Top-10 ECONOMIC PREDICTIONS FOR 2007

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GDP growth has decelerated in the United States, but has—so far—remained strong in most other parts of the world and accelerated in some others, notably the Eurozone. Whether the rest of the world has become immune to U.S. cycles (even a mild one) is one of the larger uncertainties about the outlook for next year. Global Insight believes that even if the rest of the world follows the U.S. lead, the deceleration worldwide will be relatively mild. We expect global growth to decline from 3.9% this year to 3.3% in 2007.

1 SLUGGISH GROWTH FOR THE UNITED STATES.

The American economy will only grow about 2.2% next year. The downturn in housing is turning out to be quite pronounced and is beginning to have a measurable impact on consumer and capital spending. But the good news is that thanks to strong fundamentals for consumer spending (decent job growth and improving real wages, helped by lower gasoline prices), capital spending (strong profits and still-high capacity utilization rates), and exports (a weaker dollar and strong growth overseas), slowing growth is unlikely to develop into anything worse.

2 OTHER REGIONS WILL ALSO SLOW A LITTLE.

One of the best pieces of global economic news in the second half of 2006 was the resurgence of GDP growth in the Eurozone to 2.6%—the fastest rate since 2000. Unfortunately, the pace is set to slow to 2.0% next year, for domestic as well as global reasons. Interest rates are expected to rise more, fiscal policy will be tightened in key countries (notably Germany and Italy), the euro is rising, and export growth should slow. For similar reasons, we expect Japanese growth to downshift from 2.7% this year to 1.8% in 2007. Slower global GDP and import growth will ripple across the rest of the world.

3 ONCE AGAIN, CHINA AND INDIA WILL BE STAR PERFORMERS.

China's GDP growth was a sizzling 11.0% in the first half of this year, but then cooled to (a mere) 10.4% in the third quarter. Global Insight expects a further deceleration to 9.5% next year, mostly because of the government's desire to dampen investment spending. Indian growth has also amazed—averaging more than 9% since January, although it should come in around 8% next year. Unlike China, much of India's growth is consumer-led. While India's inflation rate is a little higher than China's (5% versus 2%), there are very few signs of overheating in either economy.

4 OIL PRICES SHOULD REMAIN HIGH.

After falling from their $75/barrel high in July, oil prices have been fluctuating around $60 for the past four months. Global Insight does not expect much relief over the next few years. We predict that prices will fluctuate in the $60–65 range for the next three to four years and then gradually ease. Because of still-sluggish real investment activity (held back by rapidly rising costs), markets are likely to remain tight and excess capacity quite limited. Moreover, OPEC has indicated that it will cut production if the price of the reference basket of crudes falls below the $55–60 range (the equivalent of $60–65 for WTI and $58–63 for Brent). The longer-term price relief will come as high prices encourage new supplies of both conventional and nonconventional fuels.

5 CORE INFLATION WILL EASE.

Among industrialized economies, the United States has been, arguably, the most prone to inflation in recent years (because of above-trend growth and a weaker dollar). But the very good news is that record-high oil prices have had almost no impact on core inflation. We believe that whether measured by the CPI or the personal consumption expenditures deflator, core inflation has peaked and will fall further in 2007, reaching 2% by the second half of the year. Elsewhere, the story is equally benign. Core inflation in the Eurozone should remain below 2%, while core Japanese inflation is still slightly negative (by some measures).

6 THE FEDERAL RESERVE WILL CUT RATES AS OTHER CENTRAL BANKS TIGHTEN.

Global Insight expects that the Fed will cut interest rates three times next year, bringing the federal funds rate back down to 4.5%. The cuts could begin as early as March, but no later than May. At the same time, the European Central Bank is likely to raise rates at least one more time, probably next March, leaving the overnight rate at 3.75%. Similarly, we expect that the Bank of Japan will raise rates from 0.25% today to 1.0% by the end of 2007, and that the People's Bank of China will hike a couple of times next year.

7 HOUSING WILL KEEP DAMPENING U.S. GROWTH, AND COULD BECOME A THREAT ELSEWHERE.

The U.S. housing crunch has already cut GDP growth by more than 1.0 percentage point in the second half of this year. It will remain a drag on growth throughout much of 2007, although with diminishing impact as the year progresses. As global growth decelerates, other economies with booming housing markets (i.e., Ireland, the United Kingdom, Spain, and Australia) may also experience a crunch. Both the British and Australian housing markets suffered through a mild correction a couple of years ago, but have since rebounded. In a weak growth environment, though, strong house price appreciation is unlikely to be sustained anywhere.

8 CURRENT-ACCOUNT IMBALANCES WILL EASE A LITTLE.

Global Insight expects that the U.S. current-account deficit peaked at more than $900 billion in the third quarter and will ease to just above $800 billion during 2007. A combination of weaker domestic demand and strong exports in the United States, along with stronger domestic demand growth elsewhere in the world (especially the Eurozone) are—finally—bringing about the long-desired correction in global imbalances. Whether this correction is the beginning of a sustained move to a more-balanced global economy will depend on the relative growth rates of domestic demand in the U.S. economy compared with the rest of the world.

9 THE DOWNWARD PRESSURE ON THE DOLLAR WILL NOT EASE.

Until recently, the U.S. dollar was being pulled in opposite directions: down by a huge (and deteriorating) current-account deficit, and up by stronger growth and higher interest rates than in many other major trading partners. Now, with growth slowing and interest-rate cuts expected, the forces on the dollar are uniformly downward—and should remain so for all of 2007, and even beyond. As a result, Global Insight expects the euro to rise in value from its early December level of around $1.33 to a little more than $1.40 by the end of next year. At the same time, the yen will appreciate from around 115 to about 105 per dollar, while the value of the Chinese renminbi increases about 5%.

10 NO RECESSION WITHOUT MUCH HIGHER OIL PRICES, INFLATION, AND INTEREST RATES.

Even if the housing market deteriorates further in the United States, and turns down in other developed economies, this is unlikely to trigger recessions, given the low inflation and interest-rate environment in the world economy today. Nevertheless, this picture would look a lot bleaker if (because of a major supply disruption) oil prices were to climb dramatically again, pushing up inflation and interest rates around the globe. The combination of a deeper housing recession and higher inflation and interest rates (and a disruption in oil supplies) would probably be enough to push the U.S. and world economies into a recession. Fortunately, the probability of such a scenario is still relatively low—only between 20% and 25%.