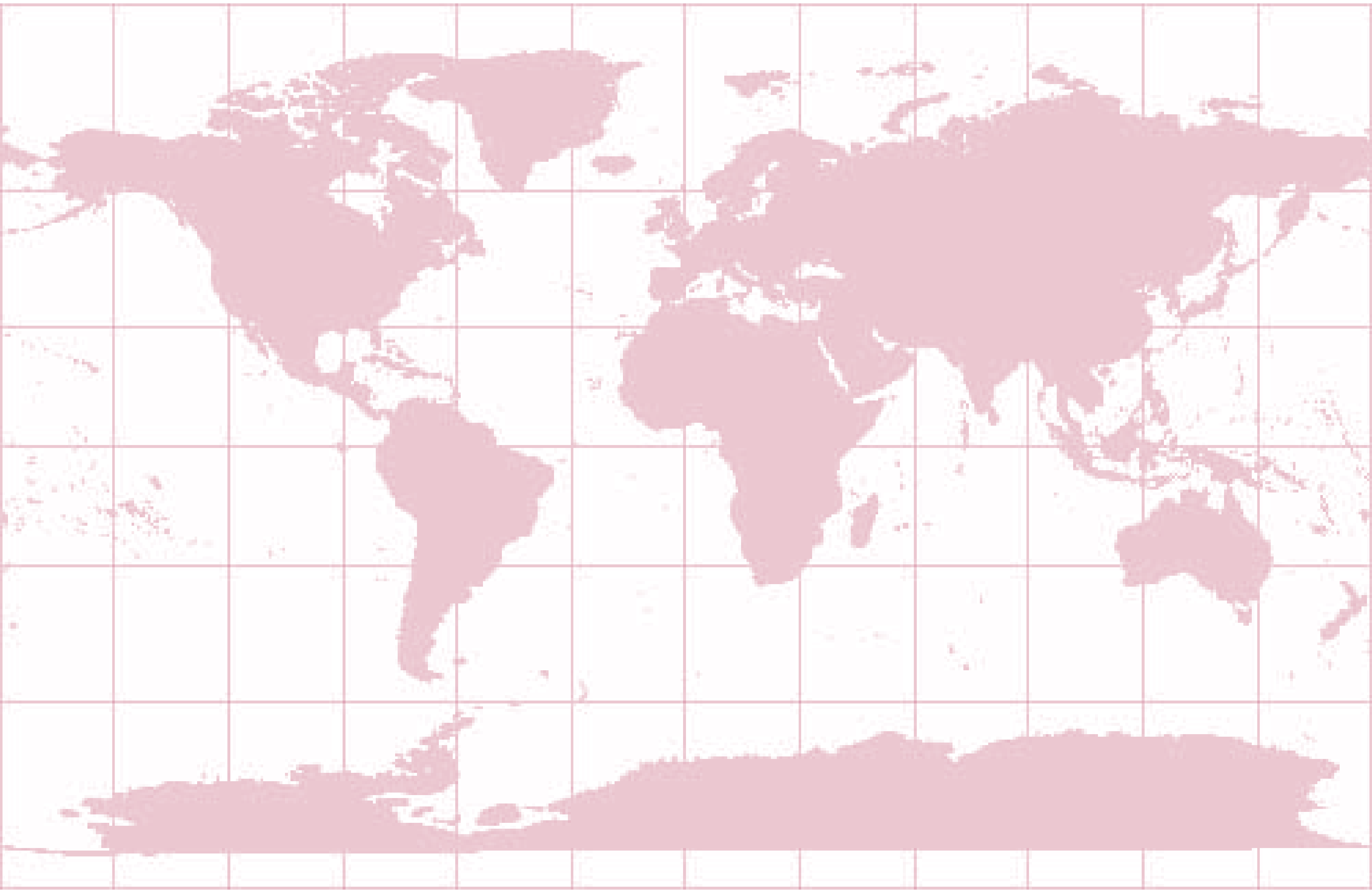
World Economic Situation and Prospects 2006



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Executive Summary

The global outlook

Moderate world economic growth in 2006

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

Strong, yet insufficient growth in the poorest countries

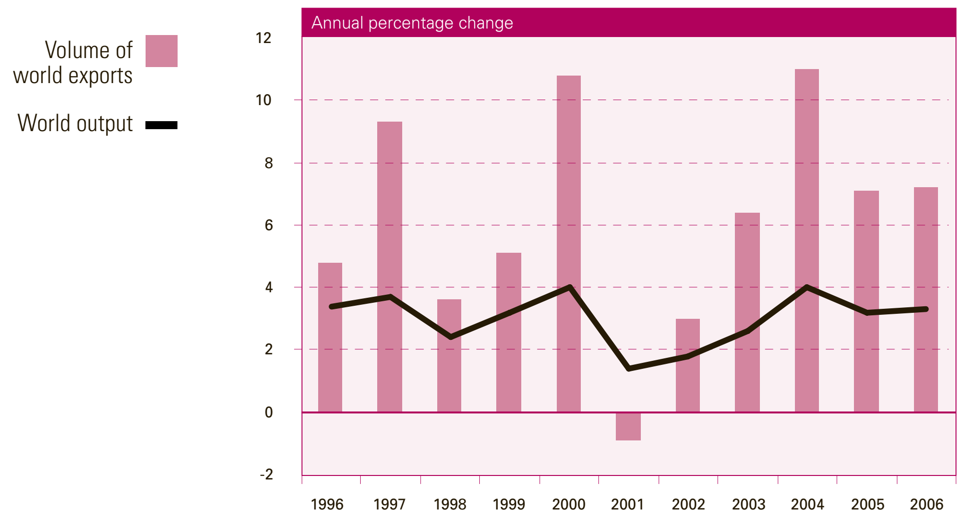
Generally, economic growth in most parts of the developing world and the economies in transition is well above the world average. On average, developing economies are expected to expand at a rate of 5.6 per cent and the economies in transition at 5.9 per cent, despite the fact that these economies may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

Lacklustre employment growth worldwide

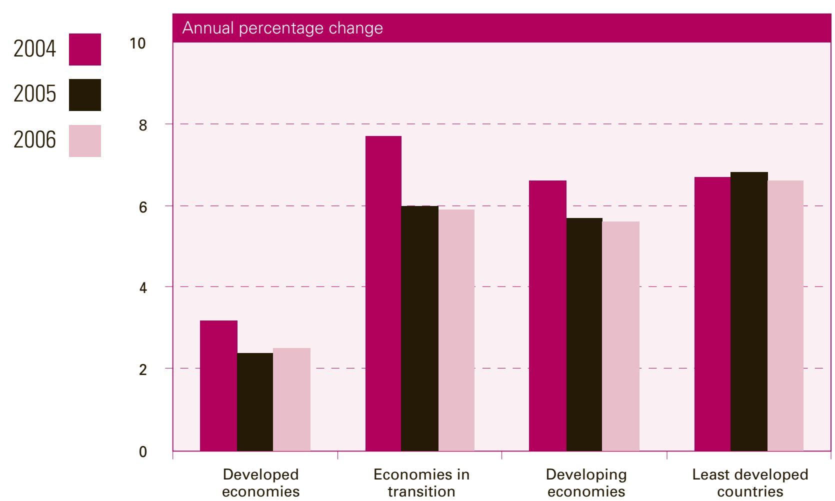
The employment situation worldwide remains unsatisfactory. The slowdown in growth partly explains this. More importantly, though, employment creation is falling short of the increment in labour supply in the majority of countries. Consequently, in a large number of countries, unemployment rates are still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

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

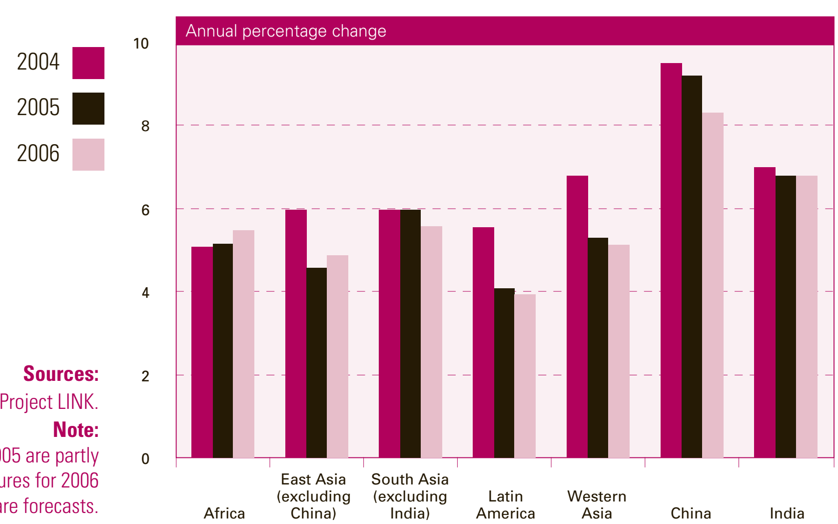
World economic growth slows down, but still robust for the decade



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



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



Sources:
UN/DESA and Project LINK.

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

Rising inflation, mainly due to oil price increases

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

The negative consequences of higher oil prices will be felt more

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

Global imbalances constitute a downside risk

Global imbalances are widening further

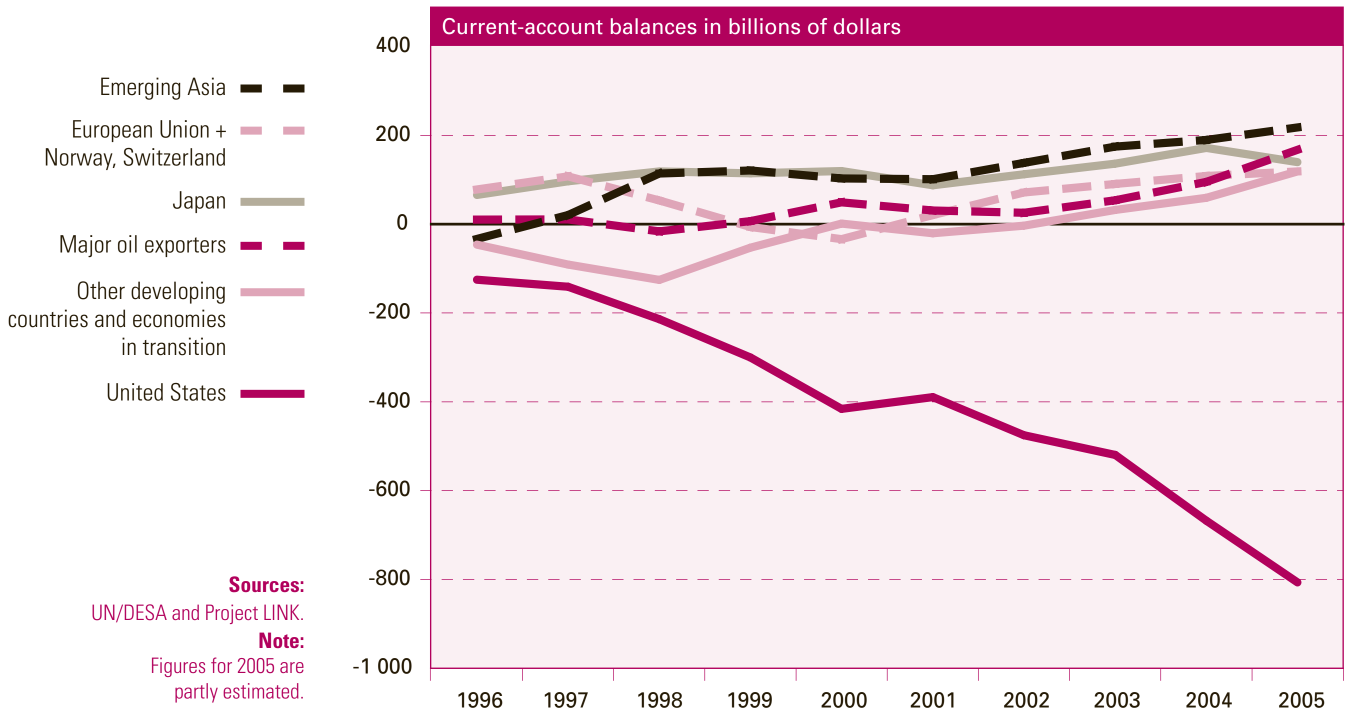
The projected growth and relative stability of the world economy are subject to some degree of uncertainty. The possibility of a disorderly adjustment of the widening macroeconomic imbalances of the major economies is a major risk which could harm the stability and growth of the world economy.

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

Investment has been 'anaemic' worldwide

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

Widening global imbalances



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

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

Disorderly adjustment of global imbalances is a clear and present danger

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

Exchange-rate realignment is not the solution

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

Policy dilemmas in managing exchange rates and reserves in developing countries

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

Other downside risks

Oil prices are expected to remain high

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

An end to the house price bubble?

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

The cost of an avian influenza pandemic

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

Policy challenges to address the global imbalances

International macroeconomic policy coordination is needed

To mitigate the risk of a disorderly adjustment in the global imbalances, the major economies should coordinate their macroeconomic policies over the medium run. It should be recognized that an orderly adjustment of the imbalances will take some time. This is so, firstly, because savings and investment patterns are not easily changed, and, secondly, because the adjustment of the widely divergent net foreign asset and liability positions will require a prolonged shift in the savings-investment balances of the major economies. Concretely, the adjustment will require measures that will stimulate savings in the deficit countries and investment, or, more generally, domestic spending in the surplus countries. More specifically, the United States should stimulate household savings and reduce public dissaving. Europe should keep interest rates down to stimulate private demand as room for fiscal expansion seems limited in most countries. More efforts should be made to revitalize investment, which the structural reform policies of recent years have failed to achieve. In Japan, financial sector reform should continue, and fiscal incentives to stimulate private investment demand should be strengthened further. Most Asian surplus countries should boost public and private investment rates, while China should boost broad-based consumption demand. Oil-exporting countries may increase social spending and investment in their oil production capacity as well as in the diversification of their production structures. Given its nature, the International Monetary Fund would provide the natural forum for international policy coordination.

Galvanizing financial resources for achieving the MDGs

In addition, all major economies should contribute to the mobilization of the additional financial resources to assist the poorest countries in achieving the Millennium Development Goals, in compliance with international agreements. To support an orderly and equitable global adjustment process, the major surplus countries in developed and emerging Asia and Europe, as well as the major oil-exporting countries, could further contribute to global development by channelling more of their excess savings to the developing countries, which are lacking adequate investment finance for their economic and social infrastructure needs.

International trade

World trade continues to expand, but non-oil commodity prices are likely to come down

International trade is still providing an important impetus to the growth of the world economy. Trade flows continue to expand at double the pace of world output. The larger developing countries, such as China and India, have seen sustained and strong export dynamics. A fair number of other developing countries have gained from substantial improvement in their terms of trade over the past few years, thanks largely to increases in the prices of oil and other commodities. However, a number of oil-importing countries that export agricultural commodities have suffered important terms-of-trade losses, because some of their export prices fell, because oil prices outpaced their export prices, or for both reasons. In general, prices of primary commodities seem to have reached a plateau, and the outlook for many non-oil commodities is for a decline in prices.

Little progress in multilateral trade negotiations…

Multilateral trade negotiations in the context of the Doha Round moved forward with the Sixth World Trade Organization (WTO) Ministerial Conference in Hong Kong Special Administrative Region (SAR) of China in December 2005. Contrary to low expectations, and even predictions of another failure, the results achieved could be qualified as very modest and marginal, but nevertheless positive. The ministerial commitment “to complete the Doha Work Programme fully and to conclude the negotiations launched at Doha successfully in 2006” will require considerable political will from the participants in order to make tough decisions and conclude negotiations within a very tight time frame.

The agreement reached at the Hong Kong Ministerial Conference represents a small step towards completing that agenda. First, a deadline was set to eliminate agricultural export subsidies in developed countries by 2013. This agreement, however, is conditional upon future agreements on full negotiating modalities as well as upon the establishment of multilateral discipline on export competition measures, such as export credits, export credit guarantees or insurance programmes, trade-distorting practices of State-trading enterprises and food aid. Despite these caveats, the agreement represents a substantial systemic advance by bringing agricultural trade further under the umbrella of general multilateral trade rules, which prohibit the use of export subsidies. Secondly, agreement was reached on a limited “development package” for LDCs. This consists of several commitments, including the permanent granting of duty-free and quota-free market access by developed countries and developing countries. In practical terms, the value of such treatment of exports from LDCs will directly depend on the inclusiveness of product coverage. If, for example, textiles and clothing (which account for roughly 20 per cent of LDC exports) are excluded by some developed countries, the gains of such a decision would be marginal. Some progress was achieved in developing the Aid for Trade initiative, which should provide additional assistance to developing countries, particularly LDCs, to improve their supply capacity and trade infrastructure in a manner which will allow them to benefit from the increased opportunities brought about by trade liberalization. Third, a decision was made by developed countries to eliminate all export subsidies for cotton in 2006. This decision is expected to have limited economic impact in the medium term. Domestic support measures for cotton producers in developed countries affect developing country cotton exporters much more strongly, particularly those in Western Africa. These trade- and price-distorting measures still have to be dealt with in the context of overall negotiations on agriculture.

… and trends towards renewed protectionism

Paralleling these advances, signs of increased protectionism and other distortions to world trade have emerged. In the aftermath of the expiration of the Agreement on Textiles and Clothing, the European Union and the United States introduced limits on imports of certain Chinese textiles. The use of non-tariff barriers has increased worldwide, partially offsetting the advances brought about by lower tariffs. Finally, there has been a mushrooming of regional and bilateral free trade agreements. These have eroded the scope of the application of most favoured nation tariffs and often exclude products of export interest to developing countries. Such trade policies may well hamper the successful completion of the Doha Round.

Finance for development

Despite more favourable financing conditions for developing countries…

Access to international finance has improved for developing countries over the past year. Private capital inflows to emerging market economies declined in 2005, yet market access continued to be favourable, and external financing costs dropped to historical lows. These conditions have favoured the emerging market economies in particular. Developments need to be followed with caution. The exceptionally low risk premiums for the external borrowing by these countries may risk financial market overexuberance. This could be followed by a sharp reversal of the capital flows in the future, causing costly destabilizing effects should the global adjustment process entail rising interest rates or substantial swings in the exchange rates of the major currencies.

…. net transfers flow from poor to rich

Despite growing private equity financing and foreign direct investment, developing countries transfer in the aggregate more resources to developed countries than they receive. This net transfer refers to the net inflow of financial resources less interest and other investment income payments. The pattern of negative transfers has lasted for about ten years and reflects the growing export surpluses of developing countries. The magnitude of these transfers has risen steadily from about $8 billion in 1997 to $483 billion in 2005. Net transfers to the poorest countries in sub-Saharan Africa are still positive, but also on the decline, reaching $2 billion in 2005, down from $7.5 billion in 1997.

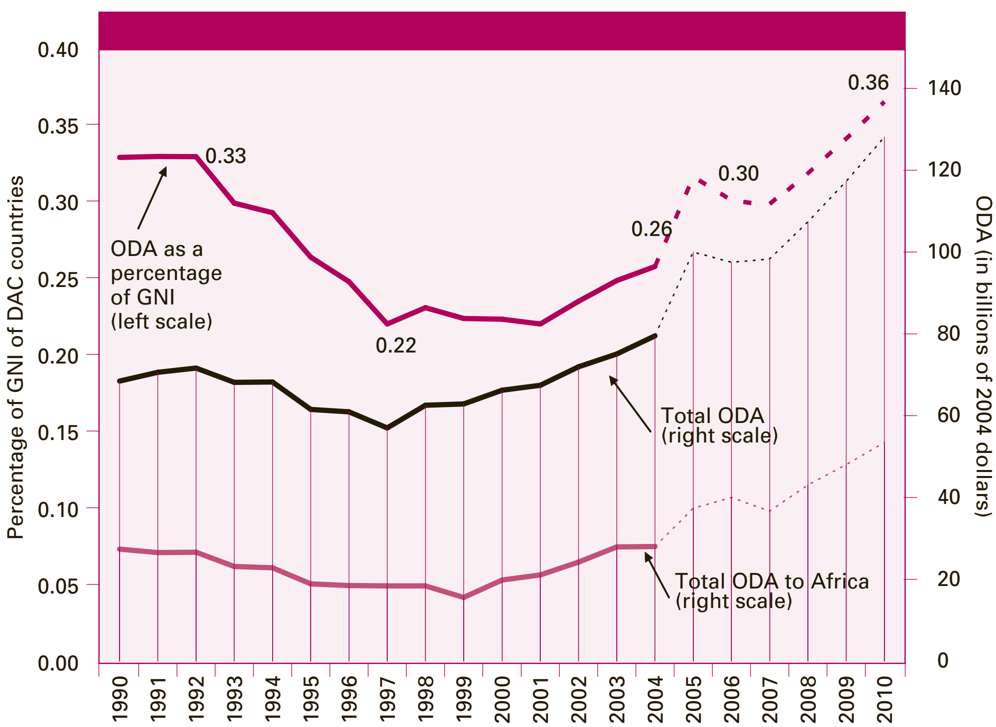
More aid, but still not enough

Official development assistance has recently increased in nominal terms, but the amount of aid received by the LDCs in recent years, after excluding resource flows for emergency assistance, debt relief and reconstruction, was only marginally higher than a decade ago. More encouraging, however, is the prospect of development aid over the medium term as significant progress has been made on commitments by major donors to deliver increased and more effective aid. Nonetheless, even with these commitments, the share of ODA in the gross national income (GNI) of Development Assistance Committee (DAC) countries would reach 0.36 per cent, still far short of the 0.7 per cent target reaffirmed in the 2005 World Summit Outcome, and hence is also short of the estimated needs to finance actions by developing country Governments in order to meet the Millennium Development Goals.

Enhanced South-South cooperation

New commitments have been made to strengthen and widen cooperation among developing countries, or South-South cooperation, the United Nations being at the forefront of efforts to foster such cooperation. Besides technical cooperation, other forms of South-South cooperation have been flourishing, such as monetary and financial cooperation, debt relief and grant assistance.

Increasing, but insufficient official development assistance (ODA)



Source: OECD/DAC.

Note: Data for 2005-2010 are projections based on pledges by DAC member states.

Slow progress has been made in the implementation of the HIPC debt-relief initiative

The implementation of the Heavily Indebted Poor Country (HIPC) Initiative for debt relief continues to move forward, albeit slowly. Most debt indicators of developing countries are improving. However, the HIPCs continue to face difficulties in reconciling the objectives of achieving and maintaining debt sustainability, promoting long-term growth and reducing poverty, as some of them have to engage in borrowing to meet the increased needs for financing their poverty reduction strategies. Unless they receive additional grant financing, many of these countries would have to rely on new borrowing to fund their poverty reduction expenditures, creating the possibility of a new cycle of large-scale external borrowing and unsustainable debt.

Rising to the challenge of poverty reduction

The recent improvement in the growth of many poor countries is still not strong enough to enable them to achieve the Millennium Development Goal of halving poverty by 2015 or to meet the other internationally agreed development goals. At the 2005 World Summit, the world's leaders reiterated their political commitments already expressed at the previous high-level international meetings on development issues, particularly the commitments contained in the Millennium Declaration and the Monterrey Consensus. The challenge for all countries is to live up to these commitments at the agreed level and within the agreed time frame.