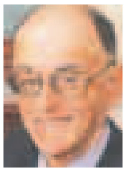

DAVID KERN ASSESSES THE CHANCES OF THE GLOBAL ECONOMY BEING NEITHER TOO HOT NOR TOO COLD.

Precarious optimism

Although GDP growth slowed in all the major economies in 2005, the previous year had been exceptional, making growth in 2005 very satisfactory, particularly given the threats to the global economy: recurring oil price spikes, huge trade imbalances, higher US interest rates, and natural disasters. 2005 ended on a positive note and the mood of optimism has strengthened in 2006. Most major stock markets have risen to multi-year peaks, and the markets' confidence has increased, even though problems have deepened. Oil prices have touched new highs, and global imbalances are ballooning. Fears of higher inflation have worsened, and aggressive interest rate increases are serious and widespread. The European Central Bank and the Bank of Japan are preparing to tighten policy more forcefully. Is the markets' optimism well founded or will it all end in tears?

NEW IMF FORECASTS The optimism over growth prospects cannot be shrugged off as speculative exuberance. The most recent issue of the IMF's half-yearly World Economic Outlook report was unusually bullish about the outlook for 2006 and 2007. The IMF speaks in measured language, and its report highlights the dangers of large and persistent global trade imbalances unless corrective action is taken. But the IMF's central message is indisputably positive: whether based on market exchange rates or purchasing power parities (which gives greater weight to non-market transactions), world GDP is forecast to grow faster than its average in the previous decade (see *Chart 1*).

THE MAJOR PLAYERS The central IMF growth forecasts, for the world economy as a whole and for the major economies (See *Table 1*), highlight a relatively benign and stable outlook. Though the US, China and India are expected to decelerate a little in 2006 and 2007, these three key economies are set to continue expanding at a satisfactory pace while Japan and the euro zone are gradually improving after a long period of underperformance. UK growth is also set to strengthen in 2006, after a disappointing slowdown in 2005.

Executive summary

- Global growth forecasts are robust, with share prices near to their historical highs.
- The markets are optimistic and the latest IMF global forecasts are unusually strong, but there are heightened tensions over Iran, new peaks in oil and commodity prices, and strong rises in bond yields.
- The global imbalances arising from the huge US deficit are unresolved. If central banks embark on aggressive tightening, global growth will be threatened.

GEOPOLITICAL RISKS Prospects are benign but dangers persist – mainly the threat of terrorism and tensions over Iran's nuclear ambitions. It is difficult to quantify the effect of terrorism fears, but every serious incident heightens uncertainties and damages sectors such as travel and tourism. The dispute with Iran has also been a key factor pushing up oil and energy prices. Even if a military confrontation can be avoided, Iran's reaction to the threat of sanctions could restrict oil supplies and push oil prices to new peaks.

GLOBAL IMBALANCES The global economy remains afflicted by major geographic and structural imbalances, mostly manifested in

Chart 1. IMF Forecasts of World GDP Growth

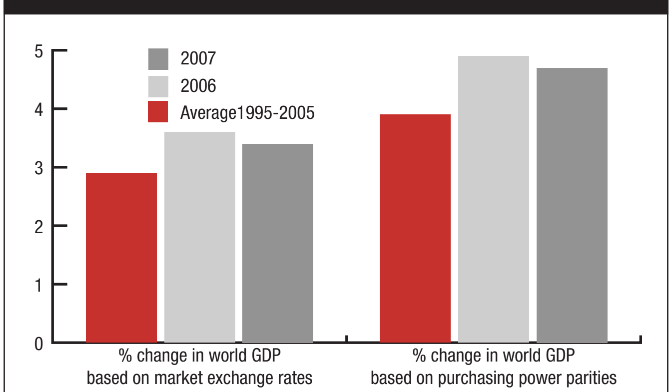

Chart 2. Current Account Deficits & Surpluses

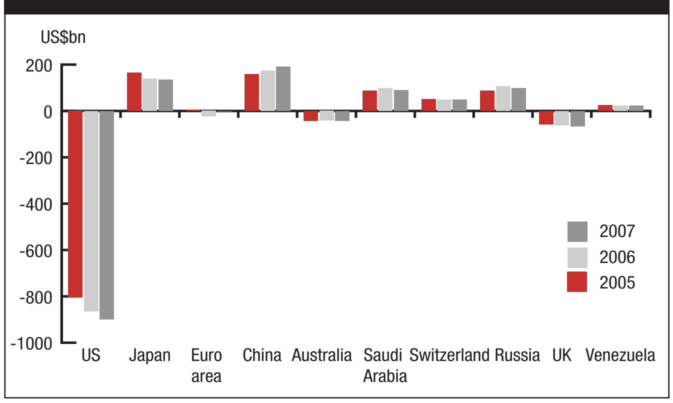

Table 1. GDP Growth 2000-2007, the Major Economies
% Change on Previous Year, Recent Experience and IMF Forecasts

	2000	2001	2002	2003	2004	2005	2006	2007
United States	3.7	0.8	1.6	2.7	4.2	3.5	3.4	3.3
Japan	2.9	0.4	0.1	1.8	2.3	2.7	2.8	2.1
Euro area	3.8	1.9	0.9	0.7	2.1	1.3	2.0	1.9
Germany	3.1	1.2	0.1	-0.2	1.6	0.9	1.3	1.0
France	4.1	2.1	1.3	0.9	2.1	1.4	2.0	2.1
UK	4.0	2.2	2.0	2.5	3.1	1.8	2.5	2.7
China	8.4	8.3	9.1	10.0	10.1	9.9	9.5	9.0
India	5.3	4.1	4.2	7.2	8.1	8.3	7.3	7.0

the huge US external deficit. The deficit is at an unprecedented level (an estimated 6.4% of US GDP in 2005) and a major correction will probably be necessary. The US deficit – and the corresponding surpluses of Japan, China, Russia and the major oil exporters – will remain a major unresolved global imbalance for some years (see *Chart 2*). Sharp slowdowns in consumer spending, mainly in the US, due to weaker house prices and the correction of other asset price bubbles, are another, global threat. Against this background, growth optimism may be overstated and share prices overstretched. Current trends could make the eventual correction more painful.

POLICY ISSUES There is widespread agreement that a number of key factors, some of them overlapping, explain the imbalances, including:

- Unduly low US savings, forcing the US to import capital;
- Excessive savings and persistent low growth in Japan and euro zone;
- Inadequate domestic demand growth in China, other Asian emerging economies, and some oil exporting countries;
- The tendency of US domestic demand to grow faster than total US output, and faster than domestic demand in some of its main rivals;
- Excessive accumulation of foreign exchange reserves in China, Japan, and other Asian economies; and
- Alleged over-valuation of the US dollar.

THE US DOLLAR There are conflicting views on the question of whether the huge US deficit will eventually trigger sharp US dollar falls. A weaker dollar is a necessary (though insufficient) condition for reducing the massive US deficit, but very large falls (or, indeed, rises) in the exchange rate would be destabilising and damaging. If the dollar were to plummet and the US were forced to raise interest rates sharply to contain inflationary pressures, the threat of world recession would intensify. On the other hand, a large appreciation of the dollar would result in even bigger and more unsustainable US external deficits. Consensus market forecasts (see *Table 2*) expect significant but orderly declines in the dollar over the next two years, and that dollar falls will be larger against Asian currencies than against the euro.

A GOLDILOCKS ECONOMY The IMF and most private sector forecasts expect a "Goldilocks" economy in the next two years: neither too hot, nor too cold. The markets think that the central banks can rein in inflation without taking interest rates to a level that dampens growth. But the possibility cannot be ruled out that other, more pessimistic, outcomes may prevail:

- Higher oil and commodity prices may squeeze profits unduly and boost inflation, leading to an unpleasant bout of stagflation.
- The central banks may damage economic growth unnecessarily by exaggerating the threat of inflation and raising interest rates too aggressively.
- The central banks may misjudge and understate the inflationary pressures, stop fiscal tightening too early, and subsequently be forced to tighten more savagely if inflation accelerates.

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Table 2. The Major Currencies
Market Consensus of Exchange Rate Forecasts for Next 24 Months

	Actual			Forecasts				
	end-04	end-05	28.04.06	3-month	6-month	12-month	18-month	24-month
US$ per euro	1.359	1.182	1.262	1.27	1.30	1.34	1.37	1.40
Yen (100s) per US$	1.025	1.181	1.137	1.10	1.07	1.03	1.00	0.97
US$ per £	1.920	1.718	1.823	1.78	1.74	1.74	1.79	1.83
Chinese yuan per US$	8.28	8.07	8.017	7.95	7.85	7.50	7.00	6.70
£ per euro	0.708	0.688	0.692	0.71	0.75	0.77	0.77	0.77