WORLD FLASH

OCTOBER 2006

A Mild Global Slowdown Relieves Inflationary Pressures

The United States is leading a mild downshift in the global economy from above-trend growth in 2004-06 to trend growth in 2007-10. Global Insight projects that the world's real GDP growth will slow from 3.9% this year to 3.3% in 2007, ending a three-year run of above-trend economic growth. All major regions except the Middle East will see some moderation in growth next year, but only North America will perform significantly below potential. A steep downturn in housing markets, coupled with a mild deceleration in consumer spending, will cause U.S. real GDP growth to slide from 3.3% in 2006 to just 2.4% next year.

China's economic growth peaked this spring, when investment reached a frenzied pace. As investment and exports decelerate, growth will moderate but remain strong. Global Insight forecasts China's real GDP growth to slow from 10.6% this year to 9.0% in 2007 and 8.4% in 2008, in response to further monetary tightening and a slowdown in exports to the key U.S. market. We expect that Beijing will blunt the economic slowdown by limiting the renminbi's appreciation against the U.S. dollar to 3-4% annually.

Despite soaring commodity prices, worldwide consumer price index (CPI) inflation has held close to 3% since 2003. In the year ahead, any nascent inflationary pressures will ease, as demand growth slows in key markets, while investments in new capacity will alleviate commodity shortages. Although Global Insight expects some recovery in energy prices this winter, prices of most other commodities will retreat.

Although some further interest rate hikes are expected in Europe and Asia, the global monetary tightening cycle is nearing its end. With inflation beginning to ease, the pressure on central banks will diminish in the year ahead. The U.S. Federal Reserve is likely to leave the federal funds rate at 5.25% into early 2007, followed by three reductions to 4.50% by the end of next year, countering the economic slowdown.

Persistent trade imbalances and narrowing interest rate differentials will put further downward pressure on the dollar's exchange rate. The U.S. dollar has been surprisingly stable in recent months, even as the current-account deficit has hit a new record of over US$900 billion (annualized) in the third quarter, when oil prices peaked. We expect that the dollar's depreciation will gain speed as spreads between U.S. and foreign interest rates narrow in the year ahead.

In summary, the global economy will experience a soft landing and milder inflation in 2007. The risks of a more problematic downturn remain low. Although world growth is set to slow, the expected mild deceleration will probably not turn into anything worse. Inflation is easing, interest rates (both nominal and real) are still relatively low, fiscal policies remain loose, and exchange rate volatility has been surprisingly low. Thus, the global economic environment is likely to remain benign for a least another year.

A Quick Look at the Numbers

	2002	2003	2004	2005	2006	2007	2008	2009	2010
Real GDP Growth (Annual percent change)									
World	1.8	2.7	4.0	3.5	3.9	3.3	3.5	3.5	3.3
United States	1.6	2.5	3.9	3.2	3.3	2.4	3.3	3.3	3.2
Eurozone	0.9	0.8	1.7	1.5	2.5	1.7	1.8	2.0	1.9
Japan	0.1	1.8	2.3	2.6	2.7	2.3	1.8	1.6	1.4
Non-Japan Asia	6.1	6.5	7.4	6.9	7.3	6.6	6.5	6.3	6.1
Exchange Rates (Year-end)									
Dollar/Euro	1.05	1.26	1.36	1.18	1.30	1.40	1.47	1.47	1.40
Yen/Dollar	119.9	107.1	104.1	118.0	109.6	102.5	98.4	95.4	93.5

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