



## Global Economic Issues 2007

While 2006 has been a challenging year for the world's major economies, what's in store for 2007?

IT IS THAT TIME OF THE YEAR AGAIN, WHEN ECONOMISTS PUT ON their thinking caps and scrutinise all kinds of statistics to come up with different economic scenarios for the next one year!

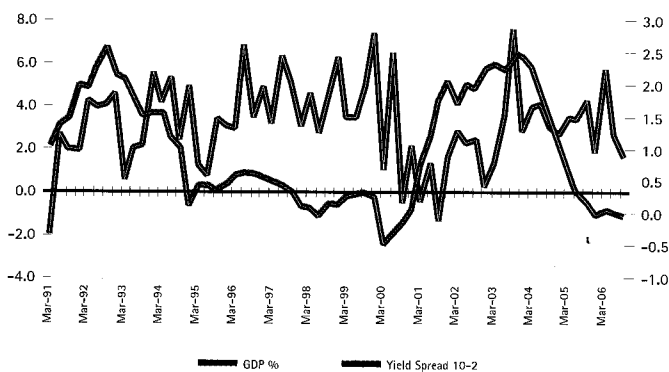
2006 has been a challenging year for policy-makers in the major economies as they try to contain the risk of rising prices without jeopardising growth prospects.

Admittedly, it is tough to make a call with regard to the world's largest economy – the United States – in the next 12 months. True enough that economists' expectations are generally well known: growth is moderating as the housing sector drags down consumer spending. Inflation is seen to be slowing and a temporary soft patch would pull the growth to below its long-term potential.

The evidence is already out there. Gross Domestic Product (GDP) grew at a much slower pace of 2.2% in the third quarter, according to the revised statistics, suggesting that a housing malaise is starting to bite.

Going into 2007, however, a crucial question is whether growth will moderate as forecast by the US Federal Reserve Bank (Fed). Growth trajectory is clearly on a downside bias as it is mainly influenced by the housing sector, which is still not out of the woods.

Chart 1: US GDP and US Treasury Yield Spread (10 minus 2) – An Indication of Slower Growth Rate Ahead?



Source: Bloomberg

Construction spending contracted for the sixth month in September, the longest streak since 1995. New home sales slumped 25.4% year-on-year in October, the 10th monthly consecutive decline, while median prices of new homes fell 9.7% in the earlier month, the biggest drop in the past 36 years.

From this set of statistics, growth prospects in the next 12 months look rather bleak at this juncture. Even the bond market has been emitting negative signals in the past few months. Yield curves have inverted, signalling rising probability of a significant slowdown in economic activity. The spread between yields of 10-year and two-year US Treasury is now around 20 basis points in favour of the shorter tenor.

The recent inversion started in mid-August. While some are sceptical about the usefulness of yield spreads as an indicator of recession, others continue to pay close attention to such relationships as past experiences fail to indicate otherwise.

Notwithstanding the above evidence, some quarters are still optimistic about the strength of consumer spending. After all, Americans are big-time spenders. Looking at another set of statistics, consumer spending may still be strong enough to support the economy in 2007. The job market is stable and the tight labour market, evidenced from a decline in the jobless rate to 4.4% recently, may lead to further indulgence in conspicuous consumption.

Some argue that the impact of income growth is at least 10 times more than wealth in determining consumption patterns in the US. That means irrespective of the decline in home prices, consumption will remain relatively strong and that will keep the wheels spinning.

Another crucial question about the US economy is whether inflation is going to slow enough to cause the Fed not to resume its interest rate hike in 2007. The Fed's favourite inflation gauge, core private consumption-expenditure (PCE), remains well above the central bank's comfort zone of 2% despite the recent sharp decline in gasoline prices.

Another important issue is that, contrary to what the Fed believes, core inflation may still remain elevated even if growth moderates. That will pose a critical problem to policy-makers as

they would be unable to use the traditional Keynesian prescription to combat high consumer prices.

That leads us to a scenario of mild stagflation where growth moderates in 2007 but inflationary pressures remain intact. Subdued oil prices would to some extent help curb further acceleration in consumer prices, but that also means a higher probability of sustained consumer spending that would keep the Fed on its toes. Despite slowing growth, another rise in the federal funds rate (FFR) is thus not impossible under such circumstances, as the Fed would be forced to control inflation expectations.

The Euro region is facing almost the same dilemma. Growth for 2006 looks commendable as most countries benefit from favourable trade conditions.

Even with the strong euro currency, Germany's exports expanded by 6.6% in September, the biggest since 2002. Business confidence among executives and consumers climbed to a five-year high in October as the unemployment rate slipped to a historical low of 7.8%.

Germany's growth accelerated in the first three quarters and is expected to exceed 2%. Spain's growth sizzled to 3.8% in the third quarter, the fastest pace in five years. Overall growth is anticipated to be in the upper range of the central bank's forecast of 2.2% to 2.8%.

While growth expectation for the Euro region has risen following favourable GDP statistics in the first three quarters, the prospect for 2007 may not be as stellar as some are projecting.

Germany's economy is expected to bear the brunt of the higher value added tax (VAT) which will commence in January next year. France's economy has already stalled in the third quarter and is expected to go through a soft patch next year. At the same time, a rapid increase in the cost of borrowing from 2% to 3.25% is finally denting consumer optimism.

The inflation rate has subsided in the recent month to less than the targeted rate of 2%. That, however, does not stop its central bank, the European Central Bank (ECB), from going full speed in hiking up interest rate in the hope of taming future inflationary pressures.

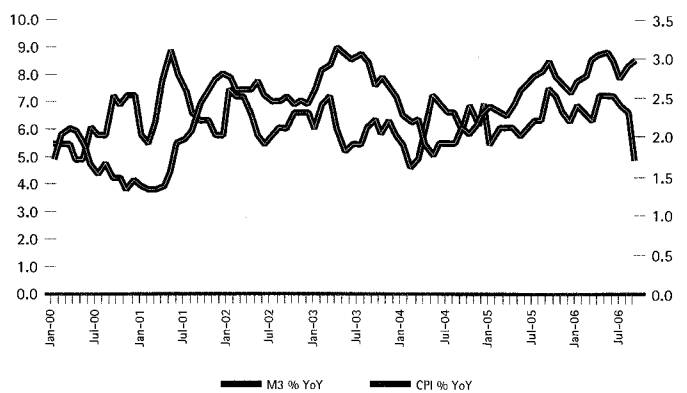
The ECB's single mandate of controlling inflation makes it harder for it to focus on growth prospects for the region. In addition, the rapid growth of money supply has not abated and consumer prices are expected to gain at an average rate of 2.4% this year, the eighth year exceeding the ECB's target of 2%.

Not surprisingly, the ECB members led by Jean Claude Trichet have clearly indicated their intention to further remove monetary accommodation in order to tame inflationary pressures next year. Should the ECB remain uncompromised with the current level of inflation, growth could moderate more than expected in 2007.

Germany's economy will be adversely affected by the three-percentage increase in VAT and other countries will experience slower consumer spending as a result of high borrowing costs. At the same time, the strong euro will dampen the region's trade contributions towards growth. Under such a scenario, we anticipate a decline in growth rate to around 1.7% next year.

In Asia, Japan's economy is humming well, driven by corporate spending and a pick-up in consumer expenditure. The third quarter growth of 2% was well above market consensus as

Chart 2: EURO - Growth of M3 and Inflation



Source: Bloomberg

corporate spending surged by 2.9%, three times more than economists' expectation. External trade also contributed about 0.4-percentage point to the growth.

While growth is cruising along nicely this year, policy-makers are still debating as to whether its central bank should continue to raise interest rates this year.

The Bank of Japan, led by Toshihiko Fukui, is in favour of removing policy accommodation after hiking up its interest rate in June this year, the first increase since 1998. Fukui indicated that such an increase is necessary to avoid rising inflation from corporate boom and overheating in the future.

Business conditions are indeed improving, with the Tankan business confidence among large manufacturers continuing to climb in the third quarter. Companies are also planning to increase spending by 11.5% in the fiscal year ending March 2007, the fastest in 16 years.

The government however feels uneasy with such drastic moves, fearing that the economy is not on a sound footing and that growth may tumble again as it did in 1998. Moreover, the government is still waiting for further evidence of a sustained increase in consumer prices before getting ready to jack up borrowing costs.

An important issue that needs constant monitoring is consumer spending. Anecdotal evidence seems to suggest that labour market conditions have improved. The unemployment rate has declined to an eight-year low of 4% in May and remained at 4.2% in September. The job-to-application ratio has improved to 1.08 in September this year. Nevertheless, spending remains tepid simply because wages are not growing. That has prevented consumers from splurging.

The overall picture remains mixed in Japan. We are of the opinion that the central bank should not be in a hurry to raise borrowing costs until growth is really on a strong footing. As a country that has grappled with deflationary pressures in the past several years, Japan may wish to see stronger inflation numbers before it starts to think about inflationary threats. Headwinds on the global horizon are also another reason for keeping a close watch on the growth prospects next year. **mb**

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