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Prospects for the Global Economy

Summary of the medium-term outlook

Despite high commodity prices, rising short-term interest rates, and a bout of financial market volatility, global growth accelerated in the first half of 2006. While there are indications that the pace of the expansion is already slowing, developing economies are projected to expand by 7 percent for the year as a whole, more than twice as fast as high-income countries (3.1 percent), with all developing regions growing by close to or more than 5 percent.

The very fast growth of developing countries over the past five years has been fueled by low interest rates and abundant global liquidity. This has led to rising commodity prices and overheating in some high-income and developing countries. This, in turn, has provoked a tightening of monetary policy that is in part responsible for the slowdown that has already begun. However, in most countries strong productivity growth, due in part to the absorption of China and the former Eastern Bloc countries into the global economy, has checked inflationary pressures.

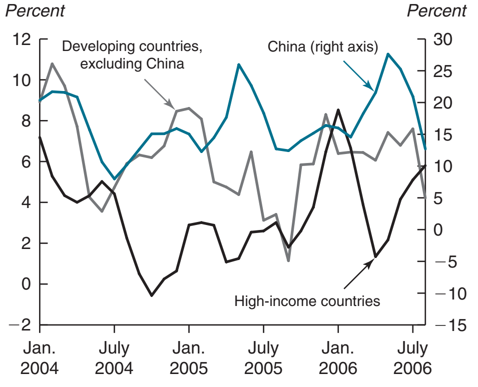
Limited inflationary pressures and high savings among oil exporters and in Europe (as Europeans prepare to meet the challenges of their aging society) are expected to keep long-term interest rates low. Moreover, improved fundamentals have boosted trend growth rates in many developing countries. Together these factors suggest that, while developing-country growth is projected to slow over the next two years, it should remain robust at 6.1 percent in 2008. Mainly because of the continued expansion of developing economies, global growth will remain robust and this should keep commodity prices high. Nevertheless, increases in supply, combined with demand-side substitution and conservation measures, should allow for some easing of commodity prices, including that of oil.

This positive outlook is subject to significant risks. Past episodes of fast growth and favorable financial conditions have been followed by sharp and largely unanticipated reversals. While stronger fundamentals in most developing countries reduce the likelihood that a hard landing would be as severe as in the past, countries need to take particular care to ensure that their fiscal, monetary, and structural policies are in order so as to minimize the domestic consequences of external shocks—a point driven home by the financial market turbulence observed in the spring of 2006, which affected most sharply those countries whose fundamentals were most out of balance.

A soft landing remains likely, but the global economy has reached a turning point and many factors could result in a more pronounced slowdown. A faster-than-expected weakening of housing markets in high-income countries could generate a much sharper downturn and even recession, with potentially significant effects for developing countries. Much slower growth would likely cause commodity prices to weaken more than already projected, potentially placing many developing countries that have so far avoided current-account problems in difficulty. In addition, demand is expanding unsustainably rapidly in many developing countries. Should efforts to contain growth in these countries fail, their economies could overheat, yielding initially stronger growth outcomes and additional inflation, but a much sharper slowdown later on. An oil-sector supply shock could be similarly disruptive, driving up oil prices even further, while simultaneously slowing growth and weakening the prices of non-oil commodities. Finally, although global imbalances appear to be stabilizing, they remain large. There is a continuing risk that they will be resolved in a more disruptive manner than is assumed in the baseline scenario outlined here.

Figure 1.1 Industrial production may be slowing

3-month annualized growth rate



Source: World Bank.

Global growth surged to 3.9 percent in 2006

Despite oil prices that topped $75 a barrel during the course of the year, world gross domestic product (GDP) growth is estimated to have strengthened in 2006, coming in at 3.9 percent, compared with 3.5 percent in 2005 (table 1.1). To a significant degree, this strong global performance reflects the very rapid expansion in developing economies, which grew by 7 percent—more than twice as fast as high-income countries (3.1 percent). Overall, 38 percent of the increase in global output originated in developing countries, far exceeding their 22 percent share in world GDP. As discussed in chapter 2, continued faster growth among developing countries over the next two decades is expected to lift their share of world output to about 31 percent in 2030.

Very strong growth (10.4 percent) in China played a significant role in the recent strength of developing countries, contributing an expected 0.5 percentage points to global growth. Nevertheless, the pickup was broadly based. Even excluding China and India, developing countries grew 5.5 percent (5 percent for small oil exporters), and all regions are expected to have grown by close to, or more than, 5 percent.

Most of the acceleration in global growth was concentrated in the first half of the year. World industrial production grew 6.7 percent in the first six months of 2006, compared with 4.3 percent in 2005 (figure 1.1). Among developing countries, rates of growth of industrial production eased in the second and third quarters, although this was partially offset by stronger growth among high-income countries. Order books and business sector confidence are strong in both Europe and Japan, suggesting that industrial activity should remain robust for the remainder of the year, while in the United States there are clear signs that industrial production is slowing.

In the United States, the acceleration in industrial output was mirrored by GDP, which began 2006 expanding by a torrid 5.6 percent. However, responding to higher short-term interest rates, residential investment spending has fallen sharply and a cooling housing market has moderated consumer demand.[1] As a result, the economy slowed in the third quarter to a 1.6 percent annualized growth rate, with most of the slowdown restricted to the

Table 1.1 The global outlook in summary

Percentage change from previous year, except interest rates and oil price

	1960–80	1980–2000	2004	2005	Estimate 2006	Forecast 2007	Forecast 2008	2008–30
Global conditions								
World trade volume	—	5.8	10.4	7.7	9.7	7.5	7.8	
Consumer prices								
G-7 countries[a,b]			1.8	2.2	2.5	2.1	1.7	
United States			2.7	3.4	3.4	2.5	2.1	
Commodity prices (US$)								
Non-oil commodities			17.5	13.4	20.6	−4.5	−8.4	
Oil price (US$ per barrel)[c]			37.7	53.4	64.0	55.9	52.7	
Oil price (percent change)			30.6	41.5	19.9	−12.7	−5.7	
Manufactures unit export value[d]			6.9	0.8	2.4	3.8	0.4	
Interest rates								
$, 6-month (percent)			1.6	3.6	5.4	5.7	5.0	
€, 6-month (percent)			2.1	2.2	3.0	3.6	4.2	
Real GDP growth[e]								
World	4.7	3.0	4.1	3.5	3.9	3.2	3.5	2.9
Memo item: World (PPP weights)[f]			5.2	4.7	5.1	4.5	4.6	
High-income	4.5	2.9	3.3	2.7	3.1	2.4	2.8	2.4
OECD countries			3.2	2.6	3.0	2.3	2.7	
Euro Area			1.7	1.4	2.4	1.9	1.9	
Japan			2.7	2.6	2.9	2.4	2.5	
United States			4.2	3.2	3.2	2.1	3.0	
Non-OECD countries			6.4	5.8	5.3	4.7	4.8	
Developing countries	6.2	3.4	7.2	6.6	7.0	6.4	6.1	4.0
East Asia and the Pacific	5.5	8.5	9.0	9.0	9.2	8.7	8.1	5.1
China			10.1	10.2	10.4	9.6	8.7	
Indonesia			5.1	5.6	5.5	6.2	6.5	
Thailand			6.2	4.5	4.5	4.6	5.0	
Europe and Central Asia	10.7	0.6	7.2	6.0	6.4	5.7	5.5	2.7
Poland			5.3	3.4	5.4	5.1	5.2	
Russian Federation			7.2	6.4	6.8	6.0	5.5	
Turkey			8.9	7.4	6.0	5.0	5.0	
Latin America and the Caribbean	5.5	2.2	6.0	4.5	5.0	4.2	4.0	3.0
Argentina			9.0	9.2	7.7	5.6	4.0	
Brazil			4.9	2.3	3.5	3.4	3.8	
Mexico			4.4	3.0	4.5	3.5	3.5	
Middle East and North Africa	5.9	4.0	4.8	4.4	4.9	4.9	4.8	3.6
Algeria			5.2	5.3	3.0	4.5	4.3	
Egypt, Arab Rep. of			4.2	4.9	5.8	5.6	5.8	
Iran, Islamic Rep. of			5.1	4.4	5.8	5.0	4.7	
South Asia	3.7	5.4	8.0	8.1	8.2	7.5	7.0	4.7
Bangladesh			6.3	6.2	6.7	6.2	6.5	
India			8.5	8.5	8.7	7.7	7.2	
Pakistan			6.4	7.8	6.6	7.0	6.5	
Sub-Saharan Africa	4.4	2.2	5.2	5.5	5.3	5.3	5.4	3.3
Kenya			4.9	5.8	4.9	5.1	4.9	
Nigeria			6.5	6.2	4.8	5.1	5.4	
South Africa			4.5	4.9	4.6	3.9	4.3	
Memorandum items								
Developing countries								
excluding transition countries	5.1	4.2	7.3	6.8	7.0	6.4	6.1	
excluding China and India	6.6	2.3	6.1	5.1	5.5	4.9	4.9	

Source: World Bank.

Note: PPP = purchasing power parity.
a. Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.
b. In local currency, aggregated using 2000 GDP weights.
c. Simple average of Dubai, Brent, and West Texas Intermediate.
d. Unit value index of manufactured exports from major economies, expressed in U.S. dollars.
e. GDP in 2000 constant dollars; 2000 prices and market exchange rates.
f. GDP measured at 2000 PPP weights.

housing sector. Importantly profits, nonresidential investment, and consumption remain robust and inflation and unemployment low. As a consequence, although growth is expected to remain subdued, it should not decline in the fourth quarter and the strong first quarter means that output for the year as a whole is expected to increase 3.2 percent.

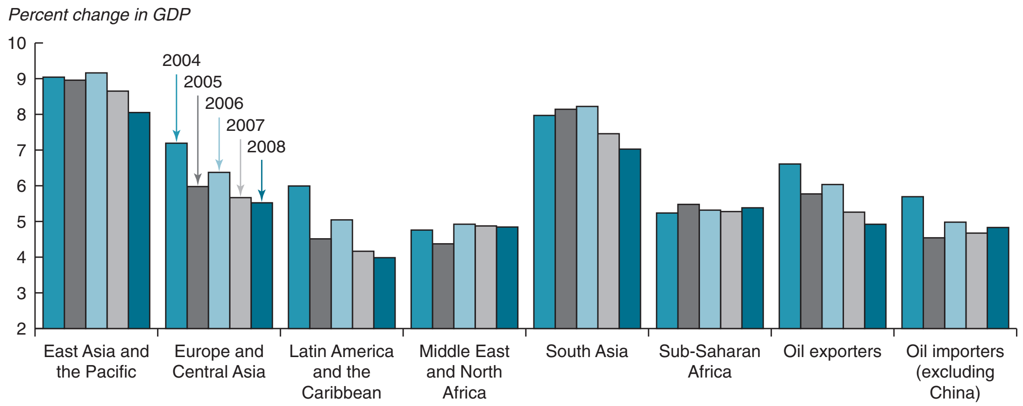
In high-income Europe, following several years of weakness, growth also accelerated in the first half of 2006. GDP expanded by about 3.3 percent in the first two quarters of the year, as private consumption and investment spending took over from exports as the main drivers of the recovery. Growth slowed to a 2 percent pace in the third quarter, with growth in France having stalled as investment expenditures turned negative and exports weakened. However, both in France and in the rest of Europe, consumer demand remained robust and consumer and business surveys suggest that economic activity should be robust in the fourth quarter, leading to an estimated 2.5 percent increase in GDP for the year as a whole (2.4 percent for the Euro Area).

In Japan, the acceleration in output that began in 2005 has continued, with GDP estimated to have expanded by 2.9 percent in 2006. A slowdown in exports contributed to weaker growth in the second quarter of the year, but growth rebounded in the third quarter led by a surge in investment spending. As of August, exports were up 11 percent from a year earlier, partly reflecting a 25.6 percent increase in sales to China, where import volumes have strengthened markedly.

Developing economies grew 7 percent in 2006. Much stronger European and continued robust Japanese growth, combined with low real interest rates and interest rate spreads, made for robust activity among the world's developing economies, which are expected to have expanded by 7 percent in 2006. This represents the fourth consecutive year that their growth rates have exceeded 5 percent.

The expansion was particularly robust in China and India, where output is estimated to have increased by 10.4 and 8.7 percent, respectively. But the strong performance was broadly based, with all developing regions growing by close to or by more than 5 percent (figure 1.2). Despite further substantial increases in the price of oil during the first half of the year, growth among the remaining oil-importing developing countries actually

Figure 1.2 Regional growth trends



Source: World Bank.

strengthened and is expected to come in at 5 percent for the year as a whole.

Developing economies to outperform high-income countries in 2007–08

High oil prices are expected to continue to weigh on growth in industrialized countries. The slowdown that they and higher interest rates (working through residential investment and household consumption) have already initiated in the United States is projected to continue into the first half of 2007 before an expected relaxation of monetary policy permits the economy to pick up. Overall, GDP in the United States is projected to increase 2.1 percent in 2007 and 3 percent in 2008. Weaker domestic demand is expected to be reflected in slower import growth and should result in a decline in the trade and current account deficits of the United States, with the latter coming in around 5.5 percent of GDP in 2008.

Continued accommodative macroeconomic policy and pent-up investment demand following several years of very weak growth should maintain the pace of the expansion in most European countries, without exacerbating underlying inflationary pressures. However, a planned 3 percent increase in the German value-added tax (VAT) is projected to slow demand in that country in 2007, with knock-on effects elsewhere in the continent. The higher VAT can also be expected to prompt a one-time increase in inflation, although its effect should be attenuated by slower growth. Overall, GDP in high-income Europe is projected to slow to about 2.1 percent (1.9 percent for the Euro Area) in 2007 and 2008.

In Japan, vigorous growth in developing East Asia, renewed consumer and business confidence, and reduced drag from consolidation are positive factors expected to maintain growth at about 2.5 percent in 2007 and 2008. The recent return to positive inflation is projected to persist, allowing short-term interest rates to gradually rise to around 2 percent by the end of 2008. At the same time, domestic demand is expected to firm as unemployment declines toward 3.5 percent of the labor force. As a result, the current account surplus should decline to about 3 percent of GDP in 2008.

In most developing regions, high oil prices, rising interest rates, and the maturation of the business cycle are expected to restrain growth in 2007–08. As a group, however, low- and middle-income countries should again outperform high-income economies by a wide margin—and this strong performance will continue to be a critical driver of global growth. Administrative restrictions on investment and slower export growth are expected to bring Chinese growth down to a more sustainable 8.7 percent by 2008. Higher interest rates and some further fiscal tightening are expected to slow the expansion in India to about 7.2 percent over the same period, helping to unwind some of the inflationary tensions that have built up in that country.

Prospects for the *remaining oil importers* are varied. Many, particularly in Eastern and Central Europe, are overheating and have entered a phase of policy tightening. These countries are expected to decelerate. Others, including Brazil and Mexico, are projected to accelerate or enjoy high but stable growth rates as they continue to benefit from a favorable external climate, including low long-term real interest rates and interest-rate spreads. Overall, developing-country oil importers, excluding China and India, are projected to enjoy broadly stable growth of about 4.8 percent in 2007–08.

For oil exporters (and other large commodity exporters) strong revenue inflows should continue to fuel robust domestic demand growth despite lower prices and less rapid increases in global demand for commodities, resulting in rapid growth of both imports and the noncommodity sectors of these economies. Overall, the pace of the expansion in developing-country oil exporters is expected to decline from 6 percent this year to 4.9 percent in 2008, as capacity constraints slow growth in the resource sector and a rising share of demand is met by imports.

Regional outlooks

More detailed descriptions of economic developments in developing regions, including regional forecast summaries and country-specific forecasts, are available online at http://www.worldbank.org/globaloutlook. Country-specific forecasts are reported in the appendix.

East Asia and the Pacific[2]

An emerging growth pole.

The economies of the East Asia and Pacific region continued to expand at robust rates in 2006, with regional GDP growth expected to accelerate to 9.2 percent in 2006 from 9 percent the year before. In China, continued rapid investment growth, in conjunction with an unexpected surge in exports as new capacity came on stream, led to a 10.7 percent year-over-year increase in GDP over the first three quarters. The overall contribution of the external sector to GDP growth was up because, even though import growth accelerated, increased output from China's import-competing sectors prevented import volumes from expanding as rapidly as exports. Investment spending has been spurred by growth in credit and the money supply as well as strong profits. Concerns about excessive investment creating potential overcapacity in specific sectors led the authorities to reinforce administrative measures aimed at containing investment growth.

The expansion in the rest of the region remains robust. A rebound in global high-tech demand and stronger import demand from China prompted an acceleration in exports that began in the second half of 2005 and continued into 2006. Vietnam's growth is expected to reach 8 percent, backed by across-the-board strength in exports, domestic consumption, and investment. In Indonesia, growth slowed in the first six months of 2006 following a substantial reduction of fuel subsidies and monetary tightening in the latter part of 2005. Activity appears to be picking up now, with monthly indicators suggesting a strong rebound in domestic consumption and investment in the third quarter. For the year as a whole, GDP is expected to increase by about 5.5 percent. Growth in Malaysia and the Philippines is also expected to come in at around 5.5 percent, while in Thailand it is expected to reach only about 4.5 percent, because, despite strong export growth, consumption and investment have been depressed by high oil prices, rising interest rates, and continued political uncertainty.

High oil prices and rapid growth have raised inflation in the region, prompting a general tightening of monetary policies during 2005. As a result, both headline and core inflation are now easing in most of the larger economies in the region. Regional equity markets were subject to the general correction affecting many emerging markets during May–June 2006. However, spreads on bonds remain low, and equity markets began recovering in August, suggesting that the earlier correction did not represent a reassessment of the region's economic fundamentals.

Growth is expected to moderate only somewhat. In China, investment growth and domestic demand are projected to remain robust. However, with investment at some 50 percent of GDP, more forceful policy action may be needed to keep credit and investment growth in check. Moreover, the country's large and persistent current account surplus suggests the need, over the longer term, to promote a more consumption-oriented pattern of growth. In Indonesia, the ongoing recovery in growth is projected to continue, with GDP expanding by 6.5 percent in 2008.

Economic pressures for the revaluation of developing Asian currencies are likely to intensify. In addition to reducing global imbalances, revaluation would also reduce inflationary pressures, improve domestic macroeconomic management capabilities, steady asset markets, and improve living standards for local populations.

Finally, the region remains susceptible to outside risks, including a worsening of the avian influenza epidemic—either through wider effects on domestic animals or because transmission to (or between) humans becomes more efficient (World Bank 2006).

Europe and Central Asia

Oil exporters and European Union integration underpin strong growth.

Economic activity in the Europe and Central Asia region is estimated to have increased by 6.4 percent in 2006, up from 6 percent in 2005. This acceleration comes despite slower growth in Turkey, where a significant tightening of monetary policy following this spring's financial market turbulence is projected to reduce growth from 7.4 percent last year to 6 percent in 2006.

Faster growth in Europe and low real interest rates have helped to maintain growth at high levels elsewhere in the region. Among the largest economies, growth in the Russian Federation is estimated to have picked up to 6.8 percent in 2006, supported by high oil prices. Improved incomes and activity in the mining sector boosted growth in Ukraine to an estimated 6 percent pace in 2006 versus 2.6 percent in 2005, while rising wages and falling unemployment increased growth in Poland from 3.4 percent in 2005 to an estimated 5.4 percent in 2006. Elsewhere, rebounding demand in industrial Europe, coupled with rapidly growing demand from regional oil exporters, notably Russia, bolstered exports among smaller oil importers, whose economies grew 6.1 percent, up from 5.8 percent in 2005. Higher oil prices and the coming on stream of oil projects lifted the GDP growth among oil exporters to 7.3 percent.

The pace of demand growth in many countries in the region continues to exceed supply and, as a result, 13 countries have current-account deficits in excess of 5 percent of GDP, and inflation is rising in 12. Strong capital inflows, predominantly in the form of foreign direct investment (FDI), coupled with extremely rapid domestic credit expansion, are at the root of excess demand in several countries (the Baltic countries, Bulgaria, Hungary, Romania, the Republic of Serbia, and Turkey). Although FDI flows are less easily reversed than portfolio and equity investments and are more likely to be associated with physical investments, more volatile capital flows are also increasing, and a substantial portion of the FDI is going into the banking sector, where it may be more volatile than in other sectors. While such flows are likely to remain strong, motivated by investment opportunities associated with European Union (EU) integration, the real-side disequilibrium that these inflows are provoking may make these countries sensitive to a change in investor sentiment. Indeed, as events in the spring of 2006 highlighted, countries with large current account deficits are particularly vulnerable—especially those with pegged exchange rates (Hungary and Latvia) and currency boards (Bulgaria, Estonia, Lithuania)—because sharp reductions in inflows may require very large and disruptive real-side adjustments. In Hungary, a budget deficit of close to 10 percent of GDP poses further challenges.

Excess demand has also contributed to inflationary pressures and a tightening of monetary policy. Overheating remains a risk both there and in Azerbaijan, the Baltic states, Belarus, Bulgaria, the Czech Republic, Kazakhstan, Romania, Russia, the Slovak Republic, Turkey, and Ukraine. Other factors contributing to the slower growth include a slump in manufacturing activity (especially mining) in Armenia, a marked deceleration of export growth in Latvia, and rising capacity constraints combined with declining competitiveness in Belarus. Growth is continuing at a modest pace in the former Yugoslav Republic of Macedonia (4 percent in 2006), where domestic demand is recovering slowly following a period of fiscal consolidation and violent conflict in 2001.

Growth in the region is expected to slow somewhat over the next two years, coming in at about 5.5 percent in 2008. Slower growth in industrialized Europe and higher short-term interest rates are expected to cause regional export growth to decline for both oil importers and oil exporters. In the case of the latter, domestic demand growth is expected to ease but remain strong, because, although oil revenues will decline, they will remain high. Lower prices will contribute to the expected slowdown in oil exporters' GDP growth from 7.3 percent in 2006 to 6.2 percent in 2008. In addition, it will also slow demand for exports from regional oil importers, which, in combination with weaker export demand from Germany and the United States in 2007, is expected to reduce their GDP growth to about 5.2 percent in 2008.

The combination of rising inflation and elevated current account deficits poses a persistent challenge for regional policy makers. To the extent that the contractionary influence of higher interest rates continues to be offset by capital inflows, further fiscal tightening may be unavoidable—even if it means pushing government balances into surplus in some countries. For many countries in the Commonwealth of Independent States, future prospects will be dependent on continued strong demand from Russia. Prospects for the poorer countries in the region will also depend on the extent to which these countries are able to strengthen domestic institutions so as to sustain high growth rates.

Latin America and the Caribbean

Improved performance but still underperforming.

Economic activity in Latin America and the Caribbean has picked up and GDP is estimated to have increased by 5 percent in 2006. The faster growth reflects favorable international financial conditions, strong commodity prices, and a relaxation of monetary policy in Brazil and Mexico, two of the region's largest economies.

In Mexico, GDP accelerated sharply in the first half of 2006, growing 5.5 and 4.7 percent (year-over-year) in the first two quarters as lower interest rates boosted domestic demand and construction activity. Stronger sales of cars to the United States and oil exports also contributed. Brazil, too, benefited from a more relaxed monetary policy stance, although real interest rates remain high at 11 percent. GDP accelerated to about 5.2 percent in the first quarter, and although it slowed in the second quarter, growth for the year as a whole is expected at 3.5 percent.

In contrast, demand in Argentina and República Bolivariana de Venezuela, which had been expanding at unsustainable rates, slowed. Nevertheless, demand in each country remains very strong, and GDP is projected to expand by 7.7 and 8.5 percent, respectively, well beyond potential. Unsurprisingly in these conditions, inflation has picked up and now exceeds 10 percent in both countries. In each case, this surge occurred despite price freezes in a number of sectors that are hurting sectoral investment and supply (inflation of uncontrolled goods and services is running at 16 percent in Argentina). The rapid expansion of demand in República Bolivariana de Venezuela has been fueled by ballooning government transfers. The growth in supply has been concentrated in the non-oil sector, as reductions in investment by the government's oil company and by private oil firms (discouraged by high taxes and royalties and antibusiness policies) have caused oil production to decline.

Other countries in the region are also growing relatively rapidly. In Chile, a waning investment boom and higher imports have contributed to a slight slowing of growth in 2006. In Central America, growth is expected to accelerate in most countries in 2006, boosted by exports and investments associated with free trade agreements (Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua), strong remittance inflows, increased agricultural production due to better weather, and post-hurricane investment spurts (El Salvador). In the Caribbean, growth in Jamaica and the Dominican Republic has picked up, reflecting foreign investments in the tourism and mining sectors (Jamaica) and a growth rebound following the 2003 currency crisis (Dominican Republic). Uncertainty over the results of elections in Nicaragua has hurt investor confidence, partially offsetting the beneficial effects of a relatively buoyant agricultural sector and the writing off of $975 million in debt.

Electoral uncertainty and concerns about the future path of U.S. interest-rate policy contributed to volatility in financial markets in the spring of 2006. The currencies of a number of countries depreciated, following earlier appreciations in some cases (Brazil and Colombia). Stock markets also underwent a major correction. However, the improved fiscal stance and reduced indebtedness of many countries meant that the region was not particularly affected by this episode. Risk premia, after rising somewhat, have once again declined and currently are just 20 points above their historical minimums.

Prospects for countries in the region reflect a number of offsetting influences. The projected slowdown in global activity is expected to moderate demand for commodities, resulting in a modest decline in their prices and slower volume growth. As a result, while revenues from this sector will remain elevated, they will decline, as will their contribution to the growth of domestic demand in commodity-exporting countries. Overall, GDP among commodity exporters (excluding República Bolivariana de Venezuela, see below) is projected to slow to about 3.8 percent in 2008. Commodity importers also will feel the effect of slower global and U.S. growth. In the case of Mexico, the anticipated cycle in the United States is expected to be reflected in slower exports and growth. For most commodity importers the slowdown is expected to be less marked (from 4.6 to 4 percent, excluding Mexico), in part because many countries have considerable spare capacity.

As indicated above, unsustainably rapid growth in Argentina and República Bolivariana de Venezuela, boosted by a dangerously expansionary fiscal and monetary policy, has already strained capacity in these countries. In the baseline projection, this unsustainable demand stimulus is expected to continue, with domestic demand increasing at double-digit rates. The inability of domestic supply to keep pace means that GDP will grow less quickly, declining to 4 percent in Argentina and 5.5 in República Bolivariana de Venezuela in 2008, as imports and inflation rise rapidly. Unless significant policy restraint is introduced in the near future, these developments will result in a deterioration of current account balances, leading to an erosion of Argentina's current account surplus to about 0.9 percent of GDP and a much-reduced surplus of 7.6 percent in República Bolivariana de Venezuela by 2008. The longer the two countries' aggressively expansionary macroeconomic policies keep demand growing in excess of supply, the sharper and more disruptive will be the recession required to reestablish equilibrium.

Middle East and North Africa[3]

Riding the oil boom.

High oil prices and strong oil demand continue to be key drivers for the developing economies of the Middle East and North Africa.[4] Overall, these countries' GDP increased by an estimated 4.9 percent in 2006, the fastest pace in some four years. Among developing-country oil exporters, growth is expected to reach 4.9 percent, up from last year's 4.7 percent.

Reflecting strong investment and remittance flows from high-income oil exporters and the Euro Area, output among regional oil importers has strengthened. For the year as a whole, output is expected to come in at 5 percent. Strong Suez Canal revenues in the Arab Republic of Egypt, better crops following a drought in the Maghreb, hefty tourism receipts throughout the region, and a pickup in European demand are additional factors explaining this relative strength. An exception is Lebanon, where the war and political uncertainty weighed heavily on activity in the first three quarters. While reconstruction efforts are expected to give a fillip to growth toward the end of the year and into 2007/08, Lebanese GDP is expected to contract by about 5.5 percent in 2006.

Generous fuel subsidies are pervasive throughout the region. For countries that do not benefit from large oil revenues, these subsidies have strained fiscal balances. Countries such as Egypt, Jordan, Morocco, and Tunisia saw fiscal deficits pick up within a range of 0.5 to 2 percent of GDP over the course of 2005, in part linked to oil subsidies. Since then, Jordan reduced subsidy expenditures by 59 percent in the second quarter. In Egypt, these and other steps have helped reduce the consolidated government deficit from 9.1 percent in fiscal year 2005 to 6.5 percent in 2006. Nevertheless, such subsidies remain important in the region and threaten the fiscal sustainability of some countries. They also impede adjustment, although their balance of payments consequences have been mitigated by strong remittance and investment flows.

Rising oil prices during the first eight months of 2006 bolstered revenues of the major exporting countries in the region. Oil-related revenues were up 33 percent in the Islamic Republic of Iran and 30 percent in Algeria, and many governments boosted spending. Measures included substantial investments to augment oil-sector capacity, infrastructure projects, and other non-oil-sector investments in human and social capital, all of which should help boost future supply. However, a significant share of the additional spending, such as substantial civil service wage increases in several countries and increased spending on fuel subsidies, merely stoke demand and may prove difficult to sustain should oil prices decline further.

The surge in oil revenue and government spending among oil exporters has yet to generate substantial inflationary pressures. However, inflation is up in a number of countries, including Egypt, Jordan, Oman, and Tunisia. In the Islamic Republic of Iran, although inflation is declining, it still exceeds 10 percent. Moreover, regional stock and housing markets have appreciated enormously throughout the region. While local markets lost as much as 25–33 percent of their value in the May–June 2006 market correction, valuations remain high, and there are concerns about increased leverage in private sector balance sheets (IMF 2006).

High oil prices are expected to continue feeding domestic demand in oil-producing countries, causing imports to continue rising rapidly, even as growth of export revenue slows. Capacity constraints and strong import growth is projected to slow GDP growth among developing oil-exporting countries to 4.7 percent in 2007 and 4.5 percent in 2008. Their current account surpluses should decline from 11 percent of GDP in 2005 to about 5.3 percent of GDP in 2008. In the oil-importing economies, growth is expected to gradually pick up from 5 percent in 2006 to 5.3 percent in 2008, reflecting assumed improvements in crop conditions, stronger European growth and continued robust investment and remittance inflows from regional oil exporters.

South Asia

Rapid growth is pushing against capacity constraints.

Despite a tightening of both monetary and fiscal policy, real interest rates remain low, and growth in the South Asia region picked up to an estimated 8.2 percent in 2006. Direct and indirect subsidization of consumer energy prices have helped contain inflationary pressures but are keeping government deficits high and contributing to strong domestic demand.

With the exception of Nepal, which is only now emerging from political strife, growth throughout the region was strong in the first half of the year. In India, GDP increased by 9.3 percent in the first quarter, supported by strong industrial and service-sector production, while in Pakistan industrial production was up 12 percent. Partly reflecting improved sales of textiles and clothing after the restrictions on Chinese exports were reintroduced, merchandise exports in the region increased more than 30 percent in the first half of 2006 (on a year-over-year basis). A good start to the monsoon season suggests that agricultural output (and incomes) will be strong also. Overall, regional GDP is projected to increase by 8.2 percent for the year, or 6.4 percent if the two largest economies (India and Pakistan) are excluded. In the Maldives a rebound in tourism and post-tsunami reconstruction efforts are expected to contribute to a 19 percent expansion in GDP, while a new hydroelectric plant may help boost output in Bhutan by 10 percent.

Notwithstanding robust export demand and a first-quarter current account surplus in India, strong domestic demand is expected to result in a small further deterioration of regional current account deficits in 2006, particularly in Pakistan, where increased government spending (tied to the Kashmir earthquake and ongoing military expenditures) is projected to push the current account deficit to 3.9 percent of GDP. In contrast, strong remittance flows and robust exports are expected to propel the current account of Bangladesh toward balance.

Rapid growth and the relatively expansionary stance of fiscal and monetary policies in the region have provoked a rise in inflation. Successive hikes in policy rates in India have increased interest rates, but higher inflation means that real rates were negative in August. In Pakistan, tighter monetary policy brought inflation down to 6.2 percent in April, but it picked up again and was 8.1 percent in October. Ample domestic and international liquidity has also contributed to substantial increases in local stock market valuations (up about 45 percent in both India and Pakistan). Throughout the region, higher international oil prices have yet to be fully passed through to consumers, placing a strain on government accounts and implying significant additional inflationary pressure in the pipeline.

Despite tighter monetary and fiscal policies in India and Pakistan, and weaker export demand from the United States, low real interest rates, strong international capital inflows, and high government deficits are expected to keep domestic demand expanding rapidly. When added to the delayed pass-through of higher oil prices, this should maintain inflation pressures in the region and sustain rapid import growth. As a result, the external sector is expected to make a significant negative contribution to growth, and regional GDP growth should moderate to about 7 percent by 2008. Owing to continued strong growth, the region's current account deficit is projected to deteriorate further despite falling oil and non-oil commodity prices.

Sub-Saharan Africa

Another good year.

GDP in Sub-Saharan Africa expanded by an estimated 5.3 percent in 2006. Oil-exporting economies are expected to grow 6.9 percent in 2006, about the same as last year. Among oil importers (excluding South Africa), the expansion has been sustained, and growth is estimated to have increased 4.7 percent.

South Africa, the region's largest economy, expanded at growth rates above its potential for the third consecutive year. Household expenditure has been exceptionally strong, benefiting from low nominal interest rates, rising real incomes, and wealth effects. As a result, domestic demand and output growth in the manufacturing and service sectors have been very strong. Despite a large positive terms-of-trade shock as metal prices soared, the external sector's contribution to growth was negative, owing to strong import growth fueled by robust household consumption and the stronger rand. The surge in imports caused the current account deficit to deteriorate to 6.2 percent of GDP in the first half of 2006, which contributed to the sharp depreciation of the rand during May–June. Overall, the rand has depreciated 20 percent on a trade-weighted basis since the beginning of the year, and this has contributed to inflationary pressures. Nevertheless, consumer confidence and demand remain at historically high levels.

In Nigeria, the region's second-largest economy, attacks on oil infrastructure slowed growth, as oil production fell by 25 percent during the first five months of 2006. It has since picked up but remains down 6.5 percent from a year ago. Nevertheless, the non-oil economy is expanding rapidly (up 12.8 percent in the second quarter) and supplementary budgetary spending is expected to bolster growth, perhaps leading to a buildup in inflationary pressures.

The regional expansion is broadly based, with a third of the countries experiencing growth in excess of 5 percent. Among oil exporters, growth was particularly strong in Angola (16.9 percent), Sudan (11.8 percent), and Mauritania (17.9 percent), which began oil production in February. In addition to a strong expansion in oil production, buoyant domestic demand is projected to spur rapid growth in the non-oil sectors of most oil-exporting countries.

The aggregate stability and strength of growth among the region's oil importers reflects divergent patterns. A number of countries that recently emerged from conflict are experiencing very strong growth rates (Burundi, the Democratic Republic of Congo, Liberia, and Sierra Leone). Elsewhere strong international metal and mineral prices are generating revenue streams and prompting additional investments, which have contributed to strong growth. However, drought-related crop failure, high fuel costs, and energy rationing have resulted in weaker results for East African oil-importing countries. In addition, although both the numbers and the intensity of conflicts in Africa have subsided, the risks associated with political turmoil remain high and are undermining growth in Chad, Côte d'Ivoire, the Democratic Republic of Congo, Eritrea, Lesotho, the Seychelles, Somalia, Swaziland, and Zimbabwe.

Current accounts have come under pressure in several oil-importing economies in the region, although higher commodity prices and increased official and private transfers have helped contain the deterioration. The most notable decline in the current account came in South Africa, where an initial appreciation of the rand boosted imports and dampened exports, driving the current account deficit to 6.2 percent of GDP in the first half of 2006. Debt relief from Paris Club creditors under the Multilateral Debt Relief Initiative should reduce debt-servicing cost by substantial margins in several countries, which, in combination with the expected easing in oil prices, is projected to provide some relief to current accounts over the projection period.

Inflation is up in a number of countries because of higher international oil prices and seasonal and drought-induced increases in food prices. In the case of South Africa these factors have been exacerbated by excessive domestic demand. Inflation there is projected to exceed 6 percent, above the upper limit set by the Reserve Bank. In Nigeria, year-over-year inflation remains high but is declining rapidly, owing in part to the appreciation of the naira.

GDP growth for the region as a whole is projected to remain broadly stable, coming in at about 5.4 percent in 2008, with weaker growth in South Africa offsetting a pickup among oil exporters and stable growth among smaller oil importers. In South Africa, higher interest rates are projected to overcome strong mining and manufacturing growth in 2007, before the latter forces generate a recovery in 2008. In the baseline projection, emerging electrical shortages due to insufficient generating capacity are expected to constrain growth in Burundi, Kenya, Malawi, Rwanda, Tanzania, Uganda, and Zambia, but improved rainfall in East and West Africa should help replenish hydroelectric dams, thereby improving electrical supply and manufacturing output. An end to drought should also boost agricultural output and domestic incomes, although weaker agricultural prices and high fertilizer prices may negatively affect agricultural crops and could represent a drag on growth.

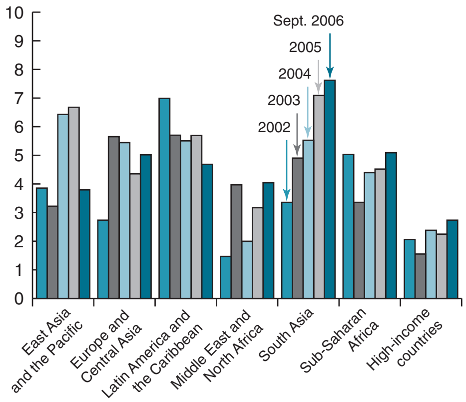
Financial markets

Some signs of emerging inflationary pressures

High oil prices and the rapid pace of global growth have contributed to a gradual increase in median inflation among developing countries, from about 1.7 percent in 2002 to 3.2 percent during the third quarter of 2006 (figure 1.3). The acceleration was not consistent across the globe. Inflation has been stable or declining in half of the developing regions over the past year, falling to an average level of 5.3 in the third quarter. In contrast, in

Figure 1.3 Inflation has increased moderately

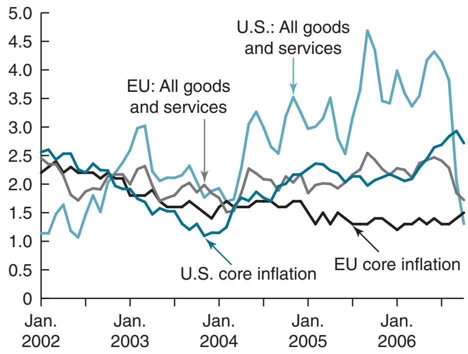
End of period, year-over-year monthly inflation rate (%)



Source: World Bank.

Figure 1.4 Inflation is rising in high-income countries

Percent change, year-over-year



Sources: World Bank; Datastream.

high-income countries it rose from 1.3 to 2.7 percent before falling to 1.4 percent in October as oil prices declined.

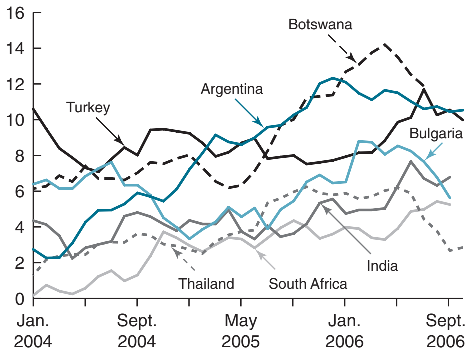
Most of the increase appears to reflect the direct impact of higher oil prices. Until recently, core inflation in high-income countries has been relatively stable (figure 1.4). Core inflation in the United States was rising much of the year, but it has been easing recently and stood at 2.7 percent in October 2006. In many developing countries, inflation first picked up in response to higher oil prices, but it has since declined, reflecting both solid productivity growth and the impact of more credible monetary policies that have helped anchor inflation expectations.

However, developments in a number of low- and middle-income countries run counter to these general trends. In these countries, inflation is rising, reflecting the combined influence of several years of above-trend growth and steep increases in global commodity prices (figure 1.5). Higher inflation would appear to reflect overheating in Argentina and several countries in Europe and Central Asia, the Middle East, North Africa, and South Asia.

Inflation has also picked up in Sub-Saharan Africa. There, in addition to several years of

Figure 1.5 Signs of overheating in some developing countries

Percent change in consumer prices, year-over-year monthly



Source: World Bank.

rapid growth, high food prices following successive droughts are playing a role. The concern is that if an inflationary spiral develops, because the credibility of monetary policy is not yet well entrenched, it could have serious consequences for macroeconomic stability and affect the ability of those economies to sustain the strong growth of the past several years.

In countries such as India, regional imbalances in the distribution of growth contribute

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to difficulties because inflationary pressures and capacity constraints are concentrated in rapidly growing cities and co-exist with considerable slack elsewhere in the economy.

Rising short-term interest rates

Higher inflation throughout the developed world has translated into rising short-term interest rates and the gradual removal of the monetary policy stimulus that has characterized the past several years. Although policy rates are increasing throughout the developed world, the process is most advanced in the United States, while at relatively early stages in Europe and Japan. Many developing countries also have acted to restrain credit expansion and contain inflation. Policy rates have risen sharply and appear to be slowing inflation in Bulgaria, Indonesia, Thailand, and Turkey. In others (Argentina, India, Pakistan) the tightening cycle is less advanced and, as a result, real interest rates remain low and inflation high.

Long-term interest rates (see figure 1.8) remain low and the yield curve flat, suggesting that markets are confident that the monetary authorities will be successful in containing inflationary expectations—a contention supported by the spread between inflation-indexed bonds and nonindexed bonds, which has remained relatively stable at around 2.5 percentage points.

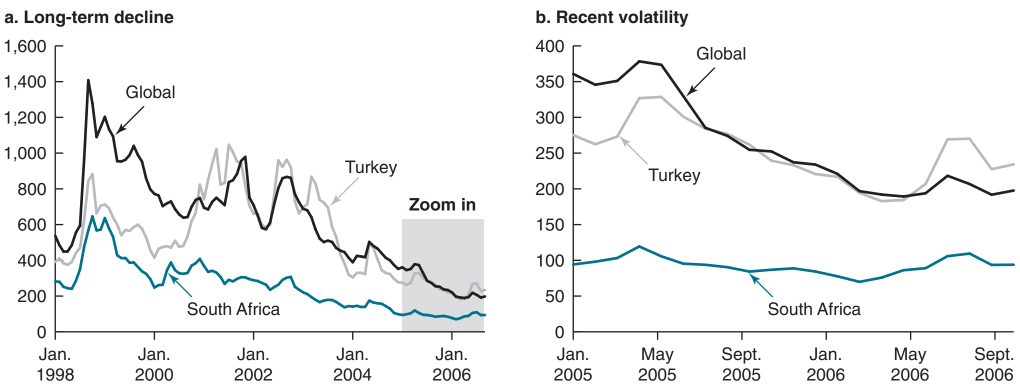
More volatile financial conditions for developing countries

Despite high short-term interest rates, financial conditions for developing countries remain highly favorable. Several years of very loose monetary policy, an ample supply of global savings (due to aging populations in Europe and rapidly increasing incomes among oil exporters), business-sector consolidation in the United States and Asia, and high savings rates in the fastest-growing sectors of the world economy have combined to buoy global liquidity. This helps explain the low long-term bond yields and the search for yield that has boosted the flow of private capital to developing countries. That flow, in combination with improved fundamentals, has brought interest spreads down to historically low levels.[5]

However, conditions have become more volatile (figure 1.6). The transition from a slow and widely anticipated tightening of U.S. monetary policy toward a more data-driven approach increased uncertainty in financial markets during the second quarter of 2006. Initially,

Figure 1.6 Despite turbulence, financing conditions remain favorable

Emerging-market spread as compared with 10-year U.S. T-bill

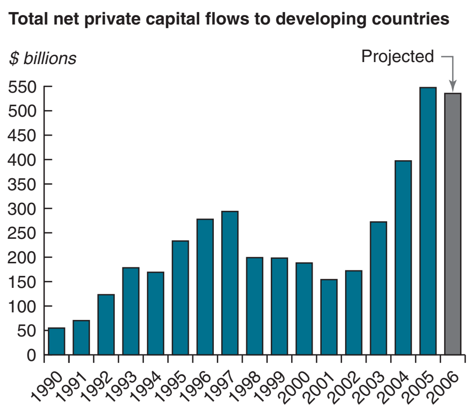


Sources: Datastream; JP Morgan; World Bank.

the prospect that dollar-denominated returns would no longer be rising resulted in a surge of flows into emerging market stocks, commodity markets, and currencies. As values of these assets rose, the market reassessed long-term prospects, resulting in a substantial correction.

For the most part, this volatility failed to disrupt growth, and net private capital flows to developing countries are expected to rival last year's record highs (figure 1.7). However, in some countries, particularly those with large current account deficits (such as South Africa and Turkey) and relatively heavy debt burdens, the correction was more severe and is expected to result in much slower growth in 2006 and 2007, as the real side of these economies adjusts to weaker financial inflows.

Figure 1.7 Private capital flows to developing countries remain strong



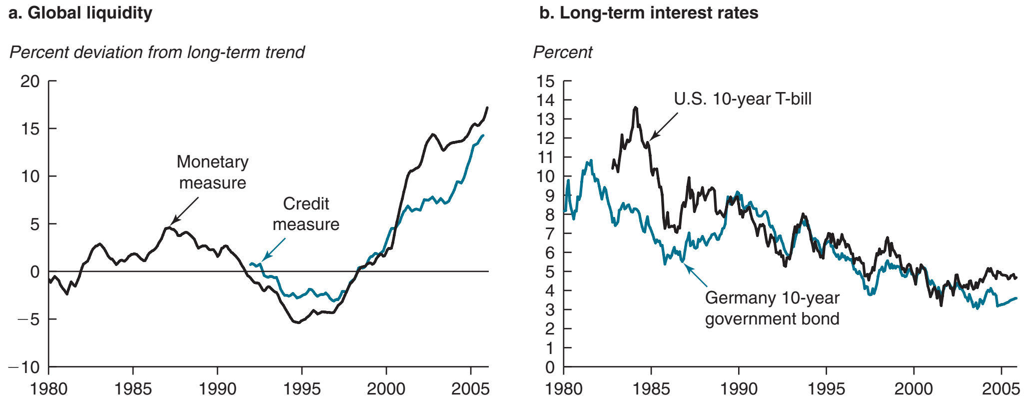
Source: World Bank.

The combination of several years of low interest rates has increased global liquidity substantially (see earlier versions of *Global Economic Prospects* and *Global Development Finance*). Despite the increase in short-term interest rates, the persistence of low long-term interest rates, due in part to high savings rates among oil-exporting countries, has kept global liquidity abundant. The OECD (2006) estimates that depending on the measure employed, high-income liquidity exceeds historical norms by between 15 and 17 percent (figure 1.8). In the baseline, although interest rates are projected to rise somewhat, liquidity is projected to remain relatively abundant and continue to be a factor behind strong developing-country growth.

Global imbalances are stabilizing

The imbalances in global spending patterns that have characterized the world economy over the past five years began to show signs of

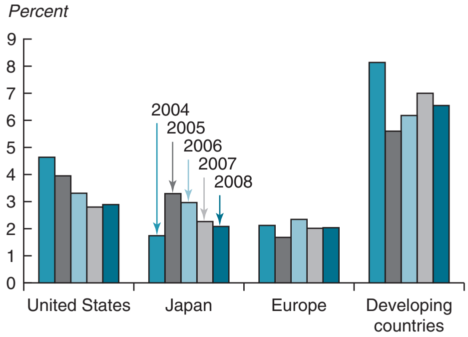
Figure 1.8 Ample liquidity keeps long-term interest rates low



Sources: OECD (liquidity measures); World Bank.

Figure 1.9 Global demand shifts from the United States to Europe and developing countries

Contribution of domestic demand to growth



Source: World Bank.

stabilizing in 2006. Weaker domestic demand in the United States, the acceleration of economic activity in Europe, and continued recovery in Japan helped to stabilize the U.S. current account deficit, which is expected to come in at about $850 billion, roughly the same share of GDP as in 2005.

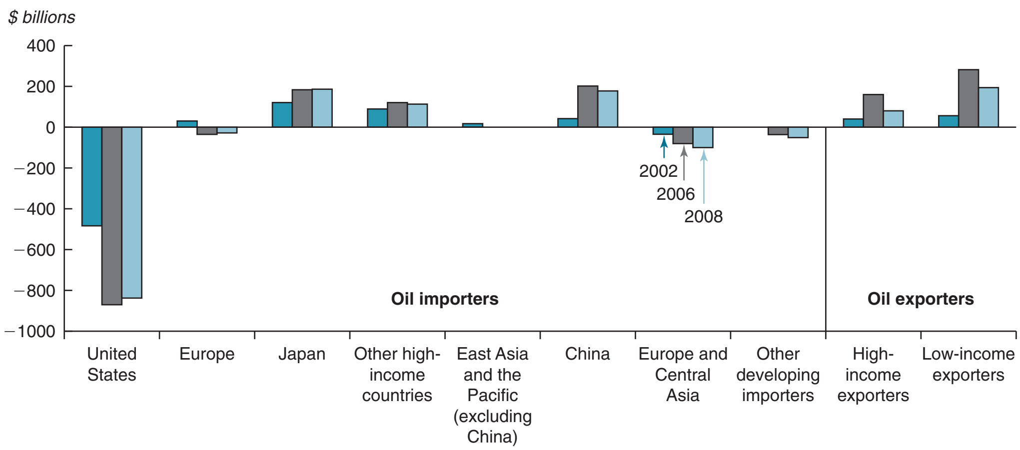
An important component of this story has been the slowing in U.S. domestic demand and the simultaneous increase in developing-country domestic demand (figure 1.9). This rotation of growth, plus the lagged effect of past depreciations, contributed to a 13 percent increase in the volume of U.S. exports in the first half of 2006, almost twice the growth rate for imports (7 percent). Nevertheless, the U.S. trade balance declined further, in part because of very high oil prices during the first eight months of the year. The subsequent decline in oil prices should reduce the value of U.S. imports, resulting in an improved trade balance during the fourth quarter. Because of this strong volume performance and declining oil prices, global imbalances are not expected to deteriorate significantly over the projection period—in stark contrast to the recent past, when they deteriorated sharply each year (figure 1.10).

Exchange rates are broadly stable

Despite the substantial financial flows required to finance the U.S. current account deficit, the dollar has remained broadly stable against major currencies during 2006—up about 2 percent

Figure 1.10 A start to orderly adjustment?

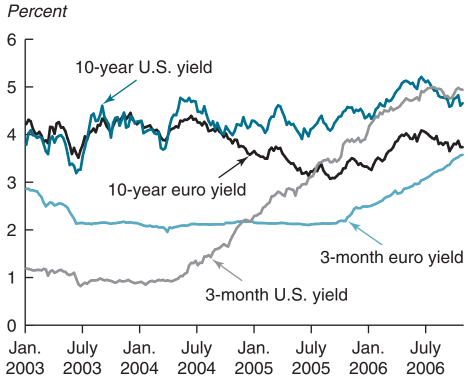
Current account balance, 2002, 2006, and 2008



Source: World Bank.

Figure 1.11 Interest rate spreads support the dollar

3-month and 10-year bond yield



Sources: World Bank; Datastream.

against the yen and depreciating by about 5 percent against the euro. In real-effective terms it has lost only 2 percent of its value. In part, this relative strength is explained because many of those countries running large current-account surpluses (China and several oil exporters) have resisted upward pressure on their currencies with respect to the dollar.

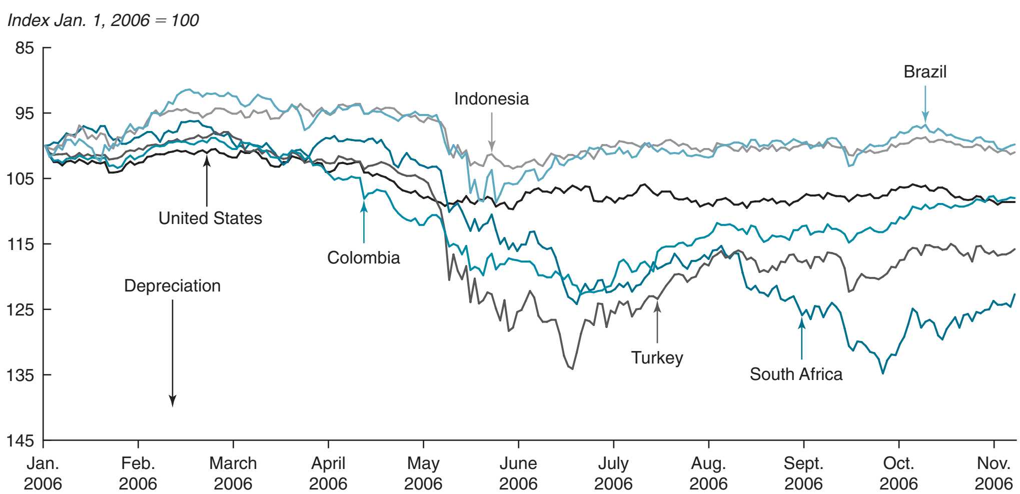
The depreciation against the euro occurred despite a substantial premium currently being offered on both short- and long-term U.S. bonds (see figure 1.11). With U.S. monetary policy nearing or at the end of its tightening cycle, these differences are expected to narrow. In the baseline forecast, this narrowing and slower growth in the United States are projected to cause the dollar to depreciate by a further 5 percent against the euro in each of 2007 and 2008, which should further facilitate the unwinding of global imbalances.

However, should downward pressures be more severe, the depreciation could be stronger or interest rates in the U.S. may have to rise further (see the section on risks).

Currency developments for the remaining developing countries were dominated by the reemergence of financial market volatility in the first half of 2006 (figure 1.12). Downward pressure on the dollar toward the end of 2005 and at the beginning of 2006 saw the currencies

Figure 1.12 Turbulence resulted in sharp depreciations for some developing countries

Index of euro exchange rates



Source: World Bank.

of many developing countries appreciate strongly. For many countries that appreciation was reversed in May and June as investors reassessed their positions. While disruptive, and provoking a sharp rise in interest rates in some countries, the volatility was short-lived and in most cases merely served to unwind earlier appreciations that had been out of step with countries' underlying fundamentals.

World trade

Stronger industrial activity was mirrored in world trade. Merchandise trade growth grew 11 percent during the first eight months of 2006, up from 6 percent the year before. Most of the acceleration occurred in China, Japan, and the United States and was concentrated in the first quarter. Weaker U.S. consumption and investment demand, and growing domestic demand in the developing world combined with the lagged effects of past depreciations to boost U.S. export volumes by an annualized rate of 13 percent in the first half of 2006, compared with 7 percent in the last half of 2005. Measured on the same basis and over the same period, exports in Japan and China increased by 10 and 30 percent, respectively. Trade flows weakened in the second quarter but show signs of picking up once again in the third quarter.

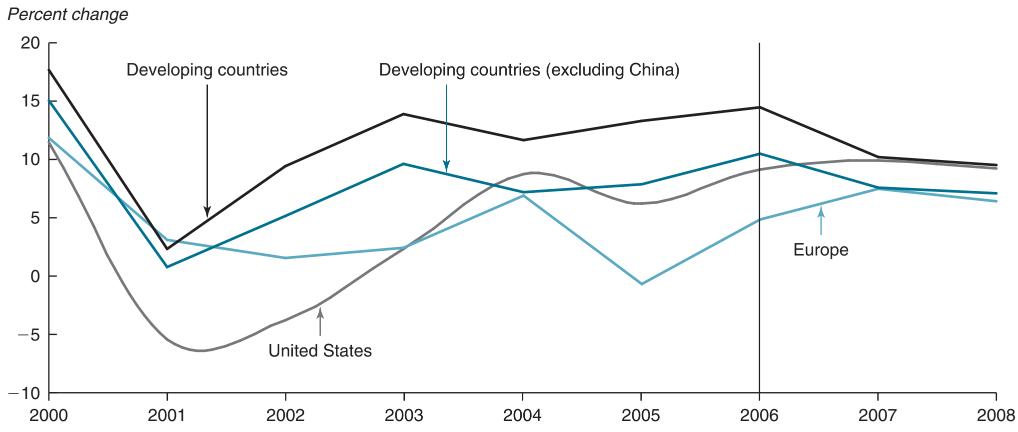
Over the medium term, growth in merchandise trade volumes is projected to ease to about 9 percent, in line with slower global GDP growth. The recent relative strength of U.S. export volumes is projected to persist (figure 1.13). Those volumes are projected to rise by more than 9 percent in 2007 and 2008 as the cumulative effect of past and expected future depreciations increase the international competitiveness of U.S. products. For developing countries, weaker U.S. import demand should be partially compensated by stronger demand from Europe, but, overall, developing-country export growth is projected to slow from an estimated 12.2 percent in 2006 to 10 percent in 2008, even as countries continue to increase their market share.

Trade outlook—continued expansion

Developing-country trade reached a landmark in 2006. Following 25 years of solid growth, the value of China's exports overtook those of the United States, making China the world's

Figure 1.13 Rotation in global trade

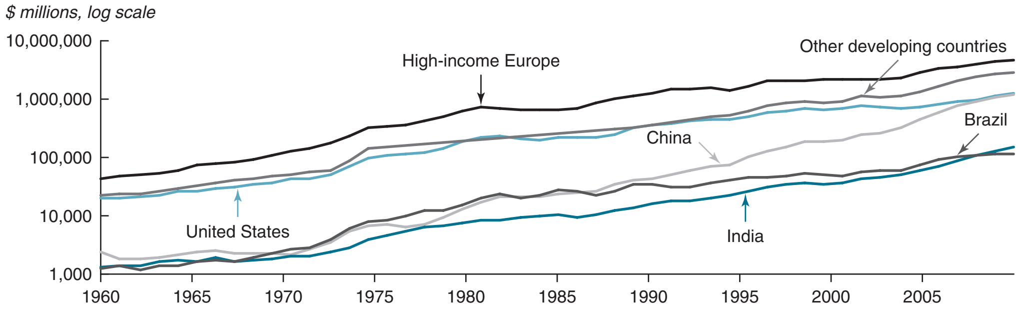
Merchandise trade volumes



Source: World Bank.

Figure 1.14 China's exports exceed those of the United States

Merchandise exports



Source: World Bank.

second-largest exporter. Increasing exports in other developing countries, notably Brazil and India, have further increased the weight of developing countries in world trade (figure 1.14). Over the long term, as these trends continue, the share of developing countries in world trade is projected to reach some 45 percent by 2030 (see chapter 2).

While the phenomenal success that China has enjoyed in expanding its world market share since the introduction of market reforms has increased competitive pressure on both developing and developed countries (see chapter 4), Chinese imports also have grown very rapidly (up 477 percent in value terms over the past decade), and China is a growing destination for the exports of other developing countries (Dimaranan, Ianchovichina, and Martin 2006). Sixty-three percent of China's imports are intermediate goods, 31 percent in the form of parts and components. Overall, 79 percent of China's imports are sourced from developing countries. Partly as a result of China's rapid increase in imports, the value of other developing countries' non-oil exports has risen by 153 percent, and their global market share has increased by 2.3 percentage points.

In addition to these direct effects, the expansion of developing-country commerce means that these countries are increasingly becoming privileged destinations for FDI, both as an export platform for multinational companies and because they represent the fastest-growing market segment.

The extent to which other developing countries will be able to take advantage of the expected continued strong growth of China and India (see chapter 2) will depend on their ability to expand exports. This requires eliminating the anti-export bias in their incentive framework, reducing costs of produced services, and improving customs procedures that undermine competitiveness. It also requires investments in transport systems to reduce transit times (Newfarmer 2005) and in other forms of infrastructure, such as electrical generators so as to facilitate the expansion of capacity. In addition, as discussed in chapter 4, countries need to reduce rigidities in product, labor, and financial markets so that firms can react with agility to new opportunities to expand the range of products they produce and sell.

On the multilateral front, the suspension of talks on the Doha Round in July 2006 poses significant challenges. Weakened confidence in the multilateral system could lead to trade disputes, rising protectionist sentiment, and trade diversion arising from proliferating bilateral and regional trade agreements. To capitalize on progress already made in the Doha Round, such as the offer to end agricultural export subsidies by 2013, it is important that parties return to the negotiating table with the necessary flexibility to conclude an ambitious deal.

Commodity markets

Strong global growth, and especially the rapid expansion of output in developing countries, is largely responsible for the run-up in commodity prices over the past several years. Improvements in technology and new discoveries are expected to preclude any major disruptions to growth over the long term (see chapter 2), but increased demand for energy and other natural resources may generate significant environmental pressures (see chapter 5).

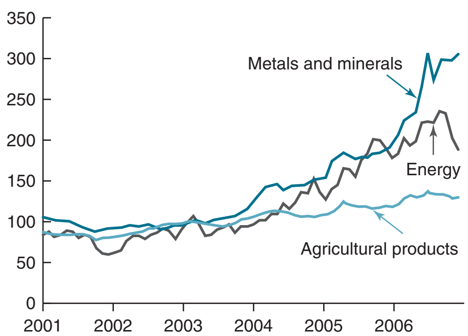
Non-oil commodities

Metals and minerals take off.

While oil-price increases have received the bulk of media attention, the rise in the price of metals and minerals during the course of 2006 has been much stronger (figure 1.15). Continued rapid growth in global output, speculative demand, low stocks, and numerous supply disruptions have pushed metals and minerals prices up by some 48 percent since the beginning of 2006. Agricultural prices also posted gains in dollar terms, up 7 percent by the beginning of November, but were broadly stable if expressed in euros.

Figure 1.15 Diverging trends in commodity prices

Index, Jan. 2003 = 100



Source: World Bank.

The biggest increases in metals prices were those of copper (up 64 percent), zinc (up 110 percent), and nickel (up 144 percent). High prices and continued strong demand have prompted significant destocking of copper and nickel in China—suggesting that prices may remain high even as supply disruptions ease. Nevertheless, stocks of other products such as aluminum, lead, and tin have recovered, and their prices have eased or stabilized, suggesting that a peak in the metals market may have been reached.

Financial sector activity also played a big role in price developments during 2006. Recent estimates suggest that more than $19 billion flowed into retail commodity funds during the first eight months of the year, when prices were rising. More recently, these flows have reversed sharply. Outflows from exchange-trade commodities totaled $12 billion during the first two weeks of September, when prices were falling (Norman and Shen 2006).

With global growth projected to slow somewhat but remain strong, the overall metals and minerals index is expected to decline in 2007 and 2008, but remain elevated.

Moderate gains in agricultural prices.

Agricultural prices have risen an estimated 11 percent in 2006 compared with 2005, reflecting a weaker dollar and the impact of higher energy and fertilizer prices. Other factors, such as crop-specific supply shortfalls and droughts, low carryover stocks, and strong demand growth contributed to the price increases. Real agricultural prices have increased 35 percent since their cyclical lows in 2001.[6] This increase is well below the increases in oils and metals, in part because agricultural demand is less sensitive than industrial demand to economic growth, and because agricultural supply responds more quickly to increased demand and prices.

High energy prices have contributed directly to the surge in the price of some agricultural commodities that are either used as energy crops (biofuels) or compete with synthetic products made from petroleum. The price of sugar, which is being diverted to ethanol production for automotive fuel, more than doubled from late 2004 until early 2006, while that of natural rubber (a substitute for synthetics produced from petroleum products) rose 60 percent between December and June 2006. The price of maize, which is used as the feedstock for ethanol production in the United States, is expected to rise 8 percent in 2006.

High energy costs also have contributed to increasing agricultural prices by raising the cost of fertilizers. This prompts an increase in the cost of production of agricultural goods, but also induces a reduction in yields because farmers use less fertilizer. As a result, energy- and fertilizer-intensive crops such as grains are expected to show reduced yields and higher prices in 2006. These factors, plus low carryover stocks and poor harvests in several important producing areas, are projected to push wheat prices up 28 percent in 2006 and even higher next year before production increases enough to rebuild stocks. In the case of rice, higher costs and reduced yields are expected to boost prices by 8 percent.

In contrast, prices of fats and oils are expected to be 5 percent lower, because markets appear to be well supplied. Drought in Kenya is keeping tea prices high (up 14 percent from 2005). Robust coffee prices are expected to average 18 percent higher in 2006, a continuation of the price increases that began in 2002. Timber prices are projected to increase 14 percent owing to strong demand, particularly from China, while international supplies remain limited because of controlled logging and export quotas.

Prospects for agricultural prices in 2007 are mixed, with grains and oilseeds higher, while beverages and raw materials prices will be lower. Overall, agricultural prices are expected to decline by about 1 percent in 2007 and 2.8 percent in 2008 as higher prices begin to moderate demand and induce increased supply. Should oil prices rise further, agricultural prices could also strengthen because of cost-push factors and because higher energy prices make biofuel more economically viable, generating an additional source of demand for products such as maize and sugar cane. Already, 20 percent of the U.S. maize crop and 50 percent of the Brazilian sugar cane crop are used to produce ethanol. Should this trend continue, demand for other commodities, especially grains, will increase to substitute for crops used for biofuels.

Oil market

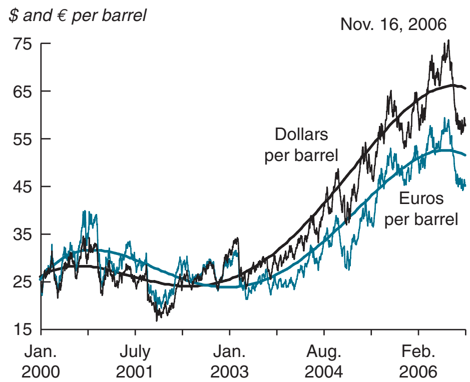
Rising supply and slow demand cause prices to ease.

After showing signs of stabilizing in the fall of 2005, the price of oil shot up once again in the first half of 2006 (figure 1.16). Prices have since declined and were below $60 in late November—bringing the price of oil below the level at which it began the year. Expressed in euros, the price has declined 7 percent since the beginning of the year and stands at about the same level as before the hurricanes of last summer and fall.

High prices slowed the growth in demand for oil despite the acceleration in economic activity in 2006. Oil demand increased by 0.5 million barrels per day (mbpd) in the three quarters of 2006, compared with 3.2 mbpd

Figure 1.16 Oil prices continue to rise

Price of oil, World Bank average

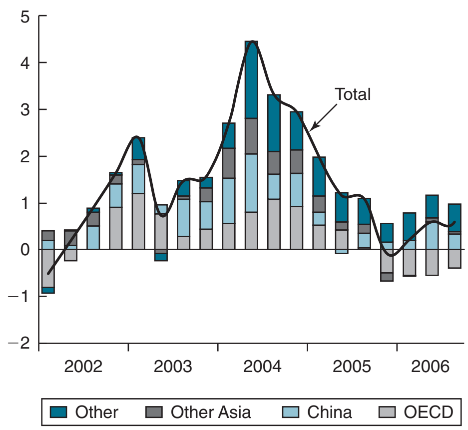


Sources: Datastream; World Bank.

Figure 1.17 Higher prices slow oil demand

Change in apparent oil demand

Millions of barrels of oil per day

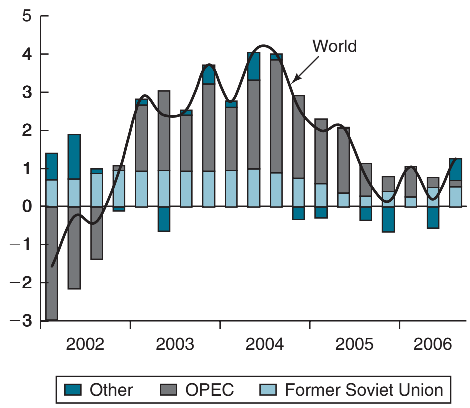


Source: International Energy Agency.

Figure 1.18 A disappointing supply response

Change in global oil deliveries

Millions of barrels of oil per day



Source: International Energy Agency.

in 2004 (figure 1.17). Demand among OECD countries actually declined by about 0.5 mbpd, and although demand in developing countries continued to increase by just under 1 mbpd, this was much slower than the increases recorded in 2003 and 2004. Econometric estimates suggest that had prices remain unchanged, oil demand would have increased by some 2–2.5 mbpd.[7]

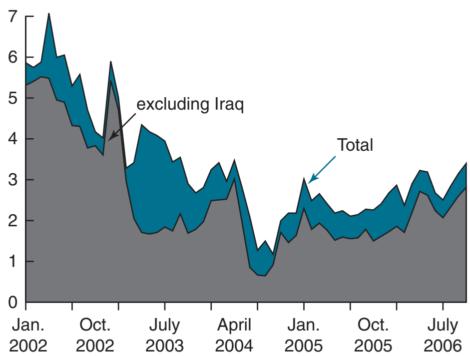
Notwithstanding some three years of higher prices since the recent upward trend in oil prices began in early 2003, and the arrival on stream of new fields in Africa and elsewhere, aggregate non-OPEC (Organization of Petroleum Exporting Countries) oil supply was relatively slow to increase (figure 1.18).[8] Most recently, there has been a pickup in deliveries from the former Soviet Union and other non-OPEC sources, with the result that supply rose by 0.8 mbpd during the first nine months of 2006.

Despite the limited responsiveness of supply in the first half of 2006, growth of final oil demand was even weaker, and as a result inventories and global spare capacity increased somewhat (figure 1.19). However, spare capacity remains low (at just 3 mbpd), leaving the world vulnerable to a significant supply shock (see the section on risks below). It is that vulnerability, plus concerns about future Middle East supplies, that provides the best explanation for the increase in oil prices observed during the spring and early summer.

Figure 1.19 Spare production capacity remains low

OPEC spare production capacity

Millions of barrels per day



Sources: World Bank; International Energy Agency.

Financial market speculation also likely played a role, especially in the first half of 2006, when a weakening dollar coincided with a significant run-up in emerging-market assets (among them the prices of some commodities), followed by a significant reversal in May and June. An indication of the importance that such forces may have played was the 30 percent fall in U.S. wholesale gasoline prices in August following the decision of Goldman Sachs to reduce the share of gasoline in its commodity indexes.

Over the near term, limited spare capacity and strong global growth suggest that oil prices will remain volatile. However, high prices should continue to moderate demand growth, while investments in new capacity already in the works are projected to increase output by about 15 mbpd by 2010, implying a 3 mbpd annual increase—well above expected increases in demand of between 1.5 and 2 mbpd annually. As a result, the price of oil is projected to decline modestly over the next two years, reaching an average level of $53 in 2008.

Downside risks predominate

A number of factors suggest the soft-landing scenario outlined above as the most likely outcome. Tighter monetary policy in high-income and a number of developing countries is slowing growth in those countries and should alleviate inflationary tensions. Meanwhile, still-low long-term interest rates and emerging-market spreads are expected to maintain favorable external conditions for developing countries, allowing them to grow at a slower but still robust pace of 6 percent.

While the soft landing is the most likely scenario, the global economy is at a turning point following several years of very strong growth—and such periods are fraught with risk. Indeed, as described in chapter 2, the last century began under similarly auspicious circumstances, characterized by an extended period of strong growth buoyed by technological change and ample liquidity. Rather than continuing forward as anticipated by leading economists at that time, the world plunged into the Great Depression. Thus, while much in the current environment is reassuring, a note of caution is merited.

The remainder of this chapter explores four main risks to the outlook.

Overheating could provoke a sharper slowdown

The world economy and, in particular, developing countries have been expanding at near-record rates over the past few years. So far, the inflationary effects of fast growth have been largely confined to the markets for global goods, such as commodity markets. The inflationary response at the national level has been remarkably muted. Improved monetary policy has succeeded in anchoring inflationary expectations at low levels, while competitive pressures induced by the entry into the global marketplace of the countries of the former Soviet Bloc and China, with their relatively high skills and low wages (see chapter 4), have boosted global productivity and kept the pricing power of firms in check. In the baseline projection these factors are assumed to continue to hold sway, while tightening of monetary policy and slower growth in countries where signs of a pickup of inflation have emerged are assumed to prevent inflation from rising further.

However, long-term interest rates are projected to remain low and international financial conditions relatively loose. As a result, global growth is expected to remain strong and further inflationary pressures may yet emerge. In particular, given projected levels of global demand, further price hikes in commodity markets cannot be ruled out.

Moreover, should measures to slow growth in several key developing economies (Argentina, China, India, and many European and Central Asian economies) fail, as they have to varying degrees in recent years, inflation in those countries could pick up. That could lead to a more marked slowdown later on, either because of a much sharper tightening of policy or because of endogenous factors such as a loss of external competitiveness.

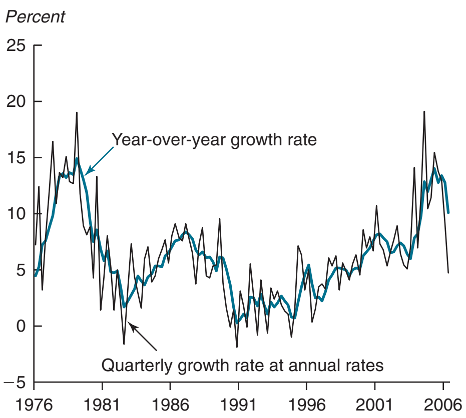
A housing market crisis could cause a recession

Growth in the United States and several other high-income countries[9] has been bolstered over the past several years by rapidly rising housing prices. In the United States, rising housing prices increased household wealth by 14.6 percent of GDP between 2000 and mid-2006. The pickup in housing valuations was spurred by low interest rates and the introduction of new interest-only variable-rate mortgages. Higher valuations in turn generated a boom in home-equity withdrawals, which boosted consumer spending and residential investment.

As short-term interest rates rose, demand for variable-rate mortgages dried up, and the rate of increase of housing prices cooled substantially[10] (figure 1.20). By the third quarter of 2006, the contribution to growth of residential investment had swung from a strong 0.5 percentage points in 2005 to a strongly negative −1.1 percentage points. That swing, plus the end of the additional consumption demand generated by home-equity withdrawals, underlies the slowdown in U.S. growth observed in the second and third quarters, which is projected to continue into the first half of 2007.

Figure 1.20 After rising rapidly, housing price growth slows sharply

Increase in the price of existing U.S. houses



Sources: World Bank; Office of Federal Housing Enterprise Oversight.

The risk is that the slowdown may be much more severe, either because house prices decline more sharply or because the indirect effects of the anticipated 9.3 percent decline in residential investment has wider impacts on the rest of the economy. A much steeper slowdown following a sharp decline in housing prices[11] could accentuate the decline in residential investment, driving it down by as much as 20 percent from its level in mid-2006, while the reversal in the trend to household wealth could cut as much as 1 percent from growth in personal consumption. On the plus side, Australia, the Netherlands, and the United Kingdom have all observed substantial decelerations and even declines in housing prices without recession (see OECD 2006 for more details).

Such a shock could prompt a recession in the United States, with growth slowing to as little as –0.2 percent of GDP in 2007 and 2.7 percent in 2008. Slower growth would weaken inflationary pressure in the United States, allowing for lower interest rates in the course of 2007, helping to spur a recovery toward the end of 2008.

Such a U.S. recession would affect developing economies through three channels: reduced exports to the United States, lower commodity and oil prices owing to slower global growth, and more favorable financing conditions. The balance of these forces would vary across regions and countries. Regions with the tightest trade ties, such as Latin America and East Asia, would suffer the greatest negative impact. The combination of weaker domestic demand in the United States and less marked slowdowns elsewhere would help to reduce global imbalances.

A disorderly unwinding of global imbalances remains possible

The rotation of growth away from the United States and increased consumption demand in Europe and the developing world are welcome developments that mark the beginning of an orderly adjustment of global imbalances. In particular, they signal an end to a troubling trend of rapidly rising U.S. current account deficits. While relative stability should reduce financial market concerns, the financing of the gap in the U.S. current account, at 6.5 percent of GDP, remains a challenge. Such a deficit is not sustainable over the long run. Each year, it augments the net international debtor position of the Unites States and its financing costs. The United States has already become the world's largest net debtor, with the value of foreign-owned U.S. assets exceeding that of U.S.-owned foreign assets by 21 percent of U.S. GDP in 2005. In addition, the balance of the interest payments on these debts was −$8.8 billion during the first three quarters of 2006, the first time in some 30 years that the United States paid out more than it received on internationally held financial assets. Unless savings in the United States increase substantially, even assuming further improvements in the trade balance, the net asset position of the United States will continue to deteriorate, potentially reaching between 65 and 48 percent of GDP by 2015 (Higgins, Klitgaard, and Tille 2005).

As long as the trend toward real-side adjustment (increased savings in the United States and increased domestic demand and imports abroad) continues, the resolution of global imbalances should proceed in an orderly manner, even though it may take several years beyond our medium-term projection period (2006–08) before the U.S. current account deficit reaches sustainable levels. That said, the medium-term risk to the global economy remains that adjustment will occur not on the real side but on the financial side, either because investors rapidly lose confidence in the dollar—thereby provoking a currency crisis, much higher U.S. interest rates, and financial market turmoil—or because they increasingly demand higher interest rates on U.S.-denominated assets. While this would help increase U.S. savings and therefore hasten adjustment compared with an orderly adjustment, it would do so at greater cost in terms of growth in high- and low-income countries, both because of its dampening effect on investment and potential output and because a rapid adjustment would inevitably result in greater short-term misallocations of resources.

In the baseline scenario, financial sector adjustments are assumed to be benign. The expected narrowing of short-term interest-rate differentials is projected to prompt investors to continue shifting assets into euros, placing downward pressure on the dollar. This should be offset somewhat by a tendency for U.S. long-term rates to rise relative to those in Europe. While the relative depreciation of the dollar should be smooth, the dollar could weaken quickly if investors were to react nervously. That would provoke much higher U.S. interest rates and a sharper slowdown. Such a risk can be reduced by collaborative policy actions to increase public and private savings in the United States, strengthen demand in the rest of the world, and provide for more flexible management of exchange rates.

However adjustment occurs—be it a sharp adjustment led by the financial sector or a more gradual real-side adjustment—the process is likely to be relatively short-lived in the context of the 25-year projections reported in chapter 2. Although a disorderly adjustment would imply up to two years of substantially below-trend growth for the global economy, this would have minimal effects on the average long-term growth rates reported there.

An oil-sector supply shock could disrupt growth

With spare production capacity at only 3 mbpd, the world oil market remains vulnerable to a supply shock. Because no country can easily ramp up production, if output in a producing country were to fall significantly, world supply would fall, provoking a decline in economic activity.

Simulations presented in last year's *Global Economic Prospects* (World Bank 2006) suggest that a negative supply shock of two million barrels per day that caused oil prices to double for a period of three months and then remained at $80 for nine further months would cause global output to shrink initially by about 1.5 percent of GDP, as compared with the baseline scenario.[12] Inflation would pick up rapidly, and on average the current account position of oil-importing countries would deteriorate by about 1.1 percent of GDP. The impact would be more severe in large low-income and middle-income countries, both because of higher energy intensities and a greater inflationary impact, which requires a larger contraction to eliminate.

While the impact in terms of GDP for current-account-constrained low-income countries is smaller, it is more severe in terms of domestic consumption and investment. Such countries have limited access to international capital markets and their capacity to pay higher oil prices is limited by their export revenues. If these revenues are stable, such countries would be forced to reduce domestic demand and non-oil imports in order to pay their higher oil bill. As a consequence, when oil prices rise, oil consumption remains relatively constant in terms of volume (being generally inelastic in the short run), but the oil bill rises. To compensate, non-oil imports and domestic demand tend to decline in unison—leaving GDP relatively unchanged. For these countries, the terms-of-trade-shock of the initial increase in oil prices is estimated at 4.1 percent of their GDP, which would translate into a 2.7 percent decline in domestic demand, with potentially serious impacts on poverty.

Notes

1. Housing prices, which had been rising by 10 percent a year, declined at a 1.2 percent annualized pace in the third quarter of 2006. As a result, increases in household wealth slowed, and home-equity withdrawals, which boosted GDP growth by as much as 1 percentage point during 2000–05, turned negative. At the same time, the contribution of residential investment to GDP growth fell from 0.5 percentage points in 2005 to −0.7 and −1.1 percentage points in the second and third quarters of 2006, respectively.

2. In addition to the *Prospects for the Global Economy* Web site (www.worldbank.org/outlook) the World Bank's East Asia update provides more detailed information on recent developments and prospects for the East Asia and Pacific region (www.worldbank.org/eapupdate/).

3. In addition to the *Prospects for the Global Economy* Web site (www.worldbank.org/globaloutlook), which describes regional developments in more detail, the World Bank's Middle East and North Africa Web site, *Economic Developments and Prospects* (www.worldbank.org/mena) provides an even more comprehensive discussion of recent economic developments, projections, and policy priorities.

4. For the purposes of this report the developing countries of the region are Algeria, the Arab Republic of Egypt, Jordan, the Islamic Republic of Iran, Morocco, Oman, the Syrian Arab Republic, Tunisia, and the Republic of Yemen. Djibouti, Iraq, Lebanon, and Libya were excluded from the projections because of a lack of data. Important regional players such as Bahrain, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates are included in the high-income aggregate.

5. As of early November 2006, the credit ratings of 34 emerging market countries have been upgraded. Only 3 have been downgraded.

6. Agricultural prices are quoted in U.S. dollars and therefore have been deflated by U.S. inflation.

7. The short-term price elasticity of oil demand is estimated at between −0.01 and −0.2 percent (Burger 2005), implying that immediately following a 100 percent increase in oil prices, such as observed between 2002 and 2005, oil demand would be expected to decelerate by between 1 and 20 percent. Long-term elasticities are larger (between −0.2 and −0.6 percent), implying that the negative effect of higher prices over the past few years will continue to be felt.

8. In the three years following both the 1973 and 1979 oil price hikes, non-OPEC and non–former Soviet Union oil producers increased their output by some 3.5 million barrels per day. In contrast, since 2002, production from these sources has actually declined. OPEC did increase its deliveries during 2004 by drawing down its spare capacity, but so far investment to increase that capacity has been limited.

9. Robust increases in residential investment and rising housing prices have been important drivers of growth in recent years in Canada, Denmark, France, Ireland, Spain, and the United States.

10. As of September 2006 the median sales price of houses in the United States had fallen 1.2 percent (year-over-year). This measure, produced by the National Association of Realtors, differs from data provided by the OFHEO, which are reproduced in figure 1.20, because it does not control for the quality of the houses being sold.

11. Girouard and others (2006) estimate that U.S. housing prices have a more than 75 percent chance of falling if interest rates rise by 100 basis points.

12. Studies suggest that the likelihood of such a disruption occurring over the next several years may be as high as 70 percent (Beccue and Huntington 2005).

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