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Economic Report

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Global Economic Outlook: Challenges for 2006

This paper summarizes the highlights of the 2005 performance of the world economy and the global economic outlook for 2006. The report culls from the studies prepared by the International Monetary Fund (IMF), World Bank (WB) and Asian Development Bank (ADB).

2005 PERFORMANCE

In 2005, the global economy is expected to have grown slower compared to the 5 percent growth in 2004. The IMF forecasts the world GDP[1] to grow by 4.3 percent while the World Bank places it at 4.4 percent.

Advanced economies are seen to have grown by 2.5 percent, led by the steady growth of the newly industrialized economies (NIEs) in Asia[2] and the United States. Among the NIEs, Hongkong is expected to have grown the fastest with its GDP pegged between 5.5 percent and 6.3 percent. Hongkong's exports grew more robust last year relative to its neighbors, owing to its close integration with the rapidly developing Pearl River Delta and its re-exports to Mainland China (ADB).

The US economy expanded more slowly at 3.5 percent in contrast to 4.2 percent in 2004. Its output was dampened by the combined effects of the oil price hikes, increase in short-term interest rates and the hurricanes that hit the country. The slowdown was not as marked though, because long-term interest rates remained low which boosted domestic demand. Likewise, the cumulative effect of dollar depreciations improved export receipts. Thus, even with a diminished growth, the US was still a significant contributor to the high-income economies' growth.

In Europe, weak domestic demand and the slowdown in export production continued to retard economic growth. Similarly, the Japanese economy decelerated due to lower exports to China. Domestic demand, however, has already started to pick up, leading to projections that it will soon get out of its deflationary environment.

Table 1. 2005 GDP Projections, Selected Economies (growth rates)

	IMF	WB
World Output (PPP weights)	4.3	4.4
Advanced Economies	2.5	-
Japan	2.0	2.3
United States	3.5	3.5
Euro Area	1.2	1.1
Newly Industrialized Economies	4.4	4.2
Korea	3.8	3.8
Singapore	3.9	4.1
Taiwan	3.4	3.2
Hongkong, SAR	6.3	5.5
Emerging Markets		
China	9.0	9.3
India	7.1	7.0
ASEAN 4	4.9	4.9
Indonesia	5.8	5.7
Malaysia	5.5	5.0
Thailand	3.5	4.0
Philippines	4.7	4.7
Commonwealth of Independent States	6.0	-

Sources: IMF and WB

[1] Based on the purchasing power parity valuation of country GDPs

[2] Newly industrialized economies (NIEs) comprise Hong Kong, China, Republic of Korea, Singapore and Taiwan.

Emerging and developing economies, on the other hand, are expected to have grown at a rate of 6.4 percent led by Developing Asia and the Commonwealth of Independent States. Developing Asia grew by 7.0 percent with China and India as the main growth propellers. Both countries experienced surging exports and strong investments, particularly in the information technology-enabled services.

Countries in the Commonwealth of Independent States, which include Russia, Mongolia, and Ukraine, among others,maintained robust growth due to favorable commodity and oil prices. Likewise, oil-exporting economies in the Middle East and North Africa continued to benefit from high oil prices.

Oil prices. World oil prices have surged by approximately 43.6 percent[3], way above an earlier projection of 23.1 percent[4]. Tighter demand and supply situation, and the uncertainty caused by supply disruptions due to weather and geopolitical factors triggered the price hikes. Nonetheless, the impact of higher oil prices on growth and inflation is said to be tame. The IMF noted that the world economy slowed down by only 0.8 percent compared to their initial estimates of over 2 percent of GDP.

The resilience of the global economy in the face of oil price increases stems from many factors. One is that the oil price increase was largely due to an increase in consumption and it acted as an automatic stabilizer. The high oil prices slowed the growth of economies, reducing consumption, hence, curbing demand for oil. Second, there has been a substantial improvement in energy efficiency. Compared to the late 1970s, global oil intensity[5] has declined by 38 percent. This means that now, less amount of oil is required to generate a dollar's worth of GDP. Third, higher oil prices have yet to manifest themselves in core inflation[6]. So far, inflation has been restrained, easing the pressure to increase interest rates. Consumers and producers treated the high oil prices as temporary and did not adjust their spending plans right away. In addition, with increased global competition, producers had less flexibility to just pass on the full price increase in cost to their consumers. Furthermore, some governments opted to absorb the rising fuel costs through some form of subsidies (IMF). Indonesia, Malaysia, India and Thailand, for instance, provided fuel subsidies to shield their citizens from the oil price hike. They eventually had to cut them when it became a huge fiscal burden.

Because of these, there are fears that the second round effect of higher oil prices will be felt in 2006.

Table 2. Summary of Inflation Rates, 2005

Countries	2004	2005
Advanced Economies	2.0	2.2
United States	2.7	3.1
Japan	-	-0.4
Euro Area	2.1	2.1
Other Emerging Market and Developing Countries	5.9	5.9
Africa	7.8	8.2
Central and Eastern Europe	6.5	4.8
Commonwealth of Independent States	10.3	12.6
Developing Asia	4.2	4.2
Middle East	8.4	10.0
Western Hemisphere	6.5	6.3
Newly Industrialized Economies	2.2	2.2

Source: IMF

Inflation. While inflation was lower than expected in 2005, consumer prices were generally higher in almost all economies. This is largely due to the continued economic growth of the economies and the higher oil prices. The inflationary pressure was most evident in countries belonging to the Commonwealth of Independent States.

Interest rates. Generally, interest rates were relatively stable. Because of weak domestic demand and slow growth, Japan and the Euro area kept their interest rates low to encourage domestic expansion. In contrast, US short- term interest rates gradually increased from 2.25 percent in December 2004 to 4.25 percent in December 2005. Meanwhile, long-term interest rates

[3] This is a simple average of spot prices of UK Brent, Dubai and West Texas Intermediate crude oil. (IMF World Economic Outlook, September 2005)
[4] IMF World Economic Outlook, April 2005
[5] Oil intensity is the ratio between oil consumption and economic output.
[6] Core inflation aims to capture the permanent or long-run trend in the prices of consumer goods and services by taking out the effects of temporary disturbances or shocks on the average consumer prices.

continued to remain low and hardly unchanged compared to 2004. This is due to excess liquidity stemming from the long-period of low short-term interest rates, low inflation environment owing to improved credibility of monetary policy, and an increase in global savings due to increases in corporate savings in East Asia and savings from impending pension payments in Europe (WB).

Table 3. Actual Interest Rates, Selected Economies

Items	2002	2003	2004	August 2005
Short-term Interest Rates				
Advanced Economies	2.0	1.6	1.8	2.5
US	1.6	1.0	2.2	4.2*
Euro Area	3.3	2.3	2.1	2.1
Japan	0.0	0.0	0.0	0.0
United Kingdom	4.0	3.7	4.6	4.8
Canada	2.6	2.9	2.2	2.7
Newly Industrialized Asian Economies	0.7	3.0	3.7	3.4
Long-term Interest Rates				
Advanced Economies	4.2	3.7	3.9	3.6
US	4.6	4.0	4.3	4.5*
Euro Area	4.9	4.2	4.3	3.5
Japan	1.3	1.0	1.5	1.3
United Kingdom	4.8	4.5	4.8	4.4
Canada	5.3	4.8	4.6	3.8
Newly Industrialized Asian Economies	4.8	4.8	4.9	4.3

Source: WEO 2005, IMF
**as of December 2005*

Slower trade. World trade is projected to have slowed down to 7 percent in 2005 compared to a robust growth of 10.3 percent in 2004. Exports of advanced economies, which accounted for 72 percent of total world exports in 2004, dwindled to 5 percent from 8.3 percent last year. Imports suffered as well, dropping to 5.4 percent from 8.8 percent. Sluggish economic growth and the downswing experienced by the high technology industries largely explain the trade decline.

The East and Southeast Asian economies were the most affected by the downturn in the high technology sector. In 2004, 30 percent of total exports of Asian countries were electronics. In the Philippines, electronics' share in total exports goes as high as 65 percent. (IMF Regional Outlook, September 2005).

Exchange rate adjustments. In light of a huge current account deficit in the US, mainly accounted for by huge importations of Chinese exports, multilaterals expect the Chinese yuan and other currencies in emerging Asia to appreciate against the dollar; and the dollar to depreciate.

In July 21, 2005, China revalued its peg to the dollar in a response to international calls for its exchange rate to appreciate. From 8.28 yuans to the US dollar, the exchange rate peg was moved to 8.11 yuans per greenback, effectively appreciating the Chinese currency by 2.1 percent against the dollar. Chinese monetary authorities also disclosed that the yuan would be allowed to fluctuate against a basket of currencies although kept within a tight band. University of Maryland professor Peter Morici estimates that the yuan is 40 percent undervalued and asserts that the recent devaluation is but a fig leaf of the needed adjustment (Isidore, July 21, 2005).

Table 4. Volume of Trade, 2005
(annual percentage change)

Items	2004		2005	
World Trade Volume	***10.3***		***7.0***	
	Exports	Imports	Exports	Imports
Advanced Economies	8.3	8.8	5.0	5.4
United States	8.4	10.7	8.2	6.6
Japan	14.5	8.9	5.4	6.7
Euro Area	6.1	6.2	3.5	4.1
Newly Industrialized Economies	17.3	16.5	7.6	7.0
Other Emerging Market and Developing Countries	14.4	17.4	10.2	14.1
Africa	7.1	8.8	4.5	11.4
Central and Eastern Europe	15.3	16.0	8.2	7.4
Commonwealth of Independent States	12.1	16.7	7.0	20.4
Developing Asia	19.4	22.6	15.6	17.8
Middle East	9.1	13.0	8.9	13.4
Western Hemisphere	10.6	12.9	4.4	10.9

Source: IMF

Table 5. Movements of Selected Asian Currencies Against the US Dollar
Closing as of End-2005 vs. End-2004

Currency	Percentage Change
Philippine Peso	5.67
Chinese Yuan	2.55
Malaysian Ringgit	0.54
Singaporean Dollar	(1.85)
Taiwanese Dollar	(3.53)
Indian Rupee	(3.71)
Thai Baht	(4.99)
Indonesian Rupiah	(6.14)
Japanese Yen	(12.87)

Source: Yap and Lema, Businessworld, December 30, 2005
Note: Positive values indicate an appreciation of a currency against the US Dollar while negative values (in parenthesis) indicate depreciation.

The dollar was strong against most regional currencies in 2005. In fact, the dollar gained 12.7 percent in the composite dollar index. In table 5, the dollar appreciated in 2005 against six major world currencies (Yap and Lema, December 30, 2005). The wider spread between the US and European short-term rates attracted private inflows to the US. This helped strengthen the US dollar and finance the huge US current account deficit (WB).

2006 OUTLOOK

Global output growth is expected to plateau in 2006 at 4.3 percent from the same growth rate in 2005. However, the distribution of growth is expected to be different in 2006 with developed economies accelerating in growth from 2.5-percent growth in 2005 to a 2.7-percent growth this year. This is expected to be supported by a higher growth of the Euro area, 1.8 percent this year from 1.2 percent in 2005; the United Kingdom, 2.2 percent from 1.9 percent; and NIEs in Asia, 4.7 percent from 4 percent. Amidst expectations of higher growth compared to their more advanced counterparts, the emerging economies' growth rates are expected to decelerate from last year. In 2006, emerging market and developing economies are estimated to grow by 6.1 percent from 6.4 percent in the preceding year.

Table 6. 2006 GDP Projection, Selected Economies (growth rates)

Items	2005	2006
World Output	**4.3**	**4.3**
Advanced Economies	**2.5**	**2.7**
United States	3.5	3.3
Euro Area	1.2	1.8
Japan	2.0	2.0
United Kingdom	1.9	2.2
Newly Industrialized Asian Economies	4.0	4.7
Other Emerging Market and Developing Countries	**6.4**	**6.1**
Africa	4.5	5.9
Central & Eastern Europe	4.3	4.6
Commonwealth of Independent States	6.0	5.7
Developing Asia	7.8	7.2
China	9.0	8.2
India	7.1	6.3
ASEAN - 4	4.9	5.4
Middle East	5.4	5.0
Western Hemisphere	4.1	3.8
Memo Items:		
World trade volume	7.0	7.4
Commodity prices (U.S. dollars) Oil (% change)	43.6	13.9
Consumer Prices (% change) Advanced economies	2.2	2.0
Other Emerging Market and Developing Countries	5.9	5.7
London Interbank offered rate on U.S. dollar deposits	3.6	4.5

Source: IMF WEO, September 2005.

Keeping the growth from accelerating this year are the relatively slower world trade growth, a continuation of oil price uptick although at a slower pace, and tighter monetary policy in the form of higher interest rates.

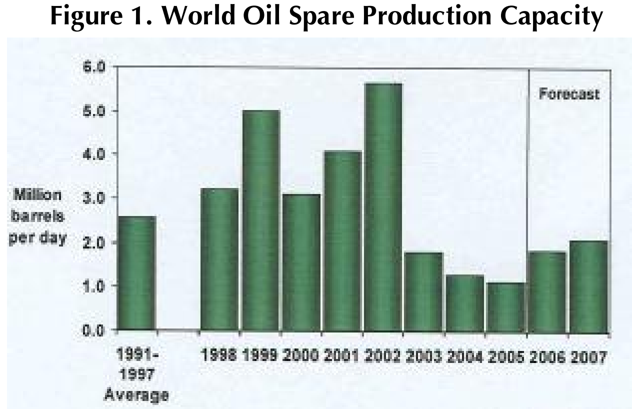
CHALLENGES FOR 2006

Persistent high oil prices. Amidst the global economy's increased resilience to the 43.6-percent increase of oil prices in 2005, high oil price remain to be the most important potential risk in 2006. Economists forecast that it takes a year or two to feel the full effects of the oil price increases (Stiglitz, December 2005). Hence, it is expected that its impact on global economic growth will be more pronounced in 2006.

The demand and supply situation is expected to ease in 2006, but will remain tight. Supply is expected to increase, particularly from non-OPEC countries (Business Week, Dec. 27, 2005). Global demand for oil is projected at 1.6 million barrels per day or an increase of 1.9 percent from 2004 (Short Term Energy Outlook, January 2006). The rate of increase is showing signs of easing compared to 2004.

Spare production capacity is expected to increase in 2006 and 2007 largely from a rebound in non-OPEC output. Estimates show that non-OPEC output will rise between 900,000 (Energy Information Administration) to 1.1 million barrels per

Figure 1. World Oil Spare Production Capacity



Source: EIA, Short-term Energy Outlook, January 2006 day or around 2.2 percent this year (Business Week). This results in a spare production capacity of 2-2.5 million barrels per day in 2006 and 2007 (EIA).

The supply side vulnerabilities remain to be the biggest risk to the oil market. Any indication of a disruption in supply, which includes terrorist threats in the Middle East, geopolitical problems in oil producing countries and natural calamities make the oil market jittery. This is evident in the US$4.81/bbl[7] average increase in oil prices in January of this year over the December 2005 average due largely to concerns over the unrest in Nigeria and tension between Iran and the West over its nuclear ambitions, which created fears of supply disruptions. Though forecast show that oil price increase in 2006 will not be as high as 2005 on the average, prices will still remain to be very volatile.

Table 7. Oil Price Increase, 2003-2006 (annual percentage change)

Year	Oil Price Increase*
2003	15.8
2004	30.7
2005^p	43.6
2006^p	13.9

Source: WEO September 2005, IMF
**This is a simple average of spot prices of UK Brent, Dubai and West Texas Intermediate crude oil.*
^{p}projection

Inflation and tighter monetary policy. While inflation inched up in many economies particularly in Asia and OECD countries, a more relaxed inflation environment is seen in 2006. This is due to the continued tightening of monetary policy as a response to the threat of oil price increases; and slower growth in some of the economies.

With the continued threat of rising oil prices, prices of goods will be higher in 2006. With this, one can expect tighter monetary policy and higher short-term rates as in 2005.

The risk of higher interest rates will cause economic growth to further slow down. The magnitudes of these adjustments will determine how the global economy will fare. World Bank estimates that a 200 basis-point increase in interest rates in high income countries and a 200 basis-point increase in spreads of developing countries will reduce global growth by half for a period of two years (WB, November 2005). The implication for developing countries is an increase in their future borrowing cost. For highly indebted countries, this could pose a real fiscal threat particularly, if they have high levels of short term debt.

Table 8. Projected Inflation Rate, 2005-2006

Items	2005	2006
Advanced Economies	2.2	2.0
Japan	(0.4)	(0.1)
United States	3.1	2.8
Euro Area	2.1	1.8
Other Advanced Economies	2.1	2.2
Other Emerging Markets and Developing Countries	5.9	5.7
Africa	8.2	7.0
Central and Eastern Europe	4.8	4.3
Commonwealth of Independent States	12.6	10.5
Developing Asia	4.2	4.7
Middle East	10.0	9.7
Western Hemisphere	6.3	5.4

Source: WEO, IMF

Nonetheless, the interest rates are not expected to soar in the near future as projections remain benign for 2006. A medium-term risk that may spur interest rates to soar is the adjustment in global imbalance.

Table 9. Projected Short-Term Interest Rates of Selected Economies, 2005-2006

Items	2005	2006
Japan	0.1	0.2
United States	3.1	4.2
Euro Area	2.1	2.4
LIBOR	3.6	4.5

Source: WEO, IMF

Adjustments to correct global imbalances. The current global imbalance is characterized by high income countries becoming huge dissavers, and emerging and developing states having huge savings. The current account deficit of advanced economies increased to 1.4 percent, while surpluses of emerging economies are widening, especially China and more recently the oil exporting countries. The imbalance is growing as international reserves are increasing in emerging economies.

[7] Asian Dubai prices, as of January 24, 2006.

Table 10. Projected Current Account Balance of Selected Economies, 2005-2006 (in percent of GDP)

Items	2005	2006
Advanced Economies	(1.3)	(1.4)
Japan	3.3	3.0
United States	(6.1)	(6.1)
Euro Area	0.2	0.2
Newly Industrialized Asian Economies	5.5	5.0
Korea	2.0	1.5
Singapore	25.7	22.7
Taiwan	4.3	4.6
Hongkong, SAR	10.3	10.2
Other Emerging Market and Developing Countries	-	-
Africa	1.6	3.5
Central and Western Europe	(4.8)	(5.0)
Commonwealth of Independent States	10.6	10.3
Developing Asia	3.0	2.8
China	6.1	5.6
India	(1.8)	(2.0)
Malaysia	13.5	12.4
Philippines	2.1	1.9
Middle East	21.1	23.5
Western Hemisphere	0.9	0.6

Source: WEO, IMF

The deficit of the United States is being financed by countries with high reserves. This is expected to result in the depreciation of the US dollar and the currencies of the countries with surpluses to appreciate. Since early 2002, the US dollar has depreciated by 12 percent but this was arrested in the first seven months of 2005. Meanwhile, currencies of emerging markets have largely been unchanged (IMF).

This global imbalance is causing uncertainty for the global economy because any change in investor sentiment may bring about a slide in the US dollar and can cause a global recession. As the dollar continues to depreciate, investors will demand higher interest rates on dollar-denominated investments forcing the US to raise interest rates further. This will then choke off growth. Just recently, the Federal Reserve has raised its short- term interest rate to 4.5 percent. Furthermore, a big slide in the value of the dollar will adversely affect exports of countries highly dependent on the US market; particularly at risk are countries in Asia. Likewise, countries with huge dollar investments will suffer big losses, affecting their economies.

Table 11. Projected Reserves of Selected Economies, 2005-2006, (in billion US$)

Items	2005	2006
Other Emerging Market and Developing Countries	2,335.8	2,795.0
Africa	165.7	226.7
Central and Eastern Europe	200.2	202.5
Commonwealth of Independent States	229.1	341.3
Developing Asia	1,181.4	1,370.4
China	818.9*	985.5
India	131.0*	151.7
Middle East	309.8	384.7
Western Hemisphere	249.5	269.3

Source: WEO, IMF and The Economist
**actual data*

Whether the current imbalance will persist and for how long remains to be seen. Some economists believe that the imbalance can continue to exist for a long period, without causing a recession as long as countries deliberately pursue an export-led development strategy. It is also posited that the imbalance is a reflection of the role of better functioning and increasing integration of global capital markets.

Nonetheless, a rebalancing will eventually occur because the US debt cannot continue to build up indefinitely. The manner of adjustments will depend on the following factors:

1. Greater exchange rate flexibility of the emerging Asia, where countries will allow their currencies to move based on market forces. Also, part of the global rebalancing policies that the IMF proposes is an investment recovery in Asia. It is argued that a 5-percent-of-GDP increase in investment would reduce US current account deficit by 0.75 percent of GDP after three years. Here, monetary policy might help by providing incentives to domestic banks to increase lending;

2. Increase in the national savings of the United States, through tighter monetary policy, a depreciation of the US dollar and fiscal consolidation; and

3. Structural reforms in the Euro area and Japan to stimulate domestic growth.

CONCLUSION

The impact of continued oil price increases, global imbalance, higher interest rates, higher consumer prices, slower trade, and exchange rate adjustments was not as severe as what was expected in 2005. The resilience of the world economy was due to excess liquidity in the global market, improvement in energy efficiency, increase in global savings and low inflation environment.

A number of risks will still face the global economy in 2006. Most of them are carried over from last year. Among these risks are the effects of oil price increases due to instability of the supply of oil, and the huge financial imbalance between the US and the rest of the world. How the effects of these risks will unfold will determine the direction of the world economy. An orderly adjustment is hoped for to ensure a smooth transition to the next stage of global growth.

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