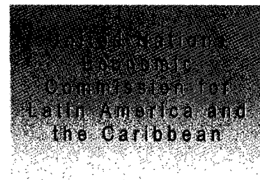

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UNITED STATES ECONOMIC OUTLOOK

Quarterly Developments

UNITED NATIONS

Washington, D.C. December 10, 2007

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U.S. ECONOMIC OUTLOOK

The U.S. economy grew at a 4.9% annual rate in the third quarter of 2007, a much faster pace than in the second quarter and than previously estimated, and the highest growth rate in four years. Much of the third-quarter strength came from a 19% jump in exports, which contributed 1.4 percentage points to growth as the dollar fell to new levels and foreign economies grew rapidly. Falling housing investment subtracted 1% from growth. Productivity growth was the strongest in four years in the third quarter, driving down labor costs.

A slumping housing sector and waning consumer confidence is expected to weaken fourth-quarter growth, however, and analysts say that risks are rising for a recession next year. Growth is expected to slow to an annual pace of just 1.5% or less in the final three months of the year. Among the more pessimistic assessments, Merrill Lynch expects to see fourth-quarter growth expanding at just 0.4% at an annual rate.

Forecasts for U.S. Economic Growth

	Q4 2007(qoq)
What Markets Say	
National Association of Realtors	1.4%
Merrill Lynch	0.4%
Moody's Economy.com	1.6%
J.P. Morgan	0.5%
Wachovia	2.5%
Mortgage Bankers Association	1.4%
Forecasts average	***1.3%***

* All Forecasts as of *November and December 2007*

The Federal Reserve decided to cut the federal funds rate by a half-percentage point on September 18 and by a quarter-percentage point on October 31. The decision was driven by concerns that the recent turbulence in financial markets is different from previous episodes in recent years. In 1987 and in 1998 problems started in the stock and currency markets and did not spread extensively to the broader economy. This time around, in contrast, the credit crunch began in the housing sector and directly threatens consumer spending, which is key to the health of the economy.

The dollar fell to its lowest level since 1992 against a basket of six currencies following the September 18 cut on concerns that lower U.S. interest rates would corrode the value of dollar assets. The impact of a falling dollar has already helped lift exports and reduce the trade deficit with the rest of the world. On the other hand, the dollar decline has helped push up commodity prices, most of which are denominated in dollars, which is sparking inflation fears. The risk is that foreign investors, anticipating inflation, could start to dump some of their U.S. debt holdings. This could turn the dollar decline into a disorderly situation, with the Fed loosing some control of monetary policy.

So far the efforts by the Federal Reserve have fallen short of their goals as financial conditions have deteriorated further since it last cut rates on October 31, and the economic backdrop has deteriorated beyond the central bank's expectations. According to Ben Bernanke, *"the combination of higher gas prices, the weak housing market, tighter credit conditions and declines in stock prices seem likely to create some headwinds for the consumer in the months ahead."* Markets now believe the Fed will cut federal funds rates again at its next meeting on December 11.

The most recent released data on the U.S. economy, however, suggests slowing, rather than plummeting, economic growth. Employment in the U.S. private sector rose almost four times faster than expected in November according to private sources, soothing fears that the credit crisis is about to cause a sharp economic slowdown. The Labor Department payrolls data also showed a reasonably healthy jobs picture. The economy added 94,000 jobs in November against expectations of 80,000, while the October numbers were revised slightly higher. The manufacturing sector continued to shed jobs but there was strong growth in services. Headline unemployment remained at 4.7% for a third month in a row.

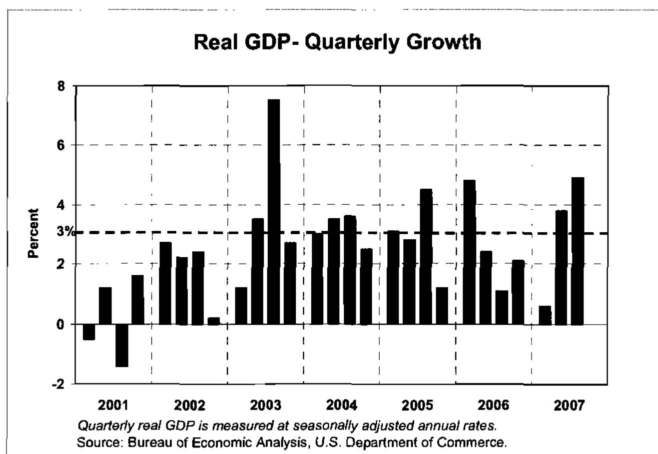
Up to the first week of December, market projections indicated that the odds of a 50 basis points ease were rising. However, following the release of the data on employment in the U.S. private sector, the

implied probability of a 50 basis points FOMC rate cut on December 11 as shown by options prices fell to 33%, from 50% earlier in the week, and continued to fall further in the wake of the Labor Department's payrolls data. Expectations now focus firmly on only a 25 basis points cut.

I. CURRENT ASSESSMENT

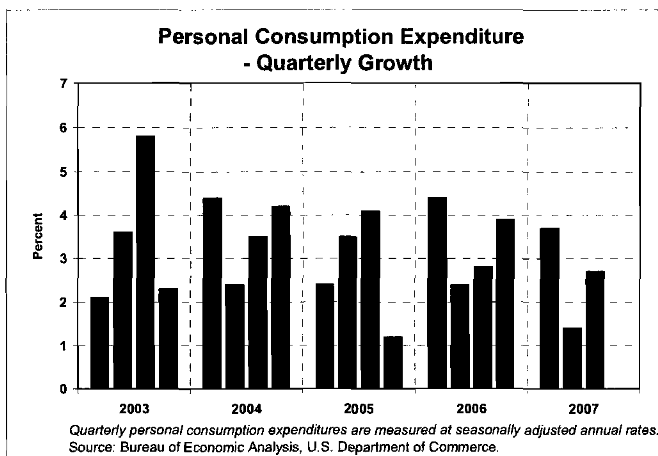
- **GDP growth**

According to the preliminary estimates released by the U.S. Department of Commerce on November 29, the U.S. economy grew at an annual rate of 4.9% in the third quarter of 2007, a faster pace than in the second quarter, when the economy grew at 3.8%, and a much faster pace than in the first quarter, when the economy grew at a rate of only 0.6%. Third-quarter growth was the highest growth rate since the third quarter of 2003, and the fastest quarterly rate in four years. The economy grew above potential growth for the second quarter in a row, following four consecutive quarters of growth below potential.[1]



Quarterly real GDP is measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Consumer spending grew at a 2.7% pace in the third quarter, up from a weak 1.4% in the second quarter, but still considered somewhat subdued by some analysts. Growth in consumer spending was particularly strong on durables. However, underlying problems in the economy, particularly in the housing market, suggest that this performance may not be repeated, and that consumer growth may lag overall GDP growth in the near term. Consumers are expected to turn cautious in the fourth quarter, a factor taken into consideration in the latest forecasts of slower overall economic growth. However, post-Thanksgiving sales were more promising than expected. Real consumer expenditure, which accounts for more than two-thirds of GDP, added 1.88% to third-quarter GDP growth.



Quarterly personal consumption expenditures are measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Real nonresidential fixed investment, which represents overall business spending, increased 9.4% in the third quarter, compared with an increase of 11% in the second quarter. Investment in equipment and software increased 7.2%, following a 4.7% increase in the second quarter. Business spending added 0.97% to the economy's growth rate.

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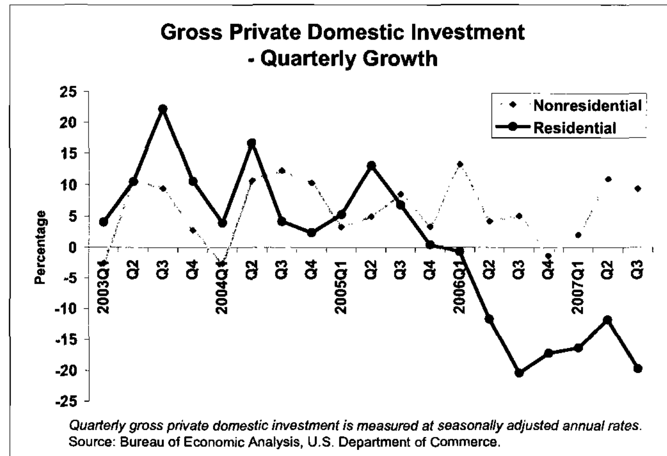
[1] The government revised economic growth up to 4.9% for the third quarter from an earlier estimate of 3.9%. The revision was driven by greater increases in inventory investment and net exports. The U.S Department of Commerce revises its GDP figure twice after its initial estimate, and will publish its final figure for third-quarter performance on December 20.

The housing market continued to weigh on the economy in the third quarter. Real investment in residential structures fell an annualized 19.7% in the third quarter, its seventh consecutive quarterly decline, subtracting 1.03% from growth. Credit problems have made it harder for future buyers to finance a home, deepening the house slump. The inventory of unsold homes continues to pile up and builders continue to cut back. Total fixed investment (residential and nonresidential) subtracted 0.06% from overall GDP growth.

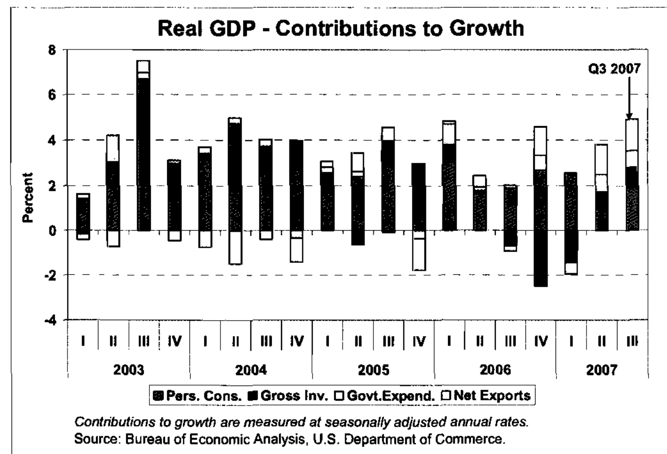


Quarterly gross private domestic investment is measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Inventory building added 0.98% to growth. However, with growth expected to slow, inventories should move from a positive to a negative, as businesses look to reduce their stockpiles. Private businesses increased inventories by US$ 32.9 billion in the third quarter, following an increase of US$ 5.8 billion in the second quarter. Overall, gross private domestic investment added 0.92% to GDP growth in the third quarter (-0.06% due to fixed investment, plus 0.98% due to inventories).

Federal spending increased 7% in the third quarter, following an increase of 6% in the second quarter. Federal spending added 0.49% to the economy's growth rate, while state and local spending added 0.26%. Overall, government spending added 0.75% to growth in the third quarter.

A shrinking trade deficit accounted for much of the improvement in third-quarter GDP, adding 1.37% to overall growth. Higher exports of goods and services contributed 2.08% to overall GDP growth, while imports subtracted 0.70%. Exports are up because of the weaker dollar and strong growth overseas.



Contributions to growth are measured at seasonally adjusted annual rates.
Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Despite the very strong performance in the third quarter, downside risks to GDP growth predominate. Businesses are uncertain about future market conditions, and credit could tighten considerably. Surveys of corporate chief executives and chief financial officers released in the first week of December showed sharp declines in optimism about the economy and business conditions. Market uncertainty and investor pessimism can lead to a cutback on investment despite record profits, while tightening credit markets can further depress the housing sector and reduce household wealth, leading to lower than expected consumer spending and lower growth. However, the Personal Consumption Expenditure (PCE) price index excluding food and energy rose at an annualized 1.8% in the third quarter. It was up from 1.4% in the second quarter, but still within the Fed's comfort zone. Slower core inflation gives the Federal Reserve more maneuvering room. The Fed is expected to loosen monetary policy again at the FOMC meeting on December 11, with further rate cuts possible in 2008.This could help to offset market concerns about reduced access to credit, and to partially counter the recent increase in risk aversion.

- **Sectoral Developments**

Industrial production rose at an annual rate of 4.4% (SAAR) in the third quarter of 2007, compared with 3.5 % in the second quarter and 1.1% in the first. The capacity utilization rate was 82.2% in the third quarter, higher than in the second and first quarters. Capacity utilization increased slightly in the third quarter after inventory adjustments removed excess supplies. Capacity utilization increased to 82.2% in September and to 81.7% in October, from 81.8% in June. However, in October capacity utilization fell back to rates similar to those of the first half of the year, and production followed. Despite this softening in industrial activity, capacity utilization remains above 80%, suggesting that firms are still responding to solid, although flattening, demand.

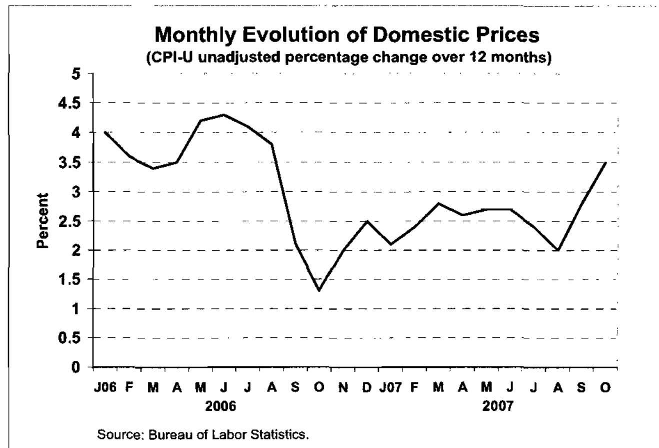
Industrial Outlook

2007	Total Industrial Production		Capacity Utilization Rate (%)
	Index 2002=100	Percentage Change From Previous Period	Total Industry
2007 Q1	**112.2**	**1.1**	**81.3**
January	111.7	-0.5	81.1
February	112.5	0.8	81.6
March	112.4	-0.1	81.4
2007 Q2	**113.2**	**3.5**	**81.7**
April	113.1	0.6	81.7
May	113.0	-0.1	81.5
June	113.6	0.6	81.8
2007 Q3	**114.4**	**4.4**	**82.2**
July	114.2	0.5	82.2
August	114.4	0.2	82.2
September	114.6	0.2	82.2
2007 Q4	na	na	na
October	114.0	-0.5	81.7

Source: Federal Reserve.
Note: Quarterly changes are at annual rates. Annual changes are calculated from annual averages.

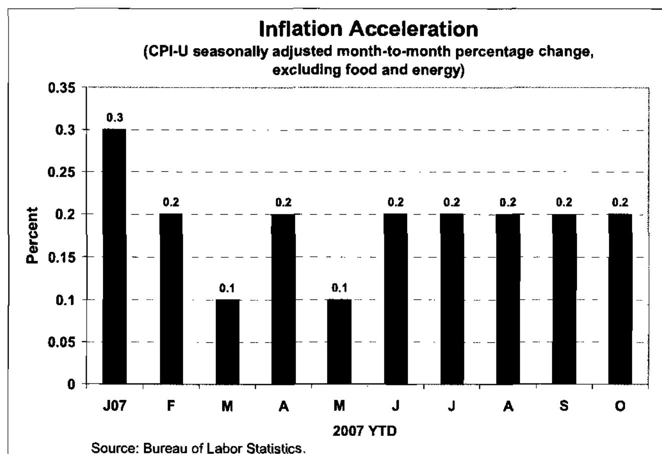
- **Inflation**

The Consumer Price Index for All Urban Consumers (CPI-U) increased at a seasonally adjusted annual rate (SAAR) of 1% in the third quarter, following an increase of 5.2% in the second quarter, and 4.7% in the first quarter. For the 12-month period ended in September, the CPI rose 2.8%. This brings the annual rate for the first nine months of the year to 3.6% and compares with an increase of 2.5% in all of 2006. The energy price index, after rising at a 27.8% SAAR in the first half of 2007, declined at a 14.8% rate in the third quarter. For the first nine months of the year energy costs have risen at an 11.7% SAAR, what compares to an increase of 2.9% for all of 2006. The food index advanced at a 5.7% SAAR in the first nine months of the year, after advancing 2.1% for all of 2006.

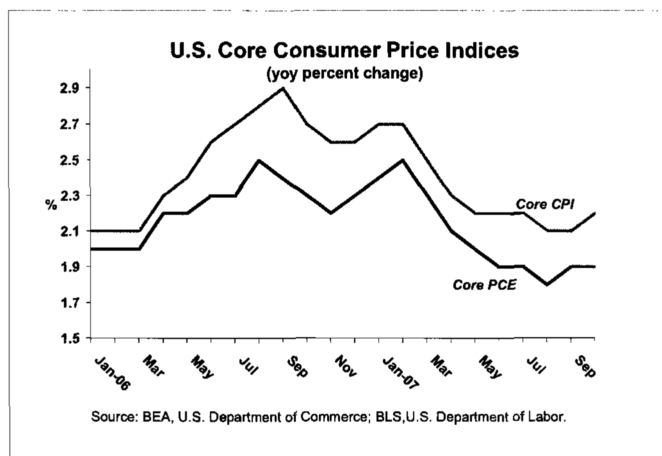


In July and August, the CPI-U was down from June's level, and stood at 2.4% and 2% year-on-year, respectively. On a seasonally adjusted basis, the CPI-U declined 0.1% in August, the first decline since a 0.4% decrease in October 2006. The index of energy was down 3.2% in August, its third consecutive monthly decline. However, in September the CPI-U increased 0.3%, and the index of energy also increased, albeit only by 0.3%. The CPI stood at 2.8% year-on-year in September, and at 3.5% in October. A main contributor to the increase in consumer prices in October was the energy component, which increased by 1.4%.

Excluding food and energy, the CPI-U advanced at a 2.5% seasonally adjusted annual rate in the third quarter, following increases at rates of 2.3% in each of the first two quarters of 2007. For the first nine months of the year, core CPI advanced at 2.3%, what compares to a 2.6% rise for all of 2006. The deceleration reflects a slower advance in the index for shelter, and a downturn in the apparel index. On a monthly basis, core CPI increased 0.2% in July, August, September, and October.

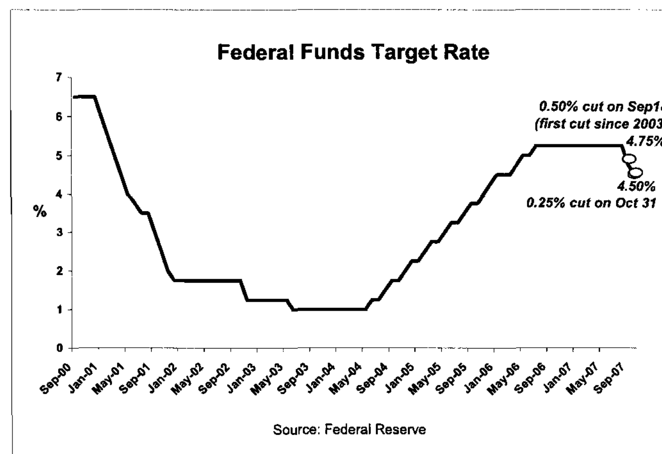


The Personal Consumption Expenditure (PCE) price index excluding food and energy, the most closely watched measure by the Federal Reserve, increased in the third quarter of 2007, although it stayed within the Federal Reserve's comfort zone. It increased to 1.8% at an annualized rate, compared to 1.4% in the second quarter and to 2.4% in the first. The core PCE declined from its peak of 2.5% yoy in August 2006 to 1.8% in August and September 2007. In June, July, August and September the core PCE readings were below 2%, considered to be the top threshold for the Federal Reserve (consistent gains above 2% are considered a concern for policymakers and investors). Although core inflation has been contained recently, concerns about inflation remain. Given the recent acceleration in oil and food prices, inflationary pressures may rematerialize.



- **Monetary policy**

The U.S. Federal Reserve met two times in the third quarter of 2007, on August 7, holding its interest rate at 5.25% for the 10th consecutive meeting, and on September 18. In its last meeting, the FOMC cut its target for the federal funds rate by 50 basis points for the first time since 2003, going beyond broad market expectations for a 25 bps cut. The decision was the Committee's sharpest reversal of course since January 2001, when it abruptly reduced rates at an unscheduled emergency meeting because of signs that the economy was slipping into a recession. The Fed also lowered the discount rate - the rate at which it lends to banks - by 50 basis points to 5.25%.



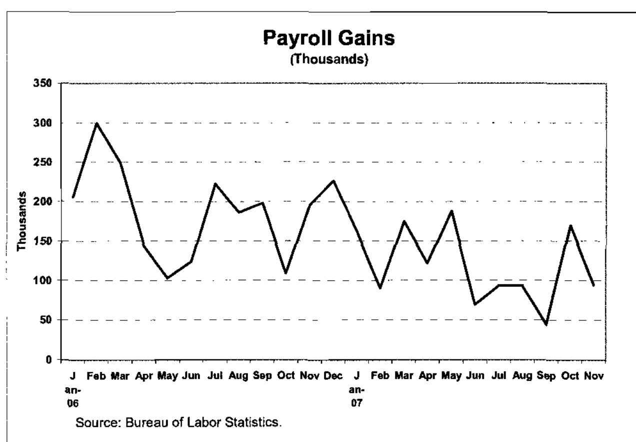
The FOMC met again on October 31, cutting the interest rates by a further 25 basis points to 4.5%, and also lowering the discount rate by 25 basis points, to 5.0%. In its statement, the committee cited an easing in financial market conditions and strong third quarter growth. However, the housing market continues to weight on growth, and the FOMC expects growth to be below potential in the near term. Although inflation has eased, higher energy prices are a concern. The statement moved the monetary policy bias toward neutral, saying that with the fed funds rate at 4.5%, the risks to the economy are roughly balanced between upside and downside. One member voted to hold the fed funds rate steady at 4.75%.

Economic conditions have deteriorated further since this last meeting, however. Downside risks to growth have increased, which has tilted the balance, markets believe, toward an easing on the December 11 meeting of the FOMC. Market hopes that the Fed would cut interest rates by more than a quarter point were damped, though, after new figures showed that the U.S. economy continues to add jobs at a reasonable rate in November.

With global financial markets under stress, the U.S. housing market in decline and fears of a recession growing, markets expect the Fed to lower the target rate by 25 basis points to a more accommodative 4.25%. The December decision will be another close call, with the potential for dissent from one or two FOMC members concerned that additional reductions in the target will fan inflationary pressures and threaten to dislodge long-term inflation expectations.

- **Labor markets**

The labor market has remained resilient, with 94,000 jobs being added on net in November. The rise in jobs was less than in October, however. According to Wachovia Economics Group, employment growth in November was consistent with slower household income and consumption growth in the fourth quarter, and slightly below-trend growth for the overall economy. Employment fell in construction, real estate and financial services, but there was an overall growth in jobs, suggesting that the housing downturn has remained contained so far. Broad gains are reflected in the diffusion index, which is above 50, suggesting that the job losses are concentrated and more of a sector story. [2]

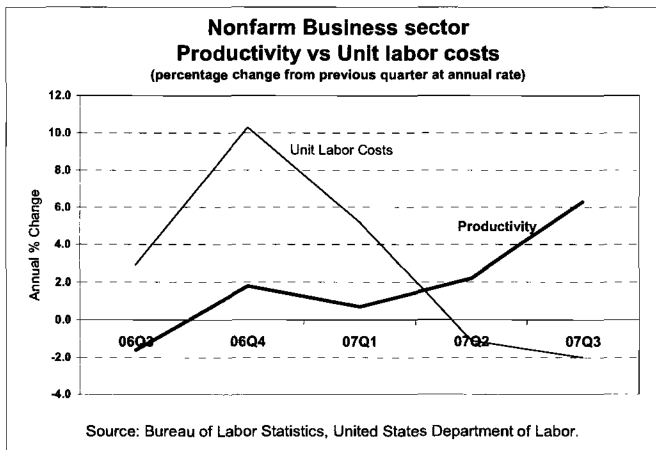


For the third quarter, the U.S economy created 230,000 jobs, less than the 379,000 jobs created in the second quarter and the 427,000 jobs created in the first. The unemployment rate increased to 4.7% in September from 4.6% in August, and has remained unchanged since then. The labor

[2] The dour August numbers mentioned in our last report underwent a large revision, with the decline of 4,000 turning into a gain of 93,000. The revision was largely due to a revision in government employment, the sector that held the preliminary numbers down.

force participation rate edged up to 66.1% from 65.9%in October.

Productivity growth was very strong in the third quarter. Nonfarm business productivity rose at a stronger than expected 6.7% annual rate, up from 2.2% in the second quarter. The year-over-year pace rebounded to 2.7% from 0.9% in the second quarter. Nonfarm unit labor costs fell an annualized 2% in the third quarter, surprising markets, as the consensus was initially for an increase, and after the preliminary third-quarter numbers were released in November, the consensus was for a smaller downward revision. Year-over-year, labor costs fell to 3% from 4.2% in the second quarter. This was an inflation-friendly report. However, the good news may be only temporary according to some analysts, as the economy is expected to slow sharply in the fourth quarter and to should continue to slow in the first months of 2008.



- **Financial markets**

Following the fall in August in response to the crisis in credit markets, equity prices recovered and reached record levels in October, recuperating the previous losses. The S&P rose to 1,540 in October, the Dow Jones to 13,901, and the NASDAQ to 2,780.

Treasuries have returned 8.2 percent in 2007, the most in five years, according to Merrill Lynch, as concern that losses from U.S. subprime-mortgages are spreading, fuels demand for the relative safety of government debt. The collapse of the U.S. subprime market has led to about $76 billion of losses and markdowns at securities firms and banks this year, prompting the Federal Reserve to reduce borrowing costs twice since Sept. 18. Policy makers are due to announce their latest rate decision tomorrow. Another round of downgrades of securities tied to subprime mortgages at the beginning of December spurred a flight to safer investments and sent stocks down, albeit modestly.

Stock Prices

	Dow Jones Industrial Average	S&P 500	Nasdaq
	Monthly Stock prices		
2007			
January	12,512.89	1,424.16	2,453.19
February	12,631.48	1,444.79	2,479.86
March	12,268.53	1,406.95	2,401.49
April	12,754.80	1,463.65	2,499.57
May	13,407.76	1,511.14	2,562.14
June	13,480.21	1,514.49	2,595.40
July	13,677.89	1,520.70	2,655.08
August	13,239.71	1,454.62	2,539.50
September	13,557.69	1,497.12	2,634.47
October	13,901.28	1539.66	2,780.42

Source: Economic Indicators, U.S. Government Printing Office.

The Administration has unveiled a subprime mortgage rescue plan, following an agreement with the mortgage industry on a plan to freeze interest rates for up to five years for a portion of the two million homeowners who bought houses in the last few years with subprime loans.

While praised by some as a first step in the right direction, the strategy has also received criticism. Barney Frank, Democratic congressman from Massachusetts and chairman of the House financial services committee said he welcomed the Administration's efforts, but took issue with many provisions of the plan. In particular, he considered a "grave error" not to offer to help people with high scores from consumer credit rating groups. Credit scores above 660 face a heavier burden to get help under the plan. According to Paul Krugman, there is an incentive under the plan for high-scorers to miss

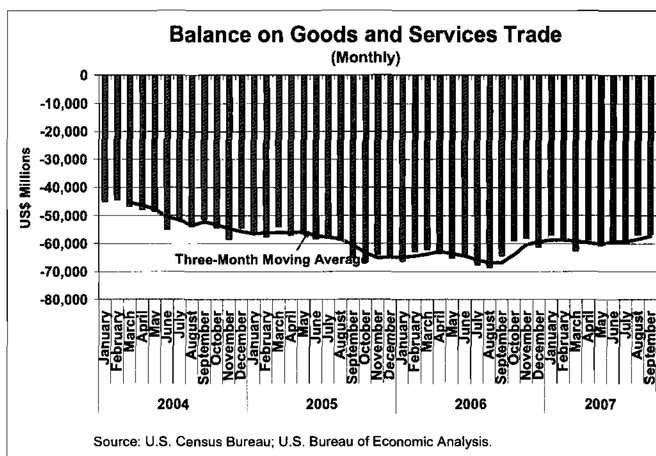
debt payments, because that would make them look like bad credit risks and eligible for relief. He believes that Mr. Paulson's plan focuses on investors' losses, rather than on borrowers' troubles. The plan would work if it reduced investor losses enough to seriously improve the overall financial situation. However, with only a small fraction of subprime borrowers qualifying for relief, and with many of them eventually facing foreclosures anyway, the plan is unlikely to reduce overall mortgage-related losses enough to improve financial stability.

Willingness by foreign investors to purchases U.S. securities has been adversely affected by recent dislocations in credit markets. There was a net outflow of capital in the third quarter of US$ 24.7 billion according to the Treasury International Capital (TIC) report. The weaker dollar has contributed to a steady narrowing of the U.S. trade deficit, which declined to US$ 172 billion in the third quarter from US$ 178 billion in the second. Despite the decline, the U.S. economy would still need monthly capital inflows of at least US$ 70 billion to finance the deficit in the current account.

Portfolio flows in September suggested a modest return in foreign appetite for dollar-denominated long-term U.S. financial assets, in sharp contrast with August, when the turmoil in credit markets led to an outflow of US$ 71 billion. There was an increase in foreign interest in corporate bonds and equities. Despite the improvement, the inflow of US$ 26.4 billion in September was still not enough to cover the trade deficit of US$ 56.5 billion. Diminished foreign appetite for long-term U.S. financial assets is a source of concern, and will weight on the dollar, but the current account deficit as a share of GDP has been shrinking, which has helped to slightly reduce the pressure for financing.

- **External sector**

The U.S. goods and services trade deficit narrowed by widened by 3% in the third quarter to US$ 172.3 billion from US$ 177.7 billion second. The September trade deficit in goods and services narrowed by 0.6% to US$ 56.5 billion from a revised US$ 56.8 billion deficit in August. This is the fourth consecutive month the deficit is improving. In September, both exports and imports increased, while exports increased more than imports. The increase in exports was partially offset by a rise in imports of capital goods.



From 2001 to 2005 trade was a consistent drag on economic growth, shaving one-half to a percentage point from real GDP growth. Trade has turned into a boost to real GDP growth now, and in the third quarter it added 1.4% to real GDP growth. This is significant because of the turmoil in credit markets stemming from the subprime mortgage problems, the weakening of the housing sector and the domestic auto sector.

Despite a higher increase in exports than in imports and a weaker dollar, the goods deficit with China widened from US$ 22.5 billion in August to US$ 23.8 billion in September. The bilateral trade deficit with China accounts for one-third of the U.S. trade deficit, and it has been a major contributor to the secular trend in the widening deficit.

II. LOOKING AHEAD

- In the third quarter of 2007, the U.S. economy grew at a 4.9% annual rate, a much faster pace than in the first quarter and than previously estimated, and the highest pace in four years. However, weakening housing activity, credit-market turmoil and waning consumer confidence suggest growth will slow significantly into next year.

- Current market projections for real GDP growth in 2007 and 2008 have been lowered in light of recent events, and now range from 1.9% to 2.5% for 2007, and from 1.4% to 2.8% for 2008.

Forecasts for Annual U.S. Economic Growth

	Real GDP		
	2007	2008	Date of Forecast
A. What Government Agencies Say			
FED	2.4 - 2.5%	1.8 - 2.5%	*Oct-07*
Council of Economic Advisors	2.3%	2.7%	*Jun-07 / Nov-07*
CBO	2.1%	2.9%	*Aug-07*
B. What Markets Say			
Goldman Sachs	2.1%	1.8%	*Dec-07*
National Association of Realtors	2.1%	2.8%	*Nov-07*
Merrill Lynch	2.2%	1.4%	*Nov-07*
Moody's Economy.com	2.1%	2.3%	*Nov-07*
Credit-Suisse	2.0%	2.2%	*Sep-07 / Dec-07*
The Economist Intelligence Unit	1.9%	1.5%	*Dec-07*
J.P. Morgan	2.2%	2.4%	*Nov-07*
Securities Industry and Financial Markets Association (SIFMA)*	2.2%	2.8%	*Jun-07*
Wachovia	2.2%	2.7%	*Nov-07*
Mortgage Bankers Association	2.4%	2.4%	*Nov-07*
C. What International Organizations Say			
United Nations DESA	2.1%		*May-07*
OECD	2.2%	2.0%	*Dec-07*
IMF	1.9%	1.9%	*Oct-07*

*previously the Bond Market Association

- Given the increasing fears that the tide of mortgage defaults will accelerate and of a possible U.S. economic recession, third-quarter growth and productivity, the November payroll report and the agreement between the Treasury and major mortgage providers to freeze interest rates on some adjustable rate subprime mortgages have provided some relief to financial markets.

- The Federal Reserve's rate cuts in September and October have alleviated some of the pressure in money markets, but so far its efforts have fallen short of their goals. Since October 31 financial conditions have deteriorated further, and Fed officials have recently indicated that the crisis in credit markets presents more risk to the economy and the financial system than inflation statistics, which so far have been benign. The Fed is expected to focus on addressing financial market problems and making sure to provide enough stimuli to offset the tightening in credit markets and the ongoing unraveling of housing market. The FOMC meets tomorrow and markets expect a quarter-point cut.