Global Economic Prospects: Growth Slowing Below Potential in 2006 (Assessment as of Mid-September 2005)

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Overview

As forecast, global real GDP growth this year is coming in at about 4 percent, after exceptionally strong—better than 5 percent—real growth in 2004. However, the recent upsurge in world oil prices to over $65 per barrel, progressive tightening by the US Federal Reserve, continuing effects of hurricane Katrina, waning housing price gains in Australia, Britain, and the United States, and the prospect of some further easing of investment growth in China make it likely that global growth will slow further in 2006. With a potential growth rate for the world economy of about 3¾ percent (on a World Economic Outlook/purchasing power parity [WEO/PPP] exchange rate–weighted basis), it now seems likely that global growth will fall below potential next year. The time pattern of slowing growth suggests that the Q4/Q4 result for 2006 will be below the year-over-year forecast of 3½ percent global growth.

Unlike 2005 and the preceding three years, when the general process of recovery from the world recession allowed global growth to be forecast with considerable confidence, the forecast for 2006 has a higher degree of risk. This risk reflects unusual uncertainty about the course of world energy prices and their economic impact, about the timing and consequences for global growth of the likely (and ultimately necessary) shift from an expanding to a contracting US external deficit, and (especially for the United States) about the economic effects of Katrina and its aftermath. With a significant fallback in energy prices, a virtuous transition to a gradually contracting US external deficit, and prompt resolution of Katrina-related difficulties, it is possible that growth next year could be sustained at about a 4 percent rate. Far more likely is the prospect that global growth will shrink to 3¼ percent. A global recession, with growth falling to 2½ percent or less, is possible, but the probability now looks no greater than about 10 percent. Surprisingly, neither world equity markets nor most economic forecasts since the mid-summer upsurge in world oil prices are yet reflecting this more subdued global growth outlook—we shall see.

On the inflation front, the sharp rise in energy prices is pushing up consumer prices across most of the globe. Core consumer price inflation remains better contained, with industrial countries generally running rates of 2½ percent or less. While not threatening, these core inflation rates are generally up from their lows of the past two or three years, and at least some important central banks are reluctant to disregard entirely the escalation of overall inflation rates. The inflation story is much the same in most emerging-market and developing countries—with a few exceptions where rising inflation is clearly a more urgent concern.

Industrial-country central banks that have tightened their monetary policies (notably the Reserve Bank of Australia, the Bank of England, and the US Federal Reserve) feel well-justified in their actions and appear unlikely to ease policies dramatically in the face of moderating economic growth rates. A pause in the Federal Reserve's "measured pace" of tightening is likely by year-end in the aftermath of Katrina, but the underlying rationale for removing monetary accommodation has not been diminished by the hurricane or the rise in world energy prices. Some emerging-market central banks (especially the central bank of Brazil and possibly the Banco de Mexico) may have room to ease if inflationary pressures recede. Others (notably the central banks of Argentina and Russia) have more work to do.

Fiscal policies have been eased in some emerging-market countries (e.g., Korea and Thailand) in the face of weaker than expected growth. The US government will inject at least $60 billion of disaster relief (financed by an increased deficit). Some industrial countries have also taken limited actions in this direction (e.g., Canada, Italy, and the United Kingdom). But the room for fiscal policy to act prudently and effectively to stimulate growth in either industrial or emerging-market countries is generally quite limited. Thus, aside from the possibility of some further easing by a clearly reluctant European Central Bank (ECB), there appears to be little that macroeconomic policies can or will (or should) do to resist a likely slowdown in global economic growth.

Major Risks

As always, risks surround the central economic forecast. For 2005 these risks are small because barely more than one quarter of the year remains, and a year-over-year global growth result of nearly 4 percent is now virtually assured. Indeed, while hurricane Katrina appears likely to cut US growth by ½ percent or more in the final four months of 2005, the year-over-year result for US growth in 2005 is only marginally affected, and the result for global growth (Yr/Yr) is barely changed at all. The direct negative effects of the devastation from the hurricane will push down Q4/Q4 growth for the United States in 2005, and recovery and rebuilding will boost the Q4/Q4 results for 2006. Distortion in the timing of trade shipments into and out of the United States due to transportation disruptions will add to volatility and uncertainty about these Q4/Q4 results. For 2006 on a year-over-year basis, these down and up and trade timing distortion effects should largely wash out. This leaves still large, basic uncertainties concerning the growth forecast for next year, which have a somewhat asymmetric downward bias.

The key factors that give rise to these asymmetric risks for global growth in 2006 relate to the behavior and effects of world energy prices and to problems associated with unwinding the large payments imbalances reflected in the huge US external deficit. It is useful to examine these two key areas of uncertainty before turning to the region-by-region analysis of economic prospects.

Uncertainty about World Energy Prices

By early April of this year, oil prices, as indicated by the price of light sweet crude, were up to around $50 per barrel and were projected (in futures markets) to fall only modestly through 2006. This was about $10 per barrel above the prices of early April 2004 and about $20 per barrel above the prices of April 2003. After an upsurge to over $70 per barrel (for light sweet crude) immediately after Katrina, spot oil prices have fallen back to around the $65 per barrel level prevailing before the hurricane. Futures markets now project that prices at about this level will be sustained through 2006 and for some years thereafter.

It is now clear that the key factor driving up world oil prices (and along with them, prices of most other forms of energy) has been the unexpectedly rapid growth of world demand against a limited near-term capability to expand supply. What is not clear is how high world oil prices will need to be in order to achieve and sustain a reasonable balance between world supply and world demand and what will be the broader macroeconomic consequences of continued high world energy prices over the next couple of years.

It is possible that the rise in world oil prices from $45 to $50 per barrel to around $65 per barrel reflects primarily short-term speculative pressures, worries about supply disruptions that may not materialize, overestimates of probable demand growth, or other factors whose reversal could lead to a substantial and rapid decline in oil prices back to, or even somewhat below, the levels of April of this year. On the other hand, it is also possible that oil prices have not yet risen enough to constrain demand growth within the achievable growth of supply or that supply disruptions might induce further oil price increases of perhaps $10 or $20 per barrel. Thus, world oil prices of either $50 or $80 per barrel within the next few months are not outrageously improbable outcomes. The disruptions caused by Katrina suggest that at least for the next few months, oil markets may focus somewhat more on the upside rather than the downside risks to prices.

Moreover, the size of the likely economic reaction to higher energy prices is quite uncertain. Based on the experience of the 1970s through the 1990s, one would have expected a much larger negative impact on global growth from the rise in world oil prices from the $25 per barrel range to the $50 per barrel range between 2002 and early 2005. Some countries (notably Korea and Thailand and, to a lesser extent, Japan and Western Europe) appear to have been negatively impacted. But economic growth in the two largest oil-importing countries, the United States and China, seems to have been virtually impervious to the rise of oil prices up to $45 to $50 per barrel.

I do not expect this imperviousness to continue with oil prices up to $65 per barrel or higher. Especially in the United States, which does not shelter domestic energy consumers to a significant extent from the higher energy prices, I expect we will see a significant negative impact on (nonenergy) real consumption spending from the recent upsurge in energy prices. The extent of this reaction, in the United States and elsewhere, remains an important uncertainty.

Finally, on the issue of world energy prices, it is essential to recognize that if the central problem is energy demand growth outstripping achievable near-term growth of energy supplies (rather a problem of speculation or misguided expectations), then the solution necessarily involves some slowing in the pace of global economic growth. In the longer run, high energy prices should encourage both more rapid energy supply growth and slower energy demand growth relative to growth of the world economy. In the short term, however, these allocative effects of high energy prices operate weakly, especially in many countries that shelter domestic energy users from high prices. Thus, a slowdown in global economic growth becomes essential to slow the growth of global energy demand.

In this situation, it does not make sense to try to use expansionary macroeconomic policy to offset the growth-slowing effects of high energy prices. The result will simply be to push energy prices even higher until the necessary demand/supply balance is achieved in world energy markets. Of course, it is even less sensible to adopt the reverse approach of tightening macroeconomic policies to resist any tendency for high energy prices to affect the general price level, thereby inducing a sharp slowdown in economic growth as the means to force lower energy prices. Rather, the point is that if there really is a problem with energy demand growth outstripping energy supply growth, then we will probably need to accept some temporary slowdown in global economic growth as an unavoidable component of the solution to this energy problem.

Unwinding of External Payments Imbalances

The tendency toward slower global growth next year includes, and is reinforced by, a likely slowdown in consumer spending growth in the United States. This, in turn, is linked to continued, measured tightening by the Federal Reserve and to a leveling off of housing prices and likely moderate decline in US residential investment next year—as well as to the negative impact of higher energy prices on household real incomes and real consumption spending.

The slowing of household spending growth in the United States should contribute to the beginnings of a reversal in the decade-long trend of ever-widening US external deficits. But, in the absence of a pick-up in demand growth in the rest of the world economy—which appears unlikely, especially in the face of high world energy prices—the global outcome will be a slowdown in global demand growth and, hence, in global output growth.

In particular, a significant acceleration of domestic demand growth in Western Europe, Japan, or much of emerging Asia appears unlikely when high energy prices combine with the probable effects on business confidence and investment of slowing exports to the United States. In China, which has supplied important impetus for global growth in recent years, we already see significant slowing of domestic demand growth, which is reflected in the rapidly widening Chinese current account surplus. With further moderation of investment growth in China not likely to be fully offset by rising consumption growth, and without some meaningful adjustment of China's exchange rate, it appears that China will become more a sink rather than a source of growth as far as the rest of the world is concerned.

This challenge for global growth from the need to reduce the US external imbalance would be exacerbated, at least in the near term, if weakening growth in the United States led to large renewed depreciation of the dollar against the euro and the yen (and perhaps some other Asian currencies). While the US economy would eventually benefit from stronger export growth linked to a weaker dollar, the more immediate consequences would be negative for growth and confidence in much of the rest of the world.

Indeed, in its extreme form, the "dollar crash" scenario could threaten world recession—especially if loss of confidence by foreign investors led to a sharp fall-off of capital flows to the United States, to an upsurge in US interest rates, and to a massive decline in the foreign exchange value of the dollar. I believe that the probability of this extreme scenario is small. Partly this is because foreign governments would be woe to countenance a sudden, substantial further depreciation of the dollar, and at least some of these governments would probably intervene massively to purchase US assets to forestall or moderate such a development. Mainly it is because the US economy remains very sound (absolutely and relative to most other major economies) and remains an attractive place for expanding volumes of foreign investment.

Nevertheless, it would be imprudent to suppose that we can long continue the trend of the past decade when, on average, US demand growth has exceeded US output growth by half of a percentage point each year and, correspondingly, the US external deficit has widened by half a percentage point of GDP each year. With the US external payments deficit already exceeding 6 percent of GDP, it seems to me that the necessary shift from an ever-expanding to a gradually contracting US external deficit needs to come sooner rather than later. Sometime during the next year or so is the likely time to start that process.

The Improbable Virtuous Scenario

It is conceivable that the shift from an expanding to a contracting US external deficit could occur benignly both for the United States and for the rest of the world. This requires that the slowdown in demand growth in the United States correspond with an offsetting improvement in US net exports that keeps US output growing in line with the potential growth rate of the US economy. At the same time, demand growth in the rest of the world would need to accelerate to offset the negative impact from the shift from an expanding to a contracting US net export deficit.

In this virtuous scenario, real effective dollar depreciation of about 10 percent since 2001—although not sufficient in the long run—could plausibly provide the necessary impetus for the required shift in the distribution of world demand toward the United States for the next year or so. Even without the aid of desirable firming of US fiscal policy, Federal Reserve tightening of an appropriate amount could induce the necessary slowdown in US demand growth. Then, with the aid of further gradual but cumulatively substantial depreciation of the dollar, continued restraint on domestic demand growth in the United States, and robust growth of domestic demand in the rest of the world, we could continue the virtuous process of reducing the US external deficit in a manner consistent with maximum sustainable global economic growth.

Unfortunately, it is difficult to see what will induce the acceleration of demand growth in the rest of the world necessary to make this virtuous scenario work out. This is especially so over the next year or so in the face of the upsurge in world energy prices. Meanwhile, the Federal Reserve has been gradually tightening US monetary policy, and, to insure that inflation remains in check, it appears determined to continue to tighten until it is clear that the growth rate of the US economy falls within potential. Uncertainties about the course and effects of energy prices and the behavior of housing and equity prices mean that it will be very difficult for the Federal Reserve (with or without Alan Greenspan) to get it exactly right. I believe that there will be—and should be—a tendency for the Fed to err modestly on the side of restraint. The bottom line is that over the next year or so we should expect a significant slowdown in demand growth in the United States, without any pick-up (or even a slowdown) of demand growth in the rest of the world. Thus, global output growth will need to slow.

The Americas

Before hurricane Katrina, the US economy appeared headed toward 4 percent or slightly better real GDP growth in the summer quarter, with positive momentum from employment gains and inventory rebuilding carrying into the fourth quarter. Now, Katrina's devastation and continuing economic dislocation in New Orleans and along the Gulf Coast will negatively impact growth in September and probably for some months thereafter. The final result will likely be that US real GDP growth for 2005 will come in a little under, rather than a little over, 3½ percent.

By early next year, the positive economic impact from rebuilding after Katrina will overtake the continuing negative economic effects of the storm itself, thereby adding a modest positive impetus to Q4/Q4 real GDP growth for 2006. For year-over-year growth for 2006, Katrina should be nearly a wash, with the slowdown late this year nearly offsetting the impetus from rebuilding next year. However, the factors (already mentioned) tending to slow US growth next year, which were in place before Katrina, are still largely in place. Thus, a slowdown in US growth in 2006 still seems likely, notwithstanding the shorter-term disruption associated with the hurricane and its aftermath.

In particular, world oil prices (as measured by light sweet crude) had surged to over $65 per barrel before Katrina. Worries about continuing disruption of oil production from the Gulf of Mexico in Katrina's aftermath briefly pushed oil prices above $70 per barrel but subsided somewhat subsequently with announcements of offsetting releases from strategic petroleum reserves. Oil product prices, particularly for gasoline in the United States, spiked upward on news of refinery shutdowns and worries of longer-term damage from Katrina. Recovery of refinery output and product shipments from Europe will help to moderate the rise in most product prices in the United States (while pushing them up in Europe), but these prices (especially in the United States) are likely to remain high relative to crude oil prices for some months at least. Natural gas prices in the United States were especially strongly affected by Katrina. While there will likely be some respite from the "worst fears" reaction immediately after the hurricane, US natural gas prices appear likely to remain exceptionally high for some time—and increased supplies from abroad (other than possibly something more from Canada) are not a meaningful solution over the next few years.

In sum, Katrina has clearly made the already serious energy price problem for the US economy even worse. The only question is how much worse for how long? An optimist would emphasize that, surprisingly in the light of earlier experience, the US economy (and the world economy more generally) has weathered increases in oil prices to more than $40 per barrel without much apparent difficulty. If the primary underlying cause of higher world oil prices is growing demand rather than (artificial) constraint on supply, why could we not successfully absorb prices of $60 or $70 per barrel for oil?

No doubt, it has mattered that the rise in world oil prices over the past three years has reflected strong growth in oil demand linked to strong economic growth in economies with large oil consumption, rather than cutbacks or severe supply constraints on the part of oil-exporting countries. But, from the perspective of the United States, it should make little difference whether the world oil price rises because of rising demand from China or falling supply from Oil and Petroleum Exporting Countries (OPEC). (Symmetrically, for

China, it should make little difference whether rising world oil prices reflect rising demand in the United States or India or reduced OPEC output.) Higher energy prices are a significant negative real shock for the US economy. And, the fact that the world oil price rise to over $60 per barrel comes on top of recent rises to over $40 per barrel probably means that the effective shock is larger rather than smaller. Thus, in my view, we need to write down the forecast for US real consumption growth for 2006 by at least a full percentage point in order to take reasonable account of the likely impact of higher energy prices.

The policy environment also matters. When world energy prices surged in the early and late 1970s, monetary policies in the United States and most industrial countries needed to combat already accelerating inflationary pressures, and the combined effects of high energy prices and tight monetary policies were steep recessions. In the current episode, monetary policies remain relaxed in most of Europe and Japan. In the United States, the Federal Reserve has gradually moved from a highly accommodative stance 15 months ago (with the federal funds rate at a historic low of 1 percent) to a stance (a federal funds rate of 3½ percent) that it still regards as moderately accommodative. With core inflation and inflationary expectations still reasonably well contained, despite high energy prices, the Federal Reserve and other leading central banks will not move to sharply tighter monetary policies, as they did after the energy price surges of the 1970s. Thus, on this occasion I see little reason to fear US or global recession as an outgrowth of the upsurge in energy prices—at least not from the upsurge we have seen so far.

Nevertheless, the Federal Reserve has been gradually tightening its monetary policy, and prior to Katrina, it appeared geared to raise the federal funds rate to at least 4 percent by year-end, with the prospect of continuing increases to 4½ or even 5 percent by the first half of 2006. Now, bond markets are celebrating the expectation that "one more and they're done." In other words, the Federal Reserve may tighten once more at the September Federal Open Market Committee (FOMC) meeting, but after that further Fed tightening will be on indefinite hold in deference to the impact of Katrina.

In my view, this is a premature judgment that reflects the overexuberance of many financial-market participants who want to foresee developments that will sustain fundamentally unsustainable trends—in this case the boom in bond prices and the associated boom in home values and consumer spending. In fact, the underlying reasons for the Federal Reserve's policy of gradually withdrawing the monetary stimulus introduced to combat the recession of 2001 and subsequent economic weakness have not been removed by Katrina. Perhaps a brief pause by the Federal Reserve is appropriate in politeness to the victims of the disaster and to allow a little breathing space for the economy. But, if anything, the likely economic effects of Katrina probably strengthen, rather than weaken, the case for a somewhat less accommodative monetary policy.

Indeed, the situation is in some ways the reverse of 1997–98. At that time, partly as a consequence of economic and financial problems in Asia and elsewhere, the US economy experienced a positive real shock from falling world commodity prices, rising capital inflows, and a strengthening dollar. The unexpected acceleration of US productivity growth added another positive supply shock. As a result of these positive real shocks, the Federal Reserve could and did pursue a somewhat more accommodative policy than would have been wise in the absence of these shocks. And, the US economy benefited from continuing strong economic growth with falling inflation—despite reductions in unemployment to levels previously thought to imply accelerating inflation.

Now, the upsurge in world energy prices before Katrina and the economic effects of Katrina itself are negative real shocks to the US economy. Over the next year or two, with neutral macroeconomic policies, the temporary effects of these real shocks will be to depress real output growth and push up inflation.

Expansionary fiscal policy, mainly in the form of disaster relief, will provide some offset to the negative real output effect of these shocks. In theory, monetary policy might seek to suppress the inflationary effect of the shocks through a sharp tightening of policy. But, the consequence would be a further depression of growth and possibly a recession. So long as core inflation and expectations of future inflation are not escalated by the surge in energy prices, it is probably wise for monetary policy to allow a once-and-for-all upward shock to the general price level to absorb the temporary inflationary impact of a sharp rise in energy prices.

What should monetary policy attempt to do about the temporary negative real shock to growth? Surely, monetary policy should resist multiplication of a negative real shock that would push the US economy into an unwarranted recession. But, monetary policy should not, and I believe will not, attempt to offset virtually all of the temporary negative growth effect of the surge in energy prices. Real adjustment to this real shock, including a period of slower real GDP growth, is necessary. The alternative would require monetary tightening to stop prematurely and probably for policy to ease back significantly in order to stimulate aggregate demand. This would probably induce longer-term interest rates to fall back further, re-igniting the housing boom and boosting growth of real consumer spending.

However, housing prices and residential investment in many areas have already reached a point where further extension of the recent boom is very likely to come to an unhappy end. With a household saving rate of virtually zero, it should be clear that further artificial stimulus to consumer spending in excess of disposable income growth is unwise. Thus, while monetary policy should not "snatch away the punch bowl" just as the US economy is hit with a sharp rise in energy prices, neither should it pour in more alcohol to keep the party swinging through 2006. Otherwise, the US economy would likely wake up with a stupendous hangover in 2007.

With these considerations in mind, the forecast is for growth of real consumer spending to fall to 2¼ percent for 2006 (Yr/Yr), down from 3¼ percent now forecast for 2005. Residential investment will also decline next year, by about 8 percent, following significant further gains in 2005. Despite some boost from post-Katrina rebuilding, growth of business fixed investment will also slow moderately (to about 7 percent), as is normal after three years of strong recovery. Overall gross private fixed investment is forecast to slow to 4 percent real growth in 2006 on a year-over-year basis.

Inventory investment is always a bit of a wild card. Recovery from low levels in the second quarter of 2005 appeared likely to boost GDP growth in the third and fourth quarters. But, the impact of Katrina makes it difficult to know whether this is still plausible. Perhaps the inventory rebuild will be postponed largely until next year, with the result that real GDP growth will be pushed down somewhat this year and boosted somewhat next year. Assuming instead an evenly spread recovery of inventory investment to its normal ratio to goods production between this and next year, the effect in each year is small.

Supported by rising revenues, state and local government spending should post moderate further gains next year. Real federal purchases should also advance moderately. Including direct spending on recovery from Katrina, increased real government purchases should contribute about ½ percent to real GDP growth for 2006 (Yr/Yr).

Adding up the components of real domestic demand (consumption plus investment plus government purchases) suggests growth of 2¾ percent for 2006 (Yr/Yr), following growth of 4 percent now forecast for 2005 (Yr/Yr). Absent the effects of Katrina, the forecast would now be 4¼ percent real domestic demand growth for 2005 and 2½ percent for 2006 (both Yr/Yr).[1]

This year, real net exports are expected to subtract about a further ½ percentage point from real domestic demand growth to yield real GDP growth of a little under 3½ percent (Yr/Yr). The modest improvement in real net exports in the second quarter GDP reports is expected to be reversed in the third and fourth quarters—partly because the disruption to trade shipments caused by Katrina is likely to have more of an impact on US exports than on US imports.

For 2006 on a year-over-year basis, it is reasonable to expect that real net exports will make approximately a zero contribution to US real GDP growth. (Net exports in nominal terms and the current account balance, however, will deteriorate further because of higher costs for given quantities of imports, especially energy imports.) The significant projected slowdown in domestic demand growth in the United States should mean slower import growth than in recent years. The downward correction of the foreign exchange value of the dollar from its peak in 2001–02 is also helping to make US exports more competitive in world markets. But stronger demand growth in key US export markets is a critical missing factor. And, there is work to be done just to stop the US net export deficit from growing further—a task that Katrina is not making easier. Assuming that there is enough to get at least this job done, leaving no further deterioration in US net exports for 2006, then real GDP growth should match the 2¾ percent growth forecast for real domestic demand.

In **Canada**, the economy appears to be on track for 2¾ percent real GDP growth for 2005 (Yr/Yr). The rise in energy prices (pre- and post-Katrina) benefits Canada as an energy exporter (natural gas and electricity to the United States, as well as some crude oil and oil products), and the province of Alberta now appears likely to experience another boom for some duration, especially if persistent very high energy prices encourage large-scale development of the province's large tar sands resources.

The rest of Canada, however, is likely to feel more of a negative impact from the surge in energy prices both as a net energy importer and because of spillovers from the

[1] Taking account of Katrina, the forecasts for Q4/Q4 growth and the comparison with my early April forecasts are a little confusing. In late August, before Katrina, I would have revised up my April forecast for 2005 Q4/Q4 real domestic demand growth by ¼ percent, while leaving my Yr/Yr forecast unchanged. Post Katrina, I have cut my Q4/Q4 forecast by ¼ percent, while still leaving the Yr/Yr forecast unchanged. In late August, I envisioned a cut of 1 percent in my April forecast for Q4/Q4 real domestic demand growth in 2006; now I have cut that forecast by ¾ percent. For real GDP growth the forecast revisions are even more confusing The effects of Katrina will likely worsen US net exports in 2005 by a further ¼ percent of GDP, to be offset by about a ¼ percent of GDP improvement in what otherwise would have been forecast for 2006 on a Q4/Q4 basis. These complexities largely wash out when looking at Yr/Yr forecasts.

effects of high energy prices in the United States. In particular, automobile production in Canada is intimately linked to automobile production in the United States; and the surge in gasoline prices should curtail new vehicle purchases in both the United States and Canada. To make matters worse, the vehicle sales most at risk are the heavier fuel consumption models that account for the profits of North American–based auto producers. Canadian lumber exports will also be hit if, as I expect, there is significant slowing of residential construction in the United States (notwithstanding the ultimate outcome of the Canadian soft lumber dispute currently before the World Trade Organization).

More generally, the forecasted slowdown of domestic demand growth in the United States is not good news for Canadian exporters whose sales (including energy, lumber, and other raw materials, as well as diversified manufactured products) are 85 percent to US customers. Indeed, even with robust demand growth in the United States, Canadian manufactures exporters were encountering headwinds because of the strong value of the Canadian dollar relative to the US currency. And, surging export receipts from the energy sector are likely to keep the current account and the Canadian dollar strong.

On the policy front, fiscal discipline has weakened somewhat under Prime Minister Martin’s minority government, but the macroeconomic effect is essentially trivial. A new election is in the offing, but even with a change of ruling party, it is unlikely that fiscal policy changes would much affect the economic outlook. The Bank of Canada’s (BOC) monetary policy is detached from that of the Federal Reserve, but recently the BOC has gotten more nervous about inflation and does not appear disposed to ignore entirely inflation increases linked primarily to higher energy prices. A modest increase in the BOC’s overnight lending rate, rather than a cut, seems most likely in the near term. Considerable weakening in the Canadian economy’s growth rate and inflation prospects would probably be needed before the BOC would shift toward monetary easing.

All things considered, growth of the Canadian economy appears more likely to slow next year rather than pick up speed. A forecast of 2¼ percent real GDP growth for 2006 (Yr/Yr) versus an expectation of 2¾ percent growth for 2005 now seems reasonable.

The story for **Mexico** is much the same. Slower growth forecast for the United States—which accounts for about 85 percent of Mexico’s exports and has tight links with many Mexican businesses, including in the auto sector—is a significant negative for the forecast of Mexico’s growth in 2006. And, there does not appear to be any development in Mexico or elsewhere abroad that will likely offset this negative influence.

Mexico does export significant amounts of crude oil, and the government budget will benefit substantially from the upsurge in crude prices. The managers, workers, and suppliers of Pemex—the Mexican state oil company—will also garner significant benefits from the rise in crude prices. The broader Mexican economy, however, will gain little from the rise in oil prices, aside from what comes back through the government budget. Instead, Mexican energy consumers will see substantial rises in prices of oil products, most of which are imported, and in prices of natural gas, much of which comes from the United States. Thus, as in Canada, although for somewhat different reasons, the upsurge in energy prices is not a positive for the broader Mexican economy.

Unlike the Canadian dollar, the Mexican peso has depreciated significantly against the US dollar since its (unsustainable) peak in 2001. This has helped Mexican exporters, at least in comparison with their Canadian counterparts. More important on the other side has been competition from Chinese exports, which have displaced exports of many low-wage products from Mexico, to the United States. And, unlike some other Latin American countries, Mexico has enjoyed very little benefit from increased exports (primarily of raw materials) to China. The slight revaluation of the Chinese yuan this July and subsequently will not materially ease this problem for Mexico. Further significant Chinese exchange rate adjustment is unlikely to come soon enough to help Mexico much in 2006.

With an upcoming presidential election and a further bonanza in oil revenues, some further easing of Mexican fiscal policy is likely. However, unlike the situation so many times before, when the PRI was firmly in political control and anxious to maintain it, divided government probably means fiscal frivolities on a more restrained scale than has proved disastrous in the past. For 2006, this means at most a modest additional economic boost from fiscal policy.

The Banco de Mexico (BOM) has been conscientious and fairly successful in pursuing its inflation target. Enhanced credibility has allowed the BOM some flexibility to respond to economic weakness with easier monetary policy—in a way that would have been quite dangerous if not impossible not so many years ago. With the cetes rate hovering around 9 ½ percent and the twelve month inflation rate coming in below 4 percent, there might be some room for monetary easing. But with higher energy prices pushing up overall inflation and with the uncertainties and fears surrounding a presidential election, the BOM will—and should—move cautiously if at all.

Thus, with the forecasted slowdown in the United States, it seems reasonable to expect that the growth rate of the Mexican economy will fall from about 3½ percent in 2005 to 3 percent in 2006. There are clearly risks to the downside, especially if the US slowdown proves greater than now forecast.

The rest of Latin America (aside from the small economies of Central America and the Caribbean, is much less tied to the US economy than Mexico. In **Brazil**, growth this year appears to be coming in about 1 percent below my April forecast of 4 percent. Slower domestic demand growth and slowing improvement in the trade balance are both responsible. The former partly reflects continued tight monetary policy (a SELIC rate of almost 20 percent versus a 12-month inflation rate down to 7 percent) plus possibly some adverse economic reaction to the ongoing political scandals. The latter is partly a natural slowdown after three years of strong improvement and partly a reaction to the significant appreciation of the Brazilian real over the past three years.

Higher world oil prices are probably pretty much of a wash for the Brazilian economy, with the exception of the possible effect on monetary policy. With the present Brazilian exchange rate and slowing growth in the United States (which has modest impact on Brazilian exports), net exports appear unlikely to contribute to growth. After three years of impressive fiscal prudence, fiscal policy will likely relax somewhat in the run-up to the presidential election, but the stimulus to economic growth will be modest. Monetary policy should normally have significant room to ease in view of the sustained success in bringing inflation down to reasonable levels. However, the central bank probably cannot afford to ignore an up-tick of inflation associated with higher energy prices combined with the uncertainties and fears about economic polities arising from the upcoming election.

In all of this, I see no clear reason to expect that growth of the Brazilian economy will either slow significantly or pick up markedly in 2006 from the 3 percent now expected for 2005.

Argentina continues to enjoy a strong recovery with real GDP finally surpassing its mid-1998 peak (from which it declined by 25 percent by mid-2002.) Growth this year now looks likely to come in between 6 and 7 percent, at least 1 percent above my April forecast. Strong increases in domestic demand, particularly private investment, is the key driver of recent growth. The trade surplus continues to moderate after large improvement in 2002–03. Notably, export growth has remained reasonably strong, while (consistent with strong domestic demand) import growth has accelerated over the past two years.

Inflation is becoming a significant problem, with consumer prices rising at about a 10 percent annual rate. This is despite a continuing government-imposed lid on most utility prices—a policy that amounts to a de facto expropriation of foreign owners of many Argentine utilities. The Central Bank of Argentina has not taken meaningful action to curb the rise of inflation. Interest rates remain low, with 30-day certificates of deposit now yielding real returns of less than minus 5 percent. Pressure for appreciation of the peso, which would help to contain inflation, is forcefully resisted by the government, which appears to have set a floor at about 2.90 pesos to the US dollar.

Meanwhile, the Argentine government remains under some international pressure (as the condition for a rollover of IMF credits) to deal constructively with foreign holders of about $20 billion of unrestructured Argentine sovereign debt, to address the issue of frozen utility prices, and to begin a comprehensive clean-up of the banking system.

There is no doubt that Argentina cannot long continue with the strong growth of the past three years or continue to ignore either rising inflation or the heritage of important problems left over from the recent crisis. But growth of 4 percent or so is still feasible for 2006 even if, as I expect, little is done to address these concerns.

Elsewhere in Latin America, 2005 has proceeded about as expected, with growth running close to my 4½ percent April forecast—well below the spectacular and unsustainable 8½ percent result for 2004. Across these countries as a group, growth is forecast to be modestly weaker for 2006, reflecting a modest net-negative effect from higher energy prices, somewhat weaker domestic demand growth in a couple of cases, and a generally weaker global growth environment. Looking to **Latin America** as a whole, growth of 3¾ percent for 2005 (down from my April forecast of 4¼ percent) is likely to be followed by growth of 3¼ percent for 2006.

Asia

In **Japan**, real GDP now appears on track to record about 1½ percent growth for 2005 (thanks partly to upward revision of earlier estimates for 2004). Thus, the relative optimism of my April forecast has been slightly exceeded.

During the summer, forward-looking indicators of consumer and business sentiment, as well as some hard data, suggested that further strengthening of growth was likely going forward. Based on such information, I would have at least maintained, if not upgraded, my April forecast of 2¼ percent growth for Japan for 2006.

However, the upsurge in world energy prices since early summer now paints a darker picture of Japan's near-term economic prospects. Although energy costs are a much smaller share of Japanese GDP than they were in the early 1970s, they are still important. Another $20 up on the world oil price for 2006 over what was expected last April implies a significant direct hit on Japanese consumers and producers. In addition, the negative impact of higher energy prices on key Japanese trading partners will feed back indirectly through Japanese exports.

Moreover, after a decade of generally weak and erratic economic performance since the collapse of the "bubble economy," consumer and business confidence in Japan are shaky. It does not take much to shift mild optimism to mild pessimism. And, there is little that Japanese economic policy can do to alter economic reality or sentiment.

Thus, in view of recent developments, it does not now seem prudent to forecast a strengthening of Japanese economic growth for 2006. A catastrophe or even a mild recession is not in prospect. But, if anything, real GDP growth that is marginally below the expected 2005 outcome is the most reasonable forecast.

Data available so far indicate that real GDP growth for **China** this year will reach 9 percent, down only modestly from 2004 and ¾ percent above my April forecast. Growth of real domestic demand does appear to have slowed, but this has been offset by surprisingly strong improvement in the trade balance as exports have continued to surge while import growth has slowed substantially. Indeed, China's current account surplus, which reached 4 percent of GDP in 2004, now appears headed for 7 or 8 percent of GDP in 2005.

The Chinese government's efforts to curb investment in areas of perceived excess provides part of the explanation for the slowing in domestic demand growth. Maintenance of a substantially undervalued exchange rate for the yuan is part of the explanation for continued very strong export growth. Slowing import growth is partly explained by increases in domestic supplies to take the place of imports, including increased domestic steel production and increased coal production to substitute for imported fuels.

With investment already amounting to an extraordinarily high share of GDP, and without apparent policy means to spur substantial increases in the share of consumption spending, it is likely that domestic demand growth will slow somewhat further in 2006. Government policies have sheltered Chinese consumers and producers from much of the rise in world energy prices, but increased pass-through of the recent energy price upsurge is desirable and probably unavoidable—with some depressing effect on growth of domestic demand. Conceivably, the government could push resources toward its stated goal of enhancing development of the interior of the country, but it will be difficult to achieve much success in this area when the policy has to fight an uphill battle against an undervalued exchange rate, which significantly advantages development in the coastal regions.

On the external front, it is difficult to envision another year of sharp improvement in the Chinese trade balance like this year, with the current account surplus rising further to the range of 10 to 12 percent of GDP. The point of political tolerance for a rising Chinese trade surplus with the United States has already been reached, and the situation vis-à-vis Europe is not much better. The attitude of China's Asian trade partners will also become less friendly if Chinese exports continue to surge while its imports from the rest of Asia stagnate. One way or another, the Chinese government will find that it is not possible to achieve a further large increase in net exports to boost substantially domestic real output.

Thus, for 2006 I forecast a slowdown in China's real GDP growth to 7½ percent—growth that is consistent with an achievable increase in domestic demand and a modest contribution from net exports.

For **India**, despite a somewhat disappointing monsoon, real GDP growth this year appears likely to be a little above my April forecast of 6½ percent. India is still a relatively closed economy (notably in comparison with China), and Indian energy consumers are sheltered from much of the rise in world energy prices (mainly at the expense of the government budget). Thus, the surge in world energy prices and other developments likely to slow global growth should be expected to have only a modest impact on India's economic growth.

Nevertheless, I expect that there will be some adverse impact. Accordingly, the forecast for India's real GDP growth for 2006 is 6½ percent, which is below the 7 percent I would have forecast a couple of months ago but above my April forecast of 6 percent growth for 2006.

In the rest of emerging Asia, growth has been somewhat disappointing this year, with real GDP now expected to rise by only about 4 percent, down about 2 percent from 2004 and about 1 percent below my April forecast for these countries. More sluggish than expected performance in Korea, Singapore, Taiwan, and Thailand account for most of the disappointment, while Indonesia has been doing a little better than earlier expected (despite the tsunami and notwithstanding recent troubles in the foreign exchange market). The negative impact of high oil prices (even before the recent upsurge) provides part of the explanation, especially for Korea. Thailand also has had to deal with domestic unrest and the tsunami. Slowing growth of imports by China from its Asian trading partners is also part of the story.

Looking to 2006, with even higher world energy prices and somewhat slower global economic growth, it is difficult to see the reasons for an upturn in these highly open Asian emerging-market economies. At the same time, for economies that have generally very strong records of economic growth over a number of years and generally sound economic policies, it is difficult to foresee performance that is much more disappointing than this year. A forecast of growth of a little under 4 percent for 2006 seems reasonable at this stage.

Europe

Once again in 2005, as in the preceding three years, growth in the **euro area** appears likely to come in below earlier expectations—but only modestly so, with real GDP growth now expected to be 1¼ percent versus my April forecast of 1½ percent. This time, **Germany** is not the principal culprit, with growth now expected to match or slightly exceed my very restrained April forecast of just ¾ of 1 percent. Rather, **Italy** is the stinker with growth now expected to be nil versus my modest April forecast of 1¼ percent. The Netherlands also looks very weak. **France** appears to be marginally disappointing with growth now expected to be only 1½ percent versus a not particularly buoyant April forecast of 1¾ percent. The rest of the euro area is doing about as expected, with Ireland at the top of the heap and Spain maintaining about 3 percent real growth.

A couple of months ago, I expected to forecast some improvement in growth for the euro area in 2006, as was generally consistent with incoming economic data and improving sentiment surveys and with my April assessment. Now, with the recent further upsurge in world energy prices and the likely slowing of growth elsewhere in the world economy, I do not see a reasonable basis for forecasting any meaningful pick up in euro area growth for 2006. Germany may do a little better as it moves at least partly past some of the problems that have hindered recent growth and if the results of the election provide a boost to confidence. Italy should be able to improve on zero growth. I fear, however, that the rest of the euro area will be a little more sluggish for the reasons just mentioned.

With its repo rate at 2 percent, the ECB has some room to ease monetary conditions in order to boost growth prospects. But the ECB is clearly reluctant to do this, or even to admit the possibility, unless recession should threaten. In 2001, 2002, and 2003, I criticized the ECB for its reluctance to ease monetary policy more aggressively in the face of very slow output growth when inflationary pressures could reasonably be assessed to be receding. In fact, the ECB did ease substantially, despite overall inflation running slightly above its desired ceiling and growth rates of monetary aggregates generally in excess of ECB guidelines (the so-called second pillar holding up the altar of ECB monetary orthodoxy). But, earlier more aggressive easing would, in my view, probably have boosted growth each year since 2001 by at least ¼ of a percentage point for a cumulative rise in the level of euro area GDP of at least 1 percent by 2005—without seriously raising the risk of inflation. This assessment is not mine alone, and it cannot be simply dismissed by the ECB as the rantings of rabid inflationists. There is a serious question of whether ECB policy did all that it could reasonably have been expected to do in a period when euro area growth was consistently and significantly below potential.

Now the situation is somewhat different, partly because the ECB has painted itself into a corner with its own rhetoric. The negative shock to real output from the upsurge in world energy prices is not something that monetary policy should seek to entirely offset. Also, while the ECB surely made a mistake in defining its inflation objective mainly in terms of the overall inflation rate rather than the core inflation rate (excluding food and energy prices and price changes due to administrative and tax changes), it is now constrained (perhaps deliberately) by its choice. Higher inflation, which is the consequence of higher energy prices, cannot now be ignored. And, even if the ECB had focused primarily on core inflation, it still would not be right to ignore entirely what is happening to overall inflation. Real people eat and buy gasoline (or diesel) for their cars and heat their homes. The “cold and hungry CPI” (as Mike McCracken describes the core CPI) is not what real people feel or care about, and central banks need to be sensitive to this reality. Thus, further easing should be on the agenda of the ECB if euro area growth slows significantly, but in present circumstances it should not be an automatic response to the prospect that the pick-up in euro area growth may be put off another year because of recent adverse real shocks.

Outside of the euro area, growth in **Sweden** is slowing below earlier forecasts, and there is no reason to expect an acceleration. The **Danish** economy appears to be growing at about a 2 percent rate but with little reason to expect any acceleration. For

Switzerland growth this year now looks unlikely to exceed 1 percent, with the possibility of a modest pick up in Germany offering only slight hope of stronger growth next year.

Growth in the **United Kingdom** appears to be slowing to about 2 percent this year versus an April forecast of 2½ percent. After 12 continuous years of economic expansion—the longest in UK history—this moderation in growth is not entirely unwelcome. Indeed, it may be said that it is a very small and necessary price to pay for the Bank of England's notable success in sustaining economic expansion while controlling inflation and, more recently, reining in the unsustainable boom in housing prices.

With the strong foreign exchange value of sterling negatively impacting net exports and restraining growth in the manufacturing sector, rising housing prices have played a significant role during recent years in boosting consumer spending and thus the overall UK economy. By any reasonable standard, however, the boom in UK housing prices had reached a point by last year where worries about the collapse of an even more extended boom were a concern of the Bank of England—on top of its more general concern about potential increases in consumer price inflation. Thus the bank has certainly not been displeased that housing prices have leveled off and even declined modestly. Evidence of slowing of the UK economy has motivated a 25 basis point cut in the bank rate (despite an opposing vote by Governor King), but the Bank of England appears unlikely to engage in a further binge of rate cutting because the economy's growth rate falls moderately below potential—and rightly so.

Although out of regional context, it is relevant to note that the Reserve Bank of Australia has confronted a situation that has some similarity with that faced by the Bank of England. There has been a long and quite vigorous expansion with inflation kept well under control. In the past couple of years, the Australian dollar has appreciated strongly on the back of rising prices for Australia's commodity exports, but manufacturing exports have suffered. Solid growth of real GDP has been sustained by strong growth of domestic demand, aided by a housing boom and its positive impact on consumer spending. Monetary tightening necessary to contain rising inflationary pressures has recently helped to slow the growth rate of the economy and dampen gains in housing prices. The Reserve Bank, however, shows no inclination to ease monetary policy substantially despite the slowing of growth to somewhat below potential, and it probably would ease only cautiously if, as I now expect, the growth slowdown persists into 2006.

From this experience in Australia and the United Kingdom, there are lessons for how the US Federal Reserve might be expected to behave. Housing prices in the United States are arguably not as extended as they have become in the United Kingdom or Australia, but there is good reason not to want to push them up even further. Also, so far monetary policy in the United States has not been tightened to the extent that it has been in either the United Kingdom or Australia, and the relatively weak US dollar does not provide the same protection against a rise in inflation as do strong sterling and strong Australian dollar. If a significant easing of monetary policy is not the right reaction to a temporary slowing of growth somewhat below potential in the United Kingdom and Australia in the circumstances of a significant negative real shock, then easing US monetary policy or keeping it well south of neutral is probably not the right reaction either.

Turning to **Central and Eastern Europe**, growth has eased back from the rapid 7 percent pace of 2004 to about 5 percent. For the two largest economies in the region, Russia and Turkey, growth has slowed from about 7 and 9 percent, respectively, to about 5½ percent—which is close to the normal growth rate that should be expected, on average, from these economies. The oil-exporting countries, Azerbaijan and Kazakhstan, which have quite small nonoil economies, are enjoying considerable booms. Other countries in the region are growing in the 3 to 6 percent range, with a size-weighted average of about 4 percent.

Looking to 2006, the oil exporters (Russia, Azerbaijan, and Kazakhstan) should continue to do well in an environment of continued very high world oil prices. The other countries of the region cannot reasonably be expected to do much better, or substantially worse, than in 2005. A forecast of a slightly lower growth rate for the region as a whole, 4½ percent rather than 5 percent, seems reasonable in light of the general factors tending to slow global economic growth.

The Middle East and Africa

The major oil exporters of the **Middle East** were benefiting substantially from oil at $45 to $50 per barrel and will benefit even more with the recent further upsurge in oil prices. The larger economies that are not dominated by oil, including Egypt, Morocco, and Pakistan, are also generally doing quite well and there is no particular reason to believe that they will do worse next year. Israel has withdrawn from Gaza, and there is at least reason for hope that an improved political and security situation may help to boost growth in both Israel and the Palestinian areas. In Iraq, the security situation remains a severe problem, but behind the fog of violence, the economy is probably making progress. The Middle East is one region of the world where at least a modest upgrade in the growth forecasts for both 2005 and 2006 now seems warranted.

The situation in **Africa** is more difficult to read. The two largest economies in sub-Saharan Africa—Nigeria (aided by high oil prices) and South Africa—are doing quite well this year. Zimbabwe remains a mess, and the situations along the border of the Congo and in Cote d'Ivoire remain unresolved. But, there have been no new disasters—natural or manmade. Accordingly, a slight upgrade of the April growth forecast for Africa in 2005 to 4½ percent seems appropriate.

For 2006, the situation is less clear. The oil exporters (notably Algeria, Angola, and Nigeria) should benefit from the further escalation of world oil prices. The bulk of African countries that are energy importers will suffer a negative shock, and this will be somewhat exacerbated by slower global growth. But, the key is avoidance of new big disasters. Assuming that luck holds, a modest upgrade of my April forecast to 4 percent growth for Africa in 2006 is a happy way to end this exposition concerning global economic prospects.

Table 1 Annualized percentage change of real GDP growth rates, year over year (Yr/Yr) and fourth quarter to fourth quarter (Q4/Q4)

Country/region	**2004 Yr/Yr**	**2005 Yr/Yr**	**2006 Yr/Yr**	**2005 Q4/Q4**	**2006 Q4/Q4**
Industrial countries	3	2¼	2	2½	2¼
United States	4¼	3½	2¾	2¾	2½
Japan	2½	1½	1½	1¾	1¼
Western Europe	2¼	1½	1½	1½	1½
United Kingdom	3¼	2	2	2	2
Other non euro area	3	2	2	2	2
Euro area	1¾	1¼	1¼	1½	1¼
Germany	1½	1	1¼	1½	1¼
France	2	1½	1¼	1½	1¼
Italy	1	0	½	½	¾
Other euro area	2¼	2¼	1¾	2¼	1¾
Other industrial countries	3	2½	2¼	2½	2¼
Emerging-market and developing countries	7¼	6	5¼		
Asia	8	7¼	6½		
China	9½	9	7½		
India	6½	7	6½		
Other Asia	5¾	4	3¾		
Latin America	6	3¾	3¼		
Argentina	8¾	6½	4		
Brazil	5	3	3		
Mexico	4	3½	3		
Other Latin America	8	4½	3¾		
Central and Eastern Europe	7	5	4½		
Middle East	5	5	4½		
Africa	4¾	4½	4		
World (WEO weights)	5	4	3½	3¾	3¼