



WORLD FLASH

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Financial Turbulence Provokes Downside Risks to the Global Outlook

The subprime mortgage crisis originating in the United States is a gathering storm for the world economy. Its breadth and intensity are still uncertain, but its potential damage is significant. Mounting delinquencies and foreclosures in the U.S. subprime mortgage market have created a maelstrom in global financial markets, characterized by heightened volatility, rising risk premia, declining prices of risky assets, frozen credit markets, and an unwinding of leverage.

The global economy, while fundamentally sound, is at an inflection point, with growth decelerating from the above-trend pace of 2004-06. The recent financial turbulence magnifies the downside risks. At this point, it is clear that the storm will inflict severe damage on the U.S. economy, but its global reach is uncertain. If the U.S. economy averts a recession and global financial markets stabilize, the world's real GDP growth might simply taper off from 3.9% in 2006 to 3.6% this year and 3.5% in 2008. But an escalating global credit crunch, the bursting of housing price bubbles in Europe, and a U.S. downturn could push global growth closer to the 2% threshold that signifies a global recession.

The credit crunch and deepening U.S. housing market recession will have spillover effects on consumer spending and business investment. U.S. housing markets are caught in a vicious cycle of excess supply, falling prices, rising mortgage foreclosures, tightening credit conditions, and declining home-building. U.S. real GDP growth is projected to average just 1.6% (annualized) over the next three quarters. Global Insight has raised its estimated probability of a U.S. recession from 20% to 30%. The downside risks to the U.S. economy include a more severe global credit crunch, an even deeper housing recession, business cutbacks in hiring and capital spending, and higher energy prices.

Western Europe's exposure to this financial turbulence is significant, and more problems are bound to surface. The regional economy is facing headwinds from an appreciating euro, high oil prices, and recent monetary and fiscal policy tightening. After steep increases in the past decade, housing prices are vulnerable to a correction in several countries, including the United Kingdom, Spain, and France. The Eurozone's real GDP growth is expected to slow from 2.9% in 2006 to 2.6% this year and 2.2% in 2008.

A faltering economy and rising yen will present challenges for Japan's next prime minister. Revised data indicate that Japan's real GDP fell at a 1.2% annual rate in the second quarter because of sluggish exports and falling capital expenditures. With the yen rising and exports decelerating, Japan's ability to sustain 2.0% growth in the year ahead will depend on consumer spending.

China and other emerging markets are enjoying buoyant economic expansions, fueled by double-digit money supply growth. But weakness in key export markets will eventually temper growth. Since their 1997-98 financial crises, both domestic and external finances of emerging markets have improved substantially. With liquidity still abundant in these markets, the global financial turbulence has done little damage so far. Nevertheless, a sharp deceleration in import demand from the United States, Europe, or China would clearly hurt emerging markets. Commodity exporters will be especially vulnerable in 2009-10, when surging capacity in metals and petrochemicals triggers a downturn in prices. Another risk is a boom-bust cycle in China, with investment retrenching and economic growth faltering after 2008 Summer Olympics.

A Quick Look at the Numbers

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP Growth (Annual percent change)									
World	2.7	4.0	3.5	3.9	3.6	3.5	3.6	3.5	3.3
United States	2.5	3.6	3.1	2.9	2.0	2.0	2.8	2.8	2.8
Eurozone	0.8	1.8	1.6	2.9	2.6	2.2	2.1	1.9	1.9
Japan	1.5	2.7	1.9	2.2	2.0	2.3	1.8	1.5	1.5
China	10.0	10.1	10.4	11.1	11.5	10.9	9.8	8.8	7.6
Exchange Rates (Year-end)									
Dollar/Euro	1.26	1.36	1.18	1.32	1.41	1.46	1.45	1.40	1.37
Yen/Dollar	107.1	104.1	118.0	119.0	109.3	103.3	98.6	95.7	94.2

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