The International Economy

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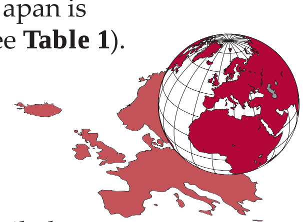
World economic growth for 2005 is projected at 4.3 percent, measured in terms of real gross domestic product (GDP). The years 2003 and 2004 had growth rates of 4.0 percent and 5.1 percent, respectively. The International Monetary Fund in Washington forecasts world economic growth for 2006 at 4.3 percent;[1] this is a constant growth rate compared with 2005, still significantly above the historical trend of 3 percent.

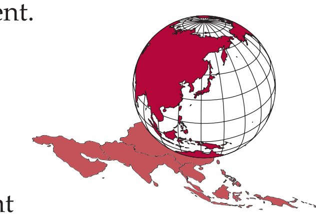
The forecast predicts continuously robust economic growth for the United States, China, and India. Middle and Eastern European countries, emerging Asian, African, Latin American, and oil-exporting countries will dynamically expand economic output. Similar to previous years, the economic outlook for Europe and Japan is lackluster (see **Table 1**).



Europe

The expected recovery in Europe has failed to appear; quite to the contrary, economic expansion faltered and the GDP growth forecast for 2005 was 1.2 percent. For 2006, an economic expansion of 1.8 percent is projected; for Germany and Italy forecasted output growth is even more modest at 1.2 and 1.4 percent, respectively. Economic performance across Europe remains mixed. For countries like Spain and France, domestic consumer demand was rather robust, while net export growth was sputtering. The opposite holds true for Germany, where export growth was very dynamic but domestic demand remained dull. Evidence suggests deeper structural problems for Europe that go well beyond a shortfall in economic demand. Long-term growth of an economy is determined by three main factors: employment, productivity growth, and capital formation. The aging European population is a big hurdle for more healthy growth rates; and rising social security spending is a burden for fiscal policy. France, Germany, Greece, Italy, and Portugal are all expected to exceed the 3 percent GDP cap stipulated by the Stability and Growth Pact. While unemployment is still high at almost 9 percent for the euro area,[2] labor utilization has to rise over the long run: Europeans will have to work longer, not retire earlier. Also alarming is the relatively low capital spending that partly explains the low productivity growth. The process of reforms has to accelerate, labor market restrictions have to be removed, and social security reforms need to continue.

The United Kingdom will do slightly better than continental Europe with an expected economic expansion of 2.2 percent.



Asia

Japan's economy expanded by 2 percent in 2005 and will continue to grow around that range in 2006. However, while the economy is growing, price levels keep declining; deflation has not come to an end yet. Domestic consumption and modest export growth have contributed to

Table 1
World Output and Unemployment

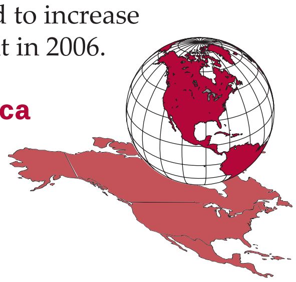
Geography	GDP 2005	GDP 2006	Inflation* 2005	Inflation* 2006	Current Account Percent of GDP 2005	Current Account Percent of GDP 2006	Unemployment 2005	Unemployment 2006
World Output	4.3	— 4.3	n/a	n/a	n/a	n/a	n/a	n/a
Advanced Economies[a]	2.5	▲ 2.7	2.2	▼ 2.0	-1.3	▼ -1.4	6.1	▼ 5.9
Emerging Asia[b]	7.3	▼ 6.9	3.9	▲ 4.4	3.7	▼ 3.4	n/a	n/a
Western Hemisphere	4.1	▼ 3.8	6.3	▼ 5.4	0.9	▼ 0.6	n/a	n/a
Africa	4.5	▲ 5.9	8.2	▼ 7.0	1.6	▲ 3.5	n/a	n/a
United States	3.5	▼ 3.3	3.1	▼ 2.8	-6.1	— -6.1	5.2	— 5.2
Japan	2.0	— 2.0	-0.4	▲ -0.1	3.3	▼ 3.0	4.3	▼ 4.1
Euro Area	1.2	▲ 1.8	2.1	▼ 1.8	0.2	— 0.2	8.7	▼ 8.4
Germany	0.8	▲ 1.2	1.7	— 1.7	4.3	▲ 4.4	9.5	▼ 9.3
France	1.5	▲ 1.8	1.9	▼ 1.8	-1.3	▼ -1.5	9.8	▼ 9.6
Italy	-	1.4	2.1	▼ 2.0	-1.7	▲ -1.4	8.1	▼ 7.8
United Kingdom	1.9	▲ 2.2	2.0	▼ 1.9	-1.9	▲ -1.8	4.7	▲ 4.8
Canada	2.9	▲ 3.2	2.2	▲ 2.5	1.5	▲ 1.7	6.8	▼ 6.7
Mexico	3.0	▲ 3.5	4.3	▼ 3.6	-1.1	▲ -0.8	3.6	▲ 3.9
Brazil[c]	3.3	▲ 3.5	6.8	▼ 4.6	1.7	— 1.7	9.5	n/a
China	9.0	▼ 8.2	3.0	▲ 3.8	6.1	▼ 5.6	9.0	▲ 9.3
India	7.1	▼ 6.3	3.9	▲ 5.1	-1.8	▼ -2.0	10.0	▼ 9.3
South Korea	3.8	▲ 5.0	2.8	▲ 2.9	2.0	▼ 1.5	3.6	▼ 3.3
Taiwan	3.4	▲ 4.3	2.0	▼ 1.8	4.3	▲ 4.6	4.3	▼ 4.2
Russia	5.5	▼ 5.3	12.8	▼ 10.7	13.2	▼ 13.0	7.7	▼ 7.4

*Consumer Price Index
[a]Advanced economies include the United States, the euro area, Japan, United Kingdom, Canada, Korea, Australia, Taiwan Province of China, Sweden, Switzerland, Hong Kong, Denmark, Norway, Israel, Singapore, New Zealand, Cyprus, and Iceland.
[b]Emerging Asia includes developing Asia, the newly industrialized Asian economies, and Mongolia.
[c]Brazil's unemployment data is for July 2005.
Sources: Center for Econometric Model Research, Indiana University; IMF World Economic Outlook, Fall 2005; The Economist Intelligence Unit, Country Reports

this slightly brighter outlook. The financial sector looks healthier, although profitability is still low. Hopefully, the planned reforms of the Postal Saving System will succeed.[3] More than any other country, Japan faces a rapid aging of its population. This implies a heavy burden for the government budget and for future economic growth, since future employment will probably shrink, not increase. Japan has the highest budget deficit and the highest government debt of all industrialized nations. Fiscal consolidation, including social security systems, is a must. Exports to the United States and China are a very crucial demand component. Possible exchange rate changes make this component fragile.

Over the last two years, China and India have accounted for 28 percent and 10 percent of world economic growth, respectively. Average regional growth for emerging Asian countries reached 7.3 percent for 2005 and a comparable robust economic expansion is expected for 2006. Several Asian economies, among them China, Japan, South Korea, and Taiwan, continued to buy dollars in the foreign exchange market in order to avoid an appreciation of their currencies and jeopardizing export-led growth. However, regional current account surplus is projected to decline modestly to around 3.7 percent in 2005. Mostly caused by rising energy costs, inflation will gain momentum and is expected to increase above 4 percent in 2006.

North America



The economies of the NAFTA members are increasingly integrated. Strong demand from the United States caused a further increase of Mexican and Canadian exports to the United States and contributed to robust economic development in both countries. While the Canadian dollar strongly appreciated against the U.S. dollar, the Mexican peso depreciated against the dollar. Both economies are expected to grow in real terms slightly above 3 percent in 2006.

Russia and East Europe

Russia and most middle and East European countries continue to do well and the outlook is optimistic into 2006. The common explanation is, of course, the booming crude oil price. Yet, the Russian economy shows signs of imbalance, including double-digit inflation and a federal budget with an unhealthy reliance on oil export revenues, while significant structural problems are not accordingly addressed. GDP growth for 2006 should be slightly lower, decreasing from 5.5 percent in 2005 to 5.3 percent in 2006.

Latin America

Latin America continued to grow robustly in 2005 and is expected to do so again in 2006, with an estimated output increase for the region of 3.8 percent. The accelerated world market integration continues; the regional current account is expected to remain in modest surplus, although the Brazilian currency, the real, has significantly appreciated against the U.S. dollar and the euro. This is caused by huge capital inflows that make it easier to finance and restructure the still significant government debt.

The Risks

High oil prices are the biggest risk for world economic activity in 2006. The forecasts presented in **Table 1** assume a yearly average crude oil price of slightly above $60 (U.S.) per barrel.

High crude oil prices cause a redistribution of wealth from oil importing to oil exporting countries. Note, however, that the engines of world growth, the United States, China, and India are all crude oil net importers. A further rise in oil prices would have negative effects on consumption expenditures and feed fears of accelerated inflation. Several countries, particularly in Asia, try to cushion the effects of rising oil pricing on domestic demand by heavily subsidizing energy. This immense burden on national budgets is not sustainable; so in 2006, high energy costs will gradually pass through to domestic consumption in these countries and shall slow down economic expansion.

A second risk for the world economy is possible repercussions from exchange rate changes. China allowed a modest (2.1 percent) appreciation of the yuan against the U.S. dollar in July 2005. Since then, Chinese monetary authorities have continuously intervened in foreign exchange markets to avoid any further appreciation. During the third quarter of 2005, the dollar gained strength against most currencies; given market expectations of further interest rate increases by the Fed, a rather robust dollar value in 2006 is most likely. Given the more and more attractive yields for U.S. nominal assets, we expect country risk premiums to rise during the coming year.

Notes

1. International Monetary Fund, *World Economic Outlook: Building Institutions*, September 2005. Available at www.imf.org/external/pubs/ft/weo/2005/02/index.htm.
2. The euro area includes Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Finland, Greece, Portugal, Ireland, and Luxembourg.
3. The Japanese Postal Savings System is the largest financial institution in the world, with about $2.4 trillion (250 trillion yen) on deposit, or one-third of the country's total bank deposits. It is a government-run banking system based on 24,000 post offices, each having a bank inside.