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Strong Growth, Rising Inflation, and Tighter Monetary Policies This Year Point to Slower Global Growth for 2007

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Overview

With stronger than expected growth in many countries so far this year, it is now likely that the year-over-year rise in global real GDP will exceed my early April forecast and reach nearly 5 percent (see table 1).¹ As anticipated, stronger growth has brought increased inflationary pressures, and monetary authorities are reacting with tighter policies. In the United States, slowing of growth is already apparent after two years of continuous monetary tightening. For much of the rest of the world, more recent monetary restraint is likely to affect growth primarily in 2007.

The risks of recession in the United States and a substantial slowdown in global growth in 2007 have clearly escalated but are still only moderate. US growth will most likely slow to barely 2 percent next year, after 3½ percent in 2006. For the world as a whole, the year-over-year growth rate will decline about a percentage point to 4 percent in 2006, partly reflecting significant slowing in some overheating economies, most notably China, as well as in the United States.

Under this scenario, global inflation is not expected to get much worse but is unlikely to recede significantly. Monetary policies in many countries will continue to tighten this year and in early 2007 and will then likely maintain firm stances as growth continues at a more moderate pace with inflation still a worry but not an increasing worry.

There are important risks to this baseline scenario—more so than the risks that have existed for the past three years of exceptionally good global economic performance. World oil prices rose further this summer in the face of some moderate supply problems and considerable concern about political risks, before falling back below \$70 per barrel since late August. Excess global production capacity to deal with further supply problems and to allow for rising global demand remains thin. A significant supply disruption resulting from political controversies in the Middle East or a combination of more minor problems around the world would sharply increase world energy prices. On top of the tripling of oil prices that has already occurred since 2002, and with monetary policies now much less accommodative, the negative impact on global growth would likely be substantial. On the other hand, commercial inventories of oil are now above normal, and a relaxation in the tight global supply/demand situation (perhaps due partly to slowing global demand growth) could lead to

¹ The forecast for global real GDP growth for 2006 is ¾ percent higher than my forecast of early April 2006. About ¼ percent of this upgrade reflects revision of the country weights used to construct the global aggregate (giving more weight to more rapidly growing countries, especially China). The other ½ percent revision reflects upgrades to the growth forecasts for individual countries or regions.

a sharp fall in world oil prices. This would help alleviate inflationary pressures, reduce the need for monetary tightening, and contribute to stronger global GDP growth. The balance of risks with respect to world oil prices, however, still lies more with concerns about further price increases.

More generally, there is significant uncertainty about the strength of underlying inflationary pressures in the world economy. In the United States, despite some more favorable recent data, measures of core inflation as well as overall inflation have generally headed up in recent months and are at levels above those desired by the Federal Reserve. Other industrial-country central banks (including the European Central Bank, the Bank of England, the Bank of Canada, and the Reserve Bank of Australia) find themselves in a similar situation or worry that they may soon be. The expectation is that modest further monetary tightening will suffice to contain inflationary pressures. But, there is a danger that inflationary pressures are stronger than generally understood and that monetary policies will need to be tightened significantly more than now anticipated. The result would likely be slowing of 2007 GDP growth to a greater extent than now forecast.

Many developing countries face similar concerns about rising inflation and the policy responses thereto. A number of developing-country central banks, including the Reserve Bank of India, have tightened their policies in the face of rising inflation, and the extent of further tightening that may be needed is a significant uncertainty. Although reported inflation in China has remained low, an overheating economy fueled by rapid credit expansion is clearly now a key concern of the government. The nature and effectiveness of the policy reaction to this situation will have important implications for growth next year—which will likely slow significantly from its recent rapid pace.

Large international payments imbalances—specifically, the large current account deficit of the United States and the corresponding surpluses of the rest of the world—provide additional risks for global growth prospects. On the one hand, significant slowing of domestic demand growth in the United States while demand in the rest of the world continues to grow reasonably robustly will contribute to a turnaround from further deterioration to gradual improvement in the US current account. This should lessen the future danger of a “hard landing” for the dollar.

On the other hand, if the US economy slows so much (and US inflationary pressures accordingly abate) that the Federal Reserve responds with a sharp easing of monetary policy, then the dollar would likely come under downward pressure against most other currencies. For Europe and Japan, this would mean that the usual negative effect on exports to the United States from a weakening US economy would be magnified by the effects of currency appreciation—thereby spreading the effects of a US recession to other industrial countries. For China and other countries that tie their exchange rates closely to the US dollar, this exchange rate magnification effect would not immediately operate. Instead, the real effective exchange rates of these countries would likely depreciate as their currencies followed the US dollar down against the currencies of other industrial countries.

But, in the face of weakening employment in the United States and other industrial countries, protectionist rage against the currency policies of a number of developing countries would surely escalate—and not entirely without reason. China, which has overall current account surplus now rising from 7 to 8 or even 9 percent of GDP this year and is rapidly accumulating foreign exchange reserves beyond the scale of any other country, would be the number one target. Although this scenario is not the most likely, the threat that it potentially poses for both global growth and the maintenance of the principles of an open international trading system merits some concern.

The Americas

After rebounding strongly in the first quarter of 2006 to record 5.6 percent annualized real GDP growth, the US economy slowed to just below a 3 percent estimated growth rate in the second quarter. Many considerations suggest that for the next few quarters, the US economy will grow significantly more slowly than the 3¾ percent average annual rate of the past three years. Residential investment is in a slump and clearly has to go down further before it levels off. Consumer spending

is no longer being boosted by rapidly rising home values and mortgage refinancing, while high energy prices and increased payments on variable rate mortgages are cutting deeper into disposable income. To restore at least a modestly positive personal saving, consumer spending growth will need to slow below income growth—probably down to only 2 percent per year.

Business investment in equipment, software, and structures will probably continue moderately vigorous growth for a while, spurred by strong profits, high capacity utilization, and rising exports. But this strength will tend to wane as it becomes clear that the slowdown in consumer spending growth is likely to persist for some time. With government purchases likely to show only modest growth, all of this implies that US real domestic demand over the next year or so is likely to rise at only about half of the 4 percent annual rate of the past three years. Real net exports may show modest improvement as import volume growth slows under the impact of weaker domestic demand growth while export volume growth remains strong. (Nominal net exports and the current account balance, however, will continue to deteriorate because of the effect of rising import prices [particularly for energy] and the large existing excess of the value of imports over the value of exports). Such a gain in real net exports will provide a slight boost to US real GDP growth but not enough to raise it much above 2 percent.

This forecast is a percentage point below the Federal Reserve's forecast described by Chairman Ben Bernanke in his July testimony and is also below the consensus forecast of other economists. I believe, however, that the Fed and most other forecasters are underestimating the power of the forces tending to slow US growth. Moreover, it is clear that if the Federal Reserve really wants to bring inflation down from its recent up-tick, growth of the US economy will need to slow meaningfully below potential for at least a year or so. My forecast envisions such a slowdown and, accordingly, assumes only another 25 basis points of Fed tightening. However, if the US economy grows at 3 percent—in line with its potential—then significantly more Fed tightening will likely be needed. This will mean somewhat stronger growth than my forecast for the next couple of quarters, but then a more substantial slowdown—possibly a recession.

Indeed, even without further significant Fed tightening, the risk of recession in the United States has gone up somewhat relative to the low level that has prevailed for the past three years. The reason for this is simple. When the economy is expected to grow at only about a 2 percent rate, the risk that some unexpected disturbance may tip the economy into recession is obviously greater than when the economy is growing more vigorously at nearly a 4 percent rate. The disturbance could come from a variety of sources: a sharp further rise in energy prices, an upsurge in longer-term interest rates in response to declining foreign capital inflows, a larger than now projected slump in residential investment, a sudden desire of consumers to raise their saving rates, or fall in business confidence that cuts sharply into investment.

The risks of recession, however, should not be exaggerated. Taking account of the postwar business cycle history of the United States (11 expansions lasting an average of about five years and 10 recessions lasting an average of a little less than one year) and the general decline in the volatility of GDP growth over the past 25 years, the normal probability that the US economy will enter recession over the next 12 months (given that it is now in expansion) should be assessed at about 12 to 15 percent. (This is consistent with an expected length of expansions of 6½ to 8 years.) With a projected slowdown of growth to only about 2 percent and with the recent weak performance of leading indicators for the US economy, the probability of recession over the next year or so now looks to be about double the normal probability—something in the range of 25 to 30 percent.²

In **Canada**, growth picked up to over 3 percent in the first quarter (from four quarters earlier), and both overall and core consumer prices have recently shown signs of acceleration. The

² It is almost never the case that the assessed probability of entering a recession in the next 12 months exceeds 50 percent until a recession is actually underway. This reflects the fact that leading indicators of recession are not highly reliable, as well as the fact that periods of recession are relatively rare in comparison with periods of expansion (on average, there have been about six months of expansion for every month of recession during the past 60 years of US economic history).

Bank of Canada has responded with interest rate tightenings (amounting to 175 basis points from a year ago) and suggested that there may be more to come. The experience of the past four years, with unemployment declining to a multi-decade low as the Canadian economy has grown on average at $2\frac{3}{4}$ percent per year, suggests that the potential growth rate is probably no more than $2\frac{1}{2}$ percent. With the spillover effects from weaker growth south of the border, I expect that Canadian monetary policy will deliver a growth rate in line with potential in 2007 after somewhat exceeding this rate in 2006.

In **Mexico**, the economy rebounded in the first quarter to record a 5.5 percent gain over the same quarter in 2005. Reflecting slower growth in the United States and some adverse economic effects from the political turmoil surrounding Mexico's close presidential election, growth in the Mexican economy will likely slow during the remainder of this year and continue at a more sluggish pace in 2007. Nevertheless, on a year-over-year basis my growth forecast for 2006 is boosted by half a percentage point to 4 percent. For next year, I expect that growth will continue at barely above 3 percent.

In **Argentina**, growth has remained very robust supported by strong domestic demand growth. The trade balance, however, has deteriorated only modestly, thanks to the maintenance of a substantially undervalued exchange rate and strong demand for Argentine commodity exports. Although partially suppressed by price controls and government jawboning, inflation is running at about 12 percent—triple and quadruple the rates in Brazil and Mexico, respectively. Growth is now expected to reach at least 7 percent this year and slow to about 5 percent next year. Eventually the inconsistencies in Argentine economic policies will need to be unwound, probably in a messy fashion; but that time still looks a couple of years away.

In **Brazil**, output growth has accelerated after a sharp (but brief) slowdown during 2005—with good outcomes in both the fourth quarter of last year and the first quarter of this year. Economic activity, however, slowed significantly in the second quarter, making it unlikely that year-over-year growth for 2006 will reach the government's forecast of 4 percent. With support from easier monetary policy (justified by low and falling inflation), real GDP growth should rise to close to 4 percent in 2007, despite some negative effects from slower growth in the rest of the world. Moreover, Brazil's central bank still appears to have room to ease further, without inducing inflation risks, and the exchange rate of the *real* could fall back somewhat after the strong appreciation since 2003.

For the other (economically significant) countries in **Latin America**, real growth this year generally appears quite solid (and in line with forecast), running between about 3 percent for the more slowly growing countries like Bolivia and Ecuador and $5\frac{1}{2}$ to 6 percent for the stronger performers like Chile, the Dominican Republic, and Peru. On the back of very strong oil prices, the Venezuelan economy continues to grow particularly strongly.

In 2007 growth for these countries, on average, is likely to be somewhat lower than this year—reflecting slower global growth, less favorable global financial conditions, and natural slowdowns in some countries enjoying recoveries from earlier difficulties. Specifically for Chile, a modest slowing from $5\frac{1}{2}$ to 5 percent growth will reflect some further normalization of domestic interest rates by the central bank, as well as somewhat less buoyancy in key export markets. For Colombia, the upsurge in consumer spending that boosted growth early this year will probably wane somewhat as time passes, implying a slight slowdown from nearly 5 percent growth in 2006 to $4\frac{1}{4}$ percent growth for 2007. For Peru, uncertainties about the policies of the new Garcia administration and waning of special factors (including the surge in gold exports) that aided growth this year suggest that growth will slow from nearly 6 percent to about 5 percent. For Venezuela, the special benefits from the rebound from the steep recession of 2002/2003 should be exhausted this year, and growth next year will slow to a still vigorous 5 percent rate.

For Latin America as a whole, all of this suggests that growth this year should come in at about $4\frac{1}{2}$ percent, about $\frac{1}{4}$ percent above the early April forecast. For 2007, a slowdown to a little below 4 percent growth is expected.

Asia

Although they aggregate to 37 percent of world GDP (on the basis of the *World Economic Outlook's* purchasing power parity (PPP)-based exchange rates), the economies of Asia in recent years have accounted for well over half of world GDP growth. This pattern continues in 2006 and will almost surely be true thereafter.

In **Japan**, after a decade when real GDP growth averaged barely 1 percent per year, for the past three years it has averaged 2¼ percent. With strong performance at the end of last year, which moderated somewhat in the first quarter, Japan now looks set to achieve nearly 3 percent growth for 2006. While low by the standards of pre-1990 Japan, this growth rate likely exceeds the potential (or no more than 2 percent real growth) for a country with a declining labor force and population and an industrial technology that has already caught up with, and in some cases surpassed, the best elsewhere in the world.

With an end to the deflation of recent years, the Bank of Japan terminated its policy of quantitative easing this spring and moved to a modestly positive (25 basis points) policy interest rate in July. Acceleration of inflation to undesirable levels does not appear to be an imminent threat. Nevertheless, the Bank of Japan is likely to proceed gradually to increase its policy interest rate to about 1 percent over the next 9 to 12 months. This by itself should not much impede growth of the Japanese economy. However, weakening of growth in Japan's key export markets and the normal tendency toward slowing in an economy nearing potential suggest that Japanese growth for 2007 will slip back to about 2¼ percent.

Among industrial countries, **Australia** (along with the United Kingdom) has led the current global recovery. As the Australian economy felt little effect from the global slowdown of 2001 and benefited significantly from the subsequent global commodity boom, Australian monetary policy needed to tighten already in 2003 to avoid overheating. Subsequently as growth slowed somewhat (including in the housing sector), monetary policy was eased back modestly. Most recently, as economic growth and inflation have picked up somewhat, the Reserve Bank has responded by increasing its policy interest rate to 5.75 percent—the highest among industrial countries (aside from New Zealand and tiny Iceland).

Over the past four years, average annual real GDP growth in Australia of 3.3 percent has been associated with a decline in the unemployment rate from 6.4 to 5.1 percent—the lowest in decades. This suggests both that the potential growth rate of the Australian economy is a little less than 3 percent and that the current level of GDP may well be above potential. Hence, if the Reserve Bank is to achieve its target of keeping inflation between 2 and 3 percent, it will need to tighten monetary policy sufficiently to slow the growth rate of the Australian economy meaningfully below 3 percent for at least a few quarters. I believe that this will happen before much longer. Accordingly, while the forecast for GDP growth this year remains at slightly over 3 percent, the forecast to 2007 envisions growth slowing below 3 percent.

Contrary to my April forecast of some slowing of growth in **China** this year, the results so far show an acceleration, with real GDP growth of 11.3 percent estimated for the second quarter versus the same quarter a year ago. Even with the government's efforts to slow the economy in the second half, it is now likely that growth this year will top last year's 10.2 percent rise (compared with my early April forecast of 9 percent growth for China this year). Growth is being driven by a further surge in fixed investment, taking its share of GDP up to an incredible 45 percent of GDP. Rapid increases in bank credit (which has already almost reached the central government's target for the entire year) have fueled this investment surge.

Strong gains in exports, significantly in excess of import growth, have also contributed to the expansion. The trade surplus so far this year is running well ahead of last year's pace, indicating that the annual outcomes for both the trade and current account surpluses will be about 2 percent of GDP larger than in 2005. This means a rise in the current account surplus to about 9 percent of GDP for 2006. Meanwhile, under China's policy of allowing only very gradual appreciation of the yuan against the US dollar, foreign exchange reserves continue to pile up at a prodigious rate,

exceeding \$940 billion by end June—the largest in the world. By year-end, reserves will surely surpass \$1 trillion.

Not only does China's exchange rate policy contribute to a rising trade balance by keeping the relative price of Chinese exports artificially low but also its financial consequences are driving monetary expansion, and the combined effect is to distort significantly the pattern of Chinese economic development. Specifically, the People's Bank of China (the Chinese central bank) finds it difficult to sterilize all of the monetary effect of the massive increases in its foreign exchange reserves, thereby contributing to rapid money and credit growth. This, in turn, fuels massive investment spending (as firms rather than consumers are the main recipients of bank credit). Meanwhile the hyper-competitive exchange rate distorts the pattern of investment toward export-oriented industries and related infrastructure.

These developments are the direct opposite of the stated goals of the Chinese authorities, which are to shift growth in favor of consumption and to shift investment toward consumption-related industries and toward the development of the interior of the country. Policy actions by the central government, however, have been inadequate to move outcomes in the desired directions. The increase in the central bank's interest rate this spring is far too small to deter rapid credit growth. Government efforts to redirect investment in line with its priorities run up against the powerful incentives to go the other way that are implicit in an undervalued exchange rate.

As in past episodes of overheating, application of direct controls on bank lending and "moral suasion" by the government will probably rein in and redirect credit growth—although in an inefficient manner. For the near term, this will curb the investment surge and contribute to a slowing of Chinese real GDP growth in the second half of 2006 and next year, leading to a forecast of 8³/₄ percent real GDP growth year-over-year for 2007. Such a growth slowdown, however, will not address the fundamental imbalances in the Chinese economy that continued to be fostered by a substantially undervalued currency.

In **India**, growth has also been somewhat stronger than forecast so far this year, and the forecast needs to be revised up from 7 percent real GDP growth to 7³/₄ percent. In contrast with China, consumption spending (along with investment) has been a key driver of the Indian economy. Also, India's trade balance has deteriorated further under the impact of rising energy import costs and will likely reach 8 percent of GDP this year. Thanks to service earnings and income transfers, the current account deficit is substantially smaller than the trade deficit, but it is likely to rise to 3 percent of GDP this year. Worries about the deteriorating trade and current account balances have put modest downward pressure on the rupee.

Meanwhile, consumer price inflation has picked up somewhat, partly reflecting increased pass-through of rises in world energy prices to domestic prices. The Reserve Bank of India has responded to these developments with modest monetary tightening and has suggested that there may be more to come. The central government's fiscal balance has deteriorated modestly (as a share of GDP) but will be under greater pressure if domestic interest rates continue to rise. With monetary policy tightening and fiscal policy broadly neutral, with the external environment turning moderately negative, and with the erosion of some of the special factors that have recently boosted Indian economic growth, it is reasonable to expect that growth for 2007 will come in somewhat below 2006, say about 7 percent.

In the rest of **emerging Asia**, growth this year now appears likely to slightly exceed 5 percent, versus an early April forecast of 4¹/₂ percent. While the factors are somewhat mixed across different economies, the basic story is that both domestic demand growth and export growth have been modestly stronger than earlier expected.

Meanwhile, inflation has picked up in some of these countries, and central banks have responded with monetary tightening. Together with a likely fall off of export growth to the United States and other countries (probably including China), this suggests that growth prospects for 2007 are modestly weaker than for this year—down to 4¹/₂ percent real GDP growth projected for 2007.

Europe

For **Western Europe**, the early April forecast of 2 percent growth for 2006 now appears to be about $\frac{1}{2}$ percent too low. In line with this modest aggregate adjustment, the adjustments to the forecasts for individual countries are all also generally positive and modest.

For the **euro area**, with good results now in for the second quarter, the growth forecast for 2006 is upgraded by $\frac{1}{2}$ percent. Germany appears to be coming in $\frac{1}{2}$ percent stronger than earlier forecast, with growth now projected to be $2\frac{1}{4}$ percent. Both France and Italy also look a little stronger than expected, with growth rates now projected to be $2\frac{1}{4}$ and $1\frac{1}{2}$ percent, respectively. Spain is likely to reach the $3\frac{1}{2}$ percent growth forecast in April. Most of the smaller euro area countries are doing a little better than earlier expected.

With growth improving to about $2\frac{1}{4}$ percent from last year's $1\frac{1}{2}$ percent result, and with inflation rising above the desired ceiling of 2 percent and money growth still exceeding target, the European Central Bank (ECB) has continued to tighten monetary policy, raising its key policy interest rate by 100 basis points to 3 percent since last November. Unlike the Federal Reserve two years ago, the ECB has not suggested a schedule for future policy tightening. In view of the growth and inflation data, however, it seems clear that further tightening is on the way, with the policy interest rate likely to be raised one or two more times this year. Assuming that growth does not slow below about $1\frac{1}{2}$ percent, the policy rate will probably reach 4 percent early next year. If (headline) inflation falls back to 2 percent (because energy prices stop rising), this would imply that in real terms the policy interest rate is 2 percent—not exceptionally easy but not particularly tight. It remains to be seen how much more the ECB will feel it has to do to keep inflation adequately contained.

The fact that the unemployment rate in the euro area and the unemployment rates in most of its member countries have declined over the past three years, while growth has averaged less than $1\frac{1}{2}$ percent per year, suggests that potential output growth in the euro area is below 2 percent, perhaps even below $1\frac{1}{2}$ percent. With the unemployment rate now down almost to the low reached at the end of the last expansion (when inflation was headed up), the ECB is more likely to be reassured rather than worried if growth next year falls off somewhat from this year's pace. Indeed, the mandate of the ECB to focus primarily on inflation (rather than growth) and the record of the past six years of inflation running slightly but consistently above its desired ceiling are likely to make the ECB more cautious than the Federal Reserve about the risks of ending monetary tightening too soon.

With this in mind, it seems prudent to forecast that euro area growth next year will fall below 2 percent. In addition to ECB tightening, this slowdown will likely reflect weaker export growth, perhaps partly induced by some further appreciation of the euro against the dollar.

In the **United Kingdom**, growth now looks likely to come in about $\frac{1}{4}$ percent stronger than the early April forecast of $2\frac{1}{4}$ percent. Inflation pressures also appear to have picked up somewhat. Thus financial markets should not have been so surprised when the Bank of England's Monetary Policy Committee decided to boost the repo rate by 25 basis points at its August meeting. The subsequently released inflation report indicates that the possibility of inflation running above target is likely to remain a key concern, but it is not clear whether further tightening will be needed to contain this risk.

Significant slowing of the US economy and some slowing of the euro area economy next year will be negative factors for UK export growth. This could be offset by sharp depreciation of sterling against the euro—which would make sense in light of Britain's rising current account deficit and the possibility that future interest rate increases in the euro area will significantly exceed those of the Bank of England. A sharp decline in sterling, however, would add to inflationary pressures and likely provoke some interest rate response for the Bank of England.

Thus, all things considered, it is reasonable to forecast that there will be at least a modest slowing of real GDP growth in the United Kingdom next year. My assessment that the potential growth rate of the UK economy is about $2\frac{1}{4}$ percent suggests this rate as the baseline forecast.

The smaller Western European economies outside of the euro area (leaving tiny Iceland aside) are generally doing quite well and now seem likely to enjoy, in 2006, the strongest growth they have seen in a number of years. Sweden appears headed for nearly 4 percent growth. Switzerland's growth may reach almost 3 percent, and Denmark's economy should expand by at least 2½ percent.

For all of these countries, it is likely that growth will be somewhat slower next year. This partly reflects normal slowing after unusually strong growth (by the recent standards of these countries). It also reflects the likely negative impact of slower growth in key partner countries in Europe and North America. And it reflects the policy tightening that has recently started in response to some rising concerns about inflation.

Central and Eastern Europe and the Former Soviet Union

Among the countries of Central and Eastern Europe and the former Soviet Union, the Russian economy is performing as expected in early April, and growth of 6½ percent is still projected for this year. Most of the rest of the former Soviet Union is also performing about as expected in early April, with the energy-rich countries (Kazakhstan and especially Azerbaijan) growing strongly, and the Baltic countries (Estonia, Latvia, and Lithuania) continuing to do very well, while Ukraine suffers relative stagnation in the face of continued domestic political turmoil. Overall, the economies of the former Soviet Union will probably grow about 7 percent this year and slightly less rapidly in 2007.

In contrast, the Turkish economy has suffered from financial market nervousness about the large current account deficit and the now apparent overvaluation of the Turkish lira. A sharp monetary tightening (amounting to 400 basis points) by the Turkish central bank has been the necessary and appropriate response to stabilize the situation and has restored credibility to the inflation target. But the consequence is that growth is likely to be cut from 7½ percent in 2005 to about 4½ percent this year. At present there is little reason to expect a re-acceleration in 2007 as monetary policy is likely to need to retain a relatively firm stance to offset inflationary pressures that would otherwise emerge from a weakening lira in the face of a still large current account deficit.

In the economies of Central Europe, growth this year appears modestly stronger than was expected in early April, with the Czech Republic now expected to achieve 6 percent real growth while Poland's economy expands by nearly 5 percent and Hungary dodges the bullet for another year and grows by just over 4 percent. Trouble is brewing, however, especially in Hungary with its large budget and current account deficits. More generally, somewhat slower growth in Western Europe in 2007 is likely to spill over to affect growth to the east.

Middle East and Africa

Growth in both of these regions continues to benefit from very strong global commodity prices, including oil. The oil-exporting countries (Saudi Arabia, Kuwait, the smaller Gulf states, Algeria, Angola, and Nigeria) all continue to grow strongly, notwithstanding occasional supply disruptions in Nigeria; and real GDP growth rates in the range of 5 to 6 percent appear likely to continue at least through 2007. The Iranian economy is also expanding reasonably rapidly, aided by high oil export revenues; but growth prospects are somewhat clouded by the possibility of wider economic sanctions that might be imposed in response to Iran's continued nuclear development program.

The non-oil-exporting economies in these regions (most notably Egypt and South Africa) are also growing strongly this year and may reasonably be expected to continue with similar performance in 2007. In Africa, the strong economic performance of the past few years (and prospects for the future) has been significantly aided by the relative absence of armed conflicts, despite continuing difficulties in Somalia, Sudan, the Congo, and Cote d'Ivoire, and the mess in Zimbabwe. In the Middle East, the economy of Lebanon was clearly devastated by the August war, and growth this year in the significant-sized Israeli economy also felt a sharp but brief setback. In

Iraq, escalating sectarian violence is undoubtedly an important impediment to more rapid economic recovery, although there are some indications that economic activity is rising in more peaceful regions of the country.

On balance, if growth in the rest of the world economy is slowing by about one percentage point between 2006 and 2007, it is reasonable to expect that this slowdown will be reflected in somewhat less buoyant global commodity markets and more generally in a modest negative spillover to growth in Middle East and Africa.

Table 1 Real GDP growth rate projections (percent change, year over year)

Country/region	2005	2006	2007
Industrial countries	2¾	3	2
United States	3¼	3½	2¼
Canada	3	3	2½
Japan	2½	3	2¼
Western Europe	1¾	2½	2
United Kingdom	2	2½	2¼
Other West Europe	2¼	3¼	2½
Euro area	1½	2¼	1¾
Germany	1	2¼	1½
France	1¼	2¼	1¾
Italy	0	1½	2¾
Other euro area	2¾	3¼	2½
Developing countries	7	7	6
Asia	8½	8½	7
China	10¼	10¼	8¾
India	8½	7¾	7
Other Asia	4¾	5½	4½
Latin America	4¼	4½	3¾
Argentina	9¼	7½	4½
Brazil	2¼	3¾	3¾
Mexico	3	4	3¼
Other Latin America	7	5	4
Central and Eastern Europe	5	4½	4
Commonwealth of Independent States	7	7	6½
Russia	6½	6½	6
Middle East	6	5½	5
Africa	5¼	5½	4½
World	4¾	5	4