



# WORLD FLASH

MAY 2007

## The Global Economy in 2007: Upside Risks for Growth, Inflation, and Interest Rates

**The world economy is expected to grow 3.5% in 2007 and 2008, a pace that is near its potential.** Despite the pronounced slowdown in the U.S. economy, the world's real GDP growth is projected to slow by just half a percentage point this year. After a period of robust growth in 2004-06, global output is nearing its potential and resource utilization is tight. Rapid liquidity growth worldwide suggests the need for further interest rate increases to contain inflationary pressures. With the exceptions of the Middle East and Africa, every major region of the world is expected to experience some diminution in growth this year. Global trade imbalances are beginning to narrow in response to exchange rate adjustments and shifting growth patterns.

**After a first-quarter lull, the U.S. economy is beginning to accelerate, led by exports and business investment.** As 2007 began, growth was held back by a plummeting residential construction, a downward adjustment in inventory investment, and a surprise drop in exports. With the inventory correction progressing, exports rebounding, and capital spending strengthening, real GDP growth is expected to pick up from a 1.3% annual rate in the first quarter to 2.2% in the spring quarter and hit its 2.6% potential rate by year's end. This improvement comes despite an expected moderation in consumer spending and further declines in residential construction.

**Eurozone growth will remain healthy in 2007, but lose momentum in 2008 in response to policy tightening and the euro's appreciation.** The Eurozone outlook continues to brighten, as rising employment and incomes spark a long-awaited revival in consumer spending. With the gap between actual and potential output closing, inflationary pressures remain a concern. Interest rates will rise further, putting upward pressure on the euro. Housing overvaluation remains a threat to many European economies, especially Spain, Ireland, France, and the United Kingdom.

**The Japanese economy is settling into a pattern of slow, balanced growth.** The economy is expected to grow 2.2% in 2007 and 1.9% in 2008, with the lead role shifting from exports to domestic demands. A tightening labor market should lead to an acceleration in wages, encouraging more consumer spending.

**China's investment boom shows no signs of decelerating, raising the risk of an eventual hard landing.** Investment has been fueled by high liquidity, which has been inflated by central bank efforts to stem upward pressure on the exchange rate. Rampant credit growth threatens to exacerbate oversupply in the economy and create a new generation of non-performing loans in the banking system. With asset bubbles percolating, the risk of a boom-bust cycle has increased to 33%. We expect the government will step up the frequency of policy tightening. With export and investment growth gradually cooling, real GDP growth will taper off from 10.7% in 2006 to 10.5% this year, 9.5% in 2008, and 8.5% in 2009.

**Bottom line: The world economy has strong momentum, and the risks are shifting to the upside.** Rapid liquidity growth, rising asset prices, and inflationary pressures could lead to a boom-bust cycle. Stronger global growth and inflation would prompt more aggressive tightening of monetary policies, which could set the stage for weaker performance beyond 2007.

### A Quick Look at the Numbers

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP Growth (Annual percent change)									
World	2.6	4.1	3.5	4.0	3.5	3.5	3.6	3.4	3.2
United States	2.5	3.9	3.2	3.3	2.1	2.8	3.3	3.1	2.6
Eurozone	0.8	1.8	1.5	2.8	2.6	2.1	2.0	1.9	1.8
Japan	1.5	2.7	1.9	2.2	2.2	1.9	1.7	1.6	1.6
Non-Japan Asia	6.5	7.5	7.3	7.5	7.2	7.1	6.7	6.5	6.2
Exchange Rates (Year-end)									
Dollar/Euro	1.26	1.36	1.18	1.32	1.42	1.48	1.47	1.40	1.37
Yen/Dollar	107.1	104.1	118.0	119.0	109.5	101.8	97.1	94.2	92.7

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