Global Economic Prospects 2006/2007:

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Overview

After the slightly more than 5 percent real GDP growth in 2004—the highest in a generation—the world economy achieved nearly 4½ percent growth in 2005. Despite sharp rises in world energy prices, this growth was still more than ½ percent above the potential global economic growth rate. For 2006, the prospect is for continued solid global economic growth but at a slightly slower pace than 2005—about 4 percent on a year-over-year (Yr/Yr) basis (using the IMF's World Economic Outlook's purchasing power parity [PPP] exchange rates to aggregate GDP across countries); see table 1. This will mark the first time since the early 1970s when the world economy has expanded at more than a 4 percent annual rate for four years running. Substantial uncertainty is attached, however, to global growth prospects for 2007—linked primarily to uncertainty about the degree of monetary tightening that will be needed to insure against an undesirable rise of inflationary pressures and risks from energy prices, international payments imbalances, possible overextension in some financial markets, and the possibility of mutation of the H5N1 bird flu virus to intrahuman contagion.1

Abstracting from food and energy prices, core consumer price inflation around the world generally remained well-contained in 2005, although up modestly from the lows of 2003. However, prices of many crude goods and industrial materials (not just energy) have continued to surge, and broad measures of inflation that include these prices, such as GDP price indices, are generally showing somewhat more inflation than core consumer prices. Margins of slack have been eliminated or have clearly diminished in several key countries. Key central banks have responded or are beginning to respond to this situation by removing the extraordinary monetary accommodation introduced to combat the economic slowdown of 2001–03. There should be little doubt that central banks generally will do what is necessary to avert a significant and sustained increase in inflation.

1 The outcome for global growth in 2005 is ½ percent above my September 2005 forecast of 4 percent, and the present forecast for 2006 growth is ¾ percent above my September 2006 forecast. These differences reflect primarily stronger-than-predicted performance in Japan and emerging Asia in 2005 and an upgrading of the forecast for these countries for 2006. There was also a computation error in calculating my September 2005 forecast for global growth arising from using incorrect weights in aggregating forecasts for different regions and countries. This computation error subtracted about 0.15 percent from the global growth forecast for both 2005 and 2006.
There may be, however, somewhat of an underestimate of what will need to be done, how fast, and with what consequences for economic growth and financial markets.

In particular, with core inflation in the United States running at or slightly above the midpoint of the apparent “comfort zone” of the Federal Reserve, US monetary tightening has already proceeded significantly further than was generally anticipated in financial markets a year ago, and US long-term interest rates have been pushed up about 95 basis points since early April 2005. Indications of an increase in underlying inflationary pressures or even continuation of economic growth at a pace that brings significant further reductions in margins of slack would likely induce the Federal Reserve to tighten by more than the additional 25 to 50 basis points now anticipated in the federal funds futures market. In this event, US long-term interest rates would head higher and US economic growth would be slowed further late this year and especially in 2007.

Thus, for the world’s largest economy two scenarios now appear likely: Either the slowdown of residential investment now underway, together with a more general slowing of consumer spending growth after the first quarter, will reduce US real GDP growth to no more than about 3 percent (Yr/Yr) for 2006 and about 2½ percent (Yr/Yr) for 2007. Or, the Federal Reserve will respond to the inflationary pressures attendant upon continued growth greater than US potential in 2006, with the result of a sharper economic slowdown in 2007.

Meanwhile, the European Central Bank (ECB) has begun its cycle of tightening with 25 basis point increases in its repo rate last December and this March. A modest pick-up of growth in Germany from barely over 1 percent in 2005 to 1¼ percent in 2006 and a move from zero to slightly positive growth for Italy this year will help boost euro area growth from just below 1½ percent last year to about 2 percent for 2006 and 2007. With such growth, the ECB is likely to continue tightening at the pace of 25 basis points per quarter, taking the repo rate to 3½ percent by this time next year and probably pushing the ten-year German bund rate moderately above 4 percent by that time. Growth much above 2 percent or signs of rising inflationary pressures would likely accelerate ECB tightening and induce larger longer-term interest rate increases.

In Western Europe outside of the euro area, the Bank of England’s monetary policy is well attuned to an economy operating at potential. For the United Kingdom, a slight pick-up in growth on a year-over-year basis to about 2¼ percent is likely. A modest rise in growth to 2 percent in Switzerland and about 3 percent in Norway and Sweden will help push growth for all of Western Europe up slightly to 2 percent (Yr/Yr)—a pace that (unfortunately) appears to be no more than the potential growth rate for this important region.

With real growth of 2¼ percent in 2005 following average growth of 2 percent the preceding two years, and with recent evidence of the end of deflation, the Bank of Japan (BOJ) has announced an end to its policy of quantitative easing. Even assuming some payback during the first quarter of this year of the very rapid growth in the fourth quarter of 2005, Japanese real GDP growth is forecast to reach 2½ percent (Yr/Yr) for 2006. With a declining population, however, it is unlikely that the potential growth rate of the Japanese economy is as high as 2 percent—and it might not be much above 1 percent. This consideration reinforces the likelihood that the BOJ will end its zero interest rate policy sometime this summer and will push overnight interbank interest rates up to at least 50 basis points by year-end. A slowdown of Japanese growth in 2007 to the potential growth rate of the economy is now a reasonable forecast. Meaningful appreciation of the yen against the US dollar may be one of the mechanisms contributing to this slowdown.

The Australian and Canadian economies are operating at potential, and their respective monetary policies are being adjusted to maintain this situation and avoid any rise of inflationary pressures. Growth of no more than about 3 percent is likely for both these countries this year and next.

Across the industrial countries, the extraordinary easing of monetary policies that took place in 2001–03 has been or is now being reversed. In view of the usual lags in the effects of monetary policy, it is reasonable to expect some slowing of industrial-country growth this year and further slowing next year. If the monetary authorities accidentally overdo the degree of monetary tightening or if they find that a greater-than-now-anticipated tightening is needed to contain inflationary
pressures, the growth slowdown in 2007 could be quite significant. Because of this and other important risks, there is greater uncertainty concerning industrial country growth for 2007 and global financial conditions over the next 18 months than has existed for the past four years.

Developing countries enjoyed another year of strong growth in 2005 with real GDP (on a WEO basis) rising 6½ percent, off only modestly from the spectacular 7½ percent growth recorded for 2004. All major developing-country regions and most individual countries did well, and there were very few disasters. For 2006, a further moderation of growth down to a still strong 6 percent is likely, as some of the high flyers of the preceding two years do a little less well and because there will be somewhat less stimulus from growth of exports to industrial countries, notably the United States. For 2007, a slight further slowing of developing-country growth to 5½ percent is forecast—assuming that the baseline forecast for modestly slower growth in the industrial countries proves accurate.

Among emerging-market and developing countries, recently revised data indicate that China led with 10 percent real growth in 2005—about one-fifth of which was accounted for by improved net exports. This year, domestic demand growth may accelerate somewhat but probably not enough to offset a smaller contribution to growth from further rises in net exports. India should continue strong growth at a 7 to 8 percent rate. Korea, in contrast, will continue to be hampered by high energy prices, the strong won, and some weakening of demand growth in key export markets. Among other emerging Asian economies, the picture is somewhat mixed (depending on exposure to energy prices, global high-technology markets, and trade with the United States), but on average another two years of solid growth, about in line with or slightly below 2005, is a reasonable prospect.

Elsewhere among important emerging-market economies, the growth rates for the high flyers of the past couple of years (Russia, Turkey, Ukraine, Pakistan, Argentina, and Venezuela) will likely come down somewhat in 2006 but still be quite vigorous. Aided by falling domestic interest rates (and possibly some downward correction in the foreign exchange value of the real), growth in Brazil should pick up to 3½ percent in 2006 after a sluggish 2005. Some weakening of US growth and the uncertainties of the upcoming presidential election suggest that growth in Mexico will not accelerate from the 3 percent pace of 2005. The rest of Latin America should grow at a respectable 4 percent rate, off modestly from the 2005 result. With Western Europe sustaining the modest growth pick up of 2005, Central Europe (Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Croatia, Romania, and Bulgaria) should sustain about 4½ percent real growth in 2006-07. The oil exporters of the Middle East and Africa will continue to grow quite vigorously—as they did in 2005. Other important economies in these regions (notably South Africa and Egypt) will also continue their recent solid growth rates (of 4½ to 5 percent).

With few exceptions (notably Argentina, Indonesia, Russia, and Venezuela), inflation rates in important developing countries remain quite low, and the determination to contain inflation in most developing countries now appears quite strong—and likely to be successful. Efforts in this regard in some countries with histories of high inflation (especially Brazil, Mexico, and Turkey) have been particularly impressive. Some general increase of interest rates in developing countries and the influence of higher interest rates in industrial countries are likely to keep inflation in check. However, in some important developing countries that have established credible inflation targets, monetary easing may be both feasible and an aid to growth.

**Major Global Risks**

There are, of course, risks to this central forecast for global growth and inflation in 2006 and 2007—both on the upside and downside. Usually, the downside risks for growth are somewhat easier to perceive than the factors that give an upside potential for growth, and this paper has some of that bias. Nevertheless, the central forecast of global real GDP growth of 4¼ percent for this year is intended as an unbiased, midpoint forecast with reasonably balanced risks to the up and down sides. For 2007, the central forecast is arguably somewhat biased to the upside because it makes little allowance for the likely catastrophe if the H5N1 bird flu virus began to spread rapidly among
humans. In contrast, a major successful terrorist attack (other than one significantly affecting world energy supplies) seems unlikely to have much effect on global GDP growth.

As already highlighted, one key global risk arises from potential increases of inflationary pressures and monetary tightening in the industrial countries. This risk will be examined further in the discussion of individual countries.

A second important risk at the global level arises from energy prices. World oil prices (for light sweet crude) are now above $65 per barrel, only slightly below their all time peak of late August 2005. The current prices probably reflect fears about a possible disruption of oil supplies associated with the controversy over Iran’s nuclear program (despite relatively high commercial inventories of oil and oil products). If these fears abate, oil prices could fall back to the $50 to $55 per barrel range, with modest positive implications for global economic growth in 2006 (although with some possible problems for a few oil exporters). On the other hand, an actual and sustained disruption of oil supplies of a couple of million barrels per day (from Iran or elsewhere) will probably cause world oil prices to spike upwards to $90 to $100 per barrel and would be a significant negative for global economic growth.

A third important global risk is associated with the need to shift the US and the world economies from an expanding US current account deficit (already reaching 6½ percent of US GDP in 2005) to a declining US current account deficit. In absolute terms, this deficit is by far the largest ever recorded by any country and relative to US GDP is approaching double the previous peak of 1987. Some kooks believe with unbridled confidence that the US current account deficit can not only be sustained but keep growing virtually forever. Good sense, however, suggests that the inevitable transition from a growing to a shrinking deficit must begin reasonably soon. I am not among those who believe that this transition involves a high risk of a “dollar crash” with a substantial negative impact on US and global economic growth. Nevertheless, this transition does pose significant challenges for growth and some risk of financial turmoil.

Fourth, in a global environment of cheap credit and generous liquidity supported by industrial-country central banks and of reasonably strong growth and generally sound policies across most emerging-market economies, net capital flows to emerging markets have recently surpassed their previous 1996 peak (according to the Institute of International Finance). Interest rate spreads for many emerging-market borrowers have contracted to all-time lows, and values of emerging-market equities have generally shown substantial (in some cases spectacular) gains. As the global environment for emerging-market financing is likely to turn somewhat less favorable in the face of tighter industrial-country monetary policies, the risk of emerging-market financial crises may be increasing. After a devastating series of crises from 1995 through 2002, for the past three years there have been no major crises. A few countries may be at risk in 2006. By 2007, the deterioration of conditions in some emerging-market economies and a less forgiving global environment could expand these risks.

The United States

The US economy is at a critical juncture, and developments in this large economy and in US economic policy are likely to exert an influence on global economic and financial developments over the next two years that exceeds the 21 percent weight of US real GDP in world real GDP (measured using PPP-based exchange rates).

Although recovery from the mild 2001 recession has not be exceptionally vigorous by the standards of earlier postwar recoveries, especially in terms of employment growth, indications are that the level of US output has reached potential while the economy is continuing to expand more rapidly than its potential growth rate. In particular, over the past three years, when US real GDP has risen on average at about a 3½ percent annual rate, the unemployment rate has fallen by 1.6 percentage points from 6.3 percent (in June 2003) to 4.7 percent (in March 2006). This suggests that the potential growth rate of the US economy is now no greater than 3 percent and possibly as low as
2½ percent. Unusually sluggish growth of the US labor force (reflecting the virtual absence of the normal cyclical recovery in labor force participation rates) is the main proximate cause of this apparent slowdown in US potential growth from the 3¼ to 3½ percent rate that appeared to characterize the long expansion of the 1990s.

Meanwhile, core inflation in the United States bottomed out in 2003 and as measured by the 12-month change in the core CPI has increased from below 1½ percent to just above 2 percent. The core price index for personal consumer expenditures (the core PCE price index) has been running about ½ percent below the core CPI and has shown a similar increase since 2003. Other broad-based price indices, especially those incorporating energy prices, have generally shown more of a pick up of inflation. Beyond the direct evidence that inflation has been picking up modestly, these inflation developments indicate that margins of slack have been used up, on average, across the US economy; if margins of slack were still significant, inflation rates should be falling, not rising. In addition, the index of capacity utilization has recently moved above its longer-term average. Measures of job vacancies are up, and more small businesses are reporting difficulty in finding qualified candidates for job openings. Most important, while there is no hard and fixed boundary below which the unemployment rate cannot fall without accelerating inflation, the recent decline to below 5 percent suggests very limited margins of remaining slack. When the unemployment rate fell below 4½ percent in 1999–2000 there were clear signs (with the usual lag) that inflation was picking up.

Recognizing the need to move from extremely easy monetary conditions to combat the recession and aid the initial stages of recovery to a neutral policy that would forestall an upsurge of inflation, the Federal Reserve progressively raised the target federal funds rate from 1 percent in June 2004 to 4¾ percent at the March 2006 Federal Open Market Committee (FOMC) meeting. The FOMC has indicated that further steps of monetary tightening may (or may not) be taken depending on what incoming data show about the performance of the economy and the evolution of inflationary pressures.

Evidence now is quite clear that the US economy re-accelerated in the first quarter of 2006, probably recording a real GDP growth rate of 4½ to 5 percent, after only 1½ percent growth in the fourth quarter of 2005. I expect that there will be sufficient momentum from the first quarter to support real GDP growth somewhat better than 3 percent for the second quarter, despite considerable weakening of residential investment. Indicators of inflation will probably neither be threatening nor particularly reassuring. In this situation, the FOMC will probably undertake one further 25 basis point tightening at its mid-May meeting.

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2 The original version of Okun’s law from the 1960s suggested that a 3 percentage point increase in actual output relative to potential output was associated with a 1 percentage point reduction in the unemployment rate. By the 1990s, the Okun’s law coefficient appeared to have declined to about 2 percentage points excess output growth above potential to generate a 1 percentage point reduction in unemployment. Even if the Okun’s law coefficient has declined somewhat further since 2000, it is very difficult to rationalize the decline of unemployment over the past three years with the idea that the potential output growth is above 3 percent.

3 In my view, the increases in the core CPI and core PCE price index understate somewhat the recent rise of inflation within the US economy. With respect to housing, which is an important component in both these price indices, an estimate of rental costs is used. Excluding home energy costs, rental costs are estimated to have been rising quite slowly, notwithstanding sharp increases in home prices. Indeed, rising home prices may have contributed to low estimates of rental costs by encouraging a shift from renting to buying and by inducing speculative building of rental units in expectation of later capital gains from conversion to owner occupation. Moreover, the core consumer price indices include prices of imported consumer goods (excluding food and energy). Prices of imported consumer goods do not reflect goods produced in the United States, and the subdued increases in the prices of many of these imported goods partly reflect unsustainable exchange rate policies of several Asian countries. Finally, in judging whether US monetary policy is contributing to an undesirable rise in inflation, it is relevant to pay some attention to the broad range of goods and services covered in GDP, beyond core consumer purchases. Taking this broader view, one sees somewhat more inflation in the US economy.
By late June, I expect that there will be indications of weakening in the growth of consumer spending, as well as significantly weaker residential investment. Assuming that there is no persuasive evidence of a pick-up of inflation, the FOMC will likely keep the federal funds rate at 5 percent and indicate that it is observing developments with careful attention to evidence of rising inflationary pressures. Since the FOMC has already undertaken considerable tightening, it will want to avoid tightening too much but will retain a slight upward bias in its policy statement in case further tightening appears to be needed.

Under my forecast, the real GDP growth will slow to about 2 percent during the second half of 2006. I expect that the Federal Reserve will keep monetary policy on hold through the end of the year. Yields on 10-year treasuries should move slightly above 5 percent to match increases in the federal funds rate and should move modestly higher through year-end as it becomes clear that inflation concerns will forestall any easing by the Federal Reserve. Also, rising longer-term yields in Europe and Japan will likely have some influence on longer-term US rates.

The slowdown of residential investment this year is already apparent in the data on home sales and housing starts and in the build-up of inventories of unsold new homes. A 10 percent drop in residential investment on a Q4/Q4 basis implies ½ percentage point subtracted from real GDP growth. The softening of home prices will probably not become an outright decline on a nationwide basis but will imply much smaller gains in household net worth than in recent years. This, in turn, will blunt the growth of real consumer spending, which on a Yr/Yr basis will slow to real growth of 2½ percent Yr/Yr (but below 2 percent on an annualized basis in the second half), following a 3½ percent gain in 2005. Business fixed investment will remain quite buoyant in 2006, spurred on by strong profits, good export growth, and the need to expand capacity in many industries. After the first quarter rebound, however, the US auto industry will suffer from weakening growth of consumer spending and the impact of high fuel costs on auto purchases.

Real government spending should post a moderate 3 percent gain in 2006. This gain reflects a rebound in defense spending from the unusual weakness of the fourth quarter of 2005, government investment spending for rebuilding in the wake of last year’s hurricanes, and solid increases in state and local government spending stimulated by rising revenues. The three components of real domestic demand (household consumption, private investment, and government spending) together are forecast to rise by slightly more than 3 percent for 2006 both on a Yr/Yr and Q4/Q4 basis.

Real net exports are projected to be about flat on a Q4/Q4 basis and to show only modest further deterioration on a Yr/Yr basis. The large, partly hurricane-related, deterioration in real net exports in 2005Q4 should be at least partially reversed. Fairly strong growth of US exports should be sustained by continued growth in the rest of the world. Growth in the volume of US imports should weaken somewhat as consumer spending grows more slowly, allowing export volume growth to exceed import volume growth by enough to keep real net exports from deteriorating further on a Q4/Q4 basis. However, increases in import prices (especially for energy) on a Yr/Yr basis that somewhat exceed increases in US export prices, together with the wide existing gap between the values of US imports and US exports, imply that nominal net exports (and the US current account balance) will worsen somewhat further in 2006. With real net exports effectively flat, real GDP growth for 2006 should match growth of real domestic demand.

For 2007, the baseline forecast is that real GDP growth will accelerate somewhat from the slowdown during the second half of 2006, and Q4/Q4 growth for next year will reach 2¾ percent—my new guess for the potential growth rate of the US economy. Residential investment will record another decline. Business fixed investment will be somewhat less buoyant, and real government purchases will rise somewhat less than they do this year. Real consumer spending will rise slightly more slowly than real GDP. Real net exports will record a slight improvement—aided by depreciation of the US dollar, which I expect will follow in the wake of the end the Federal Reserve tightening, continued firming of monetary conditions in Europe and Japan, and appreciations of the currencies of some Asian emerging-market economies.

Obviously, with fairly strong real GDP growth apparent (but not yet reported) for the first quarter of 2006, my forecast of slowing of real GDP growth to only 3 percent this year faces
significant risk of being exceeded. However, if growth this year is much above 3 percent, then unemployment is likely to fall further to near 4 percent, and the reasons for worrying about inflation are likely to become more acute. In that scenario, Federal Reserve tightening is likely to proceed beyond what I have assumed—to a federal funds rate of 5½ to 6 percent, which will tend to slow growth in 2007 by more than I have forecast.

There is a further important reason to believe that the growth rate of the US economy in terms of real domestic demand will need to slow below 3 percent in 2007 and beyond. The US current account deficit has expanded to enormous size and will probably soon need to start declining as foreign investors tire of accumulating US-based assets at such prodigious rates. In addition to depreciation of the US dollar (to help shift global demand toward US-produced goods and services), gradual reduction of the US current account deficit requires both a reduction of US domestic demand growth below the growth of US real GDP and an increase of domestic demand growth in the rest of the world above the growth rate of the rest of the world’s GDP. With the US economy now operating at potential, sustained slowing of US domestic demand growth below real GDP growth requires slowing below the rate of potential output growth. If as suggested, potential output growth is now 2¼ percent, US domestic demand growth would need to slow to no more than 2½ percent to secure even a very gradual reduction in the US current account deficit (as a share of US GDP).

Last year, US real domestic demand grew 3.6 percent. Holding domestic demand growth more than a percentage point below this rate in order to make room in the US economy for gradually improving real net exports will require a suitably firm US monetary policy. US fiscal policy should, but probably will not, take on part of this responsibility. These considerations suggest that the path of US interest rates over the next few years may be somewhat higher than is generally anticipated in financial markets.

The Rest of the Americas

The Canadian economy has performed very well in recent years, with Canadian real GDP expanding as rapidly as US real GDP over the past five years and slightly more rapidly over the past 10 years. Annual Canadian core consumer price inflation has averaged about ½ percentage point below the US rate over the past decade, and after rising slightly above 2 percent in 2001–03 has declined again about 1½ percent. Although persistently higher than in the United States, the Canadian unemployment rate has now fallen to a multidecade low. All indications are that the Canadian economy is operating at potential, and monetary policy is being carefully managed to avoid both overheating and undershooting.

The potential growth rate of the Canadian economy now appears to be about the same as that of the US economy. This is consistent with the observation that the Canadian unemployment rate tends to decline when real GDP growth runs 3 percent or higher. In view of the likely spillover effect from slowing growth in the United States, it is reasonable to forecast that Canadian real GDP growth will come in a little below 3 percent both this year and next.

Real GDP growth in the Mexican economy slowed from 4½ percent in 2004 to 3 percent last year. Tightening of monetary policy in Mexico from early 2004 through mid-2005, the slowing of growth in the US economy (Mexico’s principal export market), intense competition from Chinese and other Asian exports, and hurricane damage late last year all contributed to this slowdown in Mexican growth.

Recovery from the hurricane damage, the spillover from the first quarter rebound in US real GDP, and the effects of monetary policy easing since the middle of last year should boost Mexican growth early this year. The projected slowdown in the US economy after the first quarter, however, will negatively impact Mexican growth. On balance, there is little reason to expect that growth this year or next will differ much from last year’s 3 percent.

The Mexican presidential election this year adds an element of uncertainty, especially as the leading candidate at this stage is from the left and has not articulated a clear set of economic policies.
Nevertheless, Mexican monetary policy will likely remain very competently managed by the Banco de
Mexico, and there is little danger of fiscal policy going badly off-track as has occurred in the build up
to several earlier Mexican elections. The low yield spread on Mexico’s dollar-denominated debt
(recently about 125 basis points above 10-year US treasuries) may be somewhat vulnerable to
political developments. However, the combination of generally sound monetary and fiscal policies,
an appropriately flexible exchange rate, and a manageable public debt burden suggests that the risks
of a significant financial crisis this year or next is not large—although perhaps modestly greater than
indicated by the very low spreads on Mexican debt.

In Brazil growth last year fell to 2½ percent from nearly 5 percent in 2004. High domestic
real interest rates (to achieve the central bank’s ambitious inflation target), a strengthening currency,
and some spillover to business and consumer confidence from political scandals involving high
officials of the ruling party all contributed to the slowdown. With the Selic rate already down 3
percent from its peak last year and with more monetary easing probably yet to come, it is reasonable
to expect an acceleration of real GDP growth to 3½ to 4 percent for this year and next. However, to
be both safe and successful, further monetary easing needs to follow market sentiment that lower
domestic interest rates are appropriate—not try to force interest rate declines that the market views
as unsustainable. From this perspective, the recent resignation of Brazil’s highly effective finance
minister and his replacement by someone less clearly dedicated to fiscal responsibility is not a
positive development.

Despite the scandals, President Luiz Inacio Lula da Silva appears likely to be re-elected this
year. Some easing of Brazil’s fiscal policy is likely in the build-up to the election and in a second Lula
term, but reasonable fiscal discipline will likely be maintained by a Lula administration. Election of a
candidate to Lula’s left is implausible, and election of a candidate to Lula’s right is unlikely to imply
serious policy deterioration. If these assumptions proved inaccurate, however, the markets would
probably become more concerned about the risks of another crisis in Brazil—and rightly so.

Argentina enjoyed another year of stronger-than-expected growth (9 percent) in 2005, but
inflationary pressures were clearly picking up. Despite controls on many important prices and other
government efforts to suppress price increases, inflation rose to 12 percent last year—double the
measured rate in 2004. Against market pressures for appreciation (which would have helped contain
inflation), the exchange rate of the Argentine peso was pushed down against the US dollar in order to
offset the dollar’s rise versus the euro and maintain a highly competitive real effective exchange rate
of the peso.

These policies of inflation suppression and exchange rate undervaluation are neither
desirable nor sustainable in the longer term. For this year and probably through 2007, however, the
Argentine authorities can probably continue to get away with this nonsense. Thus, it is reasonable to
expect some slowing of Argentina’s real GDP growth from the very rapid rates of the past three
years—down to still respectable 6½ percent growth this year and to 4 percent growth next year.

Elsewhere in Latin America, the Chilean economy should continue to advance at a 5 to 6
percent rate, and Colombia should manage about 4 percent real growth. Venezuela will continue to
benefit from high world oil prices, although growth should be expected to slow somewhat as the
effects of the bounce-back from the severe recession of 2002–03 wear off. Overall, growth in Latin
America this year should nearly match the 4¼ percent result for 2005 and should be only modestly
lower for 2007.

Asia

In the ranking of regions using countries’ real GDP aggregated at PPP-based measures of exchange
rates (as set forth in the World Economic Outlook), Asia ranks as the largest region with 36 percent of
world GDP, followed by the Americas with 30½ percent. Asia’s emerging-market economies, led by
China and India, have a weight of 28 percent in world GDP, with Japan, Australia, and New Zealand
making up 8 percent of world GDP. Because Asia’s emerging-market economies have high growth
rates in comparison with the industrial countries and (to a lesser extent) with developing countries in
other regions, they play a particularly important role in determining the growth rate of world GDP—accounting for about 40 percent of world GDP growth in recent years.

Before 1990, Japan was typically the most rapidly growing industrial country, usually by a significant margin. During the 12 years following the collapse of the “bubble economy,” Japan managed barely 1 percent annual average real GDP growth—the slowest of any industrial country. During the past three years, Japan has finally started to pull out of its long stagnation, with real GDP rising by 1¼ percent in 2003, 2¼ percent in 2004 and 2¼ percent in 2005. Seven years of (mild) price deflation also appear to be ending, with consumer prices recently showing modest increases on a 12-month basis. Real estate prices (in Tokyo) have also begun to rise after more than a decade of persistent and substantial decline.

The very strong 5½ percent annualized growth rate in the fourth quarter of 2005 is likely to see some payback in terms of slower growth in the first quarter of 2006. Nevertheless, Japan appears likely to realize at least 2½ percent real GDP growth for 2006.

Prospects for 2007 and beyond depend to an important degree on the potential growth rate of the Japanese economy and on the remaining margin of slack between the levels of actual and potential output. Japan’s labor force and now even its population are shrinking. Productivity growth during the past decade has been rather slow. Estimates of the potential growth rate of the Japanese economy indicate that it is surely no greater than 2 percent and perhaps not much above 1 percent. The decline of the Japanese unemployment rate from (a postwar peak of) 5½ percent four years ago to 4½ percent today is consistent with the notion that potential growth is about 1½ percent per year. Estimates of the level of Japanese potential output from a few years ago suggest that the Japanese economy is already operating somewhat above the level of potential output, and there are some indications that Japanese industries are reaching supply constraints. It is probably too pessimistic to conclude that the Japanese economy is already operating at the level of potential output. But, the forecast of another year of actual GDP growth 1 percentage point above the potential growth rate is consistent with an assessment that slack would be virtually eliminated within a year or so. This suggests that growth for 2007 might be somewhat below that for 2006, and beyond 2007 Japanese real GDP growth will average around the potential growth rate of 1½ percent.

Recent evidence of the end of deflation in Japan has led the BOJ to announce an end to its policy of quantitative easing to be implemented over the next few months. This is expected to be followed by a move away from the BOJ’s zero interest rate policy sometime this summer. Assuming that the Japanese economy performs as anticipated this year, the BOJ’s policy interest rate appears likely to be raised to about 50 basis points by year-end. Yields on 10-year Japanese government bonds (JGBs) have already climbed back to 1.8 percent and will probably rise to somewhat above 2 percent by year-end. Nevertheless, with modestly positive inflation, Japanese real interest rates will remain quite low, and if the exchange rate of the yen remains near its present highly competitive level, overall financial conditions will stay quite accommodative.

As it becomes clear that the US Federal Reserve has ended its present cycle of tightening and that the BOJ is firmly launched on its cycle of gradual tightening, the yen is likely to appreciate against the US dollar. Indeed, although interest rate differentials are typically poor predictors of future exchange rate changes, it is noteworthy that the present difference in yields between 10-year US treasuries and 10-year JGBs is consistent with more than a 30 percent nominal appreciation of the yen against the dollar over the next decade.

Yen appreciation of roughly this magnitude, accompanied by appropriate adjustments of other exchange rates against the dollar and by other essential macroeconomic adjustments in the United States and the rest of the world will be needed over that time span to reduce present international payments imbalances to more sustainable levels. However, yen appreciation of much more than 15 percent (to below 100 yen to the dollar) over the next year or so could undermine the present Japanese economic recovery, especially if not accompanied by significant appreciation of other Asian currencies. The Japanese authorities will need to manage carefully the pace of monetary and fiscal tightening, with an eye on exchange rate developments, to keep the Japanese economy on
track. This will probably require some slowing of Japan’s real GDP growth from its recent pace, together with less of a slowing of domestic demand growth in Japan.

In contrast to Japan, the Chinese economy has maintained very high (although variable) growth rates for many years, and recent data revisions have pushed up previous estimates of growth over the past decade by an average of about ½ percentage point each year. For 2005, the revised data indicate Chinese real GDP growth of 10 percent. This overall outcome, however, involved a slowdown in domestic demand growth to about 8 percent, offset by a 2 percent contribution to GDP growth from improvement in China’s real net exports. In 2004, there was also a significant positive contribution to Chinese real GDP growth from improvement in net exports, although this contribution was somewhat smaller than for 2005. In contrast, during the preceding decade, when real GDP was growing at an average rate of about 10 percent, net exports generally contributed little to GDP growth; Chinese exports and imports were nearly equal and grew equally rapidly.

During 2005, Chinese policy shifted to encourage more rapid growth of domestic demand (including consumption), and this policy seems to be producing some of its intended result. Some forecasts for the Chinese economy envision that this policy will be so successful that real GDP growth will be sustained at about 10 percent while the trade surplus begins to contract. I suspect that this will not happen. Domestic demand growth will pick up, but real GDP growth will slow by a percentage point or so this year and next. The Chinese trade surplus will not shrink, but it will show little further expansion. Aside from developments in China itself, tolerance for further significant expansion of the Chinese trade surplus in other countries (including the United States and Europe) is limited.

The Indian economy appears to have turned in about 7½ percent real growth in the fiscal year just ended, and continued growth of 7 percent or so appears reasonable for fiscal 2006. In contrast to China, however, India’s trade balance has worsened significantly over the past two years to reach a deficit of about 6½ percent of GDP, partly due to increased costs of energy imports. The current account shows a much smaller deficit of about 2 percent of GDP, but this is down from a surplus of a similar scale in fiscal 2003. Capital inflows and remittances generally provide adequate financing for the trade deficit, but the rupee exchange rate has been under some pressure. The Reserve Bank has also indicated some concern with rising inflation. The government’s decision to liberalize India’s international capital market controls probably also implies some upward pressure on domestic Indian interest rates and on the cost of servicing the government’s substantial debt. A foreign exchange or financial crisis does not appear to be a significant risk, but some slowing of the economy’s growth rate in the next two years is likely.

For the rest of emerging Asia, growth slowed from 6 percent in 2004 to a still respectable 5 percent in 2005. Most of the larger economies (above $100 billion in annual GDP) grew more slowly in 2005, with growth in Indonesia strengthening slightly. In Singapore and Taiwan, growth slowed by more than 2 percentage points from quite high rates in 2004. In 2006, growth rates for countries in this group are likely to run in the range between 4 and 5 percent, with a decline of about ½ percentage point in the average growth rate for the group. This modest slowdown reflects the likely effect of higher energy prices and somewhat less buoyant export growth (especially to the United States). Growth in South Korea may pick up a little (despite the substantial impact of higher energy prices) as the effects of the collapse of the consumer debt bubble recede. In contrast, Hong Kong is likely to grow more slowly after two very strong years.

The Australian economy is operating at potential, with a continuing boom in the extractive sector (which employs relatively few workers). The Reserve Bank is carefully adjusting its policy to contain risks of either inflationary overheating or an unnecessary slump. Real GDP growth of about 3 percent should be expected as the successful outcome of this effort. New Zealand’s GDP is only about S$S 100 billion, and accordingly its economic performance matters little for world GDP. Nevertheless, the economic situation is quite interesting and challenging from a policy perspective. Real GDP growth fell to about 2½ percent in 2005 and appeared to be slowing in the second half—after averaging better than 4 percent the preceding three years. The current account deficit is now above 8 percent of GDP, and by any reasonable assessment the exchange rate of the New Zealand
dollar is overvalued despite the significant depreciations that have already occurred this year. Inflation has been running above the Reserve Bank’s 1 to 3 percent target range, and at 7¼ percent the policy interest rate is the highest among industrial countries. Foreign investors in New Zealand bonds who have been attracted by high domestic interest rates have been getting nervous about further exchange rate translation losses. The recent crisis in Iceland seems to have heightened these worries. The Reserve Bank is concerned both about the weak economy and about the possibility that depreciation could push inflation meaningfully above its target. For New Zealanders and devotees of inflation targeting, it will be interesting to see how this situation evolves.

Europe

In the WEO weighting scheme, the 12 countries of the euro area account for 15.3 percent of world GDP (Germany 4.3 percent, France 3.1 percent, Italy 2.9 percent, Spain 1.7 percent, and the other six 3.2 percent). For the euro area as a whole, growth has been quite disappointing in recent years, averaging only 1.4 percent per year for the past five years—more than a percentage point below the average annual growth rates of Australia, Canada, the United Kingdom, and the United States and even slightly lower than Japan. \(^4\) Meanwhile, for every year since 1999, when the euro was established, inflation in the euro area, as measured by ECB’s key price index (which does not exclude food and energy), has been running slightly above the ECB’s announced objective that inflation should be below (but close to) 2 percent. To add to the embarrassment, the growth rate of the key monetary aggregate monitored by the ECB as the “second pillar” of its monetary policy has also exceeded its prescribed range for every year since 1999.

For 2005, the early promise of stronger growth in the euro area was disappointed by weakening in the second half, and growth for the year reached only 1.4 percent, following a 1.8 percent rise in 2004. Once again, most forecasts now anticipate that 2006 and 2007 will see some pick up in euro area growth, with headline inflation expected to continue to run at or barely above the ECB’s desired ceiling. The expectation of some pick-up in euro area growth this year, but sluggish growth in the fourth quarter of 2005 and the lack of evidence of a substantial acceleration in the first quarter of 2006, suggests that an outcome much above 2 percent looks unlikely at this stage. Moreover, while there is clearly slack in the German economy and some slack for the euro area economy as a whole, the situation in several other countries suggests that remaining margins of slack may be rather limited. The ECB’s concern with pushing inflation below the official ceiling (after six years of embarrassment) and the policy pursued in light thereof portend little likelihood of much economic acceleration in 2007.

In Germany, business confidence has recently risen to peaks not seen in many years, on the back of strong export and profit growth and a buoyant equity market. There seem to be gains in business fixed investment after several years of significant declines. So far, however, private consumption in Germany has shown little recent buoyancy, after four years of virtual stagnation. It remains to be seen how much German investment can advance if the German consumer does not soon get into the game. Nevertheless, all things considered, it is reasonable to expect German economic growth to pick up from barely 1 percent Yr/Yr in 2005 to 1½ to 2 percent for 2006, with a similar outcome expected for 2007.

In Italy, growth over the past five years has been as sluggish as in Germany—an annual average real GDP gain of only ¾ percent. Domestic demand growth, however, has been a little stronger in Italy (about a 1 percent average annual rise for Italy versus a ¼ percent annual decline for Germany), but this has been offset by deteriorating trade and current account balances for Italy versus sharply improving trade and current account balances for Germany. In 2005, there was virtually no real GDP growth in Italy, while the German economy showed some signs of life with growth of just over 1 percent.

\(^4\) Euro area growth has been below most economic forecasts for every year from 2002 through 2005—including my growth forecasts, which have tended to be a little more optimistic than the average forecast.
In several respects, the Italian economy appears to be in worse shape than Germany as far as its growth prospects are concerned. Despite five years of very weak growth, the unemployment rate in Italy has come down by 1½ percentage points, wages have risen moderately, and productivity growth has been abysmal (a cumulative decline of 4½ percent over the past five years). In Germany, the unemployment rate is up 2 percentage points over five years, wage increases have been subdued, and productivity growth has been quite rapid. Inflation in Italy, both headline and core, has been running slightly above the euro area averages while both inflation rates in Germany have averaged about ½ percent below those of the euro area. Thus, Italy has been losing international cost competitiveness while Germany has been regaining it. Unit labor costs are up cumulatively 20 percent in Italy and down cumulatively 4 percent in Germany over the past five years (compared with a modest 5 percent cumulative rise for France, 2 percent for the United States, and about the same for the United Kingdom). In Germany, there appears to be a significant margin of slack, which will allow actual growth to exceed potential growth (of about 1½ percent per year) for a while as the actual level of output catches up with the level of potential. In Italy, if one takes the performance of the past five years at full face value, there appears to be little or no margin of slack, and the potential growth rate of the Italian economy appears to be not much above zero.

Nevertheless, it is reasonable to expect that growth will modestly improve from zero in 2005 to perhaps ¾ percent for 2006. I see no reason to expect much better in 2007. Likely developments in Italian economic policy, whoever wins the election, are not a cause for optimism.

With 1½ percent annual average real GDP growth over the past five years, France has done distinctly better than Germany and Italy and marginally better than the euro area average—although well behind the United States, the United Kingdom, Canada, Australia, and some of the smaller members of the euro area. Real domestic demand in France has advanced at a 2 percent average annual rate over these five years, but a deteriorating trade balance (partly reflecting weak demand growth elsewhere in the euro area) has drained off about one-quarter of the impact of this demand growth on French GDP. French inflation rates have run about in line with euro area averages. The French unemployment rate is about 1 percent above its low in 2000 but (thanks partly to government employment schemes) is down ½ percentage point from recent highs.

On balance, these facts suggest that the French economy has a potential growth rate of 1½ to 2 percent, and a modest margin of slack allows for growth above the potential rate for a year or two. Last year, French real GDP advanced only 1½ percent. Unfortunately, there is little reason to expect much of an increase in growth this year or next. Higher energy prices are a negative factor, exports to the rest of Europe are unlikely to increase more rapidly, consumer and business confidence are unlikely to respond positively to the recent round of protests and strikes, and by next year tighter ECB policy may begin to bite. Growth of 1¼ percent is a reasonable forecast for 2006 and 2007. This forecast appears to be about in line with a subdued but realistic assessment of the potential growth rate of the French economy.

The Spanish economy has been growing at nearly double the average rate for the euro area over the past five years, with domestic demand growth significantly outpacing output growth for the past three years. Headline inflation has also run about 1 percent above the euro area average, but the GDP deflator for Spain has been rising twice as fast as the euro area average. The unemployment rate is now down to 8½ percent, 2 percentage points below its previous low in 2001, 3 percentage points below its recent peak in 2003, and not much more than one-third of its spectacular level a decade ago. Not surprisingly, Spain’s trade balance has deteriorated enormously over the past few years and now amounts to almost 9 percent of GDP.

All of this points to a Spanish economy that is beginning to overheat rather seriously but where the effects of overheating are muted by Spain’s participation in the euro area. Consumer price inflation is kept only moderately above the euro area average because of the effect of prices of goods imported from lower-inflation countries in the area. The larger excess of Spanish inflation over the euro area average indicated by GDP deflators is more revealing of the overheating in the Spanish economy. Longer-term nominal interest rates on Spain’s euro-denominated debt have only modest premiums over nominal yields on German bunds, reflecting limited assessed risks of Spanish default
and the security of the euro. Real interest rates on Spanish longer-term debt measured using Spanish (actual or expected) inflation are well below real yields on bunds using German inflation. This low real yield on Spanish longer-term debt, however, is one of the reasons why the Spanish economy is overheating—not an indication that overheating is not happening.

If Spain were not in the euro area, I would forecast a crisis—either this year or next. As things stand, I believe that something will have to happen within the next three years or so to end or substantially reduce the degree of overheating in the Spanish economy. It is difficult to predict what will happen and when. However, it is prudent for forecasts of growth of the Spanish economy in 2006/2007 to take account of the chance that this correction may come sooner rather than later.

The economic situation and the economic prospects in the other eight countries of the euro area (whose GDPs aggregate to that of France) are mixed. The economy of the Netherlands has been growing very slowly in recent years (below even the meager growth rates of Germany and Italy over the past five years). Recently, the economy has perked up, and growth of about 2 percent is reasonable for this year and next. Portugal’s performance in recent years is similar to that of the Netherlands. With somewhat less confidence, there is reason to expect a modest pick-up of growth. Austria, Belgium, and Luxembourg have been performing at about the euro area average and may be expected to continue to do so. Finland, Greece, and Ireland have continued to grow more rapidly than the euro area average. Modest narrowing of this growth gap is forecast for 2006 and 2007.

Fiscal policy in the euro area is generally on hold, with no likely impact on growth. Government budgets are generally not in a situation that permits expansionary policy moves, and Germany plans a modest tightening. Even those countries that are in breach of the Stability and Growth Pact will be reluctant to take strong measures of fiscal consolidation.

The ECB started making monetary policy less accommodative late last year with a 25 basis point increase in its repo rate on December 1. This move was followed by another 25 basis point rise on March 2. If the euro area economy grows at a 1½ to 2 percent rate and headline inflation remains near the ECB’s ceiling, I expect that the ECB will continue to raise its policy rate at the pace of about 25 basis points per quarter. Over the coming year, this rise will take the repo rate to 3.5 percent, a little below the present yield on the 10-year German bund. At about that point, the ECB will probably judge that it has removed most monetary accommodation and is reasonably near a neutral policy. Further tightening will occur if the economy is growing meaningfully above 2 percent or especially if inflation is running above the ECB’s ceiling.

This is a reasonable policy. The present repo rate of 2.5 percent still represents an accommodative monetary policy. Recognizing the usual lag in the effect of monetary policy adjustments, gradual firming to a 3.5 percent repo rate over the next 9 to 12 months would still leave some effect of monetary accommodation operating on the euro area economy in 2007. Despite overheating in Spain, a positive margin of slack exists in the euro area economy, and even a quite pessimistic assessment would not conclude that the potential growth for the euro area is less than 1¼ percent. Although the concepts of “margin of slack” and “potential growth rate” are somewhat slippery, difficult to quantify, and not favored by the ECB, it is clear that the ECB does not want to undermine what appears likely to be a modest-paced economic recovery in the euro area with overly aggressive monetary tightening. If and when the ECB’s primary objective of price stability appears to be under some meaningful threat, then the ECB will move aggressively.

All things considered, with energy prices remaining about where they are today, headline inflation in the euro area will ease somewhat below 2 percent this year and next. The ECB will pursue a gradual path of monetary tightening, taking the repo rate to 3½ to 4 percent over the next year and a half. Growth in the euro area will pick up modestly from 1½ percent in 2005 to 1¼ to 2 percent in 2006 and 2007. This growth forecast is shaded slightly to the downside because of the risk of something happening in the overheating Spanish economy.

In the United Kingdom, real GDP growth slowed to 1¼ percent last year (after more than a decade of growth of at least 2 percent and generally higher). The slowdown was partly a response to the Bank of England’s efforts to avoid overheating and the consequent cooling in the housing market. All indications are that the UK economy is now operating at its potential level of output,
with unemployment up only slightly from multi-decade lows and with inflation running just in line with the Bank of England’s target.

The potential growth rate of the UK economy is probably a little above 2 percent. Growth both this year and next appears likely to match potential. An outcome that appears to be meaningfully above or below potential growth would probably be associated with expected inflation performance that is above or below, respectively, the Bank of England’s target and would provoke a corrective policy reaction.

Elsewhere in Western Europe outside of the euro area, the Swedish economy has grown at nearly a 3 percent average rate over the past decade. After a slowdown in 2001–03, the Swedish economy rebounded to 3½ percent growth in 2004 and then slowed modestly to 2½ percent growth last year. Despite inflation remaining very subdued (below 1 percent over 12 months), the Riksbank has raised its repo rate by 50 basis points to 2 percent so far this year. However, with inflation expected to remain below 1 ½ percent this year, the Riksbank may well lag behind the ECB in its future pace of monetary tightening. Real GDP growth of about 3 percent is reasonable for this year, with the expectation that there will be a slight slowing to about 2½ percent growth next year.

The Danish economy has been growing about 1 percent slower than the Swedish economy for the past decade but accelerated above the Swedish growth rate in 2005. This is not expected to last. Danish growth this year and next will probably be modestly below the Swedish standard.

The Norwegian economy (excluding North Sea oil production) has turned in solid 3½ percent real growth for the past two years, after two years of very sluggish growth. Growth of 2½ to 3 percent, in line with Norway’s potential growth rate, is likely for 2006 and 2007.

The Swiss economy has been very sluggish in recent years, doing only marginally better than Germany, and like Germany picking up modestly in the past two years. Growth of about 2 percent now seems likely for Switzerland, although a slightly better outcome would not be surprising.

The tiny Icelandic economy, which has grown at nearly a 5 percent rate for the past three years, is now experiencing a financial crisis. The business empire of one of Iceland’s richest men is in trouble. Icelandic banks, which have expanded rapidly in recent years, are finding difficulty in rolling over their credits from foreign banks. The Icelandic krona has depreciated sharply, and the central bank has responded in classic fashion with an increase in interest rates.

The Icelandic economy will probably see recession this year, which will matter primarily to the less than 300,000 Icelanders (with a GDP of only $10 billion at PPP-based exchange rates). Nevertheless, it is noteworthy that the Icelandic crisis has reverberated almost half a world away in New Zealand, whose economic situation bears some analogy to that of Iceland. Apparently, the mechanisms of financial crisis contagion that became so familiar in a host of emerging-market crises of 1995 to 2002 are not defunct and can also operate on industrial countries (at least smaller ones).

Central and Eastern Europe

Central and Eastern Europe including the former Soviet Union accounts for 7 percent of world GDP using the WEO weighting scheme. Russia has the largest economy accounting for 2.6 percent of world GDP. Rapid growth of the Russian economy in recent years has contributed importantly to the overall strong performance of the region. Last year, Russia’s economic growth slowed modestly from over 7 percent in 2004 to about 6½ percent. With world energy prices remaining high, growth at about this pace appears likely for this year and next. In the long term, however, one will need to see how uncertainties concerning property rights and the deep-seated problems of corruption and crime affect the Russian economy’s continuing progress.

Elsewhere in the former Soviet Union, the Ukrainian economy slowed considerably last year after two years of very strong performance. Some pick up of growth this year and next, to the range of 4 to 6 percent, is a reasonable guess. Internal political difficulties and problems with Russia, as well as considerable corruption, however, impair prospects for better performance. With continued high energy prices and an apparently stable but authoritarian regime, Kazakhstan should continue to see strong growth of about 8 percent. The small Baltic States continue to grow quite strongly, with
inflation generally under reasonable control. Large current account deficits (relative to GDP), which are being financed by capital inflows, however, raise some concerns about the sustainability of growth and about the exchange rates at which these countries might enter the eurozone.

As expected, real growth of the Turkish economy moderated last year to about 5½ percent after nearly 9 percent growth in 2004. The economy appeared to be picking up momentum in the second half of last year, and growth of 5 to 6 percent looks reasonable for this year and next. After decades of high inflation (exceeding 100 percent in some years), Turkey has succeeded over the past five years in finally bringing the annual inflation rate into single digits, with consumer prices rising about 8 percent in both 2004 and 2005. The central bank has recently announced that it will adopt an inflation targeting regime, with the initial objective of bringing the inflation rate down to 5 percent (plus or minus 2 percent) by the end of this year. Meanwhile, the budget remains in good shape. Aided by falling interest costs, the overall public-sector deficit has fallen to 3½ percent of GDP, and the primary budget (excluding interest costs) remains in substantial surplus.

Nevertheless, there is concern that the Turkish economy could hit a bump sometime in the next couple of years. Partly due to higher energy import costs, the trade and current account balances have deteriorated significantly over the past couple of years, with the current account deficit reaching 7 percent of GDP last year. Meanwhile, the real effective exchange rate of the Turkish lira has appreciated substantially and now appears significantly overvalued. Interest rate spreads on Turkey’s considerable foreign-currency debt have come down to 200 basis points, but at that level they may be vulnerable either to increasing concerns about economic or political developments in Turkey or to generally rising global interest rates. Turkish politicians are playing games concerning who will be the next head of the central bank. Formal discussions about Turkey’s entry into the European Union have been authorized, but when or even whether negotiations will reach a successful conclusion is subject to considerable uncertainty.

In Central Europe (Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Croatia, Romania, Bulgaria, and the small Baltic and Balkan countries), growth was about 5 percent in 2004 and slowed to about 4½ percent last year. Growth of about 4½ percent appears to be a reasonable prospect for this year and next.

Specifically, for Poland (the largest of these economies), growth slowed last year to slightly more than 3 percent after better than 5 percent growth in 2004. A modest rebound to about 4 percent real growth now seems likely, despite a confused political situation. Inflation remains well contained, the public-sector deficit has been reduced to manageable proportions, the current account deficit is not threatening, and the exchange rate does not appear to be seriously out of line with fundamentals. Similar comments apply to the Czech Republic and Slovakia, with perhaps slightly more optimism concerning growth and a little more clarity about the political situation. For Hungary and Romania, growth prospects also appear to be in the 4 to 5 percent range, but there is significant concern about burgeoning current account deficits. Policy measures to address these imbalances, or possible crises from the failure to do so, could be significant negative shocks to growth within the next couple of years.

The Middle East and Africa

After more than two decades of generally mediocre or very poor performance, both the Middle East and Africa have done much better over the past three years, turning in annual average growth of more than 5½ percent for the Middle East and more than 4½ percent for Africa. Rising world oil prices and rising prices for other commodity exports important for these regions are, of course, a key part of the story; but that is not all.

The main economies in these two regions are generally doing quite well, even those that are not so highly dependent on oil and other commodities. South Africa has been growing in the 4½ to 5 percent range and looks likely to continue at that pace. The Israeli economy has picked up again as the security situation has improved. Egypt’s growth has accelerated to 5 percent and appears sustainable at about that pace for at least the next year or so. Thanks, partly but not exclusively, to
high oil prices, Nigeria’s economy has been growing much more strongly for the past three years than in the preceding decade, and assuming that recent troubles in the oil sector are rapidly resolved, growth rates of 5 percent or better are reasonable for this year and next. Despite the controversy surrounding its nuclear program and many internal economic problems, the Iranian economy continues to report solid growth (which could be hurt if international sanctions were strengthened). With the exception of a stumble last year in Morocco, the more diversified economies of North Africa are doing reasonably well. And, the countries that are heavily dependent on oil exports, especially Saudi Arabia, the United Arab Emirates, and Kuwait, have also seen significant progress in their nonoil sectors.

Aside from the deepening disaster in Zimbabwe, the economic stagnation in Côte d’Ivoire, and the tragedy in the Darfur region in Sudan, Africa has been relatively free of both natural and man-made catastrophes, which have heavily affected growth in this region in many earlier years. In the Middle East also, military conflict and civil unrest are much less of an economic drag than they have often been in the past. Even the Iraqi economy is reported to be growing despite daily reports of continuing violence.

All things considered, economic growth in both Africa and the Middle East appears likely to continue for a while at about the 5 percent rate of the past two years. For both regions, this growth is a vast improvement over the average performance of the past 20 or 30 years.

The Boom in Emerging-Market Finance

The spectacular gains that many investors in emerging-market debt and equity instruments have enjoyed in the past couple of years are unlikely to continue for very much longer. Interest rate spreads for most of the larger emerging-market borrowers have already narrowed to an extent that prospects for further narrowing are quite limited, and interest rates in the main industrial countries (against which emerging-market spreads are measured) are probably headed upward. This does not mean that a crash is imminent for emerging-market bonds. Investors can expect to earn moderate premiums over yields on higher-quality credits of industrial-country issuers, but the big gains of recent years on the credits of big emerging-market debtors will not recur.

For emerging-market equities, the picture is more mixed for both recent performance and future prospects. Obviously, spectacular gains of over 100 percent recorded in some markets in 2005 are unlikely to be repeated. However, valuations in a number of emerging equity markets do not appear to be exceptionally high, and large gains in traditionally volatile markets (and in individual stocks) are surely still possible despite recent advances.

Turning to the risks of financial crises in emerging-market countries, it was possible to assess in 2003 that these risks were likely to remain low through 2004 and 2005. Except for a few possible cases (such as Hungary), 2006 now also looks quite safe. Risks are likely to escalate moderately in 2007 as the external financing environment for emerging-market countries turns somewhat less favorable and as individual emerging-market countries have more time to develop vulnerabilities. However, the stage is not set for another series of devastating crises like those in 1995 through 2002.

In Asia, aside from Pakistan and possibly the Philippines or Indonesia, there are no good near-term candidates for a financial crisis. Growth has been and will likely remain at least reasonably good. Current accounts are generally in substantial surplus. Foreign exchange reserves are large (in some cases gigantic). Exchange rates are not overvalued. The banking system has substantial problems in China, but this is not a near-term threat. Thailand may be building up some problems with its budget and current account, but any serious risk of crisis looks to be at least a couple of years away. For Pakistan, the political risks cannot be ignored. Indonesia and the Philippines are now doing quite well, but the long-term record for the Philippines and the instability of recent years for Indonesia suggest continued scrutiny for any signs of renewed problems.

With a bonanza from oil and gas revenues feeding into the current account and the budget, Russia is clearly not a candidate for another financial crisis anytime soon, although the equity market might be vulnerable to some correction after recent strong gains. Turkey is somewhat more worrying
because the trade and current accounts are in substantial deficit, the exchange rate appears overvalued, and the debt ratio (although reduced) is quite high by developing-country standards. However, so long as growth remains robust and the impressive progress in reducing inflation is sustained, Turkey is an unlikely near-term candidate for a crisis. Hungary has outsized budget and current account deficits, and a crisis there might actually be helpful to focus the government on the need to address these issues. With an appropriate and prompt policy response, such a crisis would probably involve relatively little economic and financial damage (as was the case with the crisis in the Czech Republic in May 1997). Most other Central and Eastern European countries (except possibly Romania) do not have indicators that suggest high risks of near-term crisis. Egypt faces important longer-term political risks, but there is little indication of likely near-term problems. South Africa looks secure as far as risks of any near-term financial crisis are concerned, although equity valuations may be at risk in the event of a tumble in global commodity prices.

In Latin America, Argentina’s efforts to contain inflation through price controls are doomed to failure in the medium term, and the substantial back-loading of interest payments on most government debt hides longer-term fiscal problems. However, another financial crisis in the next year or so looks unlikely. Foreign investors in Brazilian debt and equity did very well again in 2005, despite relatively weak economic growth and the political scandals. With inflation now quite low (especially by Brazilian standards), domestic interest rates coming down, and some possibility of an easing in the exchange rate of the real, Brazilian economic growth should pick up. Government debt, particularly foreign currency–linked debt has been reduced (relative to GDP). Despite the scandals, President Lula looks secure from a political challenge from his left—helpfully containing possible risks from potential followers of the Hugo Chàvez/Evo Morales style of populism. Chile remains very sound. Peru is more worrying. Ecuador is vulnerable if oil prices fall substantially. Spectacular recent gains in Colombian equities suggest possible valuation concerns. Venezuela has Chàvez but apparently can afford him for at least a while longer if oil prices remain high. Mexico possibly warrants somewhat more skeptical attention—not so much in absolute terms but relative to the rosy assessment now in financial markets.
Table 1 Real GDP growth rates (percent change, year-over-year)

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