



## Global Growth Creates an Updraft for the U.S. Economy

If you've been fretting about the state of the economy, you must have welcomed the latest Gross Domestic Product (GDP) data with a sense of great relief. Output growth in the United States accelerated to 3.5% in the last quarter of 2006, after two quarters of lackluster growth. (See the following chart.)



Ever since third-quarter GDP growth came in at 2.0%, people have been debating whether the economy was headed for a soft or hard landing. The latest GDP data indicate that the economy was not preparing for a landing of either kind—at least for now. Views differ regarding the exact level of potential long-term growth for the United States, but most economists think it's around 3 to 3.5%. Fourth-quarter growth was at or above this rate.

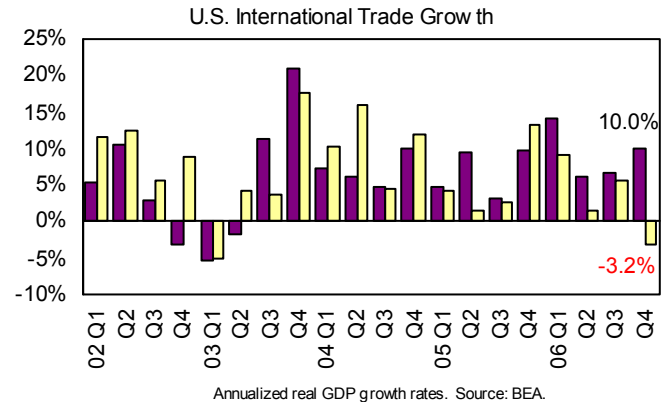
### Some surprises were in the latest GDP report.

Fourth-quarter GDP data included a few surprises—both positive and negative. On the positive side, personal consumption increased 4.4%, a big improvement over the 2.2% growth in the third quarter.

While spending on motor vehicles was down slightly, consumers shopped for furniture and household appliances with gusto, pushing up the consumption of durable goods by 6.0%. Consumers also loosened their purse strings for so-called nondurable goods, such as food and clothing, on which spending was up 6.9%.

Another positive surprise came from the international sector. As the following chart shows, exports expanded 10.0% in the fourth quarter, the biggest increase since the 14.0% increase in the first quarter of 2006. At the same time, imports fell 3.2%, making it the first decrease since the first quarter of 2003, when uncertainty regarding the war in Iraq caused both exports and imports to drop. It was

also the first time since 1991 that exports rose while imports fell.



In the accounting of GDP, rising exports increase overall growth, while rising imports have the opposite effect. In the fourth quarter, the economy received an extra boost from rising exports *and* falling imports. As a result, net international trade added 1.6 percentage points to total GDP growth, fully accounting for the difference between the third and fourth quarters.

On the negative side, the biggest surprise was the weakness of business investment, which dropped 0.4% in the fourth quarter, after expanding 10.0% in the preceding quarter. Especially notable was the 1.8% drop in equipment and software purchases. Does this suggest that U.S. businesses are curtailing investment in information technology? Probably not. Most analysts attribute this decrease to the delayed release of Microsoft's new Vista operating system.

Another negative factor was a decrease in residential investment. As homebuilders cut back production and reduced inventory, investment in residential properties fell by 19.2%. It was the fifth consecutive quarterly decrease, so it was a surprise to no one, but it nonetheless knocked off more than a full percentage point from total GDP growth.

### External factors move the U.S. economy.

Some of these surprises, especially positive ones, can be traced to external factors—something that happened offshore and ultimately had an impact on our domestic economy.

A case in point is the rapid fall in crude oil prices in the third and fourth quarters of 2006. Cheaper oil was the main

reason why imports shrank in the fourth quarter. Weak imports were by no means due to consumers' lack of appetite for foreign goods. If anything, cheaper crude oil reduced the cost of gasoline and heating oil for U.S. consumers, who then allocated more of their money for discretionary purchases.

Another positive external factor is synchronized expansion of the global economy. The United States has been enjoying solid growth of its exports because our overseas "customers" are in markedly better economic health and can absorb more U.S.-made products.

The good news is, this won't be a one-time phenomenon. The U.S. economy will likely feel a lift from global economic expansion once again in 2007. The following table is a summary of the global economic outlook, based on forecasts prepared by my colleagues at the Bank of Tokyo-Mitsubishi UFJ, Ltd. (BTMU) and myself. U.S. forecasts and estimates are by Union Bank of California, and non-U.S. predictions are from BTMU.

Global Economic Outlook

	Real GDP Growth (%)			Consumer Prices Growth (%)		
	2005	2006	2007	2005	2006	2007
USA	3.2	3.4	2.8	3.4	3.2	2.0
Euro Zone	1.5	2.6	1.9	2.2	2.2	2.0
Germany	1.1	2.5	1.2	1.9	1.8	2.2
France	1.2	2.1	2.0	1.9	1.9	1.6
Italy	0.1	1.8	1.3	2.2	2.1	1.8
UK	1.9	2.6	2.2	2.0	2.4	2.4
Japan	1.9	2.1	1.7	-0.1	0.1	0.2
China	10.2	10.6	9.8	1.8	1.4	2.0
India	8.4	7.9	7.6	4.2	5.4	4.5

U.S. forecasts as of February 5, 2007. Non-U.S. forecasts as of December 29, 2006

At this time, all major economies around the world (including the United States, the Euro Zone, and Japan) are expected to grow this year. With the prospect of continued rate hikes by the European Central Bank, however, growth of the Euro Zone is likely to slow in coming quarters.

Japan's current economic expansion has entered its sixth year, making it the longest one since the end of World War II. Unfortunately, the longevity of the expansion has not translated into vigor. Annualized growth in the third quarter was 0.8%, the weakest in almost two years. For this reason, the Bank of Japan's rate hike will probably be delayed until the second quarter of this year or later.

Some emerging markets are facing more optimistic scenarios. Central European nations, such as Poland and the Czech Republic, are expected to continue their healthy expansion, supported by the steady inflow of foreign direct investment. In Asia, China and India will likely maintain their strong momentum in 2007. As a region, Southeast Asia seems to be gearing up for solid growth this year.

The bottom line is that global economic expansion will be a tailwind for U.S. exports. The information technology and aerospace industries are likely beneficiaries of increased global demand. In addition to the tight labor market and rising household income, expanding trade will allow the U.S. economy to remain airborne well into 2008.

This should not cause the Fed to rush in and cool the economy with a rate hike. The next move by the Fed is likely to be a rate cut. Given the strength of the economy, however, the Fed's next policy move won't be necessary until the economy is further down its flight path.

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## Economic Forecasts – February 2007

UNITED STATES	2005	2006	2007	2008
Real GDP Growth (%)	<b>3.2</b>	<b>3.4</b>	2.8	3.2
Unemployment (%)	<b>5.1</b>	<b>4.6</b>	4.7	5.0
Payroll Employment Growth (%)	<b>1.7</b>	<b>1.9</b>	1.2	0.8
CPI Change (%)	<b>3.4</b>	<b>3.2</b>	2.0	2.2
Federal Funds (%)	<b>3.2</b>	<b>5.0</b>	5.2	4.6
Housing Starts (millions)	<b>2.07</b>	<b>1.82</b>	1.62	1.64
Car/Lt. Truck Sales (millions)	<b>16.9</b>	<b>16.5</b>	16.5	16.8

**Bold: Actual.**

The information in this report is based on data available as of February 5, 2007, and has been obtained from sources believed to be reliable, but its accuracy, completeness, and interpretation are not guaranteed. We do not think it should necessarily be relied upon as the sole source of information and opinion.