

## **Global Economic Prospects 2007/2008: Slowing to Sustainable Growth**

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Led by the surging Chinese and Indian economies and supported by solid performance in most industrial and emerging-market countries, world real GDP growth reaccelerated to over 5 percent in 2006. With a significant slowdown now apparent in the US economy and with most of the rest of the world economy operating at near, or even somewhat above, potential, some slackening in the pace of global economic advance—down to about 4½ percent—is now virtually certain for 2007 and 2008.

The danger of entering recession over the next year or so has gone up in the United States to roughly double its normal level but does not exceed Alan Greenspan's recent suggestion of only about a one-third chance. A mild bout of stagflation is a more likely prospect. Elsewhere in the world, there is also some concern about a modest pick up in core inflation, but there is less reason to worry, at least so far, about a substantial economic slowdown. Thus, all things considered, there is reason for optimism that the current global economic expansion that has sustained a remarkable four consecutive years of better than 4 percent real growth will continue for at least another two years.

Aside from the specific risks to economic performance in individual countries, such as the housing correction under way in the United States, four important risks cloud the general picture for global growth over the next two years. First, world commodity prices are highly volatile and oil prices, in particular, are vulnerable to political risks. Commodity-exporting countries that have done very well in the strong price environment of recent years would feel the adverse effects of a sharp drop in commodity prices. On the other hand, a further upsurge in commodity prices, especially for energy, would adversely impact importing countries by pushing up costs and impeding growth.

Second, and probably more important, as inflation pressures have picked up somewhat in many countries, central banks have tightened their policies to guard against overheating. Such actions are essential to preserve and prolong the present expansion, but they necessarily carry with them a

two-sided risk. If tightening is too aggressive, it will unnecessarily slow growth too much in the near term. If tightening is not aggressive enough, inflation pressures will rise, necessitating greater tightening later and deepening the risk of an even greater slowdown. So far, the world's leading central banks appeared to have played this game very successfully; but sometime, somewhere, somebody may make a mistake.

Third, global equity markets have advanced strongly over the past two years, reflecting solid economic growth, rising corporate profit shares, and (despite significant tightening by many key central banks) continued low long-term interest rates. Meanwhile, both interest rate spreads for traditional high-risk borrowers and measures of asset price volatility have narrowed to an unprecedented degree. The recent bout of global asset market turbulence initiated by a sudden selloff in the Chinese stock market serves as a useful reminder that these favorable asset market developments may not endure forever. If the improvement in fundamentals driving the advance in equity values and the contraction of risk spreads were to reverse or even stagnate, global asset markets could sell off with adverse implications for consumption and investment.

Fourth, international payments imbalances continue to grow with a small further widening of the US current account deficit to 6½ percent of US GDP, an upsurge in the surpluses of oil-exporting countries, and a stupendous increase in the Chinese current account surplus to an estimated 9 percent of GDP in 2006 with further increases clearly in train for 2007. Recent data indicating some improvement in US real net exports, together with the reasonable expectation that the surpluses of oil exporters will erode as they gear up spending, support my assessment that a gradual winding down of international payments imbalances is likely to occur over the next few years in a manner that is not highly disruptive for foreign exchange and financial markets or seriously damaging for global economic growth.

However, progress on key policy adjustments that are necessary and desirable to contribute to an orderly reduction of payments imbalances to sustainable proportions—especially on the issue of Chinese exchange rate policy—has been inadequate. If the deficits and surpluses of the countries with the largest imbalances continue to expand in an environment of slowing economic growth, the threat of a counterproductive protectionist reaction cannot safely be ignored.

## **The Americas**

After an anticipated rebound in the first quarter of last year, the growth rate of the **US economy** slowed (as forecast a year ago) to between 2 and 2½ percent for the final three quarters of 2006. Growth in the first quarter of 2007 (just concluded) looks likely to be somewhat under 2 percent

annual rate, with the correction in home building continuing to be an important drag. Growth prospects for the second quarter look no better.

By the second half of this year, however, most of the downward correction in new home building should be behind us, and removal of this important negative should help boost growth back above 2 percent. Nevertheless, subdued gains in consumer spending, business investment, and government purchases will keep domestic demand growth to no better than 2 percent this year. Some improvement in real net exports, which was already present in the results for the fourth quarter of 2006, will push real GDP growth modestly above 2 percent for 2007 on a year-over-year basis.

A view of the likely evolution of the main component of US GDP supports this general assessment and also points to important areas of risk. Aided by a sharp drop in energy prices, real consumption spending rebounded strongly to 4.2 percent annualized growth in the fourth quarter of 2006. The carry-over effect of solid gains in November and December and a good result for January consumption indicate that consumption spending growth will come in at over 3 percent for the first quarter. After that, I anticipate that the impact of a softening real estate market and a rebound in gasoline prices will slow consumer spending to no more than about 2 percent growth.

The anticipated correction in residential investment began in earnest last spring and was probably about half complete by the end of 2006. Further sharp declines in the first and second quarters (at about a 20 percent annual rate) will bring the new home building rate down from its peak of a little over 2 million units per year to about 1½ million. Subsequent reductions in residential investment should be modest, but it will probably still take another year at the reduced rate of new home purchases to absorb the excess inventory of unsold new homes.

Residential investment would become a more substantial and persistent drag on the economy if the rate of new home buying falls significantly further due to weakening income growth, concerns about falling house prices, or disruptions in the mortgage market. But, this should be regarded as a downside risk rather than a baseline forecast.

Solid gains in business fixed investment had been anticipated (by me and others) to offset much of the weakness in residential investment. That happened during the second and third quarters of last year; but in the fourth quarter business fixed investment recorded a moderate decline. Recent data for durable goods orders and shipments (and investment plans for small business) do not suggest a significant rebound in business spending on equipment and software, although spending on nonresidential structures still looks solid. The final report on fourth quarter 2006 GDP also indicated that the Commerce Department's broad measure of corporate profits (corporate profits before tax with inventory valuation and capital consumption adjustments) suffered a small decline after three years of strong advances. This one-quarter result should not be interpreted too ominously, but it is not a signal of likely buoyancy in corporate investment spending.

Inventory investment is often a wild card in quarterly GDP growth. In the fourth quarter of 2006, a sudden decline in inventory investment subtracted more than a percentage point from the annualized GDP growth rate. With the level of inventory investment running about \$30 billion below that needed to sustain inventory/sales ratios, some recovery of inventory investment should be anticipated during 2007. However, negative outcomes for a quarter or two cannot be excluded, especially if final demand growth sags more than now anticipated.

Real government purchases of goods and services may be anticipated to grow at a 2 to 2½ percent annual rate through the four quarters of 2007, with somewhat erratic fluctuations in the federal sector. For 2008, budgets of state and local governments will probably feel some pressures from the softening real estate market, and growth of government spending will likely slow modestly—despite election year frivolities.

Adding up the three components of domestic demand, we have the following: (1) Real consumption spending should advance by 3 percent on a year-over-year basis for 2007 but only 2¼ percent on a fourth quarter–to–fourth quarter basis. (2) Gross private domestic investment is expected to register a 3½ percent annual decline and be virtually flat on a fourth quarter–to–fourth quarter basis. (3) Real government purchases are projected to show a 2¼ percent advance both year-over-year and fourth quarter–to–fourth quarter. All this implies that real domestic demand will advance a little less than 2 percent year-over-year and by 2 percent fourth quarter–to–fourth quarter.

In the fourth quarter of 2006, US real net exports showed a sudden improvement of \$46 billion (in 2000 chained dollars) after running flat at about \$630 billion since the last quarter of 2004. Part of this sudden improvement probably reflected a draw-down of inventories of previously imported goods that will need replacement. Hence, the first quarter of this year may show some deterioration of net exports. By the end of this year, however, the slow growth of US domestic demand combined with continued robust demand growth in much of the rest of the world (and the continuing effects of dollar depreciation against most other industrial-country currencies since 2002) should bring renewed improvement to US net exports. The contribution from this improvement in real net exports should boost US real GDP growth to 2¼ percent for 2007, both year-over-year and fourth quarter–to–fourth quarter.

By 2008, the downward adjustment in residential investment should be complete and a moderate upturn could take place in this sector by the second half of the year. Business fixed investment may not be exceptionally buoyant, but total investment spending should make a modest positive contribution to growth of domestic demand and of real GDP. Real consumer spending should be expected to rise about in line with household disposable income, probably about 2½ percent per year. Real government spending would likely grow a little below 2 percent. With US real domestic demand growth only modestly stronger than in 2007 and still meaningfully below average

demand growth in the rest of the world, US real net exports should show further moderate improvement. All of this implies that US real GDP growth for 2008 would rise modestly to the range of 2½ to 3 percent.

It is noteworthy that the forecast for real GDP growth this year is half of a percentage point below my estimate of the potential growth rate of the US economy—2¾ percent. This implies that margins of slack in the US economy will widen modestly over the course of 2007. With core inflation running somewhat above the top of the Federal Reserve’s “comfort range” and with some evidence of rising wage pressures, this widening of margins of slack is important to give substance to the Federal Reserve’s announced assumption that core inflation may reasonably be expected to abate down to the comfort range over coming quarters.

Of course, there is a good chance that the outcome for US growth could come in either below or above this baseline forecast. On the downside, the required correction in residential investment might be larger and take longer than I have assumed, and consumer spending might well react more negatively to developments in home prices and mortgage markets than I have assumed. By itself, or especially in combination with weaker than anticipated performance from business fixed investment, inventory investment, or US net exports, this could turn the US economy toward recession.

The Federal Reserve would surely respond to evidence of rising risks of recession—with the confidence that substantial slowing of US economic growth would remove risks of accelerating inflation. But, with core inflation still running above its comfort zone, the Federal Reserve would (quite rightly) need to see such evidence before it would begin aggressive easing. In view of the usual lags in the effects of monetary policy, the US economy could slip into recession or near recession before even the most sophisticated and competently conducted monetary policy could do much about it.

On the upside, consumer spending and business fixed investment could easily turn out at least a little more buoyant than I have assumed. Alternatively, or in addition, growth of US exports might be stronger than I have forecast. If potential output growth is somewhat above 3 percent (rather than somewhat below it as I estimate), then US real growth outcomes of 3 percent or a little better are surely feasible.

There is, however, an important asymmetry in these risks. US real GDP growth rising much above 3 percent on average for 2007 and 2008 runs squarely into the problem that core inflation is already running above the Federal Reserve’s comfort zone, and potential output growth is surely not much above 3 percent. The upside above 3 percent real GDP growth for the next two years, therefore, is clearly very limited. In contrast, a more pronounced or prolonged growth slowdown or even a mild and brief US recession that pushed average real GDP growth for 2007/2008

meaningfully below 2 percent is comparatively easy to foresee. Accordingly, I set my baseline forecast for US real GDP growth for 2007 and 2008 slightly below the consensus forecast at this stage, at 2¼ and 2½ percent, respectively.

Turning briefly to **Canada**, real GDP growth slowed during the last three quarters of 2006 below that in the United States, leaving a year-over-year growth rate of 2¾ percent for 2006 (compared with 3¼ percent year-over-year growth for the United States). Growth of real domestic demand in Canada (both consumption and investment) remained quite buoyant. Nevertheless, with the aid of strong export earnings, especially from the energy sector, Canada's current account surplus remained substantial until a falloff in the fourth quarter.

For 2007, continued weakness in the US economy is likely to spill over to affect the Canadian economy, but with Canada growing a little more strongly than the United State due primarily to stronger growth of domestic demand in Canada. This is not entirely unwelcome in Canada. Resource utilization in the Canadian economy is quite high (with a real boom in energy-rich Alberta), and the unemployment rate has fallen to a multidecade low. Core consumer price inflation has recently been running above the Bank of Canada's 1 to 3 percent target, and the Canadian dollar has eased back by about 4 percent against the US dollar over the past six months.

In this situation, real GDP growth this year of 2½ percent, which is marginally below Canada's potential growth rate, will be helpful in containing inflationary risks. Growth much above this rate would likely bring the Bank of Canada back into action and could lead to some restrengthening of the exchange rate of the Canadian dollar.

The **Mexican** economy enjoyed a good year in 2006, turning in year-over-year growth of 4½ percent. Reflecting the slowdown north of the border, however, Mexican output growth also slowed considerably toward the end of the year. Meanwhile, consumer price inflation, which briefly breached the top of the Banco de Mexico's 2 to 4 percent target range, has fallen back within the range and is expected to moderate further during 2007. The political turmoil that surrounded last year's election has calmed down, and President Calderon has enjoyed at least initial success with his legislative program despite opposition control of the Congress.

Nevertheless, with the US economy growing no more than about 2 percent this year, it is virtually inevitable that growth in the Mexican economy will slow to no more than 3½ percent. The slowdown in the United States, however, will not have a magnified effect in Mexico, as has occurred on some past occasions. This owes much to the improvements in Mexican economic policy that have removed many of the traditional concerns that have been associated with past financial and economic instability (that often emerged in the years immediately following presidential elections).

Fiscal discipline has been well maintained with a budget that is close to balance. Monetary policy has been set on a firm foundation with a credible inflation target. The exchange rate is free to

float, and its market-determined movements appear (on balance) to help stabilize the Mexican economy. The current account and the trade balance show only modest deficits.

Unfortunately, the high-quality reforms that have been established and maintained in key areas of Mexican macroeconomic policy have not been matched in critical areas of structural policy. Beyond the present economic slowdown, whether the Mexican economy can achieve sustained growth that is somewhat better than 4 percent per year—rather than somewhat worse—will depend to a considerable extent on whether the Calderon government can successfully address some of these structural issues.

In **Brazil**, President Luiz Inacio Lula da Silva's first term began in 2003 in the midst of a financial crisis that was largely the product of fears about his administration's policies. In the event, highly disciplined fiscal and monetary policies were consistently pursued. To bring down inflation and establish the credibility of the central bank's inflation target, the overnight interbank interest rate (the Selic rate) was initially raised to very high levels and was kept quite high in real terms for the past four years. This necessarily tight monetary policy, together with a firm fiscal policy featuring a sizable primary surplus, contributed to the (unavoidable) recession of 2003. Firm monetary policy and the substantial real exchange rate appreciation it helped to engender also inhibited the growth of the Brazilian economy subsequent to the recovery of 2004.

Over the past two years the Selic rate has been cut from 20 to 12.75 percent. The real level of this rate, however, has fallen much less, as inflation has declined from around 8 percent to under 4 percent. With the credibility of the central bank's inflation target now fairly firmly established, and with inflation expected to remain around 4 percent or somewhat less, further significant reductions in the Selic rate should be feasible and are anticipated. This should take real interest rates meaningfully below 10 percent for the first time in several years.

In 2006 Brazil's real GDP growth picked up modestly from 2005 but remained below 3 percent on a year-over-year basis. The growth rate in the final quarter of last year, however, accelerated to nearly 4 percent. For 2007, with the aid of lower real interest rates and public confidence in continued sensible economic policies, it is reasonable to expect that Brazil will achieve real growth of 4 percent or slightly better, and a similar outcome is likely for 2008.

In **Argentina** last year, growth again came in somewhat above most forecasts (including mine), and forecasts for growth in 2007 have been revised upward to around 7 percent. Significant problems are building up in the Argentine economy because of government policies to repress inflation through controls and jawboning. Eventually, the cumulative effects of these problems will become serious obstacles to the efficiency and growth of the Argentine economy. However, for the next year or two, with the aid of a still highly competitive real exchange rate and strong export

markets, the Argentine economy should continue to enjoy reasonably strong real GDP growth—albeit at a somewhat slower pace than in the past four years.

Aided by export revenues from petroleum exports and by the domestic expenditure of most of these revenues, the **Venezuelan** economy appears to have achieved another year of 10 percent real GDP growth in 2006—an accomplishment that helped secure the reelection of President Hugo Chavez. A similar scale increase in government spending is not feasible for 2007 or 2008. Accordingly, it is reasonable to anticipate that real GDP growth will moderate from the 2006 result to about 7 percent this year and probably 4 to 5 percent next year.

For the longer term, it is difficult to know by how much the development of Venezuela's oil reserves will be impaired by recent actions to nationalize holdings of foreign energy companies. Without significant investment and development Venezuela's oil output will decline significantly over the next decade. For the rest of the Venezuelan economy, the dismal record of the past 50 years offers little reason for hope that the present oil-based boom will bring sustained prosperity to the Venezuelan people.

Elsewhere in **Latin America**, 2006 was generally a very good year. Colombia, Costa Rica, the Dominican Republic, Panama, Peru, and Uruguay all achieved better than 5 percent growth, in some cases considerably better. Various special factors contributed to these results, which are not likely to be repeated, and growth in these countries will come down somewhat in 2007 and 2008. In Chile, by contrast, the temporary weakening of growth last year is likely to be reversed during 2007, with the result that growth in 2008 will likely again rise to at least 5 percent. For Latin America as a whole, the relatively strong 5 percent growth for 2006 is likely to be followed by growth closer to 4 percent this year and next.

### **Asia-Pacific**

Again in 2006, Asian economies were the key drivers of global growth, led by exceptionally strong performances by both China and India. Indeed, China has reported 10¾ percent real GDP growth of 2006, the fourth consecutive year of better than 10 percent growth; and India is likely to report 9 percent real growth for the fiscal year that has just ended.

Developments during the second half of 2006 and data available on economic activity in early 2007 do not indicate much of a slowdown in China's economic juggernaut, despite the government's and central bank's efforts to cool things down. Accordingly, I am pushing up my forecast of Chinese growth this year to 9¾ percent, and I am assuming that growth next year will slow only modestly to 9¼ percent.

Despite exceptionally rapid output growth, inflation reportedly remains well contained with consumer prices in China rising less than 2 percent in 2006 and projected to rise only about 2½ percent this year. This favorable inflation outcome partly reflects government policies that repress price increases for some goods and services, such as energy and rents, as well as probably some misreporting or underreporting of some prices. Nevertheless, it does not appear that inflation has become a significant problem in China—as it did during the early 1990s.

There are, however, other important problems buried in China's outstanding economic performance. Growth has been heavily skewed toward investment, which presumably cannot continue to expand its already very large share in GDP. Investment has been skewed toward trade-related industries and their associated suppliers and infrastructure and toward the coastal regions of China, which predominate in these activities. This is contrary to the expressed desire of the Chinese authorities to foster development of the interior of the country, encourage consumption growth, and secure a more even distribution of the benefits of economic advance.<sup>1</sup> While much of this investment has been financed with internally generated funds of Chinese businesses, bank loans have also played an important role. At some point when a number of these investments turn out to be less profitable than originally anticipated, Chinese banks are likely to be stuck with a new large crop of bad loans.

In contrast with most of China's experience with rapid economic growth over the past three decades, it is noteworthy that growth in recent years has been unusually dependent on rising net exports. This is reflected in a current account surplus that has gone from an average of about 2 percent of GDP in the five years ending with 2003, to 4 percent of GDP in 2004, 7 percent of GDP in 2005, and an estimated (by Nicholas Lardy) 9 percent of GDP in 2006. And trade data for the first two months of this year indicate that another large increase in the Chinese current account surplus is in store for 2007. Surpluses of this scale and rate of increase tend to provoke protectionist reactions. We have already seen some of this and are likely to see a good deal more if the Chinese surplus continues to expand rapidly—especially in an environment where economic growth in some of China's key export customers may be slowing.

In **India**, rapid economic growth on the order of 8 percent annually since 2003 has brought some increase of inflation, from around 4 percent in 2002–03 to over 6½ percent in the 12 months to this January. The Reserve Bank of India has responded to rising concerns about inflation by pushing up its repurchase rate to 7¾ percent, and further increases may be coming. Also of some concern to the Indian authorities is the deterioration of the trade and current account balances by, respectively, 5 and 4 percentage points of GDP over the past four years. This reflects primarily rising

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<sup>1</sup> See Nicholas Lardy, *Toward a Consumption-Driven Growth Path*, Policy Briefs in International Economics PB06-6 (Washington: Peterson Institute for International Economics, October 2006).

imports associated with rapid economic growth and rising import prices, especially for energy. Because India enjoys a substantial surplus on the services account, the current account deficit is still only about 2 percent of GDP (down from an equivalent surplus four years ago). Nevertheless, the deterioration of India's international payments position provides another indication to the authorities that economic growth may need to slow at least modestly from the very rapid pace of recent years.

Accordingly, with the Indian authorities already acting to cool the economy, it is prudent to forecast that growth this fiscal year will slow modestly to around 8 percent from the 9 percent achieved last year. For next year, growth of 7½ percent is projected—still a strong result relative to India's average performance over the decade before 2003.

Among the smaller emerging-market economies of the Asia-Pacific region, 2006 was generally a fairly good but not an exceptionally good year. Real GDP growth in Indonesia, Malaysia, the Philippines, and Thailand was generally between 5 and 6 percent. Bangladesh and Pakistan probably grew a little more than 6 percent, and Vietnam's growth was close to 8 percent. On balance, these countries should be expected to grow slightly more slowly in 2007 and 2008, reflecting somewhat weaker growth in key export markets.

Four of the Asia-Pacific region's emerging-market economies are classified by the International Monetary Fund's *World Economic Outlook* (WEO) as "advanced economies" along with the traditional industrial countries: Hong Kong, Singapore, South Korea, and Taiwan. The combined GDP of these four economies now amounts to about \$1.7 trillion, with South Korea accounting for more than half of that total. On the basis of the IMF's purchasing power parity (PPP)-based exchange rate weighted aggregates, these four economies account for slightly more than 3 percent of world GDP, about the same share of world GDP as either France or the United Kingdom.

In 2006 these four economies grew by about 5¼ percent, with Singapore (the star performer) up by 8 percent and Hong Kong up about 6½ percent. For all of these countries, trade is very important, and the United States is a key export market (both directly and indirectly through exports of components for final products ultimately destined for the US market). The slowdown in the US economy suggests that we should expect somewhat slower growth in these four economies this year and next. Allowing for normal slowdown in Singapore following an unusually strong year, and taking account of the likely negative impact of the recent resurgence in world oil prices on South Korea and Taiwan, a forecast of 4¾ percent growth seems reasonable for these four countries.

In the IMF's scheme for weighting countries in world GDP, **Japan** (with a share of 6.4 percent) is well behind China (with a share of 15.4 percent), but it is still the third largest economy in the world, behind only the United States and China and slightly ahead of India.

Downward revisions to earlier estimates of Japan's quarterly GDP growth results, together with a weak third quarter result for last year, imply year-over-year growth for Japan in 2006 will come in at only 2¼ percent, rather than the 2¾ percent gain expected earlier. The strong result now reported for Japanese real GDP growth in the fourth quarter of 2006 will help boost year-over-year growth for 2007. As often happens with large quarterly swings in Japanese GDP growth, however, it is anticipated that there will be some payback in the first quarter of 2007 for the strong result in the fourth quarter of 2006. A likely slowdown in exports (or at least in the growth of exports) to the United States is another reason not to read too much into Japan's fourth quarter growth surge.

Consumption spending in Japan has grown weakly in the present economic recovery, and that recovery has depended relatively heavily on growing business investment and especially on strong export growth (particularly to the United States and China). The saving rates of Japanese households have declined significantly from the very high levels that generally prevailed before 1990. But there is still room for saving rates to fall further, and Japanese households have large hoards of accumulated savings. With continued economic recovery, there should come a recovery of consumer confidence and significant increases in consumption spending. This potential source of domestic demand growth will become particularly important if substantial appreciation of the yen or other developments cut deeply into Japanese export growth. Whether, when, and to what extent Japanese households may begin to spend more vigorously, however, remains an oriental mystery.

Another factor relevant for assessing Japan's growth prospects is likely course of inflation and Japanese monetary policy. Core consumer price inflation is now running about zero, up about a percentage point from the negative rates experienced earlier in this decade. Starting from an extraordinarily easy stance appropriate for an economy trying to fight its way out of deflation, Japanese monetary policy has been firmed over the past year.

This began with the end of "quantitative easing" phased in last spring. Then last July, the Bank of Japan (BoJ) raised the overnight call rate from zero to 25 basis points, and this was followed by another 25 basis point boost this February. Some academics and Japanese politicians criticize the BoJ for tightening too much and too soon, unnecessarily risking continued economic recovery when inflation was clearly not a threat.

In my view, these concerns were misplaced. Unlike the episode when "old rockhead" prematurely raised interest rates (reportedly because of fears of "hyperinflation"), this time the BoJ waited until the economic recovery was firmly in place and deflation had ended. In the present situation, a 50 basis point overnight call rate is not going to derail the Japanese recovery—although other things might. Moreover, with a potential growth rate in Japan of no more than about 2 percent, and with margins of slack nearly exhausted by the ongoing recovery, the BoJ needs to be concerned that it will eventually need to return its policy interest rate to more normal levels—

probably at least 2 percent. Like driving a truck with a large number of eggs packed loosely in the back, the BoJ rightly wants to avoid a situation where it will need to make significant adjustments in its policy interest rate quite suddenly. Better not to leave the overnight call rate too low for too long and then be forced to slam on the monetary brakes when inflation begins to become perceived as a potentially important concern.

Assuming that the BoJ continues to pursue interest rate normalization with suitable caution, and also assuming that the Japanese government also pursues necessary fiscal consolidation with relevant prudence (in contrast with aggressive fiscal tightening of the Hashimoto government in 1996–97), Japanese economic policy will not be the cause of a premature end of the present expansion. With the view that there is still at least a modest margin of slack remaining in the Japanese economy, growth of about 2¼ percent should be feasible this year and 2 percent growth is projected for 2008.

**Australia** accounts for just over 1 percent of world GDP in the WEO weighting scheme. The Australian economy is also particularly interesting at this time because it has been on the leading edge of the present global expansion.

The Australian economy was relatively little affected by the global slowdown of 2001 and growth picked up strongly thereafter—aided by strong commodity prices. Inflationary pressures also became a concern relatively early, and Australian monetary policy was firmed while the United States and the euro area maintained very low policy interest rates. Growth slowed a bit and inflationary pressures eased. Monetary policy was then relaxed somewhat, and growth picked up again. When inflationary pressures began to rear up again, monetary policy was retightened, leading today to a target of 6.25 percent for overnight cash rate of the Reserve Bank of Australia. Meanwhile fiscal policy has retained a well-disciplined stance. Thus, the Australian authorities (like those in Canada and the United Kingdom) have played a particularly successful game in keeping the economy on track both with respect to output and inflation.

The Australian unemployment rate is now at 4½ percent, down 2 percentage points from five years ago and at a multidecade low. During the five years over which this 2 percentage point drop in the unemployment rate was achieved, real GDP growth averaged 3¼ percent. These facts suggest that the Australian economy is probably operating a little beyond its normal level of potential output and that the annual growth rate of potential output is a little less than 3 percent. With Australian economic policy targeted so effectively on keeping the economy close to its potential, the forecast is that inflation will remain well contained and growth will come in somewhat below 3 percent both this year and next.

**New Zealand's** economy faced a difficult year in 2006. With a current account deficit equivalent to about 9 percent of GDP, New Zealand is dependent on continuing foreign capital

inflows to finance its external payments gap. When a crisis in Iceland caused financial markets to worry that similar difficulties might beset its antipolar twin, the exchange rate of New Zealand's dollar came under heavy downward pressure, which, in turn, implied upward pressure on New Zealand's inflation rate. The Reserve Bank of New Zealand was forced to respond by raising interest rates. The economy suffered both from higher interest rates and because after the crisis passed the exchange rate reappreciated. Meanwhile, resurgent capital inflows into New Zealand mortgages helped to pump up the housing market, tending to create simultaneous concerns about stagnation and overheating. Clearly, while a credible inflation target and a well-disciplined fiscal policy have generally worked well for New Zealand over the past 15 years, they have not removed all of the challenges for macroeconomic policy. Regarding the forecast, it is reasonable to expect that GDP growth will pick up this year and next to 2½ percent or so after growth of less than 2 percent in 2006.

## **Europe**

Economic growth strengthened to nearly 3 percent across Western Europe in 2006 after less than a 2 percent advance in 2005. This improvement, which averaged about a full percentage point, affected almost all countries both inside and outside the euro area.

For the **euro area**, growth increased from 1½ percent in 2005 to 2¾ percent in 2006. Significant advances were made in **Germany**, from barely more than 1 percent growth in 2005 to almost 3 percent growth in 2006, and in **Italy**, from virtually no growth to nearly a 2 percent advance. For much of the euro area, the first half of 2006 was robust, followed by a sluggish summer quarter, and ending with a surge in the fourth quarter. This pattern was particularly apparent in **France** and Italy and less so in Germany.

As growth accelerated, unemployment rates fell across the euro area, with the average rate falling more than a full percentage point from 8.4 to 7.3 percent. Meanwhile, overall consumer price inflation ran up to 2½ percent (on a 12-month basis) through August, before falling back below 2 percent as energy prices eased. Core consumer price inflation remained steady at about 1½ percent until ticking up to 1.9 percent early this year.

The European Central Bank (ECB) continued its policy (begun in December 2005) of gradually normalizing its key policy interest rate. The repo rate was moved up in five 25 basis point steps to 3.5 percent by year-end. Another 25 basis points was added this March. Notwithstanding these interest rate actions, euro area monetary aggregates (monitored closely by the ECB) continued

robust growth, with broad money advancing at nearly a 10 percent rate (from a year ago) in the fourth quarter.

Looking to 2007/2008, growth in the euro area is projected to moderate to around 2¼ percent. Specifically, for Germany, the increase in the value added tax at the beginning of this year clearly boosted consumption spending toward the end of 2006 with payback occurring early in 2007. In view of the depressed level of consumer spending in Germany, however, it is difficult to forecast whether the dropoff of consumption in the first quarter is temporary or signals a return to sluggishness of the recent past (virtually no real spending growth over the past six years). For Italy, the growth surge late last year implies a boost to year-over-year growth in 2007 even if there is some payback in the first quarter; but growth prospects for the longer term do not look very bright in view of the generally dismal economic performance of the past five years.

In contrast, **Spain**'s economy has advanced robustly over the past five years with real GDP growth averaging 3¼ percent and with domestic demand growing well above that rate (as reflected in a current account deficit that has deteriorated from 3 percent to almost 9 percent of GDP over the past five years). Here, the problem is clearly overheating, and it remains to be seen when and through what mechanisms Spain's economy will be cooled off. The same question arises for **Ireland**, where the housing boom has pushed residential investment up to a remarkable (and probably unsustainable) 15 percent of GDP.

Key issues in projecting likely growth for the euro area involve assessing both its potential rate of growth and the remaining degree of economic slack. With the average unemployment rate for the area now half a percentage point below the minimum reached during the last expansion (when ECB policy was relatively tight to forestall rising inflation), it is reasonable to suppose that there is now not much slack remaining in the area. Situations differ somewhat from country to country, with Spain showing clear signs of overheating while Germany would still appear to have at least modest slack. But for the ECB, which must consider the situation in the euro area on average, the conclusion must be that there is not much (if any) slack remaining.

Concerning the potential growth rate, it is relevant that during the past three years the average euro area unemployment rate has fallen by 1½ percentage points, from a peak of almost 9 percent in early 2004 to just below 7½ percent today. During this three-year period, real GDP growth in the euro area averaged 2¼ percent (up from an average of just under 1 percent growth the preceding two years). The combination of a 1½ percentage point decline in the unemployment rate with 2¼ percent average real GDP growth indicates that the potential growth rate for the euro area is below 2 percent and probably not greater than 1¾ percent.

The ECB does not explain its policy on the basis of analysis of margins of slack and potential growth. But it is directly concerned about inflation and prospects for inflation and, accordingly, it

must ultimately be sensitive to the implications of this analysis (whatever its official rhetoric). Growth in the euro area in line with the forecast of  $2\frac{1}{4}$  percent for this year and 2 percent for next year suggests that rising inflationary pressures will be a concern for the ECB. Monetary tightening, therefore, is likely to proceed beyond the 4 percent repo rate that the ECB will soon establish to perhaps as high as 5 percent over the next year and a half.

In this regard, it is noteworthy that monetary policy (in the euro area and elsewhere) affects primarily the growth of domestic demand. Real GDP growth can exceed or fall short of domestic demand growth depending on what is happening with real net exports. For example, over the past three years, domestic demand growth in the euro area has fallen (on average) about  $\frac{1}{4}$  of 1 percent shy of real GDP growth. Over the next couple of years, this pattern may well be reversed, with domestic demand growth moderately exceeding real GDP growth for the euro area. This will likely imply a moderate deterioration of the euro area current account from near balance today to a deficit of 1 to 2 percent of GDP. Such a development (which would contribute to resolving the problem of large international payments imbalances) should not be resisted. The task of maintaining price stability relates primarily to assuring that the euro area economy does not overheat in terms of GDP growth. If this result comes along with a moderate deterioration in the euro area current account, so be it.

Outside of the euro area, real GDP growth in the **United Kingdom** picked up to  $2\frac{3}{4}$  percent last year, after slightly under 2 percent growth in 2005. The Bank of England (BoE) has been carefully modulating its monetary policy to keep inflation within the target range and, consistent with that, to keep the economy growing near its path of potential GDP. In particular during the past nine months, as the economy recovered from its sluggishness in 2005 and signs of possible future inflation (and a renewed housing boom) began to emerge, the BoE has raised its bank rate by 75 basis points to 5.25 percent.

This degree of monetary tightening (and somewhat more if it appears to be needed) should slow the growth rate below the 3 percent growth rate (Q4 to Q4) of last year, leaving year-over-year growth at  $2\frac{3}{4}$  percent for 2007 and at  $2\frac{1}{2}$  percent for 2008. This is consistent with the assessment that the UK economy is now operating very close to its potential level and that the potential growth rate is probably between  $2\frac{1}{2}$  and  $2\frac{3}{4}$  percent. The seeming precision of these numbers, however, should not be taken too seriously. Economic policies that keep GDP growing within a range of half of a percentage point on either side of the somewhat murky notion of potential GDP are better than any reasonable person has a right to expect.

For the smaller Western European countries outside of the euro area, 2006 was a good year for growth. **Sweden** did particularly well with  $4\frac{3}{4}$  percent growth, and **Norway** (benefiting also from large oil export revenues) did almost as well. **Denmark** managed  $3\frac{1}{4}$  percent growth, and the **Swiss**

economy grew by 2¾ percent, the best result since 2000. For all of these countries, it is likely that growth will moderate somewhat in 2007 and 2008, with the average of their growth rates falling from 3¾ in 2006 to 3 percent in 2007 and to 2¾ percent in 2008.

For **Central and Eastern Europe**, 2006 was also, on average, a pretty good year. In the largest economy of the region, **Turkey**, growth slowed from a relatively high 7½ to 6½ percent. In the second largest economy, **Poland**, growth accelerated from a subpar 3½ percent to a quite respectable 5½ percent. Slovakia and Romania achieved growth of 7½ to 8 percent, while Bulgaria and the Czech Republic managed about 6 percent growth. Hungary was a relative laggard with growth a little below 4 percent.

For 2007 and 2008, growth in Central and Eastern Europe appears likely to be modestly below 2006. Hungary is facing considerable challenges in bringing down its large budget and current account deficits, and growth there is unlikely to much exceed 2 percent. Elsewhere the story is mainly that countries that last year grew more strongly than their respective averages of the past few years will tend to see their growth rates fall back toward these averages.

### **The Commonwealth of Independent States, the Middle East, and Africa**

The countries in these large and diverse regions have relatively little in common, except importance of commodity exports (especially energy) to the largest and most prosperous economies.

**Russia's** economy accounts for two-thirds of the real GDP of the countries of the Commonwealth of Independent States (the former Soviet Union less the Baltic States). Aided by huge energy export revenues and supported by substantially improved economic policies (relative to the Yeltsin era), the Russian economy has averaged about 7 percent annual real growth since the crisis of 1998. Growth last year was a little below this average. As the Russian shorter-term benefits of recovery from the traumas of transition wane, and as the remaining critical structural problems of the Russian economy impinge more deeply, it should be expected that the economy's growth rate will slow somewhat. However, continuing huge export revenues and the maintenance of reasonable macroeconomic stability suggest that this slowdown will be gradual and will be only modestly apparent in the growth results for 2007 and 2008. Provided President Putin leaves office as scheduled, he will be remembered as the leader that restored some meaningful prosperity to Russia (even if his accomplishments in other areas are regarded as more dubious).

The other energy-exporting states in the CIS are growing even more strongly than Russia. **Kazakhstan** has reportedly been growing at over 9 percent since 2000, and growth is projected to continue at about this pace at least through 2007 and 2008. Tiny **Azerbaijan** has reported

spectacular growth results (25 to 30 percent per year) for the past two years and is expected to have another very strong result for 2007 before moderating down to 12 percent growth for 2008.

Among the nonenergy exporters of the CIS, the **Ukraine** is by far the largest. Its growth has been erratic in recent years: very strong (10 to 12 percent) in 2003/2004, then much slower (barely more than 2 percent) in the face of political and social turmoil in 2005, and back up to nearly 7 percent last year as the political situation calmed down. Renewed political problems are now casting some doubt on the forecast that growth rates of 5 to 6 percent are a reasonable prospect for the next two years.

In the **Middle East**, the major oil exporters (except Iraq) have generally been growing in the range of 4 to 8 percent during the past three years of high world oil prices. The largest oil exporter, **Saudi Arabia**, is a fair representative with real GDP growth last year of about 6½ percent and growth of about 4½ percent the year before. Nonoil exporters such as Jordan and, most importantly, Egypt are also generally growing strongly. **Israel**, which has a fairly large economy by the standards of the region, also reports growth of around 5 percent for 2006, despite the disruptions of the brief war in Lebanon. **Iran** reports similar growth.

All things considered, it is reasonable to expect real GDP growth in the Middle East will continue at 5 percent or somewhat better so long as oil prices remain high. Political uncertainties, however, continue to pose major downside risks.

Finally in **Africa**, the continuing boom in world commodity markets remains a key support for growth at the highest consistent rates in the continent's (postcolonial) history. Improved economic policies in many countries and the relatively low level of conflicts (at least in comparison with the average of the past three decades) have also contributed importantly to Africa's superior economic performance over the past four years. It is reasonable both to expect that this superior performance will continue at least through this year and next and to make a modest allowance in the forecast for the possibility that it may not.

**Table 1 Real GDP growth projections as of April 4, 2007**  
(percent changes, year over year)

<b>Country/region</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>
Industrial countries	3	2½	2½
United States	3¼	2¼	2½
Canada	2¾	2½	2½
Japan	2¼	2¼	2
Australia and New Zealand	2½	2¾	2¾
Western Europe	2¾	2½	2¼
United Kingdom	2¾	2¾	2½
Other West Europe	3¾	3	2¾
Euro area	2¾	2½	2
Germany	3	2¼	2
France	2	2	2
Italy	2	2	1½
Other euro area	3½	3¼	3
Emerging markets	7½	6½	6¼
Asia	8¾	8	7¾
China	10¾	9¾	9½
India	9	8	7½
Other	5¾	5½	5
Latin America	5	4½	4½
Argentina	8	6½	5
Brazil	2¾	4	4¼
Mexico	4 ½	3¼	3¾
Other	7¾	5	4½
Central and Eastern Europe	5¾	5	4¾
Commonwealth of Independent States	7½	6¾	6½
Russia	6¾	6¼	6
Middle East	5½	5	5
Africa	5½	5	5
World (WEO weights)	5¼	4 ½	4½