UHERO Global Economic Forecast:

U.S. a Drag on Global Growth

by

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EXECUTIVE SUMMARY

Despite high oil prices, the global economy has had a very good year, and combined real gross world product is expected to end the year 3.8% higher than 2005. Next year will be considerably weaker, primarily because of slowing in the United States, where the end of the housing boom now represents a substantial drag on the economy. World output will expand by about 3.3% in 2007. The housing slowdown and the possibility of rapid adjustment of global trade imbalances are the primary downside risks.

- Gross world product, the broadest measure of world economic activity, will finish 2006 3.8% higher than 2005, an improvement from 2005. Global growth will slow to 3.3% in 2007.

- The U.S. economy is slowing, largely because of the weakening housing sector. This will continue to be a drag on the economy next year, and there is increased risk that a sharper-than-expected decline in home prices could tip the economy into recession. (See Focus on the Issues, “Goodbye Housing Boom, Hello Housing Bust?”) The recent pullback of oil prices will provide some modest stimulus to the economy in 2007. Real Gross Domestic Product (GDP) is expected to average 3.3% for the year as a whole, on par with last year. U.S. output growth will manage only 2.5% in 2007.

- Japan’s economy has been expanding for seven quarters, but at a much less buoyant rate since the Spring. As in the U.S., residential investment has been weak, and consumer spending turned down in the third quarter. Business fixed investment is likely to be relatively strong going forward, yet the external sector’s contribution will diminish because of U.S. slowing and the weaker dollar. After a revised 1.9% real GDP growth in 2005, we now expect 2.1% growth for this year as a whole. Growth will be about the same next year.

- The European region has performed better than expected this year. Growth in the 25-country European Union has accelerated by a full percentage point, from 1.7% in 2005 to an estimated 2.7% in 2006, largely because of a rebound of Western European investment expenditure, which had been notably absent in recent years. With the European Central Bank now raising rates and some countries in need of fiscal consolidation, next year will be a bit weaker. The European Union is expected to decelerate to 2.4% in 2007.

- The Asian region continues to set the pace for global expansion. China’s growth is expected to top 10% this year, with only modest slowing next year. The pace of expansion continues to amaze, doubling the size of the economy every 7 years. With a few exceptions, the other economies of East and Southeast Asia have accelerated moderately this year, compared with 2005, on the strength of exports to China and Western markets. The weaker U.S. performance expected next year will reduce growth in these export-oriented economies.

- Primary risks for the global economy include the housing downturn in the U.S. and other countries, the recent weakening of the U.S. dollar (which reduces price competitiveness of foreign exporters), the possibility of a sharper drop in the dollar if foreign capital inflows dry up, and uncertainty about the direction in which monetary policy will move.
Focus on the Issues: The Housing Cycle

Goodbye Housing Boom, Hello Housing Bust?

We have noted in the past our concern about the potential adverse consequences of an unwinding of the U.S. (and global) housing booms. In the U.S., equity borrowing linked to surging home prices exceeded 10% of personal income last year, boosting consumption spending considerably. Home prices have doubled in the U.S. in recent years, and they have tripled and quadrupled in the U.K. and Ireland.

Now the tables have clearly turned. Conditions softened in Australia and the U.K. two years ago. Housing market conditions in the U.S. have clearly deteriorated over the past year. Sales of existing single-family homes have dropped by more than 10%, and the inventory of new and existing homes has risen from a four-month supply to a seven-month supply. Home builders’ evaluations of current and prospective conditions are the lowest they have been since the 1991 recession (see figure).

U.S. Home prices, which have so far held up fairly well in most markets are now stalling or falling. The U.S. government reported that home prices continued to rise in the third quarter, but at the lowest rate since 1998, and there were quarterly price declines in more than half the cities in California. A somewhat different survey by the National Association of Realtors posted its first decline in 11 years in August. In October, the median home price according to the NAR was down 3.5% nationwide, 0.6% in the West and 5.2% in the Northeast. Because home prices in real terms have risen much further than in past expansions, there may well be considerable additional price decline yet to come, although there is no indication yet of a major price correction.

Weakness in the housing market will affect the economy in several ways. A direct negative impact is already being felt with residential investment spending falling by 18% in the third quarter, reducing GDP growth by more than 1%. With housing permits and starts running about 20% below last year’s levels and homebuilders’ confidence at its lowest level in 15 years, it is likely that residential investment will be a significant drag on the economy for some time to come.

Another important channel through which a housing slump may be felt is the effect of falling home prices on consumer spending. There has been considerable study of the links between household wealth and consumption, and, while estimates vary widely, results indicate that a 10% change in home prices may alter spending by 0.6–1.3%. In our forecast, single-digit home price declines pull consumption down several tenths of a percent below what it would otherwise be over the next two years. If large home price declines occur, this could tip the economy into recession.

It is important to note that there are a number of factors that should help to support the housing market as the boom unwinds. Long-term interest rates remain low by historical standards, helping to support home affordability. Banks generally are in good shape, making a 1980s-style banking crisis unlikely. Finally, recent oil price declines and signs of economic weakness also give the Federal Reserve wider latitude for supporting growth in the overall economy.
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Source: UHERO for U.S. and Japan, and United Nations Project LINK Global Economic Outlook, October 2006. Figures for 2006–2007 are forecasts. Detailed forecasts and analysis for major countries and regions are available to sponsors.

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