World Economic and Financial Surveys

World Economic Outlook

Financial Systems and Economic Cycles

SEPT 06

INTERNATIONAL MONETARY FUND

World Economic and Financial Surveys

WORLD ECONOMIC OUTLOOK
September 2006

Financial Systems and Economic Cycles

International Monetary Fund

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Production: IMF Multimedia Services Division
Cover and Design: Luisa Menjivar-Macdonald and Jorge Salazar
Figures: Theodore F. Peters, Jr.
Typesetting: Choon Lee

World economic outlook (International Monetary Fund)
World economic outlook: a survey by the staff of the International Monetary Fund.—1980– —Washington, D.C.: The Fund, 1980–

v.; 28 cm.—(1981–84: Occasional paper/International Monetary Fund ISSN 0251-6365)
Annual.
Has occasional updates, 1984–
ISSN 0258-7440 = World economic and financial surveys
ISSN 0256-6877 = World economic outlook (Washington)
1. Economic history—1971– —Periodicals. I. International Monetary Fund. II. Series: Occasional paper (International Monetary Fund)

HC10.W7979 84-640155
338.5'443'09048—dc19
AACR 2 MARC-S

Library of Congress 8507

Published biannually.
ISBN 1-58906-598-0

Price: US$57.00
(US$54.00 to full-time faculty members and
students at universities and colleges)

Please send orders to:
International Monetary Fund, Publication Services
700 19th Street, N.W., Washington, D.C. 20431, U.S.A.
Tel.: (202) 623-7430 Telefax: (202) 623-7201
E-mail: publications@imf.org
Internet: http://www.imf.org

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ASSUMPTIONS AND CONVENTIONS

A number of assumptions have been adopted for the projections presented in the *World Economic Outlook*. It has been assumed that real effective exchange rates will remain constant at their average levels during July 5–August 2, 2006, except for the currencies participating in the European exchange rate mechanism II (ERM II), which are assumed to remain constant in nominal terms relative to the euro; that established policies of national authorities will be maintained (for specific assumptions about fiscal and monetary policies in industrial countries, see Box A1); that the average price of oil will be $69.20 a barrel in 2006 and $75.50 a barrel in 2007, and remain unchanged in real terms over the medium term; that the six-month London interbank offered rate (LIBOR) on U.S. dollar deposits will average 5.4 percent in 2006 and 5.5 percent in 2007; that the three-month euro deposits rate will average 3.1 percent in 2006 and 3.7 percent in 2007; and that the six-month Japanese yen deposit rate will yield an average of 0.5 percent in 2006 and of 1.1 percent in 2007. These are, of course, working hypotheses rather than forecasts, and the uncertainties surrounding them add to the margin of error that would in any event be involved in the projections. The estimates and projections are based on statistical information available through end-August 2006.

The following conventions have been used throughout the *World Economic Outlook:*

. . . to indicate that data are not available or not applicable;

— to indicate that the figure is zero or negligible;

– between years or months (for example, 2004–05 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years or months (for example, 2004/05) to indicate a fiscal or financial year.

"Billion" means a thousand million; "trillion" means a thousand billion.

"Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percent point).

In figures and tables, shaded areas indicate IMF staff projections.

Minor discrepancies between sums of constituent figures and totals shown are due to rounding.

As used in this report, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

FURTHER INFORMATION AND DATA

This report on the *World Economic Outlook* is available in full on the IMF's Internet site, www.imf.org. Accompanying it on the website is a larger compilation of data from the WEO database than in the report itself, consisting of files containing the series most frequently requested by readers. These files may be downloaded for use in a variety of software packages.

Inquiries about the content of the *World Economic Outlook* and the WEO database should be sent by mail, electronic mail, or telefax (telephone inquiries cannot be accepted) to:

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PREFACE

The analysis and projections contained in the *World Economic Outlook* are integral elements of the IMF's surveillance of economic developments and policies in its member countries, of developments in international financial markets, and of the global economic system. The survey of prospects and policies is the product of a comprehensive interdepartmental review of world economic developments, which draws primarily on information the IMF staff gathers through its consultations with member countries. These consultations are carried out in particular by the IMF's area departments together with the Policy Development and Review Department, the International Capital Markets Department, the Monetary and Financial Systems Department, and the Fiscal Affairs Department.

The analysis in this report has been coordinated in the Research Department under the general direction of Raghuram Rajan, Economic Counsellor and Director of Research. The project has been directed by Charles Collyns, Deputy Director of the Research Department, and Tim Callen, Division Chief, Research Department.

The primary contributors to this report are Thomas Helbling, Subir Lall, Kalpana Kochhar, S. Hossein Samiei, Roberto Cardarelli, Florence Jaumotte, Toh Kuan, Valerie Mercer-Blackman, Hélène Poirson, Martin Sommer, Nikola Spatafora, Irina Tytell, and Johannes Wiegand. To-Nhu Dao, Christian de Guzman, Stephanie Denis, Nese Erbil, Angela Espiritu, Patrick Hettinger, Bennett Sutton, and Ercument Tulun provided research assistance. Mahnaz Hemmati, Laurent Meister, and Casper Meyer managed the database and the computer systems. Sylvia Brescia, Celia Burns, and Jemille Colon were responsible for word processing. Other contributors include Ricardo Adrogue, Sergei Antoshin, Bas Bakker, Dan Citrin, Gianni De Nicolo, Roberto García-Saltos, Christopher Gilbert, David Hauner, George Kapetanios, Manmohan Kumar, Michael Kumhof, Luc Laeven, Doug Laxton, Ross Levine, Papa N'Diaye, Christopher Otrok, Arvind Subramanian, Stephen Tokarick, Thierry Tressel, Kenichi Ueda, and Khuong Vu. Jeff Hayden of the External Relations Department edited the manuscript and coordinated the production of the publication.

The analysis has benefited from comments and suggestions by staff from other IMF departments, as well as by Executive Directors following their discussion of the report on August 22 and 23, 2006. However, both projections and policy considerations are those of the IMF staff and should not be attributed to Executive Directors or to their national authorities.

FOREWORD

The *World Economic Outlook* is truly a joint product, primarily with inputs from the Research Department of the International Monetary Fund, but also from the staff of a number of other departments. I thank Charles Collyns, David Robinson (who was with us during the important initial phase of this Outlook), Tim Callen, members of the World Economic Studies Division, and all the IMF staff from other divisions and departments who worked together to bring this *World Economic Outlook* to you.

The world economy continues to be strong, with a third year of significantly-above-trend growth. Growth continues to become more balanced with the United States slowing and the euro area picking up, while Japan's growth is moderating toward trend. A key element to the strong world performance is the extraordinary growth of emerging markets and developing countries.

Much has rightly been made of the strong productivity growth of the U.S. economy over the last decade or so, which has contributed to this purple patch for the world. Far less has been made of the equally impressive productivity growth in emerging markets and developing countries. In Chapter 3, we examine the sources of labor productivity growth in Asia (the primary source of growth in output per capita), and compare it with other regions of the world. Asian labor productivity growth has benefited not just from fast accumulation of physical and human capital but also significant total factor productivity (TFP) growth—growth that typically comes from technological progress and from using the factors of production more efficiently. Indeed, in both China and India, TFP growth exceeds the contribution of physical or human capital accumulation. This extraordinary change has been made possible through an enabling environment that has fostered the development of efficient manufacturing (and in the case of India, services), while encouraging some movement of labor out of low-productivity agriculture.

Given the still high share of employment in agriculture in China, India, and the ASEAN countries, and provided the policy environment continues to be enabling, growth will continue to come from the shift out of agriculture. Given that a substantial population will still be employed in agriculture in the poorer Asian economies for some time, an important objective of policy should be to improve agricultural productivity. Equally important for the richer countries is to improve productivity in the service sector, especially because services will constitute an increasingly important fraction of their economies. For a number of Asian economies, a critical element of any policy mix to improve agricultural and service sector productivity will be opening up these sectors to foreign entry and competition.

Productivity growth, especially when unexpected, has a number of valuable benefits. Other things equal, it reduces unit labor costs, and increases the potential growth rate of the economy. Thus it helps keep inflation under check. It also helps offset the investment and growth consequences of adverse supply shocks. That the world economy has remained robust in recent years despite higher oil and commodities prices is due, in no small part, to the enabling policies that allowed economies to continuously improve productivity.

Robust global growth over the last few years has brought some new policy challenges. For one, unexpectedly high demand for some non-oil commodities may have generated enormous revenues for some commodity producers temporarily, but conditions will change as supply catches up. As Chapter 5 suggests, prospects for non-oil commodities, especially metals, may be different from oil in that there is more likely to be a robust supply response as investment increases to meet the unexpectedly higher demand. Our model, as well as futures prices, suggests that metals prices are likely to decline in the future. Non-oil-commodity-dependent economies should anticipate this risk by being cautious on raising expenditures that are hard to reverse, such as public sector salaries, and instead focus on expenditures that help build diversified productive capacity for the future.

Another risk is that some market-led processes may overshoot when times are good. For instance, widespread productivity growth may have played a role in the emergence of global current account imbalances. The strong productivity growth in the United States, as is well known, certainly made the United States an attractive place to invest in, drawing in capital and producing a counterpart current account deficit in the late 1990s. In addition though, as Chapter 4 suggests, the United States' sophisticated arm's length financial system made it easier for consumers to borrow against future incomes and consume immediately, augmenting the size of the current account deficit. Indeed, the expectation of higher future incomes coupled with accommodative monetary policy and low interest rates may have fueled the U.S. housing boom, which boosted consumption even more as the financial system allowed borrowing against collateral.

Even though emerging markets have experienced strong productivity growth in recent years, many did not have financial systems that could translate this into either higher investment or higher consumption. Their rising incomes were therefore channeled into net savings that helped finance the United States' dissaving. The ability to run current account imbalances therefore has allowed the world to grow faster than it would otherwise have. This is a good thing but it has limits. It is important, therefore, that we bring imbalances down in stable times so that we have room to expand them when future needs arise—this is just prudent countercyclical global policy.

Prudence is especially important when the times are changing. Revisions to U.S. data suggest that productivity growth was not so high as earlier believed. Furthermore, productivity growth has been declining as the expansion matures, and unit labor costs have been accelerating. With tight labor market conditions (including in other industrial countries), and high capacity utilization, inflationary pressures are on the rise. Even as liquidity is being withdrawn, the Federal Reserve has to assess not just how much the economy will slow because of prior rate increases (and their effects via the housing market) and higher energy prices, but also what the potential growth of the economy truly is. It also has to pay attention to the narrowing global output gap. There are risks of both excessive tightening as well as overly gradual tightening.

While growth in the rest of the world is likely to pick up some of the slack of a slowing U.S. economy, it is hard to estimate precisely how much of that momentum is independent of U.S. growth because the world has become so much more closely integrated over the last few years. Our baseline is that world growth will continue to be strong, but that forecast is surrounded by significant risks to the downside.

Policymakers should recognize that some of their country's performance is not just because of their own skills at the helm but because of spillovers from the robust global economy, as well as the benign financial conditions. The emerging protectionism not just in trade, but increasingly in preventing cross-border acquisitions and foreign direct investment, can interrupt the process of global productivity growth that has been so critical to the robust health of the world in recent years. This is why country authorities should strive hard, not just to revive the Doha Round, but even to make it more ambitious. They should work together to sustain the smooth flow of goods, capital, and ideas across borders, not least through the various mechanisms proposed by the IMF's Managing Director in his Medium-Term Strategy to invigorate the quality of the multilateral dialogue. Finally, wherever possible, they should ensure that public policy does not exacerbate imbalances created by the private sector, as well as avoid creating uncertainties where none existed before. Prudent, predictable policy, in this environment of increasing uncertainty, is the need of the hour.

Raghuram Rajan
Economic Counsellor and Director, Research Department