

# Top-10

## **ECONOMIC PREDICTIONS FOR 2006**

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The resilience of the U.S. and world economies in the face of record-high oil prices in 2005 has been remarkable. Global Insight predicts that growth in 2006 will remain strong—at (or slightly above) trend. The United States and China will continue to be the main locomotives of global growth. Furthermore, without the convergence of two or more big shocks, the risk of a recession in the next couple of years will remain small.

### **1 SOLID GROWTH WILL LAST FOR AT LEAST ANOTHER YEAR.**

Strong growth momentum in the United States and Asia has been both the underlying cause of record-high energy prices and the reason why the global economy has managed to shrug them off. Global Insight expects both the U.S. and global economies to grow at a rate of about 3.5% next year (compared with 3.7% and 3.4%, respectively, in 2005). In the case of the United States, an expected slowdown in consumer spending and housing will be offset by strength in capital spending and exports, helped by a fiscal boost from hurricane-related reconstruction.

### **2 THE UNITED STATES WILL, ONCE AGAIN, OUTPACE EUROPE AND JAPAN.**

Not every region of the world will enjoy strong growth in 2006. Japan's growth spurt over the past two years is likely to peter out—with the economy expanding only 1.9% next year, compared with 2.4% this year. While the pace of growth in Western Europe will accelerate a little to 1.9% (from 1.5% this year), the fundamentals remain weak. Consumer spending is virtually flat, and more than half the growth is export led. Meanwhile, the European Central Bank (ECB) just raised interest rates and will probably tighten again during 2006, and fiscal policy is about to become more restrictive in Germany.

### **3 CHINA AND THE REST OF ASIA WILL REMAIN THE STAR PERFORMERS OF THE GLOBAL ECONOMY.**

The Asia-Pacific region, excluding Japan, will be able to sustain growth of around 6% next year. While the Chinese economy is expected to cool off a little, Global Insight predicts that next year's growth will be at least 8.4% (compared with 9.3% this year). Other key economies will also be expanding rapidly (e.g., India at 6.7% and South Korea at 6.0%). While exports continue to drive growth in these economies, domestic demand has also been robust (capital spending in the case of China and consumer spending in other economies, such as South Korea).

### **4 OIL PRICES WILL EDGE DOWN—BUT THE RISKS ARE ON THE UPSIDE.**

Oil and gasoline prices have fallen substantially since hitting record highs (before adjusting for inflation) in the wake of hurricanes Katrina and Rita. Global Insight expects that the price per barrel of West Texas Intermediate crude will continue to slide gradually from over \$60 per barrel in early January to around \$57 by the end of 2006. However, with real GDP growth and energy demand predicted to stay robust, oil market conditions will not ease up by much. This means that the risk of another spike in oil prices—triggered by a weather-related or geopolitical disruption—is still uncomfortably high.

## **5 CORE U.S. INFLATION WILL EDGE UPWARD.**

So far, inflation has remained a low-level threat worldwide, despite strong growth and high energy prices. However, since the United States has been growing above trend for the past two years, it has become more vulnerable to inflationary pressures. Global Insight expects core CPI inflation to edge up from 2.2% in 2005 to 2.3% in 2006. But inflation is unlikely to get out of control. Productivity growth has stayed strong (keeping a lid on unit labor costs) and compensation growth is still pretty tame, reflecting continued slack in labor markets. Outside the United States, inflation is even less of a threat—in Europe because growth has been below trend and in China because of its investment-led boom.

## **6 THE FED WILL KEEP TIGHTENING THROUGH THE SPRING.**

Since mid-2004, the Federal Reserve has been on a course of slow, steady tightening of monetary policy, with the goal of bringing the federal funds rate into a “neutral zone” (estimated to be 4.5% to 5.5%). Global Insight predicts that the Fed will raise rates at least three more times between December and March, before taking a breather. This will leave the funds rate at 4.75%. Other central banks are also feeling the need to become less accommodative. After two years of leaving interest rates unchanged, the ECB has begun a tightening cycle, which is likely to be more gradual than the Fed’s. Similarly, the long-expected end to CPI deflation will give the Bank of Japan some scope to move away from its policy of “quantitative easing.”

## **7 HOUSE PRICES WILL LEVEL OFF WITHOUT CRASHING.**

Rapidly rising home prices and concerns about possible housing bubbles have been among the major pre-occupations of analysts and policy makers over the past couple of years. The specter of a crash in home prices has haunted not just the United States, but other economies, including the United Kingdom, Australia, Ireland, Spain, and Sweden. So far, the British and Australian housing markets have cooled down without crashing. The same fate probably awaits the U.S. economy in 2006. Global Insight expects that the rate of increase in existing home prices will decelerate significantly, from around 9.0% in each of the last couple of years to 3.5% in 2006 and 1.9% in 2007. Thus, the housing “bubbles” are likely to deflate without bursting.

## **8 THE U.S. CURRENT-ACCOUNT DEFICIT WILL PLUMB NEW DEPTHS—AGAIN.**

After breaching the \$800-billion threshold over the past year, the U.S. current-account deficit will again break records, reaching \$900 billion (or 6.8% of GDP) during 2006. The fundamental reasons for this continuing deterioration are too much domestic-led growth in the United States and too much export-led growth in other parts of the world. The good news is that—so far—private investors and central banks in other parts of the world (especially from Asia and oil-exporting economies) have been willing to finance the growing U.S. deficit and, more selfishly, the U.S. role as the global engine of growth. How long this “co-dependency” or “symbiotic relationship” (depending on your point of view) can last is one of the larger uncertainties facing the global economy.

## **9 THE DOLLAR WILL END THE YEAR LOWER THAN AT THE START.**

Most economies with ballooning current-account deficits usually suffer large currency depreciations. This happened to the United States from 2002 to 2004. Over the past year, though, the dollar has stabilized, and even appreciated recently. Some of this can be attributed to bad news in other parts of the world (political turmoil in the Eurozone, riots in France, etc.). Nevertheless, much of the greenback’s strength during the year was thanks to stronger growth and higher interest rates in the United States, which made dollar-denominated assets much more attractive than the alternatives. As the U.S. current-account deficit continues to deteriorate next year, and as soon as the Fed stops hiking rates, investors will likely take a more pessimistic view of the dollar.

## **10 THERE WILL BE NO RECESSION IN THE NEXT COUPLE OF YEARS WITHOUT THE CONVERGENCE OF TWO OR MORE BIG SHOCKS.**

The U.S. and global economies were able to withstand a number of major shocks in 2005—one of the worst tsunamis on record (which actually occurred at the very end of 2004), one of the worst hurricanes on record, and the highest energy prices ever—without missing a beat. This remarkable resilience indicates that growth will be sustained over the next couple of years despite most shocks. Only if two or more severe shocks were to happen simultaneously would a recession become inevitable. Using its proprietary Global Scenario Model, Global Insight recently addressed the question: what would it take to trigger a global recession? The answer: a combination of oil prices above \$100 per barrel, inflation and interest rates running 3 percentage points above current levels, and a 10% drop in home prices across many industrial country markets. All possible, but unlikely in either 2006 or 2007.