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GLOBAL ECONOMIC GROWTH TO SLOW IN 2006

Washington, DC—Due to the upsurge in world energy prices, growth of the world economy will slow considerably, from 5 percent in 2004 to 4 percent this year to a bit over 3 percent in 2006. This growth slowdown includes the likely down-then-up effects of the economic dislocation and subsequent rebuilding from Hurricane Katrina in the United States, as well as the further firming of energy prices engendered by the hurricane and its aftermath. The attached table provides a detailed forecast for all key parts of the world.

This slowdown is likely despite recent signs of strengthening growth in Japan and Germany and the probable positive effects on confidence of the election results in Japan and the upcoming election in Germany—leading to reforms that may be expected to enhance growth prospects for these two large economies in the medium to longer term. The projected slowdown also contrasts with the recent buoyancy in world equity markets and with the still generally optimistic projections of most economic forecasters.

These are the main conclusions of today's semi-annual assessment of global economic prospects by a panel of three senior fellows at the Institute for International Economics: Martin Baily, chairman of the Council of Economic Advisers under President Bill Clinton; Michael Mussa, former chief economist at the International Monetary Fund and

member of the Council of Economic Advisers under President Ronald Reagan; and Adam Posen, the Institute's expert on Germany and Japan.

Baily and Mussa foresee a significant negative impact on real consumption growth from higher energy prices, implying that US real GDP growth for 2006 will fall to no more than about 2½ percent. This compares with the 3½ percent growth now expected for 2005 and the 4¼ percent growth achieved in 2004. As emphasized by Baily, a slowdown in residential investment and in the rise of house prices should be expected to contribute to the general slowing of economic growth in the United States.

Elsewhere around the world economy, high energy prices will also tend to slow demand and output growth. Also, as stressed by Mussa, the need of other countries to adjust to slowing of export growth to the United States and the need to end, and ultimately partially reverse, the burgeoning US external deficit will be a negative influence on growth and probably on business confidence in many countries. Further slowing of investment growth in China and continuing expansion of China's already large trade surplus, engendered partly by China's still greatly undervalued exchange rate, are also important negative influences on global growth. Mussa concludes that global growth will slow from 5 percent in 2004 and 4 percent in 2005 to 3½ percent or less in 2006.

Posen foresees that Prime Minister Junichiro Koizumi's decisive election victory will reinvigorate important economic reform efforts in Japan and boost consumer and business confidence, providing a positive impetus to stronger Japanese economic growth. A similar victory by reform-oriented politicians in Germany's upcoming election could supply an economic boost in that country, though resistance to reform is greater. Even for these economies, however, the near-term boost may be insufficient to overcome the headwinds

from higher energy prices and weaker export markets. At the global level, the effect will not be large enough to offset the factors tending toward economic slowdown.

About the Speakers

Michael Mussa, senior fellow since 2002, served as the chief economist at the International Monetary Fund from 1991 to 2001, where he was responsible for advising the Fund's Executive Board and the management on broad issues of economic policy and for providing analysis of ongoing developments in the world economy. Dr. Mussa served as a member of the US Council of Economic Advisers from August 1986 to September 1988. He was a member of the faculty of the Graduate School of Business at the University of Chicago (1976–91) and was on the faculty of the Department of Economics at the University of Rochester (1971–76). During this period he also served as a visiting faculty member at the Graduate Center of the City University of New York, the London School of Economics, and the Graduate Institute of International Studies in Geneva, Switzerland. He has published widely on macroeconomics, monetary economics, international economics, and municipal finance in professional journals and research volumes. He is the author of *Argentina and the Fund: From Triumph to Tragedy* (2002).

Martin Neil Baily, senior fellow since 2001, was the chairman of the Council of Economic Advisers and a member of the Cabinet from August 1999 until January 2001, after having been a member of the Council of Economic Advisers during 1994–96. He was a principal at McKinsey and Company during 1996–99, where he co-led its Global Institute's projects on services and manufacturing productivity in a number of major countries (including Brazil, France, Germany, Korea, Russia, and the United Kingdom). Dr. Baily has taught at MIT, Yale, and the University of Maryland and was a senior fellow at the Brookings Institution

through most of the 1980s, where he cofounded the microeconomics issue of the Brookings Papers on Economic Activity. He was also an academic adviser to the Congressional Budget Office and the Federal Reserve Board. His research at the Institute focuses on the international competitive position of the United States and possible strategies to increase productivity and growth in Europe. He is the coauthor of *Transforming the European Economy* (2004).

Adam Posen, senior fellow, has been associated with the Institute since 1997. He was an economist in the International Research Function of the Federal Reserve Bank of New York from 1994 to 1997. In 1992–93 he was the Arthur D. Okun Memorial Fellow in Economic Studies at the Brookings Institution, and in 1992–93 he was a Bosch Foundation Fellow in Germany. He is the author or editor of several works on monetary policy and political economy, including *The Euro at Five: Ready for a Global Role?* (2005) and *Restoring Japan's Economic Growth* (1998).

About the Institute

The Institute for International Economics, whose director is C. Fred Bergsten, is the only major research center in the United States that is devoted to global economic policy issues. The Institute's staff of about 50 focuses on macroeconomic topics, international money and finance, trade and related social issues, and international investment, and covers all key regions—especially Europe, Asia, and Latin America. The Institute averages one or more publications per month; holds one or more meetings, seminars, or conferences almost every week; and is widely tapped over its popular Web site (www.iie.com).

Table 1 Annualized percentage change of real GDP growth rates, year over year (Yr/Yr) and fourth quarter to fourth quarter (Q4/Q4)

| Country/region | 2004 Yr/Yr | 2005 Yr/Yr | 2006 Yr/Yr | 2005 Q4/Q4 | 2006 Q4/Q4 |
|---|---------------|---------------|---------------|---------------|---------------|
| Industrial countries | 3 | 2¼ | 2 | 2½ | 2¼ |
| United States | 4¼ | 3½ | 2¾ | 2¾ | 2½ |
| Japan | 2½ | 1½ | 1½ | 1¾ | 1¼ |
| Western Europe | 2¼ | 1½ | 1½ | 1½ | 1½ |
| United Kingdom | 3¼ | 2 | 2 | 2 | 2 |
| Other non-euro area | 3 | 2 | 2 | 2 | 2 |
| Euro area | 1¾ | 1¼ | 1¼ | 1½ | 1¼ |
| Germany | 1½ | 1 | 1¼ | 1½ | 1¼ |
| France | 2 | 1½ | 1¼ | 1½ | 1¼ |
| Italy | 1 | 0 | ½ | ½ | ¾ |
| Other euro area | 2¼ | 2¼ | 1¾ | 2¼ | 1¾ |
| Other industrial countries | 3 | 2½ | 2¼ | 2½ | 2¼ |
| Emerging-market and developing countries | 7¼ | 6 | 5¼ | | |
| Asia | 8 | 7¼ | 6½ | | |
| China | 9½ | 9 | 7½ | | |
| India | 6½ | 7 | 6½ | | |
| Other Asia | 5¾ | 4 | 3¾ | | |
| Latin America | 6 | 3¾ | 3¼ | | |
| Argentina | 8¾ | 6½ | 4 | | |
| Brazil | 5 | 3 | 3 | | |
| Mexico | 4 | 3½ | 3 | | |
| Other Latin America | 8 | 4½ | 3¾ | | |
| Central and Eastern Europe | 7 | 5 | 4½ | | |
| Middle East | 5 | 5 | 4½ | | |
| Africa | 4¾ | 4½ | 4 | | |
| | | | | | |
| World (WEO weights) | 5 | 4 | 3½ | 3¾ | 3¼ |