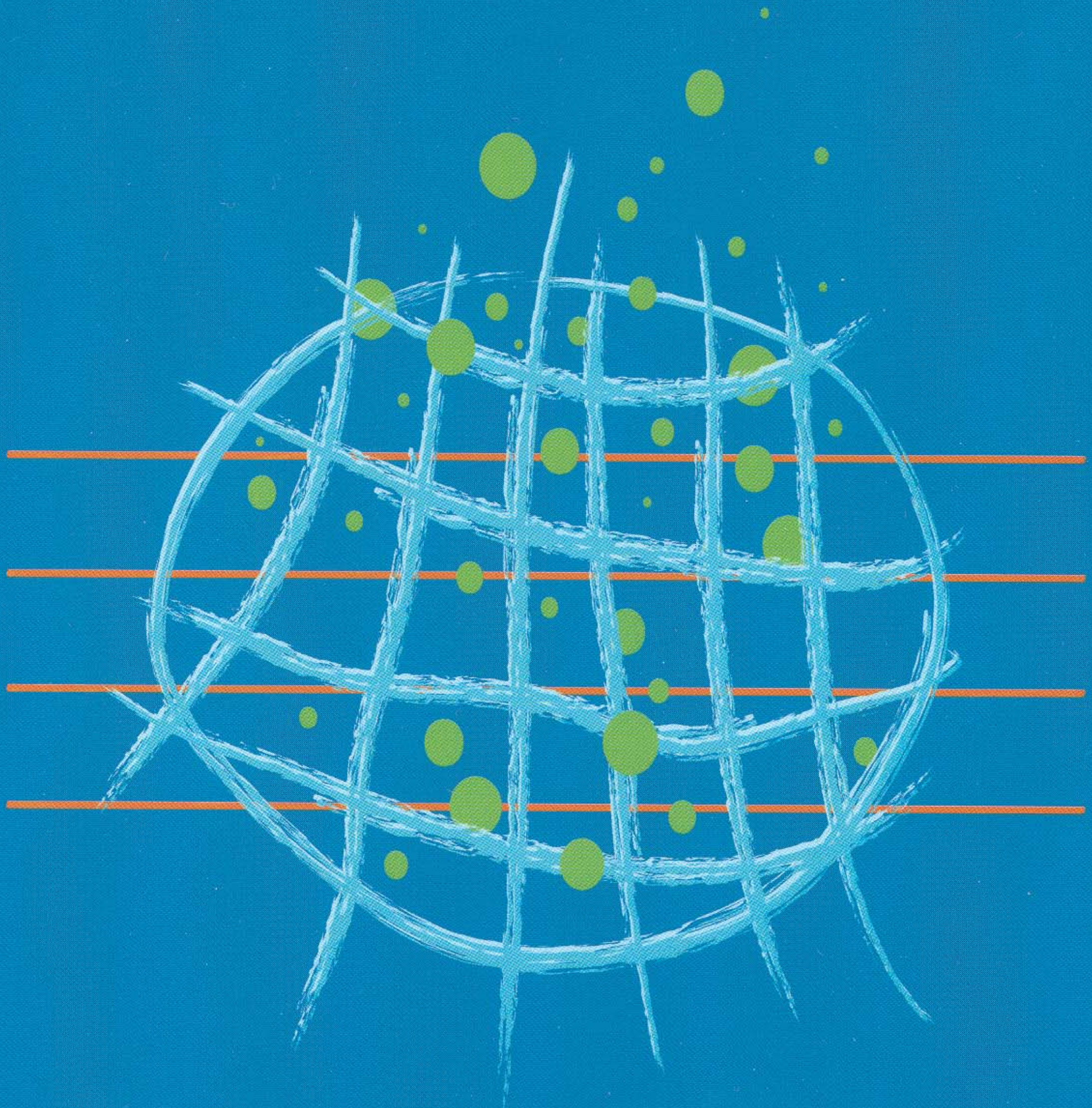
World Economic Situation and Prospects 2007



United Nations

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This report is a joint product of the Department of Economic and Social Affairs (DESA), the United Nations Conference on Trade and Development (UNCTAD) and the five United Nations regional commissions (Economic Commission for Africa (ECA), Economic Commission for Europe (ECE), Economic Commission for Latin America and the Caribbean (ECLAC), Economic and Social Commission for Asia and the Pacific (ESCAP), and Economic and Social Commission for Western Asia (ESCWA)). It provides an overview of recent global economic performance and short-term prospects for the world economy and of some key global economic policy and development issues. One of its purposes is to serve as a point of reference for discussions on economic, social and related issues taking place in various United Nations entities in 2007.

For further information, please contact:

In New York

Mr. José Antonio Ocampo
Under-Secretary-General
Department of Economic
and Social Affairs
Room DC2-2320
United Nations, New York 10017, U.S.A.
Phone: (212) 963-5958
Fax: (212) 963-1010
E-mail: jaocampo@un.org

In Geneva

Mr. Supachai Panitchpakdi
Secretary-General
United Nations Conference on
Trade and Development
Palais des Nations, Room E-9050
1211 Geneva 10, Switzerland
Phone: (41) (22) 917-5806/5634
Fax: (41) (22) 917-0465
E-mail: sgo@unctad.org

Executive summary

The global outlook

Slower global economic growth in 2007

After a solid and broad-based growth for three consecutive years, the world economy is expected to decelerate in 2007, with the growth of world gross product (WGP) moderating to a pace of 3.2 per cent, down from the estimated 3.8 per cent for 2006.[1] The economy of the United States of America will be the major drag for this global slowdown, as its growth is forecast to soften on the back of a weakening housing market to a rate of 2.2 per cent in 2007. No other developed economy is expected to emerge as an alternative engine for the world economy, as growth in Europe is forecast to slow to around 2 per cent and in Japan to below 2 per cent in 2007. There are, furthermore, substantial downside risks associated with the possibility of a much stronger slowdown of the United States economy.

Continued robust growth in developing countries

The developing countries and the economies in transition have continued their exceptionally strong economic performance during 2006, reaching average growth rates of 6.5 and 7.2 per cent, respectively. Growth is expected to remain robust in 2007, albeit with a mild moderation: 5.9 per cent for developing countries and 6.5 per cent for economies in transition. Among developing countries, sustained high growth in China and India has engendered more endogenous growth through increasing South-South trade and financial linkages. This is reflected in, among other things, continued strong demand for and higher prices of energy and primary commodities. Buoyant commodity prices benefit many developing countries and also the economies in transition, especially the Commonwealth of Independent States (CIS). The performance of the least developed countries also remains remarkably strong, averaging nearly 7 per cent in 2006. Growth in the poorest countries is expected to remain equally strong in 2007.

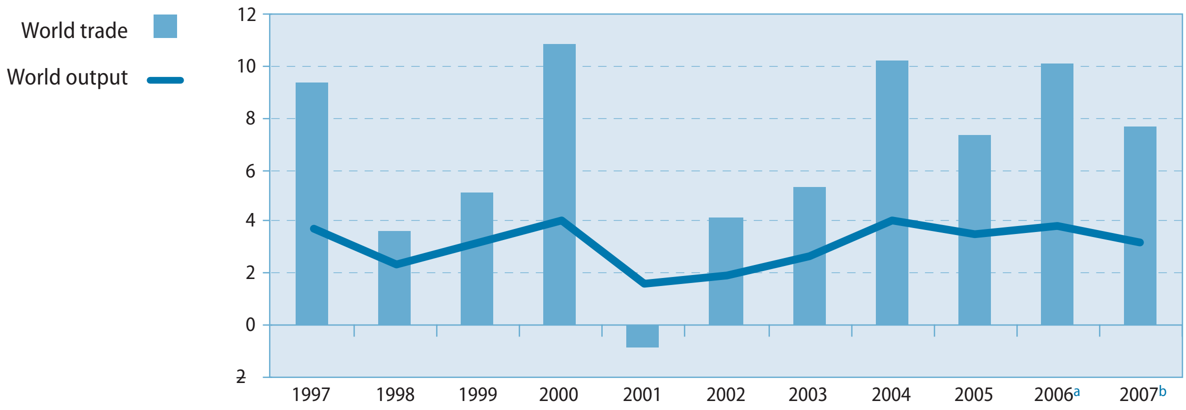
Notwithstanding the improvement in both their domestic economic conditions and stronger interregional linkages, most developing countries remain vulnerable to any slowdown in the major developed economies and to the volatility of international commodity and financial markets.

Insufficient employment growth

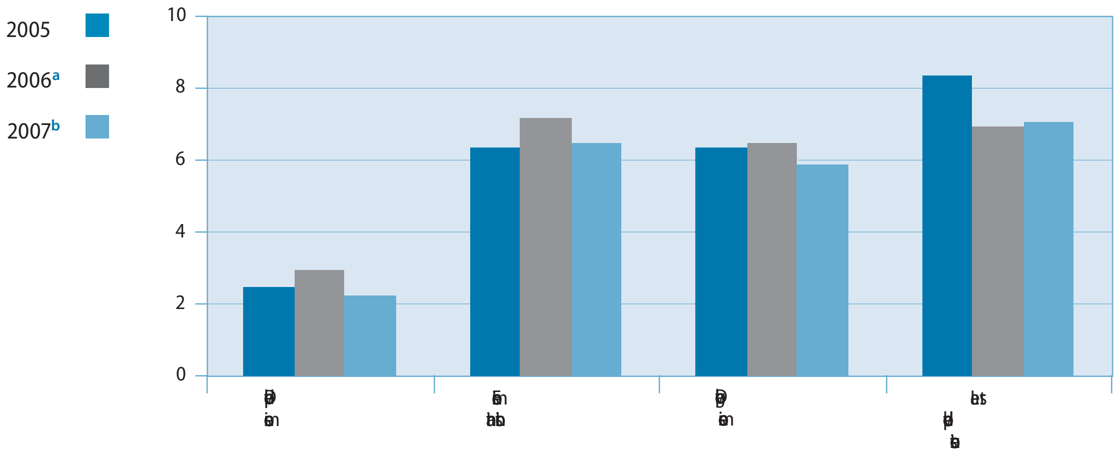
The strong growth performance of the world economy has also helped improve labour-market conditions in a large number of countries. In most developed economies, unemployment rates have declined in 2006. Nonetheless, and despite higher output growth, in important parts of the developing world, employment growth has not been strong enough to substantially reduce unemployment rates. Various factors may have impeded sufficient

1 In the United Nations estimates, the growth of world gross product (WGP) is calculated using country weights for gross domestic product (GDP) in dollars at market prices. When using purchasing power parity(PPP)-based weights, WGP growth would be 5.1 per cent for 2006 and 4.5 per cent for the forecast for 2007.

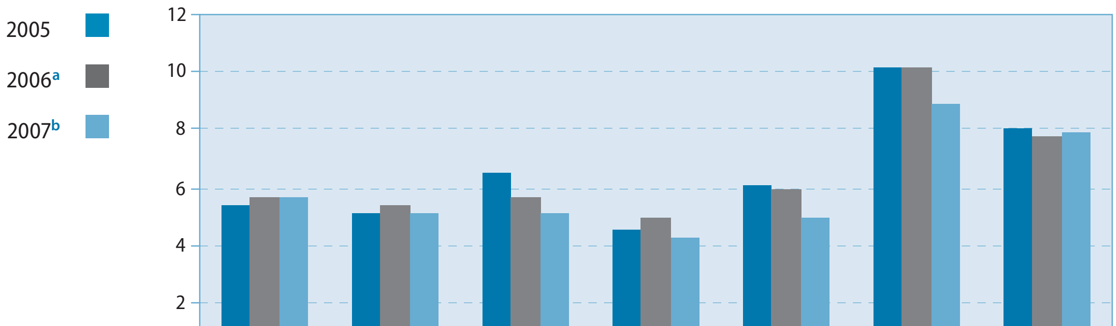
World economic growth expected to slow down, 1997-2007 (*annual percentage change*)



Growth in developing countries and economies in transition stronger than in developed countries (*annual percentage change*)



Moderation is anticipated in most developing-country regions (*annual percentage change*)



Sources: UN/DESA and Project LINK.
a Partly estimated.
b Forecasts.

job growth and/or reductions in unemployment, including the capital-intensive nature of commodity-producing sectors, which has generated most of the growth stimulus in Africa; strong increases in labour participation in both Africa and Latin America; and, in China, labour shedding resulting from the restructuring of State-owned enterprises, strong productivity growth and labour shifts out of agriculture. The situation is similar in the economies in transition, where unemployment rates generally remain high, despite solid economic growth for several consecutive years.

Benign inflation outlook

Headline inflation rates have risen in many economies in 2006, but most of the increase is attributable to first-round effects of higher oil prices. So far, there has been only limited pass-through of higher energy prices into core inflation. Inflationary pressures are expected to moderate in 2007 in view of the retreat of oil prices in the latter part of 2006, the expected slowdown in global economic growth and the tighter monetary policy stance in many economies. Exceptions include a few countries in Africa, which have experienced a sharp increase in inflation owing to food shortages, currency depreciation and/or stronger pass-through of higher oil prices to producers and consumers.

Uncertainties and downside risks

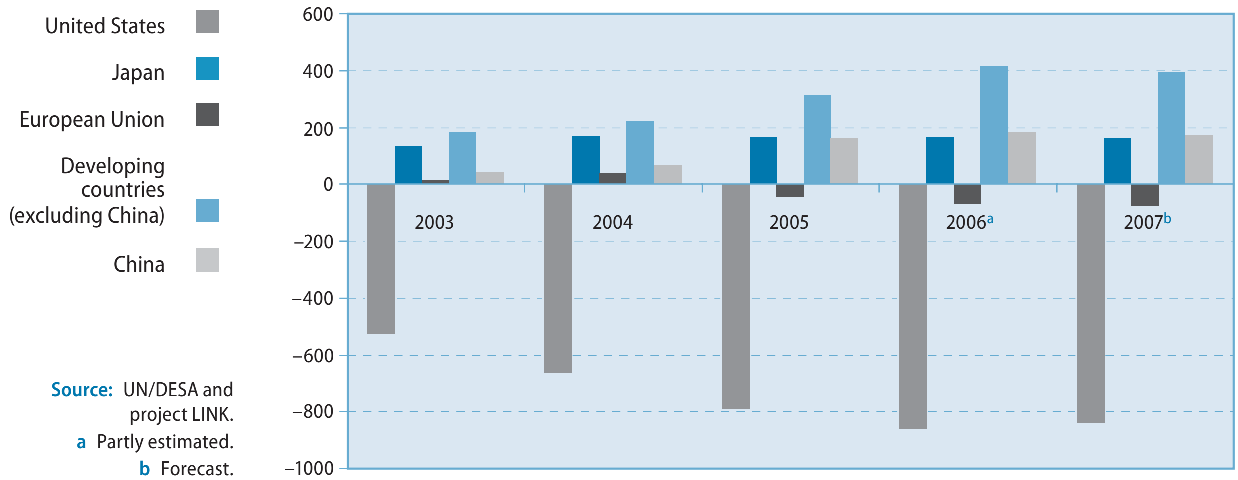
The risk of a further decline in house prices in the United States

The possibility of a more severe downturn in housing markets represents a significant downside risk to the economic outlook. A number of economies have witnessed substantial appreciation of house prices over the past decade, and the associated wealth effects have contributed to solid economic growth rates. A reversal of the process may thus lead to significant negative fallout for world economic growth. Various indicators measuring the performance of the housing market in the United States show a significant recession in activity in 2006—a reduction of close to 20 per cent in recent months. While the baseline forecast assumes a mild adjustment in the housing market, and hence a moderate slowdown in the economy, an alternative, more pessimistic scenario shows that a more severe decline in house prices in the United States would not only undercut its own growth to a pace below 1 per cent in 2007 but also substantially reduce economic growth in the rest of the world by more than one percentage point. In addition, a collapse of house prices in major economies would provoke a crisis in the mortgage markets and set in motion a deflationary adjustment in the global imbalances, enhancing the risk of a major upheaval in financial markets.

Challenges posed by persistently higher oil prices

Although oil prices have recently fallen significantly after reaching a historical high during 2006, they are forecast to remain high, but volatile, in 2007. The short-term prospect for oil prices is highly uncertain, however, owing to geopolitical tensions, new production capacities coming on stream and speculative demand. So far, higher oil prices have not had the same dampening effect on the world economy as they had in the previous episodes of comparable price movements. Among developing countries, oil exporters have benefited from the oil price increase. Buoyant non-oil commodity prices have offset rising import costs due to higher oil prices. A number of low-income, net oil-importing countries, however, did not see an improvement in their terms of trade and have been increasingly hurt

Current-account imbalances have widened further in 2006



Source: UN/DESA and project LINK.
a Partly estimated.
b Forecast.

by the impact of higher energy prices. These economies have had to reduce non-oil imports and have incurred higher fiscal burdens owing to attempts to protect consumers from higher oil prices through subsidies. Economic growth costs in these countries have already been substantial and are likely to increase as oil prices remain high and oil dependency is not reduced.

Risk of a disorderly adjustment of the global imbalances remains

Current-account imbalances across regions and countries have widened further in 2006, featuring the United States running a current-account deficit of close to $900 billion, matched by surpluses generated by Japan and Germany, and—most importantly—by developing regions and economies in transition, including the major oil exporters. As a result of its continued and widening current-account deficit, the indebtedness of the United States has deepened to a level which more seriously calls into question the sustainability of the current constellation of global imbalances. In 2007, the baseline scenario predicts a moderate reduction in these global imbalances as the slowdown in United States economic growth and the moderation in oil prices will generate a reduction in the import bill of the world's largest economy, while the expected depreciation of the dollar will stimulate exports and curb import demand. Nonetheless, the risk of a disorderly adjustment remains. Slow progress, if any, in the unwinding of the global imbalances will enhance the risk of a strong speculative wave towards dollar depreciation. Such exchange-rate depreciation could help reduce the external deficit of the United States, but given the dependence of global economic growth on demand stimuli from the world's largest economy, falling import demand in the United States would have further global deflationary repercussions. This, in turn, could quite easily unravel the momentum of economic growth in developing countries and jeopardize any further progress in poverty reduction. A hard landing of the dollar would further raise uncertainty among international investors and could upset financial markets.

Macroeconomic policy coordination

Why international macroeconomic policy coordination is needed

Existing national macroeconomic policy stances are not designed around the need for achieving an adjustment in the global imbalances. The current tendency towards more restrictive monetary and fiscal policies will have a dampening effect on demand in some of the surplus countries, such as Japan and Germany, making it more difficult for the United States to lower its external deficit through export growth. At the same time, the more expansionary fiscal policies conducted in some of the East Asian surplus countries seem insufficient either to compensate for such deflationary effects or to yield the necessary significant export growth for the United States economy, particularly in the absence of major exchange-rate adjustments.

A coordinated strategy, in contrast, could help avoid the negative growth effects and create confidence in the stability of financial and foreign-exchange markets. Cooperation would make use of the spillover effects of the policies of one country as an offsetting factor for the negative demand effects of the adjustment in another. Growth stimulus in Europe, Asia and the major oil-exporting countries, for instance, could then offset the initially contractionary effect of adjustment policies conducted by the United States.

Various proposals have been put forward as a framework for such policy coordination, including the idea of a new Plaza Agreement on specific policy measures aimed at reducing the imbalances. Despite the shortcomings of such an ad hoc initiative, it may well constitute the desirable second-best outcome in the absence of any more fundamental changes to the global monetary and financial system.

Obstacles to international policy coordination

International policy coordination faces a series of obstacles. These include, among other things, the fact that major stakeholders have different perceptions regarding the risks posed by the current situation. There are also disagreements on the current position of individual economies. In the case of the United States, for example, there are divergent views on how robust economic conditions will remain and whether current imbalances can continue to be financed without major disruptions in international financial markets. Similar uncertainty exists regarding the strength of China's economic growth in the near future and the capacity of Japan and Europe to increase their potential growth rates in the short-to-medium run. These obstacles are likely to be compounded by a problem of commitment to any negotiated international policy solution, as national policy makers may prefer that other countries bear the brunt of the adjustment or may feel constrained to follow through