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CONTINUED SOLID GLOBAL GROWTH IN 2005 BUT RISING RISKS FOR 2006

Washington, DC—In its semiannual assessment of global economic prospects, experts from the Institute for International Economics foresee global growth moderating to 4 percent this year and slightly slower in 2006, from the very rapid 5 percent advance of 2004. However, high world oil prices, increasing inflationary pressures in key economies, and the need to unwind major international imbalances (especially those of the United States and China) imply rising risks for both growth and inflation in 2006.

The Institute today released this new economic assessment by three of its senior fellows: former International Monetary Fund chief economist Michael Mussa, former Council of Economic Advisers Chairman Martin Baily, and former IMF Deputy Director Morris Goldstein.

All three concluded that the very rapid pace of global economic expansion in 2004—led by strong demand growth in the United States and China—could not be sustained. To contain risks of rising inflation, growth needs to decline to a pace consistent with economic potential, and the pattern of growth needs to become better balanced across sectors and around the world. Nevertheless, solid sustained growth remains likely if three important risks can be averted.

Mussa emphasizes that high and rising energy prices are a key risk for global growth while also putting upward pressure on inflation. Baily stresses that this energy price behavior largely reflects rising world demand against world supply that is difficult to expand rapidly—a situation that seems likely to persist for some time.

More generally, both Baily and Mussa note that rising rates of "core" inflation, especially in the United States, suggest that margins of slack are becoming small in several key countries. Hence there is a threat of inflationary pressures that may require more aggressive monetary tightening than is now generally anticipated in world financial markets.

Baily worries that too great a slowdown in US demand growth (reflecting higher energy prices and monetary tightening) could lead to output growth to fall below potential and unemployment to rise, especially if US net exports continue to deteriorate. On a slightly different tack, Mussa expresses concern that necessary improvements in US net exports (to correct an unsustainably large current account deficit) will come when there is not enough room in the US economy to accommodate both rapidly rising domestic demand and improving net exports. Without determined action to reduce the US fiscal deficit, this is likely to mean sharply tighter US monetary policy, generally higher world interest rates, and an important negative impetus to global growth—possibly as early as 2006.

Goldstein focuses on the other key driver of global growth—the Chinese economy. He emphasizes that the recent very strong growth of demand in China is based on unsustainably rapid investment growth (over 20 percent per year), which has driven the ratio of gross domestic investment to GDP above 45 percent. Growth in China, Goldstein concludes, will need to slow significantly over the next few years from the 9½ percent advance of 2004.

Meanwhile, recent trade data suggests that the Chinese current account surplus is expanding rapidly. On top of other evidence, including the massive accumulation of foreign exchange reserves by the Chinese government in recent years, Goldstein argues that this demonstrates substantial undervaluation of the pegged exchange rate of the Chinese renminbi. In view of China's economic importance in Asia and in the world economy, this pronounced and persistent undervaluation should be promptly corrected through a substantial revaluation of the Chinese currency.

Elsewhere in the world, Mussa assesses that growth prospects remain solid in most emerging-market and developing countries but are subdued in much of Western Europe and Japan (see table 1). This leaves the challenge of what will make up for slowing demand growth in the United States and China and keep global output expanding in line with potential in 2006 and beyond.

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).

Morris Goldstein, Dennis Weatherstone Senior Fellow since 1994, has held senior staff positions at the International Monetary Fund (1970–94), including deputy director of its Research Department. He has written extensively on international economic policy and on international capital markets. He is author, coauthor, or coeditor of numerous Institute books, including *Controlling Currency Mismatches in Emerging Markets* (2004), *Managed Floating Plus* (2002), *Assessing Financial Vulnerability: An Early Warning System for Emerging Markets* with Graciela Kaminsky and Carmen Reinhart (2000), *Asian Financial Crisis: Causes, Cures, and Systemic Implications* (1998), *The Case for an International Banking Standard* (1997), *Private Capital Flows to Emerging Markets After the Mexican Crisis with Guillermo Calvo* (1996), and *The Exchange Rate System and the IMF: A Modest Agenda* (1995). In addition, he was project director of *Safeguarding Prosperity in a Global Financial System: The Future International Financial Architecture* (1999) for the Council on Foreign Relations Task Force on the International Financial Architecture.

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 Global economic prospects, assessment of April 6, 2005
(annualized percentage change of real GDP growth rates)

Country or region	**2004 Yr/Yr**	**2005 Yr/Yr**	**2006 Yr/Yr**	**2005 Q4/Q4**	**2006 Q4/Q4**
Industrial countries	3¼	2½	2½	2¾	2½
United States	4½	3¾	3¼	3½	3¼
Japan	3	1¼	2¼	2	2
Western Europe	2¼	1¾	2	2	2
United Kingdom	3	2½	2½	2½	2½
Other non euro area	3	2½	2½	2½	2½
Euro area	2	1½	2	2	2
Germany	1¾	¾	1½	1¾	1¾
France	2¼	1¾	2	2	2 ¼
Italy	1¼	1¼	1¾	1¾	2
Other euro area	2½	2¼	2¾	2½	2¾
Other industrial countries	3	2¾	2¾	2¾	2¾
Emerging-market and developing countries	7¼	5¾	5¼		
Asia	8¼	7	6¾		
China	9½	8¼	7¾		
India	6½	6½	6		
Other Asia	6¼	5	4¾		
Latin America	6¼	4¼	4		
Argentina	8¾	5	4		
Brazil	5	4	4		
Mexico	4½	3¾	3½		
Other Latin America	8½	4½	3¾		
Central and Eastern Europe	6¾	5	4½		
Middle East	5	4½	4		
Africa	4¾	4¼	3¾		
World (WEO weights)	5¼	4	3¾		

Yr/Yr = year over year
Q4/Q4 = fourth quarter to fourth quarter