

1. The Global Economy: Volatile markets and increased downside risks

The robust global economy foreseen in last February's outlook has been borne out by recent developments. For the fourth year in a row, real world output will grow at more than 4%, with strong upward revisions for **China, India** and **Russia** accounting for two-thirds of recent forecast revisions. Leading indicators signal a healthy and sustained expansion for **Japan**, while the recovery in **Euroland** appears to be getting stronger every month. The **United States** seems to be the only country where forecasters expect the economy to slow in the second half of the year. But growth for the year will remain above trend of 3.25% and the fastest in the group of advanced countries.

At first blush, these developments support a soft landing scenario. Slower growth in the US, coupled with a marked pick up in the rest of the world, would provide for an **orderly reduction of global current account imbalances**. But such a scenario depends on two crucial factors. First, **core inflation** must continue to be well-behaved and not provoke abrupt monetary policy reactions. Second, the impact of **rising interest rates** on private consumption, particularly in countries that have experienced strong housing markets, must continue to be fairly negligible.

But low inflation and low interest rates may have been the result of unique developments soon to end.

According to the International Monetary Fund, an extraordinary confluence of global factors has contributed to wage and price restraint and low inflation, while "excess savings" by corporations (defined as retained earnings minus capital expenditures), which in 2003 and 2004 were more than twice the combined current account surpluses of emerging markets, has fostered an environment of unexpectedly low interest rates. However, the factors keeping a lid on inflation and holding global interest rates at exceptionally low levels are likely to disappear in future.

First on inflation: In light of tight labor markets in a number of advanced economies and rising commodity prices that are increasingly passed through into prices of final goods, global competition may no longer exert its beneficial influence in keeping a lid on inflation. In the United States, for example, the consumer price index rose 4.1% in the three months ending in April, compared with an increase of 3.4% in all of 2005. Excluding food and energy, core inflation rose 3.2% in the same three-month period, compared with 2.2% last year. These trends indicate an unwelcome jump in US inflation which may force the Federal Reserve to actually embark on a course of monetary tightening after having driven the federal funds rate to a roughly neutral level of 5% in the course of the past two years.

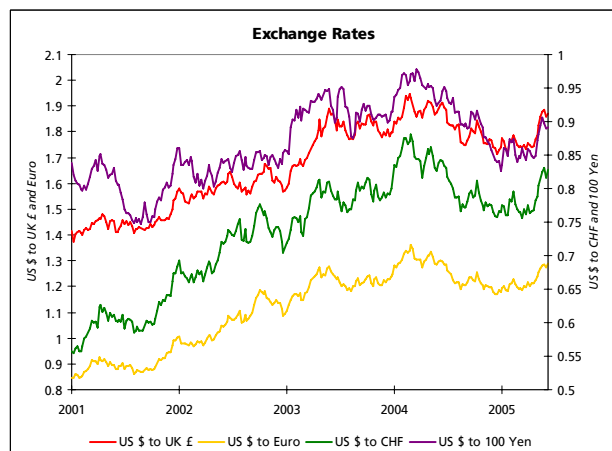
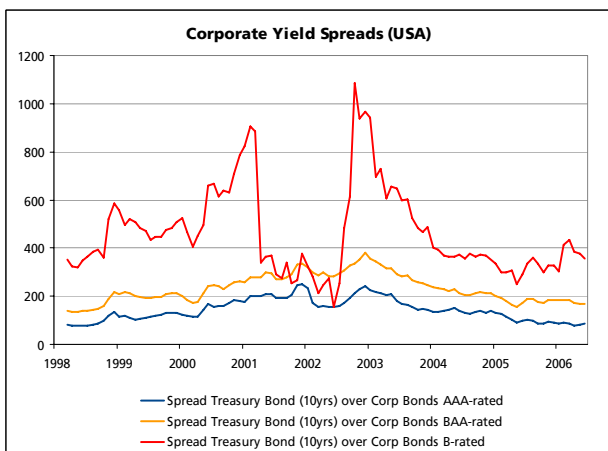
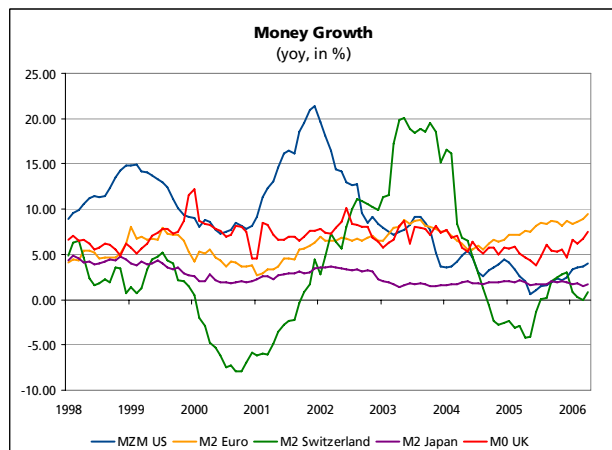
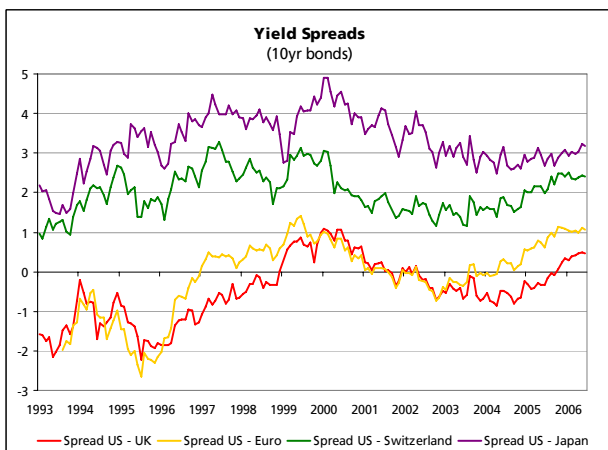
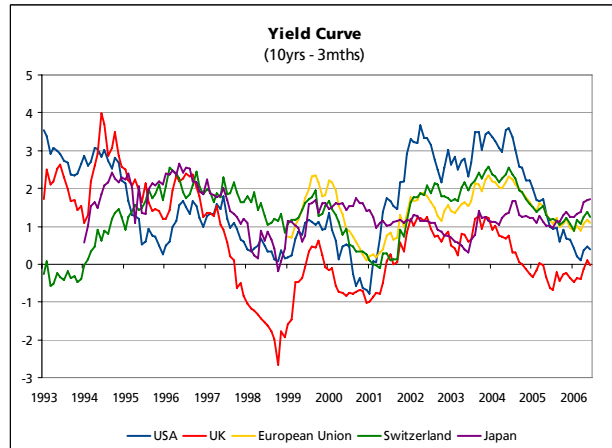
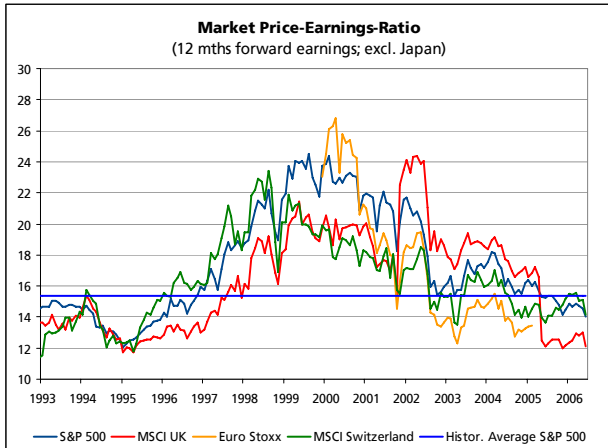
Second on interest rates: With capacity utilization rising in a number of countries, corporations are likely to increase capital expenditures. The corporate sector seems also to be ready to step up the pace of acquisitions.

These and other factors lead to the reasonable expectations that corporate excess savings are unlikely to be sustained at current record levels, and high corporate savings should no longer be relied upon to keep long term interest rates low.

Hence, risks to the short-term outlook are on the downside. This assessment is not even taking into account incalculable risks such as global pandemics or high and volatile commodity prices. More important is that monetary accommodation has been or will continue to be withdrawn in the US, Japan, and Euroland, and the investment/saving pattern among global corporations is about to change. Both developments are likely to push up long-term interest rates which may well exacerbate global current account imbalances. This is bound to increase pressure on unsustainable imbalances to be corrected. Hence, the question is not whether but how and when they will adjust. A benign goldilocks-scenario is possible. But an abrupt and disorderly adjustment, characterized by substantial dollar depreciation, an abrupt increase in interest rates and a sharp contraction of global growth, cannot be ruled out. Recent financial market turbulences appear to indicate that we are at the beginning of a volatile adjustment toward a new equilibrium with higher interest rates, slightly higher rates of inflation as well as lower and hopefully better balanced global growth.

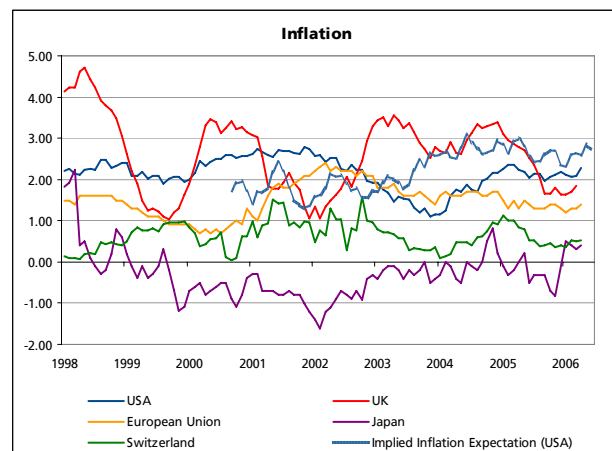
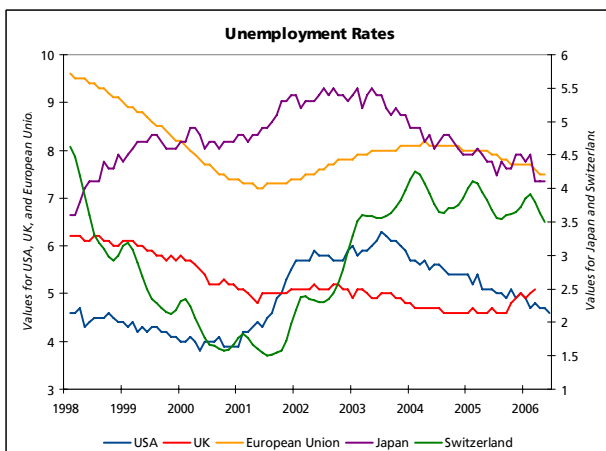
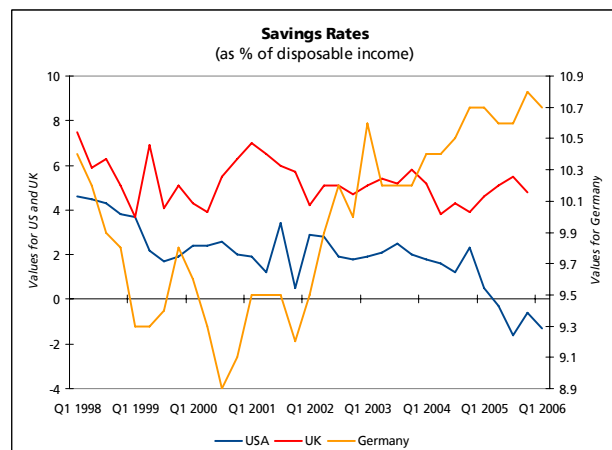
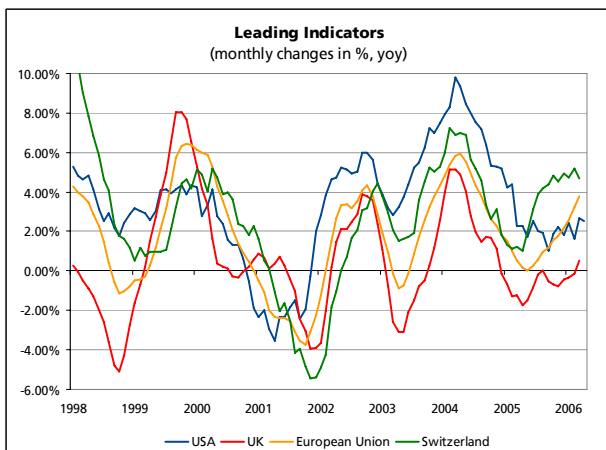
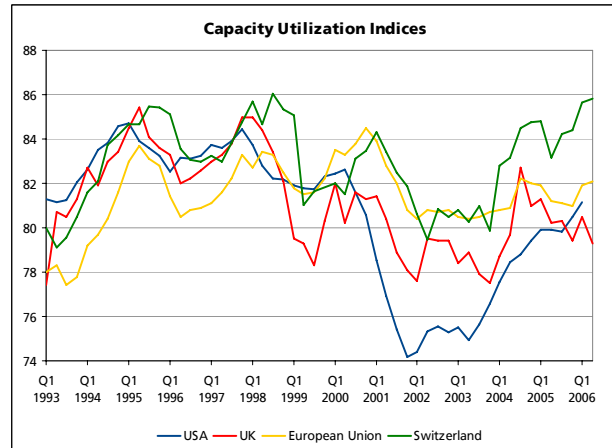
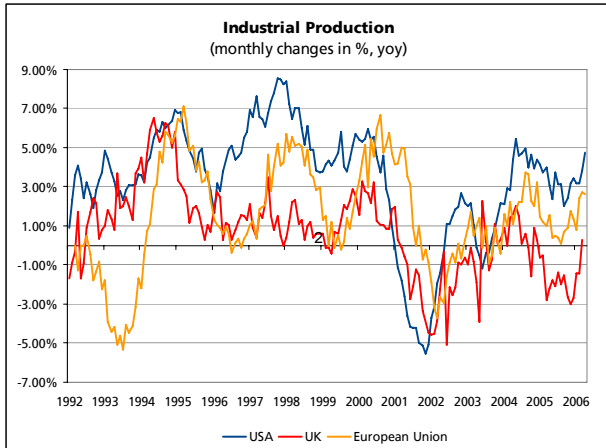
	Outlook for Main Regions (Δ in %)														
	GDP, real				Inflation (CPI or HPCI)				Interest Rates						
	04	05	06F	07F	04	05	06F	07F	3 month libor			10-year bond			
									Actual	3mF	12mF	Actual	3mF	12mF	
USA	4.2	3.5	3.6	3.0	2.7	3.4	3.5	3.0	4.68	5.00	5.10	5.02	5.25	5.75	
EMU-12	2.1	1.3	2.0	1.8	2.1	2.2	2.2	2.2	2.96	3.20	3.75	4.02	4.10	4.50	
Japan	2.3	2.7	2.8	2.2	0.0	-0.3	0.3	0.6	0.21	0.50	0.75	1.83	2.00	2.30	
UK	3.1	1.8	2.2	2.5	1.3	2.1	2.0	2.0	4.67	4.70	4.50	4.61	4.70	4.70	
CH	2.1	1.7	2.0	1.6	0.8	1.2	1.5	1.2	1.45	1.55	1.90	2.63	2.70	2.95	
China	9.9	9.9	9.5	9.0	3.9	1.8	2.0	2.2	E = Estimate F = Forecast Asean 4 = Indonesia, Malaysia, Thailand, the Philippines, CEE = Central and Eastern Europe						
India	8.1	8.3	7.3	7.0	3.8	4.2	4.8	5.0							
Asean 4	5.8	5.2	5.1	5.7	4.6	7.5	8.8	4.6							
Latin America	5.6	4.3	4.3	3.6	6.5	6.3	5.8	5.6							
Mexico	4.2	3.0	3.5	3.1	4.7	4.0	3.5	3.0							
CEE	6.5	5.3	5.2	4.8	6.1	4.8	4.1	3.4							

2. Financial sector data



Source: Datastream

3. Real Sector Data



Source: Datastream

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