Senate Economic Planning Office

Economic Report

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The World Economy in 2005:
A Backdrop of Things to Come

The Global Economy in 2004

The global economy is expected to grow at an average 5-percent in 2004, higher than the historical trend of 4 percent based on the ***International Monetary Fund (IMF) World Economic Outlook 2004***. The World Bank (WB), on the other hand, sees world gross domestic product (GDP) growing at 4 percent for the same period. Overall, strong growth in industrialized countries; exceptionally rapid expansion in emerging markets; strong upturn in industrial production and global trade flows; a pick up in private consumption strengthened by better labor market conditions; and continued strength in investments, especially in developing Asia, propped up the world economy in 2004.

From a regional perspective, global growth continued to be driven by the United States, supported by Asian economies. The economic upturn in Japan has also been strong, amid easing deflation and improvements in the corporate and financial sectors. In the euro area, recovery has become more established, but remains relatively weak and heavily dependent on external demand (particularly in Germany, which comprises one-third of the euro area). Developing Asia, the Commonwealth of Independent States and Latin America posted strong growths.

Table 1: IMF World Economic Outlook Projections
(Annual percent change)

	Current Projection	
	2004	2005
World output	5.0	4.3
Advanced economies	3.6	2.9
United States	4.3	3.5
Euro area	2.2	2.2
Japan	4.4	2.3
United Kingdom	3.4	2.5
Newly industrialized Asian economies	5.5	4.0
Other emerging market and developing countries	6.6	5.9
Africa	4.5	5.4
Central & Eastern Europe	5.5	4.8
Commonwealth of Independent States	8.0	6.6
Developing Asia	7.6	6.9
China	9.0	7.5
India	6.4	6.7
ASEAN-4	5.5	5.4
Middle East	5.1	4.8
Western Hemisphere	4.6	3.6

Source: IMF World Economic Outlook, Sept. 2004

Outlook for 2005

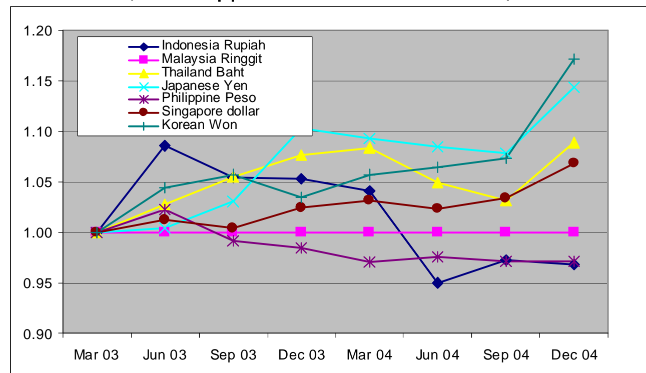
Global output is still expected to grow in 2005 but at a slower pace. IMF projects a 4.3-percent growth while the WB projects a more conservative 3.2 percent in 2005. Factors seen to shape this growth are the adjustments to correct global imbalances, global fiscal and monetary tightening, efforts to slow down the Chinese economy, increased oil and commodity prices, and the steady decline in output gaps.

Table 2: World Bank Global Outlook Summary

	Forecast	
	2004	2005
Real GDP growth	4.0	3.2
High income	3.5	2.7
OECD countries	3.5	2.6
Euro area	1.8	2.1
Japan	4.3	1.8
United States	4.3	3.2
Non-OECD countries	5.9	4.6
Developing countries	6.1	5.4
East Asia and Pacific	7.8	7.1
Europe and Central Asia	7.0	5.6
Latin America and the Caribbean	4.7	3.7
Middle East and North Africa	4.7	4.7
South Asia	6.0	6.3
Sub-Saharan Africa	3.2	3.6

Source: WB Global Economic Prospects, Nov. 2004

Figure 1: Asian Currencies vs US$
(Rise = appreciation, March 2003 = 1)



Source: Bangko Sentral ng Pilipinas

Adjustments to correct global imbalances

A macroeconomic concern of the world economy is the huge current account deficit of the United States, which is estimated at 6 percent of GDP ***(The Economist, November 13, 2004)***. Its current account deficit is largely financed by the surpluses of the emerging East Asian economies and is becoming unsustainable.

A consequence of this is the weakening of the dollar, which saw its lowest at US$1.36 to a euro as of December 28, 2004. The weakening of the dollar also means the strengthening of many Asian currencies (Figure 1). Capital Economics, a London research firm, forecasts the dollar to fall to US$1.40 against the euro by the end of 2005 ***(The Economist, December 2004)***.

In the long run, the further weakening of the dollar will result in huge foreign exchange losses for Asian central banks as many Asian economies hold their reserves in US dollars. Six Asian economies (China, Hongkong, Korea, Singapore, Taiwan and Thailand) held US$381 billion of US government securites in August, 2004, while Japan held US$722 billion (***World Bank***).

Table 3: Current Account Positions of Selected Economies
(Percent of GDP)

	2002	2003	2004	2005
Advanced economies	(0.8)	(0.8)	(0.8)	(0.8)
USA	(4.5)	(4.8)	(5.4)	(5.1)
Euro area[1]	0.8	0.3	0.8	0.9
Major advanced economies	(1.5)	(1.6)	(1.5)	(1.5)
Euro area[2]	0.8	0.4	0.3	0.5
Newly industrialized Asian Economies	5.8	7.6	6.8	6.5

[1]Calculated as the sum of the balances of individual euro area countries.
[2]Corrected for reporting discrepancies in intra-area transactions.

Source: IMF World Economic Outlook, Sept. 2004

According to a study by the Federal Reserve Bank of New York, a 10-percent rise in the Yuan against the US dollar will result in local currency loss that equals to 3 percent of China's GDP, while in Singapore the loss could be a much as 10 percent of GDP ***(The Economist, November 27, 2004)***. Asian central banks should manage the cost of the dollar fall on their economies as they diversify their reserves to other currencies, which will make the US dollar fall further.

Further, the US is expected to improve its savings rate as another measure to address its huge current account deficit. It will have to reduce its fiscal deficit, which is estimated to be 4.9 percent of GDP in 2004. This will result in a decline in private and government spending in the US, and with rising interest rates, this will mean a slowdown in the US economy, and consequently, a slowdown in global growth.

Moreover, the fall of the dollar will mean cheaper exports for the US, while its trading partners' exports will become comparatively

more expensive; hence, a slowdown in the demand for Asian exports to the US.

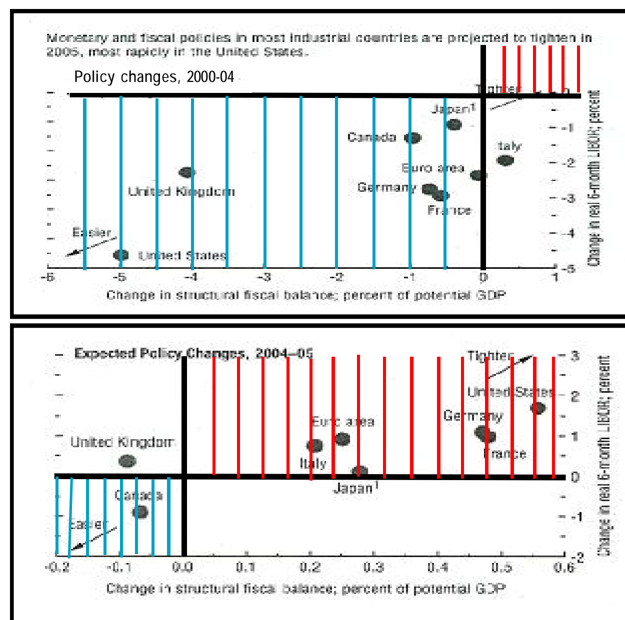
Major economies will have to coordinate these adjustments in exchange rate, fiscal and monetary policies to bring about an orderly transition and avoid a recession in the United States, which will be costly for the global economy. According to the IMF, "the key policy requirements include the medium-term fiscal consolidation in the United States to boost savings, structural reforms to boost growth prospects outside the US as many Asian economies hold their reserves in US dollars, and greater exchange rate flexibility in Asia to have an orderly reduction in current account balances." Further, they state that "countries are moving forward in the first two but little progress has been made in the third" ***(IMF World Economic Outlook)***.

Global fiscal and monetary policy tightening

With the current trend of increasing current account deficits, particularly in the US, and fiscal deficits in both industrialized and emerging economies, it is forecast that governments will lift monetary and fiscal stimulus to their economies. Figure 2 shows a marked movement of countries away from the blue (easier fiscal and monetary policy) region to the red (tighter fiscal and monetary policy) region in 2005. Interest rates in most advanced countries will rise in the coming years even as they reduce their fiscal deficits. This will dampen growth as private investment will be more expensive and government pump priming activities will decline.

The US Federal funds rates have already increased by 1.25 percentage points as of December 2004 and are expected to rise at a "measured" pace, settling at 3.5 to 4 percent by end 2005. The measured pace is in consideration of the uncertainties that growth will decelerate and inflation will increase.

Figure 2: Fiscal and Monetary Tightening in Major Advanced Countries



Source: IMF World Economic Outlook, Sept. 2004

In light of rising prices of oil and commodities, global inflation is expected to rise to 2.6 percent from 2004. This is adds to the pressure to raise interest rates.

The IMF notes that this tightening could have an adverse impact on the housing market in countries where housing prices appear highly valued and where a large share of mortgage debt is at adjustable rates. Moreover, it would also result in further deterioration in emerging market financing conditions where corporate and financial sector vulnerabilities remain significant. Countries whose non-performing loans (NPLs) remain large or private credit growth is rapid will be more vulnerable. As of June 2004, the Philippine banking system's asset quality is still bad, with NPLs amounting to 15.9 percent of total loans.

Efforts to slow down the Chinese economy

China has been a major driver of global economic activity as an efficient producer of goods and an export destination in the past few

years and this continued in 2004. In 2003, 23.5 percent of exports of newly industrializing economies, 11.9 percent of Philippines' and 10.5 percent of Malaysia's went to China. Recently, worries have been raised on China's overheating economy evidenced by excessive investment in various sectors of the economy and high inflation rates. In an effort to avoid the ill effects of overheating or a sharp decline in growth, China is undertaking efforts for a managed slowing down of their growth.

Asia is a clear stakeholder as China is one of its major export destinations. Economic growth of Asian economies, including the Philippines, will be adversely affected by the slowdown in China's economy. The IMF sees that growth in Asia will decline by 0.4-percentage point if China's nonprocessing import declines by 10 percent. This will be a shock but will be largely manageable given Asia's larger dependence on US and Euro zone for their exports. Further, IMF estimates that the effect on the Philippines will be a reduction in growth by 0.28 percentage point.

To temper the economy and maintain the healthy export and import trend, credit restrictions, administrative controls on investment and higher interest rates were imposed by the Chinese government. ADB, IMF and WB observe some success in China's effort to slow its economy and achieve a "soft landing."

Table 4: Exports of Selected Asian Economies to China[1]
(% of total exports)

Economy or Region	PRC Share of Exports			Effect of Slowdown
	2001	2002	2003	
Japan	7.7	9.6	12.2	(0.24)
Developing Asia				
NIEs	16.8	19.3	23.5	(0.50)
ASEAN (excl. Singapore)	4.3	5.2	8.8	(0.24)
Indonesia	3.9	5.1	7.2	(0.23)
Malaysia	4.3	5.6	10.5	(0.32)
Philippines	2.5	3.9	11.9	(0.28)
Thailand	4.4	5.2	7.1	(0.25)
South Asia	2.8	3.3	5.0	(0.09)

Source: ADO Update, Sept. 2004

[1] *Reduction of Real Investment Growth from 10.2 percent to 5.0 percent*

China posted a 9.5-percent growth in 2004, with fixed asset investment slowing but inflation still a source of concern, according to National Bureau of Statistics, China's economic agency. This growth though is higher than the previous estimate of 8.5 percent for 2004.

Increased Oil and Commodity Prices

In 2004, oil and commodity prices increased significantly. The increased uncertainty of oil supply due to events surrounding the Yukos in Russia (the world's largest oil producer surpassing Iraq), instability in Iraq, Venezuela and Nigeria, and rising global demand given the energy-intensive economic activities in 2004, have intensified the pressure on oil prices. This is expected to continue and the WB and IMF estimate oil prices to average US$36 in 2005.

The repercussion of increased oil prices for 2005 is significant for Asia, particularly the Philippines. If a sustained oil price increase is experienced for 2005, ADB estimates that the Philippines will be among the hardest hit in the region (Table 5). A US$10-increase would reduce GDP growth by 1.9 percentage points with consumer prices going up by 1.4 percent.

Table 5: Effects of Sustained Oil Price Increase of US$10 for 2005

Economy or Region	Effect to GDP (Percentage Pt.)	Effect to Consumer Prices
Japan	0.5	0.7
Developing Asia		
NIEs	(0.8)	0.7
ASEAN (excl. Singapore)	(1.2)	1.4
Indonesia	0.1	1.3
Malaysia	(0.9)	1.4
Philippines	(1.9)	1.4
Thailand	(2.2)	1.5

Source: ADO Update, Sept. 2004

Furthermore, non-energy commodity prices continued to rise but at a slower rate in 2004 due to efforts of China to dampen growth and interest hikes in the United States. This is expected to continue in 2005. The rise in commodity prices is explained by the upbeat demand catching up with production capacity.

Table 6: Non-Energy Commodity Prices, Growth Rates, 2004

	US dollar Terms	Contribution
Food	2.7	43.1
Beverages	5.2	3.0
Agricultural raw materials	9.0	21.4
Metals	15.3	32.5
Overall non-energy	8.2	100.0

Source: IMF World Economic Outlook, Sept. 2004

Previous underinvestment, particularly in metals production, is seen to narrow the demand and supply conditions ***(The Economist, October 11, 2004).***

High-tech exports from East Asia are expected to slow down in 2005. World semiconductors sales have reached US$18.2 billion as of August 2004, almost equal to the global peak reached in October 2000 of US$18.7 billion (***WB East Asian Update, November 2004***). Industry participants expect a cyclical peak will be reached in 2004 and a slow down in semiconductor sales will ensue in 2005.

Declining output gaps

Output gap is the difference between capacity of production and actual production. In 2003, major advanced economies are operating close to maximum capacity. This is expected to continue in 2005 as global demand continues as a result of underinvestment during the past years. Operating at 97.7 percent of full capacity, major economies (Table 7) are expected to post output gaps of 1.3 percent in 2004 and a much lower 1 percent in 2005. This is supported by fast drops in gaps of the US (2.3 percent in 2003 to 1 percent in 2005), Euro (1.9 percent to 1.7 percent) and Japanese (3.4 percent to 0.2 percent) productive capacities. The miniscule 1 percent spare production capacity essentially limits production volume in the future, tempering demand in 2005 and put pressure on price increases.

Table 7: Output Gaps in Developed Economies

	2003	2004	2005
Major advanced economies	(2.3)	(1.3)	(1.0)
United States	(2.3)	(1.3)	(1.0)
Euro area	(1.9)	(1.8)	(1.7)
Japan	(3.4)	(0.8)	(0.2)
Canada	(0.8)	(0.7)	(0.3)

Source: IMF World Economic Outlook, Sept. 2004

Conclusion

The world economy will experience a slower growth in 2005. Consequently, East Asia is seen to be in the same slow down mode at 5.9 percent (excluding Japan) by WB and 6.4 percent by ADB for the same period.

Adjustments to correct the imbalances in the current account positions of the US and Asian economies and capital flows will post interest rate and foreign exchange risks. Corrective measures like fiscal and monetary tightening are already in place and increased world interest rates is a given. Most of these measures will entail lower demand for exports and reduce consumption, thus dampening growth. Further, China's efforts for a 'soft landing' will have similar effects.

Meanwhile, the rising price of oil and other commodities will also shape slower figures for the global economy in 2005 as the supply conditions in the market tighten. The challenge then for governments is to strengthen domestic demand and increase private investments in their countries to counter the risks posed by the above factors.

A major policy issue is the strengthening of fiscal positions. The region still has to deal with a sizeable public sector debt, which they have borne for bearing the cost of restructuring insolvent institutions. The Philippines' public debt, for example, has reached almost 137 percent of the GDP as of December 2003. Progress has been made in reducing the national government and public sector deficit to 4 percent and 5.5 percent, respectively, in 2004. However, much remains to be done to reduce this to more manageable levels. The revenue base of

government needs to expand through new tax measures and improved tax administration.

Second, reforms in the financial system are necessary. The issue of high NPLs needs to be addressed which is particular to the Philippines. In light of expectations of higher interest rates, more pressure should be put on banks to unload their NPLs. Further, efforts to improve corporate governance and accounting standards should be pursued.

Third, other measures to improve the investment climate with better infrastructure and an improved regulatory environment will be necessary to to attract more capital into the country. Morevover, the inflationary effects of high oil and other commodity prices will have to be mitigated by higher productivity and efficiency in production.

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This paper was prepared by the Macroeconomics Group, under the supervision of the SEPO Director General.

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