

**Global Economic Prospects: Slower But Still Solid Growth in 2005;
Worries About Growth and Inflation for 2006
(Assessment of Early April 2005)**

By Michael Mussa
Senior Fellow
Institute for International Economics

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After surging to the highest growth rate in a generation, world real GDP is set to slow from a rate of just over 5 percent for 2004 to about 4 percent for 2005 and a tad slower for 2006. The economic slowdowns in several important economies in the second half of last year, including much of continental Europe and Japan, already make it clear that year-over-year growth will slow for 2005. But the continued strong growth of domestic demand in other countries, most notably the United States and China, virtually assures that global growth this year will not fall below potential.

Meanwhile, inflation has clearly begun to pick up in many areas of the world economy. This is most apparent in commodity prices, especially energy prices, particularly when commodities are priced in US dollars. It is also visible in broad indices of “core” inflation, which exclude or sharply de-emphasize volatile commodity prices. In the United States, the rate of increase in the core consumer price index (CPI) (on a 12-month basis) is up by a little more than 1 percent from its trough in 2003 and the core personal consumption expenditure (PCE) index is up from its trough by about $\frac{3}{4}$ of one percent. Anticipating such developments, the Federal Reserve is already advancing its strategy of “measured” monetary tightening to assure that inflationary pressures remain contained. Monetary tightening is more advanced in Australia and the United Kingdom, where levels of output appear already to have reached potential. In China, inflation picked up to significantly positive rates last year after several years of mild deflation, while in Japan the deflation experienced since 1997 appears to be abating if not ending. Only in the euro area—where exchange rate appreciation is offsetting the pass-through effects of higher commodity prices—do recent data suggest that core inflation may be falling rather than rising. Despite this and the recent weakening of growth and growth prospects in the euro area, however, European Central Bank (ECB) officials continue, somewhat bizarrely, to ruminate about possible moves to firm monetary conditions.

Concerns about rising inflationary pressures in the United States and some other countries appear still to be in the range where responsible monetary policy actions can contain the threat without raising substantial risk of a severe economic slowdown or recession. Indeed, the central forecast for 2005 and 2006 envisions that under the impact of moderate (but somewhat greater than now anticipated) monetary tightening and high energy prices, domestic demand growth in the United States will slow sufficiently after the first quarter of 2005 to keep real GDP growth somewhat below 4 percent for 2005 and at near potential (about $3\frac{1}{4}$ percent) for 2006. This will allow some room for a positive contribution to output growth from improving net exports. In Australia, Canada,

and the United Kingdom, where output levels are already at or near potential, policies appear attuned to keep growth in line with potential and thereby control inflationary risks.

All of this will allow breathing room for most of Europe and Japan to recover greater strength of demand growth, under monetary policies that will remain much more accommodative than those of the United States, the United Kingdom, Canada, and Australia. For the industrial countries as a whole, growth this year will slow moderately to 2¾ percent (from 3¼ percent in 2004) and will sustain about this pace for 2006. Under this baseline forecast, growth in the developing and transition countries will slow from the spectacular 7¼ percent for 2004 to about 6 percent for 2005 and will slow modestly further to the potential growth rate of these diverse economies (a little above 5 percent) in 2006.

Key Risks

As always, significant risks surround the central forecast—on both the downside and the upside. At least for global growth in 2005, these risks appear to be no greater than normal. Specifically, on a WEO-weighted basis, year-over-year world real GDP growth for 2005 will almost surely be somewhere between 3½ and 4½ percent, and I would bet at two-to-one odds that the final result will lie between 3¾ and 4¼ percent. For 2006, a significantly larger range of uncertainty surrounds the central growth forecast. Somewhat paradoxically, a stronger-than-expected growth this year likely implies greater risk of a weaker-than-expected result next year.

One important factor that contributes to the forecast of slower global growth and to the risks around that forecast, is the behavior of world energy prices. A year ago, futures prices for light sweet crude pointed to an average oil price (for this premium grade of crude) of almost \$40 per barrel for 2004 and couple of dollars cheaper for 2005. These prices were up about \$10 per barrel from what futures markets had been projecting in early April 2003. This rise in oil prices was widely expected to slow global economic growth over the course of 2004 and into 2005, for a cumulative negative effect of at least ½ percent on global GDP. In fact, global economic growth did slow after the first quarter of last year, and some of this slowing appears to be related to higher energy prices (e.g., in Korea). But, for the two largest oil importers, the United States and China, the sharp rise in world energy prices did not put much of a dent in economic activity, indicating that the underlying forces of economic growth were significantly stronger than I (and many others) had appreciated.

At present, the futures market for light sweet crude indicates an average of over \$50 per barrel for 2005 and nearly that much for 2006—up more than \$10 per barrel from what this market was projecting a year ago and up \$20 per barrel from projections of two years ago. In line with the experience of last year when the escalation of world oil prices appeared to have a significantly more moderate negative impact on global growth (less than ½ percentage point) than previous oil price shocks, the baseline forecast for 2005/06 assumes that there will be a similar moderate negative impact from the recent further rise in world energy prices. This assumption, however, leaves unanswered some important questions: Will the US and Chinese economies remain largely impervious to this further escalation in world energy prices, or will the world economy now begin to slow more significantly—as has been the experience with previous large and sustained increases in

energy prices? What is the likelihood that, as some oil analysts warn, oil prices could spike further upward to \$70 per barrel or higher because of supply disruptions or speculative demand pressures? Alternatively, what is the chance that a sudden abatement of speculative demand pressures embodied in present prices could induce a sharp decline in world oil prices? Around these questions swirls significant uncertainty about global growth prospects over the next two years.

Another, prospectively more important risk for the world economy arises from the persistent asymmetry in the expansion of demand across the world economy and the interaction of this asymmetry with threats of rising inflation and the need to unwind large international payments imbalances. Continuation of the global demand growth asymmetry in 2005 could well lead to stronger than forecast growth this year, at the expense of a significantly sharper global slowdown in 2006.

Specifically, strong domestic demand growth in the United States and China have propelled the present global recovery, while demand growth in much of continental Europe and Japan has remained weak. Indeed, for the United States, domestic demand growth has significantly exceeded output growth for most of the past decade, as reflected in the annual negative contributions to real GDP growth from deteriorating real net exports and in the cumulative growth of the US current account deficit. Output growth in the rest of the world benefited from this net export of demand from the United States, as well as the recent impetus from very strong growth of investment in China.

This pattern of global demand growth cannot continue much longer without serious risk that the unwinding of growing international imbalances associated with it will imply significant negative impetus to global growth. The US external payments deficit has reached a level (over 6 percent of US GDP) that is unsustainable in the longer term. This is apparent in the substantial depreciation of the US dollar against the market-determined values of the currencies of most other industrial countries over the past three years. But, the gradual reduction of the US external payments deficit through a substantial switch from deteriorating to improving real net exports cannot be successfully combined with a continued resurgence of US business investment and persistent strength in consumer spending and residential investment. There simply is not enough slack left in the US economy for these things to proceed simultaneously for very long.

Instead, the result would be an imminent threat of rising inflationary pressures, which would cause the Federal Reserve to tighten monetary conditions much more sharply than now anticipated in financial markets. US domestic demand growth would then slow markedly in 2006. Unlike 2001, however, the Federal Reserve would be constrained from easing aggressively to meet this new threat because inflationary pressures, under the influence of a weaker dollar, would not be abating. Also, the Federal Reserve would have less reason to ease in the face of sharply slowing domestic demand growth in an environment where a weaker dollar was providing a boost to US output growth through improving net exports.

Meanwhile, in the rest of the world, there would be some spillover to long-term interest rates from higher US rates. This would further complicate prospects for achieving stronger domestic demand growth, particularly in much of continental Europe and Japan, where domestic demand growth has been persistently weak. It would also probably curtail growth in several emerging-market economies as increases in interest rate spreads compounded the effect of higher US interest rates. Accordingly, at the global level, there

could be little offset to weaker demand growth in the United States, thereby raising the risk that world output growth might fall significantly below potential.

The recent spectacular growth of fixed investment in China is another key driver of global economic activity that is potentially at risk—especially so if little of the necessary slowing of this investment is achieved this year and is instead concentrated in 2006. The challenge of adjusting the exchange rate of the Chinese renminbi adds to these worries. Massive reserve accumulation (over \$200 billion in 2004) and a widening current account surplus (despite rapid growth of domestic demand) imply substantial undervaluation. Further delay of necessary exchange rate adjustment could, by 2006, lead to such a build-up of financial and international political pressures that exchange rate adjustment would be forced at a time that is inconvenient for an already slowing Chinese economy, as well as for several other Asian economies that are important suppliers to China.

Most probably, the scenario in which the Federal Reserve needs to tighten aggressively to resist the inflationary threat arising from output growth that is too rapid is not one where we should expect further significant weakening of the market-determined exchange rate of the US dollar against most other industrial-country currencies. However, sudden substantial depreciation of the US dollar against several Asian currencies, in particular the Chinese renminbi, could well occur in an environment of Fed tightening—and this would give some impetus to US inflation, which might concern the Fed.

One can also conceive of a “worst case” scenario—similar to what happened in 1979–80. At that time, the positive inflation and negative output effects of a surge in world oil prices combined with a general loss of confidence in US economic policies. Market interest rates were pushed up and the dollar crashed, and the Federal Reserve had no alternative but to tighten sharply despite a weakening US economy. In my view, we are still quite some distance from such a “worst case.” Remembering the disaster of 25 years ago, the Federal Reserve is not disposed to allow inflationary pressures to gather sufficient momentum to threaten another crisis of confidence. This offers important reassurance that the risk of a “worst case” developing by 2007–10 is low. However, it also suggests that the risk from a greater-than-anticipated Fed tightening over the next year or so—associated with continued asymmetry in the global pattern of demand growth and with the need to begin to unwind major international payments imbalances—is significant.

The Americas

From the discussion of key risks, it is apparent that the importance for the world economy of US economic performance is—as it often has been—even greater than the substantial 21 percent weight of the US economy in the WEO-based measure of world real GDP. During 2004, (contrary to my forecast) growth of real domestic demand in the United States once again significantly outstripped US output growth, and it accounted for 60 percent of the demand growth of all industrial countries. Despite sharply higher energy prices, the waning of fiscal stimulus, and the beginnings of monetary tightening, demand growth slowed only briefly in the second quarter before resuming a 5 percent annual rate of advance during the second half of 2004.

For 2005, preliminary indications for the first quarter suggest that both real GDP and real domestic demand have advanced at about 4 percent annual rates or slightly higher. The core CPI on a 12-month basis is running just below 2½ percent, and the GDP-based measure of core consumer prices is running just below 1½ percent. Both of these figures are up significantly from their lows of 2003 but are not yet above the Fed's perceived "comfort zone."

Wage growth remains subdued despite a year of moderately strong employment gains, but nonwage compensation costs (especially health care) have picked up. Labor productivity growth slowed substantially in the second half of 2004, probably partly as a cyclical payback for the productivity upsurge in the preceding few quarters. Unit labor costs are now rising moderately but not alarmingly. Materials costs (including energy), however, are up substantially, and both large and small businesses are reporting increasing "pricing power" to pass on cost increases to customers and, in some cases, to widen profit margins.

In this environment, the Federal Reserve continues with its policy of "measured" removal of monetary stimulus, with two 25 basis point increases in the federal funds rate so far this year and the virtual certainty of another one at the Federal Open Market Committee (FOMC) meeting in May. Beyond that, the pace of monetary tightening may either pick up or slow down, depending on incoming data about economic activity and inflation. In view of my (upwardly revised) forecast for the US economy and for inflation, I now expect that the federal funds rate will exceed 4 percent by end 2005 and is likely to reach 5 percent in the first half of 2006.

Of course, it would be preferable for fiscal policy to play a more important role in restraining domestic demand growth, thereby relieving some of the burden from monetary policy. In view of the challenges of an aging population, substantial fiscal consolidation is clearly needed over the medium to longer term. It makes sense to pursue this consolidation at a time when it will contribute useful restraint to demand growth. President George W. Bush's proposed budget, however, envisions only a modest path of fiscal consolidation, and it appears unlikely that the Congress will modify these proposals in the direction of greater consolidation. With a forecast of nominal GDP growth that is a little stronger than the administration's, I expect that the budget deficit for FY2005 will come in moderately below their forecast of \$417 billion. Government purchases of real goods and services (federal, state, and local) should contribute about one-half of 1 percent to the growth of both real GDP and real domestic demand in 2005 (Q4/Q4) and make a similar contribution in 2006.

In coming quarters, the growth of real consumer spending should slow from the nearly 4 percent annual pace of 2004 to 3 percent or a little less. Higher energy prices are cutting into the disposable income available for other purchases, and auto sales may also feel some negative effect from higher fuel costs. Rising interest rates at both short and long maturities should boost the cost of mortgage finance and cut down the rate of increase in home prices. Slowing the growth of a key component of household net worth that has contributed importantly to recent consumer spending growth should help slow future spending growth to, or somewhat below, disposable income growth. On the other hand, continued moderate increases in employment (on the order of 150,000 per month on the establishment payroll measure) and modest wage gains should keep consumer spending growth from falling much below the rate of growth of the US economy. All of

this suggests that growth of real consumer spending should be expected to contribute between $1\frac{1}{2}$ and $2\frac{1}{4}$ percent to the growth of real domestic demand and of real GDP during 2005 and perhaps slightly less during 2006.

For investment, it appears that inventory investment is at a level that maintains a reasonable ratio of inventory stocks to GDP. Accordingly, no significant contribution (positive or negative) should be expected from inventory investment for domestic demand or real GDP. In contrast, business fixed investment (in equipment, software, and structures) is on a strong upswing but still has some distance to go. Real spending growth in this area of 8 to 10 percent during 2005 and somewhat less during 2006 is a reasonable prospect. For residential investment, the forecast is that it has reached its peak and that under the impact of higher mortgage rates, it will decline at a modest pace through the remainder of 2005 and 2006. For investment as a whole, this implies an expected contribution of between $\frac{3}{4}$ and $1\frac{1}{4}$ percent to the real growth of domestic demand and of real GDP during 2005 and modestly less during 2006.

Adding the three components of real domestic demand (consumption, investment, and government spending), the preceding discussion suggests growth of between $2\frac{3}{4}$ and 4 percent during 2005 and between $2\frac{1}{4}$ and $3\frac{1}{2}$ percent during 2006. This leaves the behavior of real net exports—which are the difference between real GDP and real domestic demand—as the wildcard that will influence real GDP growth this year and next.

Despite the sluggish growth of employment during the present expansion, the rise of inflation since mid-2003 suggests that—all things considered—there is not a great deal of slack left in the US economy before rising resource demands begin to push inflation to undesirable levels. In particular, if real domestic demand growth of 4 percent were to be combined with modest improvement in net exports, the US economy would probably pass that point within a year.

As a central forecast, I do not expect this to happen—although it remains an important risk. Rather, through a combination of factors tending to slow the growth of domestic demand, including monetary tightening that is somewhat more aggressive than now anticipated in financial markets, I expect that domestic demand growth during 2005 will be kept to $3\frac{1}{2}$ percent or less (on a Q4/Q4 basis). This will allow for a leveling out or even a small improvement in US net exports during 2005, without serious escalation of inflationary pressures. Somewhat slower growth of US domestic demand during 2006, modestly below 3 percent, would allow a little more room for improving net exports. This is consistent with a forecast of real GDP growth for 2006 of $3\frac{1}{4}$ percent—in line with the estimated potential growth rate of the US economy.

Taking a more medium-term perspective, it is relevant to recall that between 1995 and 2000, US real GDP grew at an average annual rate that was somewhat above potential output growth (which was boosted by an unanticipated acceleration of productivity growth). In that period, the average real federal funds rate (calculated using the core CPI) was about 3 percent. This suggests that the “neutral” real federal funds rate in that period was at least 3 percent. During this period, however, real domestic demand in the United States advanced at an average annual rate that was about $\frac{1}{2}$ of one percent higher than real GDP growth, as reflected in the widening US net export and current account deficits.

Monetary policy is primarily concerned with real GDP growth (which also affects inflation), but monetary policy affects primarily the growth rate of domestic demand. If the US external deficit had not been able to widen substantially between 1995 and 2000, too much demand growth would have been bottled up in the US economy. In this hypothetical situation, US monetary policy would have had to have been meaningfully tighter in order to contain the rise of inflationary pressures.

With a current account deficit that now exceeds 6 percent of GDP and needs to come down substantially over the next few years (to no more than about 3 percent of GDP), the US economy is in the reverse situation to that of 1995–2000.¹ To accommodate a significant improvement in US net exports, domestic demand must grow more slowly than real GDP (and than potential output). Arguably, the monetary policy needed to accomplish this requires a significantly higher real federal funds rate than the rate that prevailed in 1995–2000. If so, then both the Federal Reserve and financial markets are likely to discover before much longer that US monetary policy is “well behind the curve.” The result, in this situation, would likely be a substantial increase in US interest rates across the yield curve.

Of course, other factors may point to a lower value for the “neutral” real federal funds rate. But, in view of the considerable recent strength of US domestic demand growth, despite higher oil prices and initial monetary tightening, it is relevant to recognize that the Federal Reserve may have significantly more work to do than is generally anticipated in financial markets.

Turning to **Canada**, the economy has been operating near potential for the past two years. Because of concern that the economy might overheat, the Bank of Canada began to firm its monetary policy during 2003—a year before the Federal Reserve. Along with the boom in world commodities, of which Canada is an exporter, monetary tightening probably contributed to the strong appreciation of the Canadian dollar against the US currency. This appreciation, in turn, allowed a gap to develop between rapidly rising domestic demand in Canada and increases in GDP and helped to keep potential inflationary pressures in check.

Looking to 2005–06, the strong Canadian dollar will continue to serve as a break on inflationary pressures and on the rise in real GDP. The Bank of Canada (which reversed some of its earlier tightening during 2004) may move to firm up short-term interest rates, but it will probably lag well behind the Federal Reserve. Fiscal policy will add modest stimulus as Prime Minister Paul Martin deals with the difficulties of a minority government and with the possibility of early elections. With some slowing in the US economy, I expect that Canadian real GDP will grow just under 3 percent during 2005 and perhaps a little slower than that during 2006.

As a region, **Latin America** enjoyed exceptionally strong growth in 2004, with real GDP rising by an estimated 6¼ percent. This is the strongest growth for the region for any year since the 1970s. As such, it reflected some special factors (especially sharp recoveries from deep recessions in Argentina, Uruguay, and Venezuela), which will not

¹ The analysis supporting the conclusion that the US current account deficit is unsustainably large and the implications of what is needed to reduce it to a sustainable level are examined in my essay on “Policies to Sustain Global Growth while Reducing External Imbalances” in C. Fred Bergsten, *The United States and the World Economy*, Institute for International Economics, 2005.

recur to the same extent this year or next. Nonetheless, growth prospects for the region remain quite good relative to average performance over the past 25 years.

Mexico had a good year in 2004, with real economic activity rising 4½ percent, aided by the recovery in sectors closely linked to the US economy. Inflation picked up during the year, leading the Banco de Mexico to tighten monetary conditions in order to forestall a significant overshoot of its inflation target. A bitter political fight over the budget ultimately forced President Vicente Fox to accept a less disciplined result than he initially proposed, but the outcome does not portend a return to the fiscal frivolities that have characterized several previous presidential election years. Other important elements of President Fox's reform agenda made essentially no progress last year, leaving a disappointing record for his administration. Opportunities to boost Mexico's economic performance over the longer term (including in the important energy sector) have been lost, but the short-term effects will be relatively small.

The peso firmed modestly on tightening by the Banco de Mexico, but the exchange rate remains reasonably competitive after a major downward correction from a significantly overvalued level three years ago. Competition from Chinese and other Asian products in the critical US market, however, is a problem for Mexico, and, unlike many other Latin American countries, Mexico does not get much of a benefit as an exporter to Asia. This problem would be ameliorated by significant appreciation of Asian currencies against the US dollar.

With the US economy continuing to expand but at a somewhat slower pace, and with domestic policies unlikely to supply either much stimulus or much restraint, it is reasonable to expect that the Mexican economy will grow at just under a 4 percent annual rate for 2005. With somewhat greater uncertainty, this also appears to be a reasonable forecast for 2006.

In **Brazil**, the economy got past the aftereffects of the 2002 crisis and recorded 5 percent real GDP growth for 2004. Rising exports (including exports to Asia) provided an important boost. But the key factor was a shift from shrinking to rising domestic demand—with both consumption and investment showing important gains. The substantial easing of monetary conditions during the second half of 2003 played an important role in these results. This, in turn, reflected growing confidence that both inflation and the government budget would remain under control and that the Lula government would continue to pursue sound economic policies.

The strengthening domestic economy, rising global commodity prices, and delayed pass-through effects from the large depreciation of the real during 2002 provided some upward impetus to domestic inflation, which threatened to breach the central bank's inflation target. This pushed the central bank into tightening mode. The extent of this tightening, however, will be far less than that of recent episodes in Brazil because inflation remains under much better control. The result of this and of other factors is likely to be a slowdown in the economy's growth rate to around 4 percent in 2005 and 2006.

Continuing its recovery from the catastrophic crisis of 2001–02, **Argentina** achieved nearly 9 percent real GDP growth in 2004. (This is 3 percent above my forecast of last April and even further above the Argentine government's forecast of the same vintage.) As a result, Argentina's real GDP has now recovered almost all of the ground lost in 2001 and 2002 but is still significantly below the peak of mid-1998.

This year, Argentina's real GDP growth should continue to reflect recovery from the extreme recession of 1998–2002 and should benefit from the low real exchange rate of the Argentine peso and the boom in world commodity markets. Increasingly, however, problems left unresolved from the crisis will impinge on the economy's growth.

Caps on utility and energy prices have been used to suppress inflation and extract wealth from foreign investors to the benefit of Argentine citizens. But the inevitable result has been a dearth of investment in these sectors, and important bottlenecks are clearly developing as the economy recovers. The tactic of threatening foreign owners to spur investment—whatever its domestic political popularity—will not work. The debt exchange offer that is touted as “successfully” resolving the default on the Argentine sovereign's external debt has, in fact, left holders of \$20 billion of principal value (amounting to about half of the amount actually held by foreigners before the exchange) with repudiated securities. This matters little for the Argentine economy in the near term because the Argentine sovereign has no need to access international credit markets for new loans for the next few years. More important over this time span is the effective destruction of the domestic financial system as a reliable mechanism for intermediating credit between savers and investors.

For 2005, these problems will generally not be acute, and real GDP growth of about 5 percent (the Argentine government's forecast) is a reasonable prospect. For 2006, as the economy recovers further and capacity constraints become more binding, I would expect growth to decline to 4 percent. After that, Argentina's important structural economic problems will become more of an impediment to growth.

In the face of social and political turmoil, **Venezuela** suffered a cumulative 16 percent decline in real GDP and more than a 50 percent fall in gross fixed investment during 2002–03. Last year, with the rise in world oil prices and the calming of political tensions after the victory of President Hugo Chavez in the referendum, Venezuela recaptured this real GDP loss. With world oil prices even higher in 2005 and expected to remain so in 2006, Venezuela should enjoy two more years of strong growth. For this year, I forecast real GDP growth of 6 percent (modestly above the consensus); for 2006, the forecast falls to 5 percent. After that, if President Chavez remains in office (as he surely plans to), it will take a few years to run Venezuela's economy into the ground—longer if world oil prices remain high, shorter if oil prices fall back significantly.

Elsewhere in Latin America, growth in **Chile** strengthened to about 6 percent last year (from 3½ percent in 2003), aided by rising exports and high copper prices. **Peru** also had a reasonably good year with real GDP growth of 5 percent. Aided by higher oil prices, growth in **Ecuador** rose to about 6 percent, while in **Colombia** it advanced by 3½ percent. For 2005, growth is forecast to be slightly slower than last year in Chile, Peru, and Ecuador and about the same as last year in Colombia. This pattern should hold up fairly well for 2006.

Asia

Valued at nominal exchange rates, Japan's GDP is about triple that of China. Valued at the PPP-based exchange rates used for the IMF's *World Economic Outlook* and in this discussion, China's GDP is nearly double that of Japan (and slightly more than half that of the United States). In terms of China's economic influence on the rest of the world, the

PPP-based weighting provides a much more relevant picture than the nominal exchange rate-based weighting. In particular, last year China surpassed Japan to become the world's second largest oil importer (behind the United States), and the increase in Chinese oil imports was the most important factor pushing up global demand. Rising Chinese demand was also the most important factor pushing up world demand and world prices for a number of other primary products. More generally, the growth of China's international trade (imports and exports combined) made the largest single national contribution to world trade growth in 2004.

China's real GDP rose by more than 9 percent in 2004, by far the strongest real growth among the world's ten largest economies. This growth was led by a very rapid rise in Chinese real fixed investment, taking the ratio of such investment to GDP above 45 percent. My colleagues Morris Goldstein and Nicholas Lardy argue persuasively that this high ratio of fixed investment is unsustainable and that the rate of growth of investment in the Chinese economy (and its contribution to real GDP growth) must come down significantly. Because rising consumption and net exports will not make up for the necessary substantial slowdown in investment growth, real GDP growth will need to come down from the unsustainable high rate of last year. This would be similar to the pattern of slowing Chinese growth seen in the 1990s.

I had expected that with the aid of measures adopted by the Chinese government, this growth slowdown would begin in the second half of last year and gather pace this year, with the result that Chinese real GDP growth in 2005 would fall to 7 percent. It is now clear that a slowdown of this extent is not happening. Accordingly, I boost my forecast for Chinese real GDP growth this year to 8¼ percent. For 2006, consistent with the Goldstein-Lardy scenario of gradually declining growth, I forecast that Chinese real GDP will rise 7¾ percent.

An important uncertainty in this forecast, at least as much for China's influence on the rest of the world economy as for the Chinese economy itself, concerns the exchange rate of the renminbi. It has been pegged at RMB8.3 to the US dollar since 1994. Increasingly the evidence indicates that this exchange rate has become substantially undervalued—in part because the US dollar has depreciated substantially since 2001. More than a year ago, Goldstein and Lardy estimated that the renminbi was undervalued by 15 to 25 percent. The massive accumulation of foreign exchange reserves (over \$200 billion) by the Chinese government last year, the further effective depreciation of the renminbi along with the declining US dollar, and the significant widening of the Chinese current account surplus implied by recent trade data all suggest that the extent of undervaluation is now at about 25 percent or even larger.

The generally strong growth of the Chinese economy during the 1990s, despite a real effective exchange rate that was substantially appreciated relative to today's level, indicates that an appreciation of the renminbi should not be a serious impediment to Chinese economic growth over the medium term. In the short run, however, especially in view of the increased importance of international trade to the Chinese economy, a sharp appreciation is likely to have some negative effect on Chinese output growth (which would be partly absorbed by foreign suppliers to Chinese export industries). But, attempting to spread out the necessary exchange rate adjustment is not a good remedy, as this would likely provoke more intense speculative pressures on the exchange rate and

ultimately make the adjustment more difficult. Rather, it would be best to make the necessary adjustment mainly in a single step—and not wait much longer to do so.

In **Japan**, the economy recovered reasonably robustly from early 2002 through the first quarter of 2004, but estimated real GDP growth turned negative for two quarters before posting a modest (revised) gain for the final quarter. Other data suggest that the economic slowdown last year was not as much as GDP estimates indicated, but growth no doubt slowed considerably, reflecting both slowing exports and weak domestic demand.

For a brief period, the Bank of Japan turned optimistic that the period of price deflation extending back to 1998 might soon be ending. More recently it has been reemphasized that the zero interest rate policy will continue for some time until growth in the Japanese economy is clearly on a firmer footing. Meanwhile, fiscal policy is in consolidation mode because the Japanese government is concerned about persistently large fiscal deficits, high and mounting government debt, and the fiscal challenges of a rapidly aging population. Indeed, the population of Japan will peak this year, to be followed by decades of gradual population decline. Even with reasonable rates of labor productivity growth (and structural reform that would add to efficiency in the services sector), it appears that potential growth for the Japanese economy is no more than about 2 percent per year.

Nevertheless, for the near term, I remain a mild optimist concerning the Japanese economy—at least relative to the consensus forecast. With monetary policy still very accommodative, with the yen still at quite competitive levels, and with reasonable growth expected in key Japanese export markets, and with no more than modest fiscal restraint, my forecast is that there will be some payback from the estimated weakness of GDP growth after the first quarter of last year. On a Q4/Q4 basis, I expect the Japanese economy to expand by 2½ percent this year. Year-over-year growth, however, will manage to reach only 1½ percent, to be followed by a 2 percent real GDP advance for 2006.

Among the world's ten largest economies (using WEO weights), India is by far the most dependent on its agricultural sector. Generally good weather contributed to relatively good performance in this sector in 2003 and thereby helped real GDP growth. The reverse occurred in 2004, and there will be some carry-over effect on real GDP growth for this year. This factor's influence for 2006 is unknown at this stage.

Beyond agriculture, the Indian economy consistently performed quite well recently, with industrial production and services output both up strongly during 2004. It is reasonable to expect that this performance will continue through this year and next. Inflation has run up somewhat recently, but it seems unlikely that the monetary policy response will put a serious brake on economic growth. The fiscal deficit is growing larger, from an already significant base, but fiscal restraint to address this problem also seems unlikely to significantly impede growth. The influence of international trade on the Indian economy has been rising, but its overall importance remains smaller than for most emerging Asian economies. Higher world energy prices will hurt some, but the pass-through effect to domestic energy prices and utility costs is relatively limited. On balance, a forecast of somewhat over 6 percent growth for 2005 and about the same for 2006 seems reasonable at this stage.

Real GDP growth was relatively sluggish in **Korea** in 2004, in comparison with other emerging Asian economies and with Korea's own record of strong economic growth. Continuing negative effects from the collapse of the consumer credit boom, the rise in world energy prices (to which Korea is particularly sensitive), and the slowdown in growth in Korea's principal export markets during 2004 all contributed to this somewhat disappointing result.

For 2005–06, the further rise in world energy prices will be a further drag on Korean economic growth. So too will be the short-term effect of the appreciation of the Korean won (by about 10 percent against the US dollar since mid-2004). More expansionary fiscal and monetary policies will provide a partial offset. But, real GDP growth does not seem likely to exceed 4 percent this year, and there is no reason at this stage to expect a much better result for 2006.

Elsewhere in emerging Asia, recent growth has been stronger than in Korea. **Singapore, Hong Kong, and Thailand** grew at rates of 6 percent or better in 2004. Growth in **Taiwan** accelerated to almost this pace, while **Indonesia** (despite all its problems) managed about 5 percent growth. (The tsunami of December 26, 2004 had a terrible human toll, especially in Indonesia, but the economic effects even for the Indonesian economy are likely to be relatively small.) In all of these economies (and in emerging Asia generally), growth will probably be somewhat slower in 2005–06. This reflects the nonrecurrence of special factors (notably the bounce back from the SARS crisis) that boosted growth last year, the impact of higher energy prices, and the effect of somewhat slower growth in key export markets.

Europe

Europe, particularly Western Europe, was the slowest growing region of the world economy last year—as it was the year before and is likely to be for the next two years. That said, it is important to note that economic performances differed considerably across the European region. Led by Russia and Turkey, Central and Eastern Europe grew very strongly last year (about 7 percent real GDP growth), while the United Kingdom and some countries in the euro area (including France, Spain, Belgium, Ireland, and Finland) turned in at least respectable growth. In contrast, growth in Germany and Italy was barely more than 1 percent last year, after even weaker performances in 2003, and the results were similar in Austria and the Netherlands.

Looking first at the **United Kingdom**, it is noteworthy that the economy has been in continuous expansion for 12 years—probably the longest expansion in its history. During the past six years, the United Kingdom has averaged nearly 3 percent annual real GDP growth, while the countries of the euro area have not managed to achieve as much as 2 percent annual average real GDP growth. No wonder that there is not much popular enthusiasm in the United Kingdom for joining the euro area—something that will have to await a time when the comparison of relative economic performances is more favorable for the common currency area.

In 2004, the UK economy grew by 3 percent and presently appears to be operating at potential. Core consumer price inflation is running meaningfully below the midpoint of the Bank of England's target range, but this is partly due to the strong foreign exchange value of the sterling. Housing prices, which were rising rapidly until recently,

are a signal of underlying inflationary pressures. In this situation, the Bank of England has pushed its benchmark interest rate up to 4¾ percent and may soon make a further (and likely final) upward move to 5 percent. The new budget recently presented by Chancellor Gordon Brown is mildly expansionary and perhaps mildly irresponsible—an election is scheduled for early May.

With housing price gains slowing substantially under the impact of tighter monetary policy, it seems likely that the consumer spending boom will come to an end (but not a collapse). This should help slow the rise in real GDP to around 2½ percent this year and next—in line with the potential growth rate of the UK economy. Some depreciation of the sterling against the euro would help shift the composition of output toward the beleaguered tradable goods sector, offsetting the slowdown in consumption and home building, and consistent with some easing by the Bank of England as it becomes clear that inflation remains well contained.

The situation is less satisfactory in the euro area. Consumers in **Germany** (which accounts for about a third of euro area GDP) remain in a prolonged funk, with virtually no growth of real consumer spending for more than three years. Business confidence staged a brief recovery as exports boosted growth in the first half of 2004, but recently confidence has eroded again as domestic demand has failed to follow through. Somewhat distorted by the statistical effects of labor-market reforms, seasonally adjusted unemployment has recently risen to levels not seen since the 1930s—not the stuff upon which to rebuild confidence.

In **Italy**, the economic situation has been only a little bit better, with real consumption spending rising somewhat less than 1 percent per year for the past three years, and with business investment showing modestly more vitality than in Germany.

Fortunately, **France, Spain**, and some of the smaller Western European countries have been performing distinctly better than Germany. Real consumption spending in France averaged somewhat better than 2 percent annual growth for the past three years, and in Spain it averaged nearly 3 percent annual growth. Investment in France declined in 2002 and 2003 and was quite sluggish in Spain in 2002, but it showed reasonable (but still modest) growth in both countries last year.

For the past three years, my forecasts for real growth in the euro area have exceeded the actual results. This may be explained partly by my expectation that the European Central Bank (ECB) would do somewhat more than it has done to respond to the weakness in euro area growth. It may also be explained partly by the effects of the unanticipated rise in world energy prices and in the foreign exchange value of the euro. However, an important part of the explanation is also, simply, that my forecasts were too optimistic.

Well, there is an old saying, “Once burned, twice shy.” Having been burned three years in a row, I am scaling back more euro area growth forecast to be in line with the consensus which foresees about 1½ percent real GDP growth for 2005 and about 2 percent real growth for 2006. I continue to believe that the economic performance of the euro area will eventually catch up with economic fundamentals. However, the recent further run-up in world energy prices, and the further appreciation of the euro against the US dollar over the past year, do not suggest that we are yet on the threshold of significantly stronger growth in the euro area. Accordingly, my forecast is that real GDP growth in the euro area will be about 1½ percent this year and will rise modestly to 2

percent next year. This forecast presumes that the ECB will not ease short-term interest rates but will lag well behind the Federal Reserve in its path of monetary tightening. Fiscal policy in the euro area will continue to respect the Stability and Growth Pact to about the same extent as it has in the past.

In **Central and Eastern Europe**, as previously noted, growth was quite strong in 2004. Aided by high energy prices, **Russia's** economy expanded by about 7 percent last year, and with further increases in energy prices, a similar result should be expected this year. Political uncertainties about the business climate in Russia and the security of property rights (arising out of the Yukos affair and other developments) raise questions about the likely robustness of Russia's longer-term growth, but these concerns will probably have only limited effects on near-term results.

Led by large gains in investment, **Turkey** also performed very strongly last year, recording real GDP growth of almost 10 percent. The widening trade and current account deficits (partly due to higher imported energy costs) are a concern and may begin to weigh on the exchange rate, which now appears somewhat overvalued. Inflation has come down to single digits for the first time in a generation. Domestic nominal interest rates have also dropped considerably, but domestic real interest rates are still high. The government budget continues to run impressive primary surpluses, and the public debt ratio has come down (aided by the effects of real exchange rate appreciation on the domestic value of the foreign currency debt). With high real interest costs on the domestic debt, however, the overall public-sector deficit remains substantial. Clearly, the economic situation in Turkey is much improved over the past two years, and the risk of a financial crisis has receded. Nevertheless, after two years of rapid recovery and with a strong real exchange rate, still high domestic real interest rates, and high energy prices, growth should be expected to slow in the Turkish economy to no more than about 6 percent this year and probably somewhat less next year.

Elsewhere in the region, growth last year was generally strong but not spectacularly so. Much the same can be expected this year and next, probably with results that are a little below those of 2004. For example, **Poland** bounced back in 2004 after a weak year in 2003; some slowing of growth is likely this year under the impact of higher energy prices and continued weakness in Germany. For the region as a whole, growth is forecast to run a little above 5 percent this year (after nearly 7 percent in 2004) and is expected to decline slightly in 2006.

Many of the countries of Central and Eastern Europe have sizable budget and current account deficits. In the present global environment of low interest rates and low interest rate spreads, and with the additional boost to confidence from EU accession, there is no present difficulty in financing these deficits, and it seems unlikely that problems in this area will develop over at least the next year. In the longer term, however, the budget and current account imbalances will need to be addressed, and the risk of some type of financial crisis cannot be wholly discounted.

The Middle East and Africa

Timely and reliable information about economic activity is not readily available for many of the countries in these regions, especially most of the smaller countries. Nevertheless,

2004 was clearly a very good year for both these regions, and 2005–06 promises to be nearly as good.

High oil prices were a key positive factor for the oil-exporting countries of the Middle East (including **Saudi Arabia, Kuwait, the United Arab Emirates, and Iran**) and of Africa (including **Nigeria, Algeria, and Angola**). Even higher oil prices will be a further boon for these economies in 2005–06—with the spending of much of the proceeds from oil exports boosting domestic consumption and investment. Exporters of other primary products also benefited from strong world commodity prices. Although these prices have generally fallen back somewhat from their peaks (but with coffee prices rising recently), conditions remain favorable for most primary-product exporters.

In the larger, more diversified economies of these two regions, recent economic performance has also been quite strong. **Pakistan** reportedly achieved about 7 percent real growth. **Egypt** grew better than 4 percent. **South Africa**, after a sluggish 2003, also apparently grew nearly 4 percent last year. Looking ahead, Pakistan may not sustain quite such strong performance, but Egypt and South Africa have the potential to each grow at a 4 percent rate or better.

Finally, military conflicts and social unrest typically have had significant negative effects on economic growth in both the Middle East and Africa. This was also the case in 2004 but less so than in most recent years. In **Iraq**, despite the insurgency, which attracted massive media attention, the economy recovered strongly from the devastation of 2003. In **Nigeria**, unrest over the distribution of the benefits from oil exports created some economic disruption, but this was relatively mild. **Cote d'Ivoire** remained a political mess, but so far at least, open civil war has been avoided. Turmoil continues in the **Congo**, especially along its eastern border, but the situation is not as bad as it was a few years ago. **Zimbabwe** is descending into the economic abyss, but earlier fears of adverse spillovers to neighboring countries have proved exaggerated. Provided that levels of conflict and turmoil do not escalate from those last year, economic growth in both the Middle East and Africa will likely slow only modestly from the good results of 2004.

Table 1 Global economic prospects, assessment of April 6, 2005 (annualized percentage change of real GDP growth rates)

Country or region	2004 Yr/Yr	2005 Yr/Yr	2006 Yr/Yr	2005 Q4/Q4	2006 Q4/Q4
Industrial countries	3¼	2½	2½	2¾	2½
United States	4½	3¾	3¼	3½	3¼
Japan	3	1¼	2¼	2	2
Western Europe	2¼	1¾	2	2	2
United Kingdom	3	2½	2½	2½	2½
Other non euro area	3	2½	2½	2½	2½
Euro area	2	1½	2	2	2
Germany	1¾	¾	1½	1¾	1¾
France	2¼	1¾	2	2	2 ¼
Italy	1¼	1¼	1¾	1¾	2
Other euro area	2½	2¼	2¾	2½	2¾
Other industrial countries	3	2¾	2¾	2¾	2¾
Emerging markets and developing	7¼	5¾	5¼		
Asia	8¼	7	6¾		
China	9½	8¼	7¾		
India	6½	6½	6		
Other Asia	6¼	5	4¾		
Latin America	6¼	4¼	4		
Argentina	8¾	5	4		
Brazil	5	4	4		
Mexico	4½	3¾	3½		
Other Latin America	8½	4½	3¾		
Central and Eastern Europe	6¾	5	4½		
Middle East	5	4½	4		
Africa	4¾	4¼	3¾		
World (WEO weights)	5¼	4	3¾		

Yr/Yr = year over year

Q4/Q4 = fourth quarter to fourth quarter