

Prospects for the world economy in 2007 and 2008

Outlook for the major economies

United States

The United States (US) economy grew by a solid 3.3% in 2006, reflecting an upturn in business investment and robust private consumption (Figure 1.2.1). However, quarterly GDP figures demonstrated a visible slowdown in the second half and the year ended on a less positive note. The weak spot was mainly associated with housing sector retrenchment. Residential investment contracted for five consecutive quarters from the last quarter of 2005, and both new and existing home sales fell significantly in the latter half of 2006. Although home sales are showing signs of stabilizing, housing starts and permits continue to slide (Figure 1.2.2), reflecting an excess supply of unsold homes. With falling house prices, these indicators suggest that expectations of an early resolution to the housing-induced slowdown are premature.

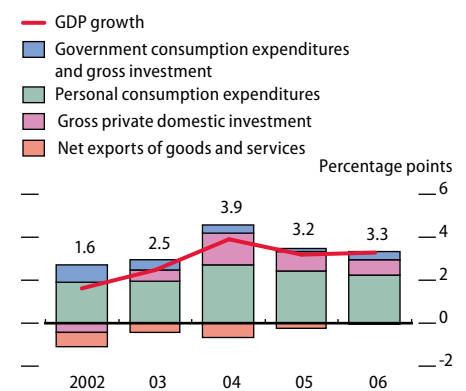
Several factors stopped the economy from going into a steep slide. Personal consumption expenditure remained buoyant and grew by 3.2% in 2006, underpinned by relatively healthy job gains and rising incomes. Household discretionary income was boosted by falling oil prices and easing inflation. Solid business investment in several quarters, on the back of strong corporate profits, was another factor.

But there are signs that the housing market trouble is spilling over into both the real economy and the financial market. Industrial production figures are slipping, with manufacturing activity slowing sharply in the last quarter. Falling orders for cars, household appliances, and construction materials could generate ripple effects. All of these added up to a contraction in business investment in the fourth quarter. The emergence of marked increases in payments delays on subprime mortgage loans since late February revealed further elements of weakness.

A pause in monetary tightening since last June has turned into a hiatus. Consumer price inflation has been ebbing, partly in reflection of the tightening, but also thanks to sharp declines in gasoline prices since the fall of 2006. Given the lessened pressure from inflation, combined with slowing economic activity, futures markets expect that the Federal Reserve may start to cut interest rates in the second half of this year. On the fiscal side, strong revenue increases reduced the 2006 US budget deficit for the second year in a row. The Congressional Budget Office projects the deficit to decline over the next 2 years.

The ongoing slowdown in US growth is expected to be moderate. The economy is projected to expand by still a respectable rate of 2.5% in 2007, followed by a quick recovery in 2008. Sustained income growth and low inflation will continue to underpin private consumption growth. A relatively benign business outlook is predicted, based on good corporate earnings and firm demand. While exports are seen maintaining recent

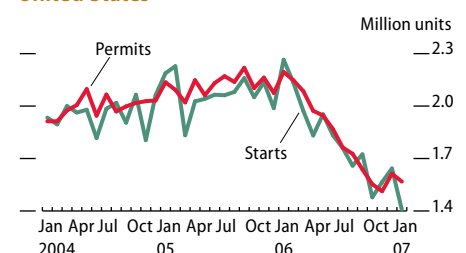
1.2.1 Contributions to growth (demand), United States



Source: Bureau of Economic Analysis, available: <http://www.bea.gov>, downloaded 1 March 2007.

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1.2.2 New residential construction, United States



Source: US Census Bureau, available: <http://www.census.gov>, downloaded 15 March 2007.

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gains, robust consumer spending will likely rekindle growth in imports this year. The current account is expected to deteriorate further, though the pace of growth in the trade deficit has stabilized.

Japan

The Japanese economy continues a moderate but steady recovery, registering 2.2% growth in 2006 (Figure 1.2.3). Although the latest revisions (February 2007) reveal less than expected strength of domestic demand, it does not alter the underlying sweep. Strong exports and export-induced business investment are underpinning the recovery, since private consumption is trudging along only slowly. Exports rose by 9.5%, contributing 1.4 percentage points to growth. The pace of private consumption visibly weakened in 2006, posting only 0.9% growth. Stagnating labor market conditions and flattened wage growth contributed to a retrenchment in consumer spending, although a strong rebound in the final quarter was encouraging.

Industrial production rose substantially, pushing capacity utilization higher. Corporate profits set yet another record, offering strong impetus to business spending. Meanwhile, firms have remained cautious in both investment and hiring decisions. Despite the improved industrial activity and job conditions of the past few years, unemployment has stayed relatively high at 4.1%, reflecting firms' reluctance to hire. This picture should brighten over the forecast period, but not markedly given heightened labor productivity and continued corporate efforts to contain rising input costs. Further out, strong corporate profits and tight capacity should eventually exert a positive influence on the job market.

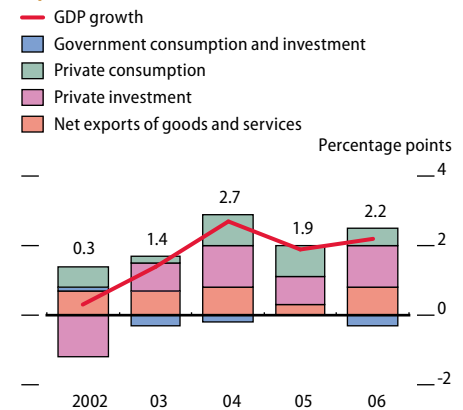
The Bank of Japan raised policy rates by another quarter point in February 2007, the second step since July 2006 in its intended move to a neutral policy stance. However, the slow pace of consumption recovery combined with weak inflation suggests little likelihood of the central bank acting aggressively, and it will probably leave the policy rate at under 1% for most of this year. Consumer price inflation barely made it into positive territory (Figure 1.2.4). If the yen strengthens and oil prices continue to fall, deflation could become a problem again.

The Japanese economy is expected to continue its modest recovery. Projected growth is 2.0% in 2007 on the ground of gradually strengthening domestic demand. Record export earnings should underpin the expansion in business capital spending, while strengthening the job market. The key to sustaining the recovery lies with consumers spending more. The country's aging demographic profile and related high pension burden continue to be a significant drag. Moreover, weakness in the domestic sector could persist, if the inevitable ending of macroeconomic stimuli over the medium term weighs down on consumer sentiment.

Euro zone

A steady recovery is under way in the euro zone, which grew by 2.6% in 2006 on strong exports and firming domestic demand (Figure 1.2.5). Despite the sustained strength of the euro, exports surged by 8.4%. This boosted industrial production across the zone, particularly in Germany, Italy, and Spain. Business and consumer sentiment has improved (Figure 1.2.6). Strong corporate profits and cheap credit bolstered

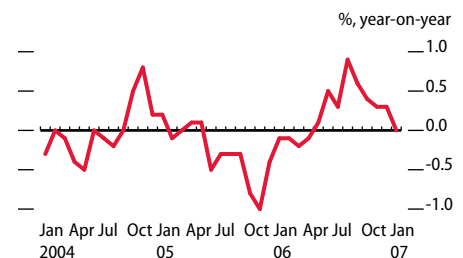
1.2.3 Contributions to growth (demand), Japan



Source: Economic and Social Research Institute of Japan, available: <http://www.esri.cao.go.jp>, downloaded 12 March 2007.

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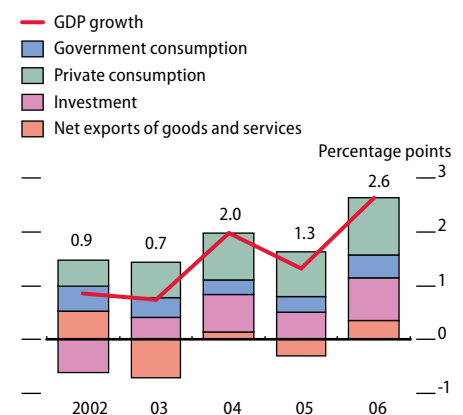
1.2.4 Inflation, Japan



Source: CEIC Data Company Ltd., downloaded 13 March 2007.

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1.2.5 Contributions to growth (demand), euro zone



Source: Eurostat, available: <http://europa.eu.int>, downloaded 8 March 2007.

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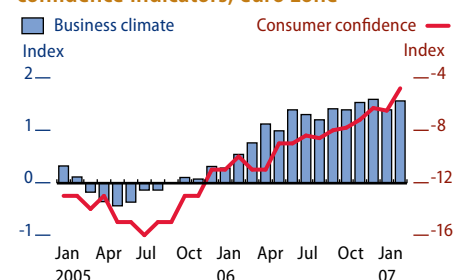
capital spending. This upward trend in turn exerted a positive influence on consumer spending, underpropping sound and balanced growth. Unemployment rates have trended down, and are now firmly under 8%.

A major downside risk is how consumers will react to tax increases. Long-term fiscal sustainability is a significant concern for the euro zone. The major economies of France, Germany, and Italy, have persistently exceeded the fiscal deficit ceiling of the stability and growth pact (3% of GDP). These economies have announced fiscal consolidation plans, combined with significant tax hikes. In both Germany and Italy, fiscal tightening is taking effect in 2007, amounting to an estimated 1% of GDP. So far, consumers appear to be relatively unswayed and their upbeat sentiment remains intact.

Although pressure is easing with falling oil prices, inflation stayed slightly above the European Central Bank (ECB) target rate of 2% in 2006. With the latest rise in March 2007 having lifted the policy rate to 3.75%, continued compression in interest rate differentials has strengthened the euro. While this curbs inflation, it may start to pinch exports. Given the improved growth outlook, ECB is expected to adopt a neutral stance after one more rate increase, perhaps in the middle of the year.

The euro zone is expected to grow by 2.2% in 2007. Prospects for exports and related business investment, as well as consumer spending, are positive. The investment outlook seems set to stay firm, reflecting the strength of corporate balance sheets and tight manufacturing capacity. A modest deceleration in world growth is not likely to seriously undermine performance of the external sector.

1.2.6 Business climate and consumer confidence indicators, euro zone



Source: European Commission, available: <http://ec.europa.eu>, downloaded 12 March 2007.

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World trade and commodity prices

World trade expanded rapidly in 2006, in volume terms accelerating to 9.7% from 7.7% in 2005 (according to World Bank estimates). Improved demand conditions in major industrial countries, along with firming consumer spending in Japan and the euro zone, buttressed strong industrial production both for major industrial countries and for developing Asia. Robust export performance from developing Asia also shored up world trade growth. The PRC continues to play a catalytic role in linking regional production chains with final demand from the rest of the world: regional partners' exports to the PRC again rose strongly, where they are processed and reexported to the rest of the world.

With a less buoyant economic performance slated for 2007, world trade growth is projected to moderate to 7.5% in export volume terms (Table 1.2.1). Industrial activity in major industrial countries has eased, with US industrial production slowing markedly. Japan and the euro zone are expected to take up some slack in demand

1.2.1 Baseline assumptions for external conditions

	2005 Actual	2006 Actual	2007 ADO 2007 projection	2008 ADO 2007 projection
GDP growth (%)				
Industrial countries ^a	2.4	2.9	2.3	2.6
United States	3.2	3.3	2.5	3.0
Japan	1.9	2.2	2.0	2.3
Euro zone	1.4	2.6	2.2	2.1
Memorandum items				
US Federal Funds rate (average, %)	3.2	5.0	5.1	4.9
Brent crude oil spot prices (\$ per barrel) (annual average)	54.4	65.4	57.0	54.0
Nonfuel commodity prices (% increase)	13.4	24.7	-4.5	-8.4
CPI inflation (OECD) (annual average)	2.6	2.3	2.1	2.0
World trade volume (% change)	7.7	9.7	7.5	8.0

^a Growth rates for industrial countries are a GDP weighted average for the US, EU, and Japan.

Sources: US Bureau of Economic Analysis, available: <http://www.bea.gov>, downloaded 28 February 2007; Eurostat, available: <http://europa.eu.int>, downloaded 8 March 2007; Economic and Social Research Institute of Japan, available: <http://www.esri.cao.go.jp>, downloaded 12 March 2007; CEIC Data Company Ltd., downloaded 8 March 2007; World Bank, Commodity Price Data, available: <http://web.worldbank.org>, downloaded 8 March 2007; OECD Main Economic Indicators, available: <http://www.oecd.org>, downloaded 8 March 2007; World Bank, *Prospects for the Global Economy Forecast Summary*, available: <http://web.worldbank.org>, downloaded 8 March 2007.

from the anticipated moderation in the US, but much strengthening in private consumption in these two economies seems doubtful.

Even with slowing momentum though, the world economy remains relatively buoyant, given the underlying strength of the corporate sector and the gradual tightening of the labor market in most countries in the Organisation for Economic Co-operation and Development. Industrial production for the major economies may surprise to the upside if consumer spending gels this year.

The strength of the global economy in 2006 boosted global sales of consumer electronics. Worldwide semiconductor sales set another record (\$247.7 billion) in 2006, an increase of 8.9% from the previous year (Figure 1.2.7), while sales in the Asia-Pacific region registered a 13% expansion, driven by strong PRC demand. Although some slackening in economic activity has been seen in major industrial countries, a modest demand-driven expansion is expected in global high-technology industries in 2007. The Semiconductor Industry Association projects global semiconductor sales to grow by about 11% in 2007.

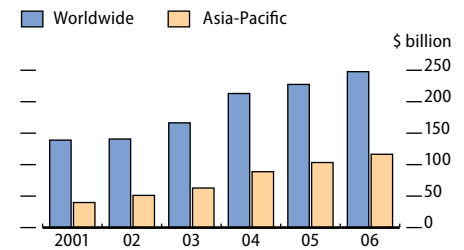
Demand for consumer electronics is partly supported by relentless global competition and falling prices. Dynamic random access memory (DRAM) prices, a proxy for global high-tech prices, have been slipping on fierce global competition and improved production capacity (Figure 1.2.8). Falling prices of popular consumer electronics have started to weigh on profit margins of the world's largest producers. Given the buoyancy of global demand, producers have maintained profits by expanding the volume of sales. But as the US economy, which is the largest market for end products, is expected to slow, further erosion of profits seems inevitable and could precipitate a downturn in the industry cycle.

The Brent crude oil price averaged \$65.4 a barrel in 2006, despite a sharp fall in the second half of the year. Global oil prices have declined by more than 20% since the peak of nearly \$80 a barrel in early August. The slump was mainly due to softening demand and rising inventories. The latest data on oil production and consumption show moderate increases in global spare capacity and inventory levels, as the supply/demand balance improves, despite lower output from the Organization of the Petroleum Exporting Countries (OPEC). However, underlying demand fundamentals remain strong, with a potential pick up in PRC demand.

On the supply side, periodic disruptions will likely continue given the political situations in major producer economies. The Brent crude oil price is expected to average about \$57 a barrel in 2007 based on futures prices adjusted for the cost of carry (Figure 1.2.9). Fundamental tightness, given the supply-demand outlook, suggests upside risks to the outlook, though.

Prices of non-oil commodities have been showing signs of stabilization since mid-2006 (Figure 1.2.10). Driven by double-digit growth in metals prices, non-oil commodity prices posted strong gains in 2006. Strong manufacturing production, particularly in the developing world, continued to support industrial demand, while supply-side difficulties persisted in production of major metals. Prices of zinc, copper, and nickel surged again in 2006 on sharp drawing-down on inventories and supply disruptions, though the combination of improving supply conditions and the prospect of slowing demand were moderating forces in the second half of the year.

1.2.7 Sales of semiconductors



Source: Semiconductor Industry Association, available: <http://www.sia-online.org>, downloaded 12 March 2007.

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1.2.8 DRAM prices

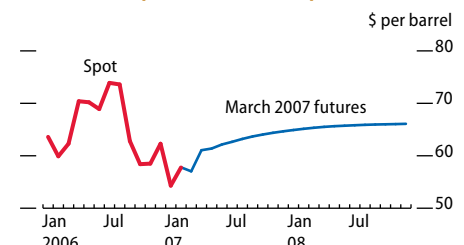


Note: US\$/256MB 333 MHz DDR (32M x 8) (Taipei, China).

Source: Bloomberg, downloaded 13 March 2007.

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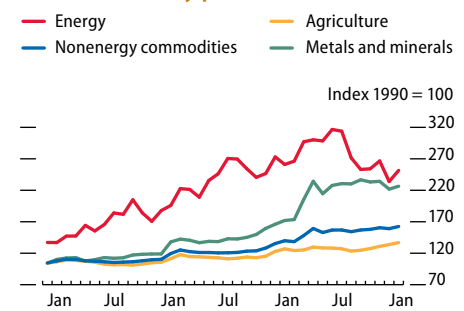
1.2.9 Brent spot and forward prices



Sources: Asian Development Outlook database; FutureSource.com, available: <http://www.futuresource.com>, downloaded 15 March 2007.

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1.2.10 Commodity prices



Source: World Bank Commodity Price Data (Pink Sheets), various issues, <http://web.worldbank.org>, downloaded 13 March 2007.

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Agricultural commodity prices also rallied, but not uniformly. Some agricultural food commodities enjoyed strong gains on weather-related supply shortfalls, declining stocks, and surging demand for biofuels. Sugar prices rose to a record high before moderating in the second half of 2006, while maize and wheat prices also made significant advances. Strong industrial demand bolstered by the PRC drove up prices of agricultural raw materials, including rubber.

After the spectacular rise in 2006, non-oil commodity prices are expected to stabilize. Some metals prices such as copper and zinc moved lower in early 2007 on the slower growth outlook. Although the supply-side constraints in some non-oil commodities are unlikely to disappear overnight, easing demand pressure along with gradual improvement in inventories should limit further price gains. Softer energy prices may also keep a lid on sugar and other oilseeds prices.

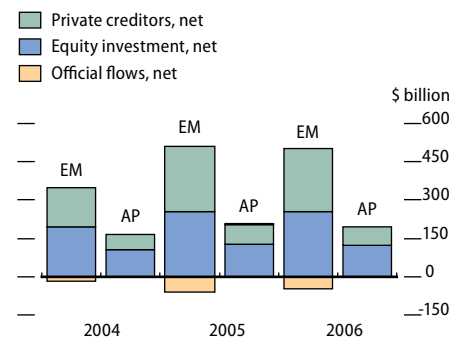
Capital flows and financial markets

The global investment climate for developing Asia remains favorable. Despite the most recent correction in February–March, emerging market asset prices have kept their earlier large gains. In 2006, emerging market equity prices again staged a strong rally after a brief midyear sell-off. The strong performance of emerging Asian market equities partly reflected external demand and was accompanied by robust capital inflows (Figure 1.2.11). Net private capital flows to emerging Asia amounted to \$197.3 billion, only slightly down by 3.9% from the previous year, due to slightly smaller foreign direct investment flows. However, with its strong growth outlook, the region continues to be the primary recipient of private equity investment, attracting again more than 60% of net portfolio equity investment flows to emerging market economies in 2006.

Relatively low interest rates and benign liquidity conditions in capital markets have kept private credit flows generally buoyant, benefiting emerging Asian borrowers. Credit spreads remained near record lows for emerging market issuers through most of 2006 (Figure 1.2.12). While the region's strong fiscal position limited the need for new issuance of sovereign debt, corporate issuers took advantage of low funding costs. Foreign investors' Asian bond purchases (which account for a majority of private creditor nonbank flows) were boosted by expectation of currency appreciation. Although Asian corporate borrowers will have ready access to bank credit, borrowing from banks abroad is expected to slow in 2007, mainly due to government measures to curtail investment in the PRC.

Asian currencies strengthened further against the US dollar in 2006. Gains ranged from 1.9% for the Indian rupee to 13.8% for the Thai baht (Figure 1.2.13). Robust performance of both current and capital accounts underpinned the strength of most Asian currencies. Narrowing interest rates continued to weigh on the dollar, which fell by 11.7% against the euro in 2006. Significant interest rate differentials between the US and Japan limited the dollar's fall against the yen to only 0.8%. Expectations for strong growth will continue to underpin the strength of Asian currencies in 2007, as will narrowing interest rate differentials, due to monetary tightening in some countries.

1.2.11 Net capital flows to emerging markets and Asia-Pacific



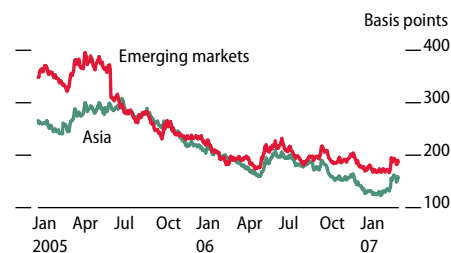
EM = emerging markets; AP = Asia-Pacific.

Note: Emerging markets and Asia-Pacific follow the definition of the Institute of International Finance Inc.

Source: Institute of International Finance Inc., *Capital Flows to Emerging Market Economies*, various issues, available: <http://www.iif.com>.

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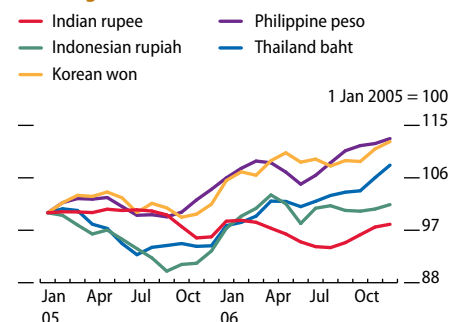
1.2.12 Sovereign credit spreads



Source: Bloomberg, downloaded 15 March 2007.

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1.2.13 Nominal United States dollar exchange rate index



Sources: International Monetary Fund, *International Financial Statistics* online database; Central Bank of China, available: <http://www.cbc.gov.tw>; both downloaded 13 March 2007.

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