



United Nations
Department of Economic and Social Affairs

LINK Global Economic Outlook
May 2005

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Economic Monitoring and Assessment Unit
Development Policy and Planning Office

For the
Project LINK Meeting
16-20 May 2005
Mexico City

PREFACE

This global economic forecast was prepared by staff of the Economic Monitoring and Assessment Unit of the United Nations Department of Economic and Social Affairs, based on inputs from national LINK centres and information from other sources as of 30 April 2005. The major global assumptions underlying the forecast are set out in the Box below. Most of the LINK Country Reports, which contain detailed forecasts and policy analyses submitted by the national LINK centres, are available on the websites of both the United Nations and the University of Toronto.¹

Major assumptions for the baseline forecast

The United States Federal Reserve is expected to raise the Federal Funds interest rate to 4.0 per cent by the end of 2005 and to maintain this rate in 2006; the European Central Bank is expected to maintain its policy rate at the current level of 2 per cent until raising it by 25 basis points in the 4th quarter of 2005, with a further increase of 50 basis points in 2006; the Bank of Japan is expected to maintain its policy interest rate at zero throughout 2005 and 2006, and to continue to maintain an accommodative monetary aggregate through operations in the bond and foreign exchange markets.

Fiscal policy worldwide will in general be less stimulatory in 2005 and 2006 than that in 2004. The assumptions regarding fiscal policy in individual countries are based mainly on official budget plans or policy statements.

The average international price of oil is assumed to be \$46 per barrel of Brent crude oil in 2005, compared with an estimated average of \$40 in 2004, and \$37 for 2006.

The future international prices of other major commodities are based on the forecasts contained in the World Bank publication *Global Development Finance 2005*, with some adjustments to take into account more recent developments.

The United States dollar is projected to continue to depreciate against the euro averaging \$1.31 per euro in 2005 and \$1.36 per euro in 2006, while against the Japanese Yen it is assumed to average 105 in both years.

¹ <http://www.un.org/esa/analysis/link> and <http://www.class.utoronto.ca/link>.

INTRODUCTION

The world economy continues to perform largely in accordance with expectations. After unusually high annual growth of close to 4 per cent in 2004, global economic activity peaked around the end of the year. The current deceleration started slightly earlier and is somewhat greater than expected in November 2004, with growth in 2005 now forecast to be somewhat below 3 per cent rather than slightly above that rate (see table 1). However, no further weakening is expected and global growth of around 3 per cent is expected to be sustained into 2006. At the same time, the world economy is facing headwinds, as well as some systemic dangers, so that the balance of risks is on the downside.

Within the global aggregate, the developed countries account for most of the slippage from the previous forecast and, within that group, the deterioration is greatest for Japan and somewhat less for the European Union. The developing countries are participating in the global slowdown, but in their case the setback is less than previously forecast. With oil output being increased and the oil price higher than previously forecast, growth in the oil-exporting countries is expected to exceed earlier forecasts although capacity constraints place a ceiling on the improvement in some cases. The asymmetry in the situation is that growth in the oil-importing countries, while universally less than in 2004, is not expected to decline to the extent previously expected.

The slowdown in developed countries is in part cyclical and anticipated in that the strong recovery from the earlier downturn peaked as economies moved towards full capacity utilization. At the same time, policy makers had been gradually reducing their previous stimuli. A second factor dampening growth, itself partly cyclical, has been the increase in oil prices and – in a further difference from the previous forecast – not only the persistence of these higher prices but additional increases in the interim. Overhanging these recent developments, there is the longer-standing question of the global imbalances and the risk that correction may take place in a precipitous manner. These last two factors have introduced a new element of uncertainty into the minds and hence actions of producers and consumers and thus into the forecasts. Some three years ago, unquantifiable geopolitical risks were seen to pose a risk to the world economy. While the possibility of such an event was generally considered to be low, there were fears that, if it materialized, the economic impact, while unknown, might be substantial. In an economic parallel, there has been confidence in some quarters that the global imbalances would not evolve in a disruptive manner, while others have feared that they could cause severe economic disruption. There now seems to be greater recognition that the global imbalances pose risks to the present period of sound growth but the concrete nature and magnitude of these risks is unknown. More importantly, however, increasing recognition of the risks does not appear to be matched by actions to address them.

A more encouraging feature of the world economy at present is the high and unusually universal growth being achieved by developing countries. In 2004, all major developing regions except Africa grew by more than 5 per cent and Africa is forecast to achieve that rate in 2005. In part, this improvement in growth reflects sounder economic conditions in the developing countries themselves, as reflected in the key macroeconomic balances – both fiscal and external deficits have been reduced, with some having been transformed into surpluses, most notably in the case of the current account. Inflation has been reduced and financial positions have been strengthened in most of the countries that have access to international capital markets. Reflecting these improved domestic conditions and confidence, domestic demand has become an increasingly strong component of growth in many developing countries.

**Table 1. Gross domestic product and world trade
(Annual percentage change)**

	May 2005 forecasts ^a			November 2004 forecasts	
	2004 ^b	2005	2006	2004	2005
Gross world product	3.9	2.9	3.0	3.8	3.2
PPP weighted	4.6	3.6	3.5	4.5	3.8
Major developed economies					
Canada	2.8	1.6	2.8	2.8	2.7
Japan	2.6	0.7	1.5	3.6	2.0
United States	4.4	3.1	3.1	4.0	3.0
European Union (EU25)	2.3	2.0	2.4	2.3	2.3
France	2.5	2.0	2.2	2.5	2.5
Germany	1.6	1.0	1.8	2.0	1.7
Italy	1.0	1.1	1.5	1.1	1.7
United Kingdom	3.1	2.7	2.5	3.3	2.9
Memo item: Euro Zone	2.0	1.6	2.1	2.0	2.1
Russia	7.1	6.0	5.2	6.5	5.3
Developing countries and regions					
Latin America and the Caribbean	6.1	4.5	4.2	5.0	3.9
Argentina	9.0	6.5	4.0	7.1	4.0
Brazil	5.2	3.8	4.1	4.4	3.7
Mexico	4.4	3.5	4.5	4.1	3.9
Africa	4.5	5.2	5.2	4.4	4.6
North Africa	4.5	5.1	5.0	4.5	5.1
Sub-Saharan Africa ^c	5.1	5.4	5.8	5.5	5.7
Nigeria	4.3	7.0	5.2	6.4	5.0
South Africa	3.8	4.0	3.8	3.0	3.1
South and East Asia	6.7	6.2	6.1	5.5	5.3
India	7.0	7.0	7.1	6.4	6.5
Indonesia	5.1	5.4	5.5	4.5	4.4
Korea, Republic of	4.6	4.0	4.3	4.9	4.5
Malaysia	7.1	6.3	6.4	7.0	5.9
Philippines	6.1	5.0	4.7	5.5	5.3
Thailand	6.1	5.5	5.7	6.0	5.5
China	9.5	8.8	8.3	9.2	8.8
Western Asia	6.5	5.3	5.0	6.2	5.0
Oil-exporting countries	6.0	5.8	5.4	5.6	5.1
Oil-importing countries	7.0	4.7	4.5	6.7	4.9
World export volume	10.8	7.2	8.1	9.3	8.0
Oil price (Brent, \$/pb)	38.3	46.0	37.0	40.0	38.0

^a Pre-Meeting forecasts.

^b Actual or most recent estimates.

^c Excluding Nigeria and South Africa.

The widespread nature of growth in developing countries in 2004 and into 2005 was attributable to the complementary impacts of the two main engines of global economic growth - the United States and China. Buoyant domestic demand in the United States boosted the exports of manufactures from developing countries, including China, while China's manufacturing sector increased global demand – and prices – for exports from developing countries that remain heavily dependent on primary commodities, including oil. Meanwhile, for capital-importing developing countries, conditions in international markets not only remained calm but interest rates generally declined.

The risk is that these favourable conditions for developing countries may change. The formerly unexpected persistence of higher oil prices will pose difficulties for oil-importing developing countries as their terms of trade deteriorate. Although the developed countries are the major consumers of oil, the oil intensity of growth is now higher in developing countries than in developed countries, with the result that the damaging impact of higher oil prices is likely to be the greatest for oil-importing developing countries. Higher oil prices are causing trade balances to deteriorate, inflation to increase and, where oil subsidies are in effect, fiscal balances to weaken. In addition their direct contractionary effects, these developments are likely to prompt restrictive policy responses as developing countries seek to maintain their hard-won macroeconomic stability.

In both of the two current engines of growth, policy makers are seeking to avoid overheating by unwinding stimulatory measures. This will have a direct negative impact on their demand for imports from the rest of the world but the tightening of monetary policy in the United States will also raise interest costs for countries borrowing on international capital markets. However, the largest risk in this respect is the possibility of an abrupt and disorderly reaction to the present global imbalances; such an occurrence would probably result in a substantial increase in United States' long-term interest rates, to the detriment of the many developing countries that have dollar-denominated debt.

ADDRESSING THE GLOBAL IMBALANCES

The global imbalances continue to widen, with the current account deficit of the United States expected to above expand from some \$650 billion in 2004 to above \$700 billion in 2005 and to remain in that range in 2006. Conceptually, the global imbalances can be decomposed into three components: cyclical, structural and institutional.

The increase in the global imbalances over the past few years has been driven partly by cyclical factors. A surge in oil prices since 2003, for example, has resulted in an increase of \$60 to \$100 billion in the cost of imports into the United States, matched by corresponding improvement in the current accounts of the oil-exporting countries. In addition, the United States current account deficit partly and directly reflects its worsening fiscal deficit, itself partly a consequence of the policy stimuli for resurrecting the economy from the cyclical downturn of 2000-2001. At the same time, a number of Asian and Latin American countries have been not only replenishing their foreign-exchange reserves from the low levels that arose as a result of the various international financial crises of the past decade, but also accumulating additional foreign-exchange reserves with a view to reducing their vulnerability to such crises in the future.

Part of the imbalances are the result of structural factors, such as economic differentials across countries and regions. A lower domestic savings rate and higher GDP growth in the United States than

in Europe and Japan for a long period, for example, have attracted capital to the United States. Many oil-exporting countries have also continuously —not just in the recent period of higher oil prices— recycled part of their oil revenues to the United States. A major reason for these capital inflows is that the United States has the world's deepest financial market with a wide variety of financial instruments providing safety and liquidity.² The global integration of trade and finance has facilitated these capital flows. Other structural factors include the export-led development strategy adopted by many developing countries, particularly Asia, which may lead to protracted external surpluses in these countries, and thus deficits in their trading partners, including the United States. The quest for trade surpluses is also part of the effort to reduce vulnerability to international financial crisis. There have also been structural changes in fiscal policy in the United States, such as the tax reforms and the expenditures on homeland security, which have compounded the cyclical movements and contributed directly to the fiscal deterioration and thus to the increased current account deficit.

Finally, there are institutional factors, particularly the international monetary arrangements, which contribute to the global imbalances, especially to a perpetual United States external deficit. For example, the United States dollar acts as the medium of exchange, store of value and unit of account in most international trade and finance transactions. This allows the United States, as the issuer of the international reserve currency, to have a continuous external deficit. In such an international monetary system, the global demand for United States dollars as a “world currency” can be expected to increase with the growth in the value of flows of international trade and finance. This implies that the United States should run an ever-increasing deficit on its balance-of-payments (a combination of current account and investment and financial accounts) in order to accommodate the growing need for liquidity in the world economy.³

It is difficult to quantify how much of the current global imbalances are cyclical, structural and institutional respectively. Moreover, the three sets of factors are not completely independent. For example, the more aggressive counter-cyclical policy stimuli in the United States are related to its role as the issuer of international reserve currency.

However, each component of the global imbalances has different implications for the world economy in terms of sustainability, efficiency and equity. For example, with the present international reserve system, the institutional component suggests that the United States needs to “sustain” a balance-of-payment deficit of about \$200 billion annually, increasing over time, so that the global economy has enough additional liquidity to grow. Meanwhile, the part of the imbalances that is attributable to structural differentials among countries may also persist if such structural differences, as demographic

² A generally accepted notion that the United States attracts foreign capital because of a higher return seems to be a misconception. Although some capital inflows may have been seeking higher returns, such as those from Japan—where yield seems to be lower, in general, the average rate of return on the foreign assets held by the United States has always been measurably higher than that on the United States foreign liability in the long run, with a yield spread of a couple of hundreds basis points.

³ If the world's total official foreign exchange reserves in dollar assets (approximately \$2 trillion) are taken as a proxy for the “monetary base” for the total non-United States demand for the dollar and the average annual growth of international trade is 6 per cent, the “quantity monetary theory”, assuming a constant velocity, suggests that the global demand for the dollar should increase by 6 per cent each year, namely \$180 billion for the current year and more in the following years. The counterpart of this increased global demand for the dollar is the annual balance-of-payments deficit of the United States.

patterns, savings rates, and productivity growth persist among countries, and justify the flows of financial assets and other resources across countries.

Equally, each component suggests different policy implications for adjusting the global imbalances. The cyclical component, for instance, should be “self-adjusting” as the relevant cyclical forces abate: if oil prices decline and if economic recovery in the United States improves the fiscal position, its current account deficit should narrow. In contrast, the adjustment of the structural component of the imbalances would require policies in both the deficit and the surplus countries to reduce the cross-country structural differentials, while the part of the imbalances that is due to institutional factors can only be readdressed by reforms of the international reserve and monetary system.

Exchange rate and adjustment in the imbalances

In the foregoing discussion, exchange rates among currencies have not been identified as a factor behind the global imbalances, not because exchange rates are not relevant, but because exchange rates are related to all the components of the imbalances. Rather than being a cause of the imbalances, exchange rates are endogenously linked to them. In the second half of the 1990s, for example, the United States dollar appreciated steadily vis-à-vis other currencies and its current account deficit increased. In this case, the appreciation of the dollar was not driving up the external deficit of the United States; rather, it was being driven by the increased global demand for the dollar and for dollar-denominated assets because of the United States’ leading role in the ICT boom. The stronger dollar, in turn, stimulated imports by the United States, reinforcing its widening external deficit. However, this does not imply that external imbalances and exchange rates are always moving in tandem. Nor does it mean that a realignment of exchange rates is sufficient to adjust the global imbalances.

Under the gold standard, the correction of balance-of-payment imbalances was closely associated with a realignment of exchange rates: currencies in the surplus countries with inflows of gold would automatically appreciate, boosting their import demand, while currencies and demand in the deficit countries would decline, leading to a rebalancing in the external accounts. Under today’s international monetary arrangement, all currencies are fiat money. The United States dollar is the numeraire for the value of other currencies and its own value is determined by a combination of other currencies, meaning that the value of all currencies is always in flux. In such a system, external imbalances across countries lead to flows of dollar-denominated financial assets across countries rather than flows of gold and do not necessarily lead to adjustments in the value of the relevant currencies or in the imbalances.

The notion of exchange-rate-led rebalancing is based mainly on the belief that a depreciation of the currency would make domestically-produced goods in the deficit country relatively cheaper and thus encourage consumers to switch their expenditure from imports to domestically-produced goods, with the opposite occurring in the surplus countries, and the external imbalances narrowing as a result. However, such expenditure-switching is likely to be limited, in addition to which, as discussed above, many factors other than relative prices of tradable goods determine the imbalances.

Since it peaked in 2001, the United States dollar has depreciated substantially vis-à-vis a number of major currencies, but its external deficit has continued to grow. Some have argued that this ineffectiveness of depreciation arises because, despite the overall depreciation, the most relevant

exchange rates have not changed: a number of surplus developing countries have either pegged their currencies to the dollar (for example, China) or have intervened to prevent their currencies from appreciating sufficiently. The present exchange rate policy and the accumulation of foreign exchange reserves in many Asian economies should, however, be seen as a result of the present international reserve system and international monetary arrangements. If the national currencies of these surplus countries were in the same position as the United States dollar in international transactions, they would not need to accumulate foreign reserves.

In the forecast, exchange rate policy in many surplus countries is expected to become more flexible and this may be helpful in global rebalancing, although the impact on the United States' external deficit is unlikely to be significant. For example, the Japanese yen has appreciated substantially against the United States dollar since the mid-1980s, but its current account surplus vis-à-vis the United States continues to grow. So far, the depreciation of the United States dollar has not shown any effects on narrowing its external deficit, although the depreciation has improved the sustainability of the deficit by reducing the value of the United States' net foreign asset position.

Most analysts and policymakers are becoming increasingly concerned about the sustainability of the current account deficit of the United States. However, this sustainability should not be judged by the size of the current account deficit, or by the accumulation of past deficits, but by the net foreign asset position of the United States, or more precisely, by the net outflows of income from the net assets. The difference between the net foreign asset position of the United States and the accumulation of past current account deficits is the change in the valuation of those assets, due to changes in asset prices and in the exchange rate. For example, the decline of the equity market in the United States in 2000-2001 should have reduced the value of the foreign holdings of United States' assets significantly. Conversely, the depreciation of the United States dollar over the past few years has increased the value of the United States' holdings of the foreign assets (since they are denominated in foreign currencies) relative to the value of the United States' foreign liabilities (denominated in dollars), thereby reducing the net indebtedness of the United States. Moreover, even with net foreign liabilities of more than \$2 trillion, the annual inflows of income from United States' holdings of foreign assets have always been higher than the outflows on its foreign liabilities. In this sense, the United States is not yet at risk of "insolvency".

The role of the United States dollar as the international reserve currency and the effect of the dollar depreciation in reducing the value of its net foreign liabilities have led to a slow, or ineffective, adjustment in its current account deficit through the real sector, namely imports and savings. However, the valuation adjustment cannot substitute for the need for an adjustment in the real sector forever because the rest of the world will eventually lose confidence in the dollar and reject it as the international reserve currency.

The inefficiency of the exchange-rate-led adjustment calls for other policies. However, the call for more expansionary policies to boost growth and demand in Europe and Japan, and to narrow their economic differentials vis-à-vis the United States, is debatable. This recommendation may be appropriate if the goal is simply to reduce the United States external deficit, but it has two problems. First, Europe and Japan have tried to raise their growth and demand over the past decade, but without success. Second, more profoundly, reducing the global imbalances by shifting financial assets and resources among the developed countries will not alter the gap between the rich and the poor in the

world. Therefore, more desirable policies to rebalance the global economy should be to promote growth in developing countries and to reduce the dependency of global growth on debt-financed demand and the ever-widening external deficit of the United States.

DEVELOPMENTS IN INTERNATIONAL TRADE AND PRICES

World trade in 2004-2005

Driven by strong demand, the volume of world trade grew by 11 per cent in 2004, but growth is expected to decelerate to about 8 per cent in 2005 and to stabilize around that level in 2006, as the world economy slows down and import demand cools off in such major world importers as the United States, Japan and, to a lesser extent, China. Further gains in the prices of commodities and—to a lesser extent—of manufactures, as well as the depreciation of the US dollar, produced an even larger increase—some 20 per cent—in US dollar terms in 2004.

Exports from the United States recovered in 2004, but failed to match the country's import performance. The depreciation of the dollar over the past few years is expected to gradually improve export performance, but export growth will also depend on the strength of foreign demand. Except for some Asian developing countries, particularly China, demand from other trade partners, especially Europe and Japan, is not expected to be strong. As a result, the country's large trade deficit is forecast to widen further. Conversely, the growth of Canadian exports, particularly of machinery and equipment and non-automotive consumer goods, has decreased since the second half of 2004 due to the appreciation of the currency although exports of commodities have remained relatively stable. Imports, however, have grown strongly. As a result, the contribution of net exports to GDP is expected to be negative in 2005-2006.

Japan's trade performance is anticipated to be negatively affected by the slowdown of the world economy in general and, in particular, by the weakening of Chinese import demand as that country attempts to cool its energy-intensive sectors. As a result, Japan's merchandise exports are expected to grow by 2-3 per cent in real terms for 2005-2006, following the double-digit pace of 2004. Reflecting the country's anemic domestic demand, the growth of imports will also decelerate, albeit less sharply.

Despite the currency appreciation, Western Europe's export performance was robust in 2004 due to strong trade with Eastern Europe and demand from oil-exporting countries as they spent their export receipts. In some countries, export price competitiveness was maintained or improved as cost-cutting measures led to falling unit labour costs, and consequently market shares held up. Other countries, however, saw their market shares slip significantly. The slowdown in external demand is expected to lead to some overall deceleration in the growth of exports in 2005 and 2006, most noticeably in the more open economies of the region. Imports also grew robustly in 2004, boosted by the pickup in activity and the strength of the currency. With growth decelerating in 2005 but picking up in 2006, the growth of import demand is expected to decelerate only modestly, sustained by strong currencies.

The new members of the EU also recorded strong export growth in 2004 due to the removal of all remaining EU trade restrictions, increased productivity growth and continuous improvements in product quality. Imports also increased, owing to production networks between these countries and the

rest of the EU, as well as strong domestic demand. Trade growth is expected to decelerate in 2005. Slower real wage growth and tighter consumer credit will restrain imports to some extent, although ongoing industrial upgrading and new investments will sustain imports of capital goods. Similarly, some slowdown in trade is expected in Southeast European countries due to exchange rate considerations, as well as tighter credit conditions.

Higher prices of crude oil and gas and strong world demand contributed to expanding exports in the energy-exporting CIS countries and Ukraine in 2004. In addition, strong growth in the largest economies in the region fueled intra-regional trade. However, as economic growth in the region moderates in 2005 and 2006, trade is expected to slow down in both nominal and real terms as a result of weakening commodity prices and demand in their main regional markets. Capacity constraints in the oil industry, as well as continuing real appreciation of the currencies in many of the energy-exporting countries, will have an additional adverse effect on exports.

Despite some slowdown, trade will remain dynamic in most developing regions in 2005. Africa's exports are expected to increase in both value and volume in 2005. Firm prices of some of the region's major commodity exports will contribute to a projected increase of exports by 16 per cent in nominal terms. Export volume will also increase, particularly in countries that have recently boosted capacity in industrial production and exports. Africa's growing trade ties with China are expected to strengthen further in 2005 and to contribute to increased exports of oil and non-oil primary commodities. On the other hand, the end of the Agreement of Clothing and Textiles (ACT) will adversely affect African exports as producers, now free of quotas, relocate to lower cost countries. The volume of African imports will continue to grow in 2005 as the expansion of production capacity and higher demand for consumer goods continue. Adverse weather conditions, poor agricultural output and higher cost of imported crude oil will contribute to Africa's growth in expenditure on imports.

Trade is anticipated to lose speed in East Asia in 2005 as economic growth slows down in the region and global demand for high-tech products —semiconductors, in particular— faces a cyclical deceleration. A recovery is expected towards the end of the year as inventories are depleted and investment picks up. On the other hand, economic growth in China will remain strong and will sustain the region's demand for imports of raw materials at relatively high levels. The end of the ACT led to a surge in exports of textile and clothing by China in the early months of 2005. Protectionist sentiments reemerged and both the United States and the EU are considering options to control the Chinese inroads into their markets.

The end of the ACT will also contribute to the expected deceleration of export growth in South Asian in 2005. Import growth is also expected to slow less due to continued strong domestic demand. Reflecting the further room for intraregional trade expansion, negotiations on a planned South Asian Free Trade Area (SAFTA) are progressing, as are bilateral trade negotiations within South Asia and with East Asian countries, especially China. On present trends, China could displace the United States as India's largest trading partner within two or three years.

Higher oil prices will sustain the growth of export receipts in Western Asia in 2005. Furthermore, relatively high economic growth, coupled with reduced uncertainties in Iraq, should boost intra-regional trade in 2005. Export revenues, however, are expected to decline in 2006 due to anticipated lower oil prices, while imports will remain strong.

Both export and import values grew by over 20 per cent in Latin America in 2004. Export earnings growth is attributed equally to volumes and prices, while the increase in volumes explained three-quarters of the import growth of the region. This has resulted in a third consecutive year of trade surplus. In 2005, the growth rates of both exports and imports are expected to decrease by half due to weaker demand from the developed countries and China and a slowdown in regional economic activity. The regional trade balance will, however, remain in surplus.

Current conditions and outlook for oil prices

Prices

International oil prices in the first five months of 2005 remained at a steep premium compared with a year earlier, despite episodes of easing during April and May; the average price of Brent oil for the first four months of 2005 was over \$47, almost 46 per cent higher than for the same period in 2004.⁴

Despite data showing inventories in developed countries at relatively high levels, and recent increases in OPEC crude production, oil markets seem largely focused on the extent to which the world's major suppliers can keep up with current demand growth and respond to disruptions; volatile market prices reflect high sensitivity to any new information in an environment in which opportunities for speculative trading are ample.

The current LINK forecast assumes that the growth of world oil demand will soften gradually with slowing world growth, relieving some of the pressure on oil markets in the medium run. More specifically, it assumes an average of US\$46 pb for Brent crude in 2005 (a 20% increase over 2004) and US\$37 pb in 2006. Nonetheless, in a context of tight supply where substantial capacity increases are likely to materialize slowly, prices are expected to remain at high levels by historical standards and be subject to frequent episodes of volatility.

Demand

World oil demand grew by 2.7 mbpd, or 3.4 per cent, in 2004. Many consider this to be a "demand shock" which, combined with tight supply conditions, was the major factor behind the recent escalation of oil prices. Demand growth, however, is expected to slow in 2005 to around 2 per cent as economic growth decelerates, particularly in the developed countries, and oil demand growth slows in major developing countries. Signs of this overall slowdown were already evident in the first quarter of 2005. Total world oil demand is now expected to increase by 1.8 mbpd in 2005, or 2.2 per cent, down from 3.4 per cent growth in 2004, according to IEA estimates. Despite this easing, oil demand is still growing at a healthy rate and will continue to do so in the medium term.

China's oil demand accounted for more than a third of the global increase in 2004 (almost 1mbpd out of the total 2.7 mbpd), but is estimated to have increased only 4.5% in the first quarter of 2005, compared with close to 20 per cent for the same period in 2004. Demand growth is also expected to slow down this year in India, and other developing countries, as well as in the CIS.

⁴ With data up to 5 May

In many developing countries, governments have been using a combination of fiscal and administrative measures to weaken the pass-through of higher energy import prices to final consumers. These policies are coming under strain, however, as fiscal flexibility is reduced and certain sectors, such as domestic suppliers, suffer from compressed margins. In China, for example, the Government raised the official retail prices of gasoline and jet fuel in March and diesel oil in May. Similar measures have been taken in other countries, including India, Indonesia, Malaysia, Thailand, and Vietnam, albeit to a limited extent in some cases. These price increases and other measures are expected to have demand-dampening effects, despite continued robust overall growth in many of these countries.

In the developed world, weaker growth in the United States, which became apparent in the first quarter of 2005, as well as generally dimmer prospects for recovery in Japan and the euro area, will be key factors behind the slowdown the growth of oil demand. In many of these economies, the extended period of higher oil prices, along with the continued gradual removal of economic policy stimuli, is already affecting domestic demand through a combination of weaker consumer confidence, reduced disposable incomes, higher interest rates, and increases in inflation as higher energy prices feed-through to other prices in the economy. In the United States, for example, gasoline prices in April 2005 were more than 20 per cent higher than a year before and demand during the summer driving season is expected to grow more slowly than last year.

Supply and stocks

Responding to the renewed tightness in oil markets since the first quarter of this year and widespread concerns about a greatly reduced supply buffer, OPEC raised its production quotas by a half million barrels per day in mid-March and again at the start of May, taking its combined quota to 28 mbpd. OPEC believes the market to be adequately supplied, a view that is supported by the current build up in stocks. This in turn suggests that OPEC is not likely to increase production quotas at its meeting in June.

Actual production levels have also increased, albeit at a different pace: total OPEC production, including Iraq's stagnant output, increased by 0.3-0.5 mbpd between the start of 2005 and mid-May, mostly from Saudi Arabia and the United Arab Emirates. Despite the huge oil-producing potential of Iraq, substantial increases in production in the short and medium run are unlikely, due to the poor state of many of the working fields, and the lack of adequate security and clear legal conditions for the amount of investment needed.

Non-OPEC supply, for its part, is expected to rise by 0.9 mbpd in 2005, approximately half of which is expected to come from countries in the CIS. Russian production is expected to increase by around 0.35 mbpd. Lingering legal and administrative issues affecting upstream investment, as well as export infrastructure investment, are likely to constrain export growth in the medium term.

Overall, limited spare production capacity remains the chief concern influencing oil markets. Total spare capacity is currently estimated at between 1.1 and 1.6 mbpd, and is concentrated almost entirely in Saudi Arabia. The perceived lack of an adequate supply buffer in the presence of potential disruptions places a permanent "volatility premium" on oil prices.

In spite of current plans to boost Saudi Arabia's capacity and mounting pressures on OPEC members in this respect, only modest increases in OPEC capacity, in the range of 0.5-1.0 mbpd, can be expected during 2005. Saudi Arabia, for example, is planning a capacity expansion of 2.0 mbpd by the year 2009. Current estimates of global capacity expansion in the medium term are similar to the increase in demand so that spare capacity is not expected to expand substantially during the period of this forecast.

In a market characterised by low spare capacity, the level of stocks has become important as an insurance against potential supply disruptions. In this respect, the stock-building over the past months in the United States has taken crude oil inventories to their highest levels since March 2002 and gasoline stocks are similarly at the upper end of their historical range. Overall OECD industry stocks, measured in days of forward coverage, are somewhat higher than a year ago. In addition to the need to build an adequate supply buffer, the current buildup in stocks in the developed countries is being supported by current futures market conditions that put a premium on forward-month over nearer-month oil deliveries.

The current oil market is thus one in which the present slowdown in demand growth is expected to gradually relieve some of the demand pressure that has characterized the past two years, but also one that continues to confront tight supply conditions. It is also a market where a degree of adjustment is taking place through stock building, in anticipation of increased seasonal demand later in the year. This is the basis for the current LINK forecast of oil prices remaining at relatively high levels by historical standards, but gradually turning down in the medium run.

Developments in non-oil commodity prices

The UNCTAD combined index of non-oil commodity prices (measured in dollars) increased by 20 per cent in 2004, following a gain of 15 per cent in 2003 (see table 2). When measured in SDRs, however, the increase in 2003 was negligible and in 2004 only 13 per cent, reflecting the depreciation of the dollar vis-à-vis other major currencies in both years.

The main driving force behind the increase in prices in 2004 was the strong growth in demand for industrial raw materials—minerals, ores, base metals and agricultural raw materials—in China, India and developed countries. The dollar index of minerals, ores and base metals prices increased by 40 per cent, reflecting strong gains for tin (74 per cent), lead (72 per cent), copper (60 per cent), nickel (44 per cent) and high double-digit increases for aluminum, bauxite, iron ore and manganese ore. Price increases for agricultural commodities—food, tropical beverages and vegetable oils and oil seeds—also increased significantly. Since there were no major weather or market-related supply shocks, increases in the prices of food and agricultural commodities in 2004 generally reflected growing worldwide incomes and increased consumption demand in China, India and other fast-growing developing countries.

Table 2. Commodity prices, 2002-2006
(Index, 2000 = 100)

	2002	2003	2004	2005	2006
Dollars	91	105	126	123.5	118.5
SDRs	99	99	112		
Food	103	107	121	113.1	111.4
Tropical beverages	89	94	100	105.0	95.6
Vegetable oils & oilseeds	117	137	155	130.2	126.3
Agricultural raw materials	94	112	123	113.2	121.1
Minerals ores and metals	87	98	137	148.6	133.8
	2002	2003	2004	2005	2006

It is anticipated that the 2003-2004 commodity price boom will end in 2005 as a result of increased global supplies and weaker demand growth. The combined dollar-price index is projected to decline by 2 per cent in 2005 and by a further 4 per cent in 2006. Within the total, the turnaround in the prices of minerals, ores and metals will be more delayed; average price growth is forecast to moderate to 8-9 per cent in 2005 but prices are expected to decline by 10 per cent in 2006. Average prices for food and other agricultural commodities are expected to decline in both 2005 and 2006.

REGIONAL OUTLOOK

North America

As expected, the *United States'* economy is facing more constraints in 2005. After 4.4 per cent in 2004, GDP growth was 3.1 per cent in the first quarter of the year. Widening external and domestic imbalances, high oil prices, the unwinding of the policy stimuli of previous years, slow, albeit improving, employment growth, a moderation in productivity growth, and low savings rates and mounting debt in the household sector are all contributing to a slowdown. On the other hand, low financial costs, strong corporate financial positions and a depreciated exchange rate should continue to support business investment and exports, preventing the economy from decelerating excessively. On balance, GDP is expected to grow by about 3 per cent in 2005-2006.

The rise in crude oil prices since late 2003 has been passing through to the prices of gasoline and heating oil and partially to the prices of other goods and services. As oil prices are expected to stay high in 2005, the adverse effects will accumulate and real disposable income and household spending will be further curbed. With the existing low household savings rate and high level of private sector debt, consumers are limited in their ability to cushion the income effects of higher oil prices. Moreover, housing prices seem likely to peak, and possibly decline, providing less support to consumption spending.

The unemployment rate has improved slightly, to about 5.2 per cent, but employment growth remains unstable from month to month. The trend monthly increase remains below 200,000, a benchmark for a healthy labour market; the moderate growth in employment is expected to continue.

Inflation has been edging up, mainly because of higher oil prices, but firms are also regaining some pricing power. Meanwhile, inflationary expectations, as reflected in the difference between the yields on inflation-indexed government bonds and on conventional government bonds, have increased only slightly. The consumer price index (CPI) is expected to rise about 3 per cent in 2005, compared to 2.7 and 2.3 per cent in 2004 and 2003 respectively.

The Federal Reserve is expected to continue raising interest rates in 2005, bringing them to 4 per cent by the end of the year and maintaining them at that level in 2006. Fiscal policy is also expected to become less stimulatory, with the budget deficit expected to narrow from above \$400 billion in 2004 to about \$350 billion in 2005 and \$300 billion in 2006, primarily as a result of a slowdown in the growth of government spending.

The depreciation of the United States dollar over the past few years is expected to gradually improve export performance. However, external demand will depend not only on relative prices, but also on the strength of other economies. Except for some Asian developing countries, particularly China, the growth of demand from leading trading partners, especially Europe and Japan, is not expected to be strong. Consequently, the large United States trade deficit—more than \$600 billion in 2004—is expected to widen further in the outlook and will remain the largest foreseeable risk to the stability of both the United States and the global economy.

The *Canadian* economy has been growing slightly below its potential, adjusting to the realignment in exchange rates, higher prices of both energy and non-energy commodities and growing competition from developing countries in manufacturing and services. Domestic demand has become the main driver for GDP growth, which is expected to be 2-2½ per cent in 2005-2006.

While the headline inflation rate has been volatile, the core CPI edged up to about 1.8 per cent at the beginning of 2005, below the 2 per cent target set by the central bank so that monetary tightening in Canada in 2005 is expected to be less aggressive than in the United States.

The appreciation of the Canadian dollar against the United States dollar has finally had an impact on the trade sector. Canadian exports, particularly of machinery and equipment and non-automotive consumer goods, have decreased considerably since the second half of 2004, although exports of commodities have remained relatively stable. In contrast, imports, particularly machinery and equipment and raw and intermediate materials, have grown rapidly. As a result, the contribution of net exports to GDP is expected to be negative for 2005-2006.

Developed Asia

Despite periodic surges, economic growth in Japan remains on a slow track. GDP is expected to increase less than 1 per cent in 2005 and about 2 per cent in 2006. Meanwhile, the economy has not yet extricated itself from its protracted deflation.

External demand remains crucial for growth in Japan. Strong demand from the rest of Asia, particularly China, has been the key driving force, and global ICT demand has also been an important factor. The appreciation of the yen vis-à-vis the United States has not had a significant adverse impact, partly because the effective exchange rate for the yen is still less than in the 1990s. Exports are expected to grow by 2-3 per cent for 2005-2006, compared to a double-digit pace in 2004.

Since growth in the first half of 2004, private consumption has stagnated, but the index of consumer confidence and some other leading indicators suggest that a recovery is on the way. The employment situation is improving slowly (with the unemployment rate expected to fall to 4.6 per cent in 2005 from 4.8 per cent of 2004) and household income is no longer declining. Although business investment has been on the uptrend, supported by an improvement in corporate profits, business sentiment remains cautious, as growth expectations are heavily dependent on external demand.

Higher prices of oil and other raw materials have led to higher producer prices, but consumer prices, excluding food prices, continue a slight downtrend and the general deflationary trend is no longer expected to disappear in 2005-2006. Consequently, monetary policy is expected to remain accommodative, with interest rates staying at zero and the Bank of Japan continuing to rely on various money market operations to meet its quantitative monetary target for liquidity. The present restrictive fiscal policy is also expected to continue, mainly through expenditure restraint, such as cuts in public investment spending. The medium-term plan for fiscal consolidation aims for a primary balance before 2010 and the government is expected to cut subsidies, reverse earlier tax cuts and raise value-added tax.

Both *Australia* and *New Zealand* have again avoided an anticipated moderation in growth because of more favourable external conditions. However, increasing capacity constraints, inflationary pressure, an expected weakening in the housing sector, currency appreciation and large current account deficits are expected to dampen the growth of both economies in 2005-2006.

In Australia, growth of 3 per cent is forecast for 2005, underpinned by a high level of confidence domestically and with a further increase in the terms of trade adding to national income. The unemployment rate has fallen to its lowest level since the 1970s, while an improvement in the country's terms of trade has mitigated the gap between the growth in volumes of imports and exports. The trade deficit has remained at about 3½ per cent of GDP, but the current account deficit has widened to about 7 per cent of GDP.

Growth in New Zealand is expected to slow gradually as a result of currency appreciation, lower immigration flows and the effects of earlier monetary tightening. The domestic economy has shown more momentum than anticipated, with an unexpected growth in employment and hours providing a boost to household income. The unemployment rate has fallen further and capacity utilization has remained at record levels, but the housing sector has begun to slow and the increase in the CPI has moved towards the upper level of the 1-3 per cent target range set by the central bank.

Central banks in both countries have been tightening monetary policy since early 2004, but the Reserve Bank of New Zealand is ahead of its counterpart in Australia. Rates have already been increased by 175 basis points in New Zealand and further increases are less likely than in Australia where further tightening is expected. Fiscal policy is expected to be neutral to slightly stimulatory for both economies.

Western Europe

After a strong start at the beginning of 2004, growth in Western Europe slowed in the second half of the year, as a result of the higher oil price and stronger currencies. In the euro area, the contribution from net exports turned from positive to negative during the year, mainly because of the deceleration in global demand and the continued appreciation of the euro. In contrast, domestic demand made a more positive contribution to growth. Investment increased after falling for a number of quarters and consumption also picked up in the fourth quarter. However, industrial production has not increased since the second half of 2004 and business surveys conducted by the European Commission indicate a decline in confidence in industry since the beginning of 2005. Consumer confidence has been stable but remains below its long term average. The IFO index for German economic activity, which also has good predictive power for activity in the euro area, declined from February until April.

Nevertheless, the outlook is for a gradual improvement over the second half of 2005, although, on yearly averages, growth will be lower than in 2004. In the EU-15(euro-zone) GDP is expected to grow by 1.9(1.6) per cent in 2005 after 2.2(2.0) per cent in 2004. The acceleration will be clearer in 2006 when growth is forecast to be 2.3(2.1) per cent. The negative impact of higher oil prices should decline if oil prices retreat as forecast. Growth will also be supported by improving domestic demand. However, the contribution from net exports will be negative, as world growth continues to decelerate and the euro continues to appreciate.

Investment is expected to drive domestic demand, with some support from consumption. Financing conditions are favourable (with real interest rates still approximately zero and bank lending picking up), profitability has improved, and corporate restructuring continues. However, this is offset by continuing uncertainty over both demand conditions and structural reforms, particularly of pensions. Consumption has been restrained by meager growth in real incomes as a result of slow growth of employment and wages, as well as the persistence of inflation. Consumption expenditure should increase as employment picks up and wages begin to rise. A number of reforms have been enacted so that uncertainty has been reduced. In some countries, rising house prices have provided a boost to consumption and it is assumed that there will be no major turnaround in housing markets. Finally, pent-up demand on both the consumer and corporate side should eventually provide further impulse.

Inflation (as measured by the HICP) has remained at or above the 2 per cent threshold that is central to the ECB's policy framework. The increase in oil prices played a major role, but seasonal food prices and some administered prices also contributed. However, with oil prices expected to moderate and with the continuing strength of the euro, inflationary pressures are expected to moderate.

Employment is forecast to increase gradually as economic growth strengthens. In addition, labour market reforms enacted over the past year should begin to have some positive influence.

Fiscal policy has moved to a slightly restrictive stance and is expected to slow activity in 2005 and 2006. Despite the reduced ability of the Stability and Growth Pact to restrain fiscal behaviour, countries with fiscal deficits in excess of 3 per cent of GDP remain likely to attempt to consolidate, but less rapidly.

Monetary policy in the euro area has remained unchanged since June 2003, with the policy interest rate at 2 per cent. As the recovery takes hold, the European Central Bank (ECB) is expected to increase rates to a more neutral level, but is held back by both the lack of acceleration in activity and the negative short term indicators so far in 2005. In addition, policy has already been effectively tightened by the appreciation of the euro at the end of 2004. The ECB is expected to wait until the fourth quarter of 2005 before increasing rates by 25 bps and then a further 50 bps in 2006.

“New EU members” Southeastern Europe

The new EU members achieved economic growth of 4.9 per cent in 2004, outpacing the EU-15; a slowdown to 4.2 per cent is expected in 2005. The expansion in 2004 was broad-based, supported by exceptionally strong exports, strong investment, and robust consumer demand. There were, however, signs of a slowdown by the end of the year. Export growth is expected to continue, but at a lower rate, and slower real wage growth will restrain private consumption. Implementation of EU-related projects and ongoing FDI should sustain investment.

With increased market share (despite weak import demand in the EU-15), the immediate beneficial impact of the EU accession turned out to be stronger than expected. Dismantling the remaining trade barriers bolstered the exports of the new member states. Although currencies in the region in general remained strong, in particular because of inflows of EU aid, strong increases in productivity offset this factor and maintained the region's competitiveness. As companies from EU-15 are continuing to look for ways to cut production costs, more industrial facilities are expected to be relocated to the region, transforming it into a new production base; the automotive industry in Slovakia is one example.

Average inflation in the region increased briefly with the EU accession, as excise taxes and VAT were increased, and most of the remaining price controls abolished. Other inflationary factors in 2004 were high fuel prices, strong real wage growth and the expansion of consumer credit.

Inflation is expected to decelerate in 2005, as real wage growth has slowed, the impact of increased administered prices seems to be over and more control is being imposed on consumer lending. A strong euro will mitigate imported inflation and stronger retail competition will help to curb prices increases. In response to lower inflationary expectations and in order to fight currency appreciation, monetary policy was relaxed throughout the region, in some cases because direct interventions in the currency market did not produce the desired effect. For 2005, monetary policy in general is expected to be supportive for businesses, while consumer credit growth will be restrained.

In addition to the three countries which had already joined the European exchange rate mechanism (Estonia, Lithuania, and Slovenia), Cyprus, Latvia, and Malta joined ERM-2 in May 2005, aiming at the adoption of the euro in two years.

Fiscal balances continue to pose a problem for Central Europe, especially as the countries move closer to the targeted dates for entering the ERM-2 and the importance of meeting the eurozone entry criteria grows. Higher revenues due to stronger growth and improved tax collection made the deficits lower than expected in some cases, but their structural component remains almost the same with parliamentary elections approaching in a number of countries, only a partial improvement is expected. The fiscal situation is better in the Baltic States, to some extent due to the maintenance of pegged exchange rates.

Increased oil prices adversely affected current accounts in the region, while the strength of the currencies affected the services and tourism sector. FDI inflows, as well as EU aid, are expected to continue so that financing of the current account should not be a problem, but an increase in international interest rates would increase the deficits on investment income.

Southeastern Europe

The countries of Southeastern Europe performed well in 2004. Although some slowdown is expected in 2005, growth will remain stronger than in the new EU members, supported both by strong exports and by domestic demand, especially investment.

Some increase in inflation was recorded in 2004 due to rising oil prices and such other factors as increases in excise taxes and the liberalization of electricity prices. Slower real wage growth and tighter credit conditions, as well as low food prices thanks to a good harvest, will restrain inflation in 2005. For the small open economies, consumer price increases will be contained by maintaining a stable exchange rate versus the euro.

Romania, where inflation traditionally exceeds the regional average, plans to adopt a direct inflation targeting policy in the second half of 2005. Capital account liberalization, however, will make it difficult to achieve the announced inflation target.

Fiscal performance in the region is monitored by the IMF and fiscal positions are closer to balance than in Central Europe. Current accounts, however, have large deficits. Inflows of FDI, prompted by accelerated privatization, should help their financing.

EU accession remains a dominant policy goal for the sub-regions. For Bulgaria and Romania, the major task is to complete the preparations for joining the EU in January 2007. The start of the accession negotiations with Croatia has been postponed, but this is not likely to lead to any changes in the accession strategy. Serbia and Montenegro is likely to start negotiations on a Stabilization and Association Agreement with the EU.

CIS region

After a strong performance for two consecutive years, growth in the CIS region is expected to moderate in 2005 and 2006. With increased demand and higher prices for commodities, in particular for oil and gas, GDP in the region rose by almost 8 per cent in 2004. A moderate slowdown began to appear in the third quarter of 2004 but became more pronounced in early 2005, largely reflecting continued currency appreciation in many of the commodity-exporting countries but also a deceleration in

institutional and structural reforms. Growth of 6½ per cent is forecast for 2005, supported by continued high international prices for oil and metals and a shift to accommodative fiscal policies in some countries.

In addition to favourable external conditions, supportive macroeconomic policies, buoyant domestic demand, increasing foreign investment and strong fixed capital formation, mainly in the extractive industries of commodity-exporting countries, remained the main drivers for growth in 2004.

Economic growth in the Russian Federation of over 7 per cent in both 2003 and 2004 is losing momentum in 2005. GDP grew at an annualized rate of 4.9 per cent in the first quarter, with the slowdown embracing industry, construction, transport and agriculture. Fixed investment spending has lost steam and the growth of real disposable income has decelerated. This slowdown reflects in part the lagged effects of the accumulated real appreciation of the rouble and growing production costs, including some impact from the long holidays and the changes in the social welfare system at the beginning of 2005. Household spending is likely to regain its position as a driver of growth in the Russian Federation in 2005-2006.

Following vigorous growth in 2004, the other large economies in the region, notably Belarus, Kazakhstan and Ukraine, also started decelerating at the beginning of 2005, mostly due to weakening external factors, such as commodity prices and demand in the countries' main markets. Nevertheless, domestic demand is expected to support growth in these economies in 2005 and 2006, albeit at a lower rate.

On average, inflation in the region decelerated in 2004 but inflationary pressures have re-emerged in the largest economies. The persistence of high consumer price inflation was associated with expansionary monetary policy in the case of the Russian Federation and with a nominal effective depreciation and pre-election fiscal loosening in Ukraine. In contrast, inflation in Belarus and the Republic of Moldova decelerated in 2004, largely due to continued administrative price controls. Inflation picked up in the first quarter of 2005 in the Russian Federation due to an increase in prices for food and public services, but the pressure is not likely to escalate since the increase in money, credit and wages are slowing down. There has been an acceleration in the increase in producer prices in many countries and the likelihood that these increases will be passed on to consumers may constrain disinflation in 2005 and 2006.

Many CIS countries are striving for a more rational monetary policy strategy for fighting inflation. However, there is little space for maneuver because capital flows to the resource-rich countries are expected to continue, as are their consequences for national currencies. There are already signs of "Dutch disease" in that the international competitiveness of domestic manufacturers in the Russian Federation is declining because of the real appreciation of the rouble. Without a more diversified export structure, this problem is likely to continue in 2005 and 2006. In addition, emerging inflationary expectations are likely to shift monetary policy priorities from currency stabilization to reducing persistently high inflation.

Meanwhile, higher oil prices contributed to the improved fiscal positions in the oil-exporting countries in 2004. Stabilization funds in Azerbaijan, Kazakhstan and the Russian Federation have accumulated windfall gains from higher-than-projected oil revenues and, in the case of the Russian

Federation, have allowed the prepayment of external debt. However, signs of procyclical fiscal loosening in 2004 and the beginning of 2005, in some cases related to pre-electoral spending, may increase inflationary pressure. In view of the price dynamics, fiscal tightening is expected in some countries, such as Ukraine.

The impact of rapid economic growth on employment has been limited, although total employment has increased since the last quarter of 2003, largely due to the creation of new jobs in Azerbaijan, Georgia, Kyrgyzstan, Russia and, most notably, Kazakhstan.

Growth in the region remains vulnerable to the volatility of commodity prices, to continuing real appreciation and to rising production costs. The slow pace of institutional and structural changes is also constraining growth, especially as the financial system is unable to transform savings into investment in an efficient manner. There continues to be a need to address the structural weaknesses in these countries, to diversify their economies and to restructure both their product and financial markets.

Africa

Economic growth in Africa is forecast to accelerate to more than 5 per cent in 2005, continuing the trend of the previous two years. Growth will be driven by increased volumes of oil exports and the higher oil prices, strong demand and favourable prices for non-oil commodities and buoyant domestic demand in most countries. Importantly, the number of conflicts on the continent is at its lowest level for several years. Several countries have benefited from strong growth in tourism revenues, reflecting the growth in global incomes and a spill-over from Asian countries that were affected by the tsunami in December 2004. Less favourably, the termination of the GATT/WTO Agreement on Textiles and Clothing on 1 January 2005 is expected to reduce exports, income and employment in several countries.

Growth is expected to accelerate in all North African countries except Morocco in 2005. In Algeria and the Libyan Arab Jamahiriya, continued strong hydrocarbon revenues will support the growth of public consumption and investment. In Egypt, reforms and plans for reductions in personal and corporate tax rates are expected to boost private consumption and investment. Weak textile output and exports is expected to dampen growth in Morocco and Tunisia in 2005 although the continued recovery of the services sector should offset this factor in Tunisia where growth is expected to remain firm.

GDP growth for Sub-Saharan Africa, excluding Nigeria and South Africa, is projected to rise from 5½ per cent in 2005 to 6 per cent in 2006, reflecting the recovery of most economies in the continent. South Africa's GDP growth accelerated to 3.8 per cent in 2004 from 2.7 per cent in 2003. Higher consumption demand and increased private investments and higher export revenues from commodities and manufactured goods were the main contributing factors. Growth is expected to increase to 4 per cent in 2005, driven mainly by favourable domestic factors (manageable inflation, low interest rates, increased private investment and higher public expenditures), despite slower export earnings growth.

In such sub-Saharan oil-producing countries as Angola, Chad, Equatorial Guinea and Sudan, continued higher oil-export revenues and increased public and private consumption are expected to sustain high GDP growth rates—most in double-digits—in 2005-2006. In Nigeria, GDP growth is

forecast to jump to 7 per cent in 2005 on the basis of stronger oil and gas output. In contrast, continued political tensions in Cote-d'Ivoire and Zimbabwe and a decline of oil production in Gabon are forecast to make these the worst-performing economies in Africa in 2005.

Monetary and fiscal policies are expected to be relatively prudent in most countries. Inflation accelerated in 2004 as oil price increases were passed on to consumers in many countries. However, in several countries that suffered from drought, poor rainfall and weak agricultural output, however, higher food prices were the main source of inflationary pressures.

Many African oil-producing countries are expected to continue to register substantial current account surpluses in 2005, aided by better terms of trade and higher oil and non-oil commodity export volumes. Some oil-producing countries have actively managed public debt; Algeria, in particular, used some of its oil windfalls to repay 4 per cent of its external debt ahead of schedule. As oil-importing countries, however, the majority of African countries are expected to face additional oil import costs. Strong export earnings, continued debt relief and a more active debt management are expected to improve Africa's external debt situation in 2005. During 2004 and the first half of 2005, an additional African countries received debt relief under the HIPC Initiative, bringing the total to 23.

Western Asia

Western Asia's combined GDP is forecast to grow by 5¼ per cent in 2005, largely maintaining the momentum gained over the past two years. Countries continue to benefit from the favourable global economic environment, notably increased oil prices, but also buoyant intra-regional linkages, complemented by strong domestic demand and generally supportive domestic policies.

In the oil-exporting countries, the increased oil prices, will continue to lend strength to the fiscal and external balances and feed into domestic demand. The non-oil sectors, ranging from petrochemicals to tourism and construction, also remain robust in many of these countries, helping to maintain growth as the oil sector nears full capacity and as oil prices weaken in the medium run.

The region's net oil-importing countries also have substantial economic momentum, with estimated aggregate growth close to 5 per cent in 2005, after a record of 7 per cent in 2004. As Jordan and Lebanon illustrate, these countries are indirectly benefiting from the region's growing oil revenues through strengthened tourism and financial inflows from the oil-exporting economies, as well as from the restoration of trade and service sector linkages with Iraq. Among these countries, growth in Turkey will remain solid in 2005 after its record in 2004, supported by robust domestic demand and improved confidence; Israel continues to recover from its 2001 recession, thanks to strong export markets and enhanced security; in the West Bank and Gaza, however, restrictions on the flow of goods and people remain major obstacles to economic recovery.

Greater confidence, stemming in part from a gradual improvement in the political and security situation, is a factor behind the stronger domestic demand and financial inflows throughout the region. Nevertheless, there remain downside risks in this respect, particularly the uncertainties surrounding stabilization and reconstruction in Iraq.

In spite of increased inflationary pressures in some countries, largely the result of higher energy prices and real currency depreciation, inflation rates remain mostly within a prudent range. In Turkey, a tight fiscal stance and an appreciated currency are expected to continue supporting the disinflation process.

Exports, trade and current account balances of the oil-exporting countries expanded strongly in 2004 and are expected to remain robust in 2005. However, declining or stable oil production in some of these countries, along with an expected moderation of oil prices in 2006, will translate into softer growth of external revenues from that source. Owing to the favourable global environment and strong intra-regional flows, many oil-importing countries also continue to enjoy robust export growth. Nevertheless, trade balances are deteriorating in some cases, largely reflecting strong domestic demand. Service exports—particularly tourism—and workers' remittances continue to be important in financing the trade gaps in some of these countries.

As oil revenues have boomed, fiscal outlays have generally expanded in the oil-exporting countries. Significant advances, however, still need to be made in terms of diversifying the sources of revenue and increasing the quality of public expenditure and investment in many of these countries. In some of the oil-importing countries, fiscal consolidation and achieving debt sustainability remain a priority.

Monetary policies in many countries of the region are subject to the maintenance of a variety of fixed or semi-fixed pegs to the United States dollar and have generally succeeded at combining growth-supportive stances and monetary stability. In this context, large capital inflows and higher trade and current account surpluses have resulted in increased foreign reserve accumulation in many countries.

South Asia: reaching a growth plateau

Despite unfavourable weather conditions and high oil prices, economic growth in the region rose to 6.9 per cent in 2004. While agriculture acted as a drag on most economies, industrial growth, in combination with services, sustained growth. Continuing higher oil prices boosted growth in Iran but weighed on the current account balances of net oil-importing countries, albeit without causing a noticeable slowdown in most cases. Growth is expected to remain largely unchanged in 2005 in most countries, except in Sri Lanka and in the Maldives, where the tourism and fisheries sectors are suffering from the effects of the December 2004 tsunami. A rebound in agriculture, as well as strong domestic consumption and investment, is expected to offset a deceleration in export growth resulting from the slowdown in the global economy. Absent unexpected shocks, and with a strong rebound in the tsunami-affected countries, growth in 2006 is again expected to be broad-based and close to 7 per cent.

The industrial sector, and especially manufacturing, continues to be the main driver of growth in the region. Gross fixed investment rates in the major economies picked up notably in 2004 and will continue to increase in 2005. The services sector is also performing strongly, especially in India, where ICT services and business process outsourcing are forecast to grow at around 30 per cent annually over the medium term. Tourism receipts in Nepal have declined since the third quarter of 2004, but may recover later in 2005, when the political situation stabilizes. Tourism receipts reached record levels in Maldives and Sri Lanka in 2004, but there was a downturn in the first half of 2005 following the tsunami. In both countries, a strong rebound is expected in 2006.

Trade was buoyant throughout the region in 2004, with double digit growth rates for both exports and imports when measured in current US dollars. However, due to high international oil prices and strong demand for imports of both investment and consumption goods, import growth far outpaced export growth, leading to an increase in merchandise trade deficits throughout the region. The exception was Iran, where exports reached record levels for the second year in a row. This trend is expected to continue in 2005, causing current account balances to deteriorate. As a result, almost all countries are forecast to post current account deficits in 2005.

Monthly inflation rates have eased since peaking in the third quarter of 2004, mainly due to lower food prices as a result of good winter harvests. However, underlying inflationary pressures remain strong, as the higher oil prices are increasingly being passed through to consumers and subsidies continue to be phased out. As a response, and in line with global interest rate movements, monetary policy in India and Pakistan had switched from an accommodative to a neutral stance by early 2005 whereas Bangladesh and Sri Lanka continue to follow an accommodative policy in order to facilitate economic recovery after the summer floods and the December tsunami, respectively. Inflation rates are expected to evolve unevenly across the region in 2005, but are forecast to decline in 2006, as oil prices ease and monetary tightening continues.

Fiscal policies continue to be expansionary in most countries, aimed at improving infrastructure, health and education. While government spending generally remains high, efforts continue to increase revenues by streamlining tax collection and placing increased emphasis on indirect taxation (for example, through the introduction of a value-added tax in India in April 2004). Nevertheless, fiscal deficits remain high in relation to GDP in India and in Sri Lanka and are likely to restrain economic growth as interest rates begin to rise. Structural reforms in the region are continuing at uneven speed, with India and Pakistan making progress but Bangladesh and Sri Lanka moving more slowly due to domestic political considerations.

Intra-regional integration is benefiting from improving Indo-Pakistani relations, while economic ties with East Asia, and especially China, are also strengthening. Meanwhile, the security situation in Nepal remains fragile, placing a continued strain on the country's economy.

East Asia

Growth in the region is expected to slow from 7.1 per cent in 2004 to 6.3 per cent in 2005 in light of uncertain or weaker conditions in the global economy, higher oil prices and appreciating exchange rates. A slowdown is expected in all economies, except Vietnam, where growth is forecast to accelerate from 7.7 per cent in 2004 to 8½ per cent in 2005. The sharpest slowdown—from 8.4 per cent in 2004 to 4¾ per cent in 2005—is expected in Singapore and is the result of the more contractionary fiscal policy stance, a weaker construction sector and the statistical effect of the rebound in growth in 2004 from the setback from SARS in 2003.

Growth in China is forecast to slow from 9½ per cent in 2004 to 8¾ per cent in 2005, mainly due to continued restrictive administrative policy measures and bottlenecks in its infrastructure and the supply of raw materials. However, this forecast may be an underestimate because the economy continues to expand at an annual rate of more than 9 per cent, driven by strong exports and continued high levels of investment in fixed assets.

Despite the region's positive economic performance, labour market conditions have improved in only some economies, notably Hong Kong SAR and Singapore, and the forthcoming slowdown, however modest, does not bode well for employment in the region.

Inflation rates are forecast to remain subdued, but monetary policy is expected to tighten throughout the region in light of both the need for policy normalization and additional inflationary pressure stemming from domestic consumption and higher oil prices. However, the appreciation of exchange rates against the United States dollar has so far reduced the need for policy makers to pursue more pronounced monetary policy tightening. Fiscal policy is also expected to maintain its restrictive bias, aiming for the consolidation of public debt through both tightening on the expenditure side and improvements in public revenues.

Latin America

After a surge to 6 per cent in 2004, growth in Latin America and the Caribbean will slow to around 4½ per cent in 2005, as external demand eases, economic policy tightens and countries which experienced post-crisis recoveries (most notably Argentina, Uruguay and Venezuela) return to more moderate growth rates. However, domestic demand will remain some of its momentum, partly compensating for these downside factors. The general slowdown will continue into 2006.

External conditions for the region will be less favourable in 2005 than in 2004 as the growth of demand from the developed countries and China for the region's exports is expected to decelerate, oil prices to maintain much of their recent gains and the increase in export commodity prices to moderate (although these prices are also expected to remain high by recent standards). Countries which are major importers of these commodities will suffer the largest slowdown in growth; the Central American region is forecast to grow the most slowly because it will also be affected by weaker demand from the US. The losses in output due to natural disasters in 2004 and 2005, especially in the agricultural sector in the Caribbean countries, have been offset by strong inflows of tourism, partly diverted from Asian destinations.

The decrease in growth in the net fuel-exporting countries in 2005 will be greater than in net fuel-importing countries, since Mexico will also have less demand from the United States and Venezuela's growth is expected to return to around 5 per cent after its exceptional 17 per cent in 2004. In addition, strong domestic demand in many net fuel-importing countries will partially compensate for the slowdown in their exports and the prices of their commodity exports will remain high, especially in the case of base metals. For these reasons, the Southern Cone will be the fastest growing sub-region.

Although less than in 2004, the region will experience an unprecedented third consecutive year of current account surplus as exports continue to be favoured by high prices. This revenue effect will counter the growth in the volume of imports which have been boosted by strong domestic demand. The current account surplus should allow countries to reduce their external debt burden, while foreign direct investment is expected to continue flowing into the region. Argentina's success in achieving 76 per cent participation in its debt restructuring will allow it to reduce its external debt to 85 per cent of GDP, but has also helped reduce the perception of risk in the region.

Inflation is expected to continue to decline for the third consecutive year in 2005 as macroeconomic policy becomes increasingly restrictive. Monetary authorities are prioritizing targeting inflation through continuous increases in policy interest rates (as in Brazil) or liquidity cuts (as in Mexico). Fiscal policies have also continued to show restraint. Nevertheless, inflationary pressures are perceived to persist, especially in net oil-importing countries. This may prevent further easing of macroeconomic policies whereas, lower expectations for growth may encourage easing.

Although unemployment in the region fell in 2004, it is expected to increase in 2005, as the previous improvement was mostly a reflection of the normalization of countries emerging from crises.

THE CHALLENGE OF INCREASING EMPLOYMENT

Global and regional trends in employment and unemployment

Despite strong economic growth, unemployment remains persistently high, with only slow and partial improvements in labour market indicators in some regions in 2004 (see table 3). Data on employment and unemployment in developing countries are weak, but it is estimated that global unemployment fell only 500,000 in 2004 (to 184.7 million from 185.2 million in 2003⁵). After three consecutive years of decline, total employment increased by 1.7 per cent in 2004, while world output continued to grow for the whole period. This weak relationship between employment and increases in output, though it varies by regions and countries, is expected to continue in 2005 and 2006, and may result in worsening labour market conditions as the growth of world output slows.

Within the developed economies, labour markets in Japan and US are slowly improving, while unemployment in the EU has remained at around 8 per cent since the beginning of 2003, although there are wide differences at the country level. In the high unemployment countries, such as Italy and Spain, unemployment has continued to come down; unemployment has remained very low in the UK; in France and particularly Germany, unemployment has risen. The industrial and agricultural sectors have suffered the most job loss while employment has increased in services. Despite the strong economic growth in the new EU members and Southeastern Europe in 2004, there was only a slight improvement in the employment situation in a number of countries.

Similarly, even with strong economic growth for two consecutive years in the CIS region, employment remains almost at the same level, constrained largely by the slow changes in labour markets. Employment in the Russian Federation has increased since the end of 2003, but in Ukraine employment declined in 2004, despite two-digit GDP growth. At the same time, unemployment went down, implying a decline in the participation rate. In central Asia, labour market performance remains uneven.

⁵ ILO, *Global Employment Trends*, BRIEF, February 2005, <http://www.ilo.org/trends>.

Table 3				
Unemployment and GDP growth by regions and selected countries, 1999-2004 (per cent)				
	Change in unemployment rate (percentage points)	Unemployment Rate		
<i>Region</i>	<i>1999-2004</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>
World	0	6.3	6.3	6.1
Developed economies	0.2	6.8	7.4	7.2
EU-15	-0.7	7.6	8	8
US	1.3	5.8	6	5.5
Japan	0	5.4	5.3	4.7
Eastern Europe ¹ and the CIS	-1.9	9.4	8.4	8.3
East Asia	-0.2	3.1	3.3	3.3
South East Asia and the Pacific	0.8	7.1	6.5	6.4
South Asia	0.8	4.8	4.8	4.7
Latin America and the Caribbean	-0.7	10.8	10.7	10
Middle East and North Africa	-0.2	11.9	11.7	11.7
Sub-Saharan Africa	0.3	10.8	10	10.1

Source: ILO, *Global Employment Trends*, BRIEF, February 2005, p.8.; *Global Employment Trends*, January 2004; and ECLAC, *Preliminary Overview of Latin America and the Caribbean 2004*, ECLAC, Santiago, 2004.

Excluding new EU members.

Across the other regions, in 2004 there was strong GDP growth and some improvement in unemployment in Latin America, Eastern Europe and the CIS countries and, to a lesser, extent in South Asia. However, output growth has not yet generated additional employment in East Asia, West Asia or North Africa. In Sub-Saharan Africa, unemployment has increased with an unemployment rate of over 10 per cent persisting for several years, despite improved output growth. Labour market performance in Western Europe remains weak, though slow growth and the hesitancy of the recovery are the major factors behind it.

In Latin America and the Caribbean, GDP growth increased from 1.9 per cent in 2003 to almost 6 per cent in 2004 and unemployment fell by about half a percentage point. Nevertheless, unemployment has remained at 10 per cent or above for the past seven years and is expected to worsen again in 2005 as the positive conditions of 2004 subside.

Labour market conditions in East Asia present no uniform picture. Economies such as Taiwan Province of China and the Republic of Korea have rates of unemployment of less than 5 per cent whereas the rates in the Philippines and Indonesia are around 10 per cent. Nevertheless, the continued

strong economic performance of the region has started to have some positive impact, with unemployment rates falling in several countries. However, in view of the expected lower growth rates across the region in 2005, only modest further improvements in employment are likely.

Unemployment levels in South Asia remain stubbornly high. In India, in spite of sustained high growth rates over the past few years, overall employment has expanded by less than 1 per cent a year over the past five years, against annual labour force growth of 2 per cent.

Possible reasons for the weak linkages between economic growth and employment

The generally low elasticity of employment with respect to economic growth observed in many countries is a consequence of several structural characteristics of regional and national labour markets.

At the microeconomic level, firms' reactions to a positive economic environment appear to have only limited effects on labour markets. In the case of Western Europe, for example, the improved resilience of the labour market during the last slowdown has led to a slow response of employment in the current upturn. In the downturn, firms were reluctant to reduce their labour force, partially but not exclusively due to regulations pertaining to the lay-off of workers. Instead, firms reduced their investment spending, resulting in a decline in labour productivity. In the present more positive economic environment, firms are concentrating on increasing productivity rather than expanding their labour force; this also applies to Central and Eastern Europe. At the same time, global competition has increased the pressure on workers to accept longer working hours in exchange for employment protection, further reducing firms' need to hire new workers in response to economic expansion.

In developing countries, especially in Latin America, the response to the last slowdown was different: it led to a fall in the general level of wages and this served as an incentive for firms to hire new workers during the current upturn. However, this implies that any positive effect of the current upswing on employment also needs to take into account lower incomes from employment.

Factors such as weak mechanisms for the regulation of markets and for the guarantee of property rights have reduced firms' incentives for internal restructuring, limiting any gains in productivity and competitiveness, as well as the potential for additional demand for labour. In the case of the CIS, for example, the lost momentum of the reform process is one of the reasons for the lagged response of employment compared to output. Structural and institutional reforms, in contrast to basic market reforms such as price and trade liberalization and small-scale privatization, are very slow and have been difficult to implement and this has adversely affected labor markets. In addition, the slow restructuring of enterprises, as reflected in the share of loss-making enterprises, and incomplete privatization in many countries in the region exacerbate the situation. The potential for further labour shedding is likely to increase the number of unemployment there, which is unlikely to be offset by the slowly emerging private sector in the short-run. However, structural weaknesses and a resulting lack of emphasis on efficiency also provide a basis for underemployment, especially in Asia and Africa, reducing the official rate of unemployment. While more competitive markets would entail transition costs in the form of an initial increase in unemployment, these may be offset by the creation of a more solid growth potential in the medium to long run.

Demographic situations also have a bearing on levels of unemployment in individual economies. In Western Asia, the growth of the labour force is over 4 per cent annually so that very high and sustained rates of overall economic growth are required to generate additional jobs; at present the unemployment rate continues to be among the world's highest, in spite of relatively high current growth rates. The same holds true for Africa, where the unemployment rate for the 15-24 age group (21 per cent in 2003) is twice as high as for the overall labour force and has remained unchanged for the past decade; there are an estimated 18.6 million young people out of work.⁶ The ratio of the youth-to-adult unemployment rates in Sub-Saharan Africa was 3.5 in 2003, indicating that young peoples' chance of being unemployed is 3.5 times higher than for adults.

A persistent and, in some cases, growing mismatch in skills creates an additional problem in reducing unemployment. China, for example, is seeing growing regional disparities between the skills offered by the labour force and those sought by firms. This is due to an educational mismatch, as well as limited labour mobility, giving rise to upward pressure on wages in regions that experience a lack of skilled or experienced labour. Similar problems exist in Africa, where low educational quality and a lack of skills contribute to the high level of unemployment. However, in an apparent contradiction, the expansion of investment in youth education in Africa in the past two decades is not being matched by increases in employment for this group. There is the opposite mismatch problem in parts of Western Asia, where unemployment is particularly high among the educated while in certain countries, particularly in the Gulf sub-region, the demand for low- and medium-skilled labour is met by immigrants.

The effect of economic growth on employment also depends on the structure of an economy and, in particular, on its capital intensity. In economies that rely on relatively capital-intensive economic sectors, growth is expected to have a weaker impact on employment than in more labour-intensive economies. In the case of Latin America, for example, the reliance of some economies on the export of industrial primary products amplifies the challenge of reducing unemployment.

Policy implications

Strengthening the linkages between employment and growth should be at the core of economic policy, especially since the former is the most direct factor in reducing poverty levels in developing countries. Although higher growth rates generate some increases in employment, these by themselves are not enough to achieve the necessary responsiveness. Direct labor market policies have recently shifted towards more active measures to improve the linkages between supply of and demand for labor, to promote training so as to improve the quality of the workforce and support the search for jobs, focusing on groups in need, assisting the self-employed and developing micro-enterprises. However, these active policies have usually not produced substantial results in terms of employment generation nor improvement in wages, although they may be necessary and useful in times of crisis.

Thus broader economy-wide policies and reforms are needed to respond to increased global competition. Many developing countries are still very dependent on the export of a few key primary products, which either do not generate enough employment or create low quality jobs. In these cases, diversification ought to be accelerated in order to create more jobs in different sectors.

⁶ ILO, Global Employment Trends for Youth 2004.

To facilitate this, market access should be increased through bilateral and multilateral trade agreements. However, market access by itself will not ensure an increase in exports and production. Hence, structural reforms geared towards making all sectors, especially labour-intensive sectors, more dynamic while creating a better investment climate need to put in place in order to improve the linkages between growth and employment.