

# ECONOMIC PREDICTIONS FOR 2008

*The U.S. economy is now in the danger zone. GDP growth in the fourth quarter of 2007 (0.0%) and first half of 2008 (0.8% in the first quarter and 1.8% in the second quarter) is expected to be very weak. This will make the United States extremely vulnerable to another shock. Furthermore, it is unlikely that the rest of the world will be able to shrug off the expected sharp deceleration in spending by American households. Global Insight currently predicts that world growth will be 3.3% in 2008, compared with 3.7% this year. With the potential for housing crunches in some European economies and a post-Olympics slowdown (or even bust) in China, the risks for the global economy are now overwhelmingly on the downside.*

## **1. U.S. GROWTH WILL BE THE WEAKEST SINCE 2002, AND POSSIBLY SINCE THE LAST RECESSION.**

Growth in 2002 was a meager 1.6%, as the economy struggled to recover from the twin shocks of the high-tech bust and the 9/11 terrorist attacks. Growth next year will be almost as low (1.9%), and there is a mounting risk that it could be lower. The main culprit is housing, which will cut real GDP growth by 1.0 percentage point during the year. However, consumer spending growth is also predicted to decelerate from 2.8% in 2007 to 1.7% in 2008. Moreover, capital spending is expected to increase a lackluster 2.6%. The only saving grace will be net exports, which will add 0.9 percentage point to growth. Global Insight forecasts that the U.S. economy will rebound in the second half, expanding 2.7%, compared with 1.3% in the first half.

## **2. MOST OTHER REGIONS OF THE WORLD WILL ALSO DECELERATE.**

Except for commodity-exporting countries and regions, world growth is expected to “re-couple” with the United States and slow down. For Canada and Mexico, weak U.S. growth will be offset by strong oil prices. However, Europe will be hit by multiple headwinds, including the global slowdown, a stronger currency, the continuing credit crunch, housing problems in some countries, and high oil prices. Japan will be similarly afflicted, although there is little evidence of fallout from the subprime and housing-related problems in the United States—so far. The fate of emerging markets will depend on if and when growth in China and the rest of Asia falters.

## **3. THERE WILL BE NO SIGNIFICANT COOLING IN CHINA AND THE REST OF ASIA UNTIL LATE 2008.**

A mild global slowdown will only put a small dent in China’s rapid rate of growth in 2008—10.8%, compared with 11.5% this year. Credit growth is still very strong and the Chinese government’s modest tightening efforts have had little impact, with fixed asset investment growing at about a 30% rate in 2007. In the first half of 2008, there are likely to be further gradual interest rates hikes and currency appreciation. After the Beijing Olympics next August, however, the government may have no choice but to tighten credit conditions more dramatically. This will further slow China’s growth, but there is a significant risk (at least 33%) that the landing could be hard. Such a scenario would hurt the rest of Asia. However, since India’s growth is predominantly domestic-led, this vibrant economy should be able to sustain a growth rate around 8.5%.

## **4. OIL PRICES WILL EASE, BUT REMAIN AT HIGH LEVELS.**

Weaker global growth will dampen oil prices and bring them more into line with supply/demand fundamentals. These fundamentals support a price between \$75 and \$80 per barrel. Global Insight expects that, on average, a barrel of WTI will cost \$75.67 next year, compared with \$72.13 in 2007. However, with markets still tight, any type of supply disruption (actual or expected) could send prices back up again—probably only temporarily. An unknown factor in oil and other commodity markets is the role of speculation. Some have referred to the recent spike in commodity prices (especially oil) as the “next bubble.” If so, the recent drop in oil prices suggests that some of these speculative positions may be unwinding.

## **5. CORE INFLATION WILL EDGE DOWN.**

The U.S. economy is now operating well below potential. This will begin to gradually push up the unemployment rate. This extra slack in the economy will put further downward pressure on core inflation, which Global Insight expects to fall from 2.0% this year to 1.8% in 2008 for the core personal consumption deflator and from 2.3% to 2.1% for the core CPI. The good news, so far, is that high energy prices have had very little impact on other prices and on wage inflation. This benign state of affairs can be expected to continue for at least another year.

## **6. THE FEDERAL RESERVE WILL KEEP CUTTING INTEREST RATES.**

With inflation not a serious threat, and the risks predominantly on the downside, the Fed will keep lowering rates. Global Insight now expects cuts of 25 basis points at the December 11 Federal Open Market Committee Meeting, 50 basis points at the January 29 – 30 meeting, and another 25 basis points at the March 18 meeting. Meanwhile, if the credit crunch and housing problems get worse, the Fed may have no choice but to inject more liquidity into the financial system, and support the subprime mortgage relief/freeze plan devised by the Bush administration.

## **7. HOUSING SECTOR ACTIVITY WILL BOTTOM OUT IN MID-2008.**

Housing activity will continue to slide in the first half of next year. Global Insight now expects that total starts will fall below 1 million units during 2008—less than half their level in 2005. During the second half of the year, we expect housing activity to stabilize and begin recovering gradually. The same cannot be said about home prices, which are likely to keep sliding, at least through 2009. The peak-to-trough drop in home prices (as measured by the OFHEO price index) will probably end up being more than 10%.

## **8. THE U.S. CURRENT-ACCOUNT DEFICIT WILL CONTINUE TO IMPROVE.**

The long-awaited correction of the gaping global imbalances is finally happening. The deceleration in the U.S. economy is likely to be much more pronounced than that across the rest of the world. Moreover, the dollar has fallen more than 20% (on a real trade-weighted basis) in the past five years and should fall a little more, before stabilizing. These developments are supercharging exports and dampening imports. During the course of the next year, the positive contribution by trade will make all the difference whether the U.S. economy suffers through a recession or not. Global Insight forecasts that the current-account deficit will fall from \$755 billion in 2007 to \$659 billion in 2008.

## **9. THE DOLLAR WILL REACH A TROUGH AGAINST SOME CURRENCIES IN 2008.**

While the dollar has been on a downward trend since 2002 (mostly because of the huge current-account deficit), the recent weakness is a function of fears over the subprime crisis and a U.S. recession, combined with expectations that the Fed will cut interest rates more than other central banks. As the economy begins to recover in the second half of 2008 and early 2009, though, sentiments on the dollar will turn more positive, at least against some currencies. We expect that the euro will top out around \$1.55 next summer and fall to \$1.49 by year-end. The Canadian dollar may have peaked already, if oil prices keep falling. However, both the Japanese yen and the Chinese renminbi should keep appreciating vis-à-vis the dollar, given the large current-account surpluses in both economies.

## **10 WITH U.S. GROWTH BARELY POSITIVE THROUGH MID-2008, EVEN A SMALL SHOCK WILL PUSH THE ECONOMY OVER THE EDGE.**

For the past two years, Global Insight has been saying that it would take two or more shocks to trigger a U.S. recession. There is a growing risk that such a scenario may be about to unfold. The combination of the housing/subprime crisis and higher oil prices could be enough to push growth into negative territory. If oil prices continue to fall, and end up in the \$75 – 80/barrel range early in 2008, the U.S. economy will probably be able to escape recession. However, either another rise in oil prices or some other shock (even a small one) could be the straw that breaks the camel's back. Has raised the probability of a U.S. recession from 35% to 40%.