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Rising Risks to the Global Housing Market

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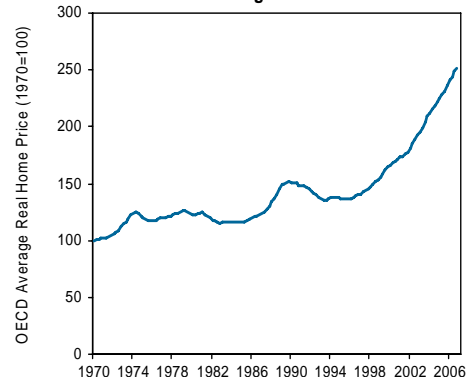
The past decade has seen a boom in real estate prices and construction across many OECD and emerging economies. With the notable exception of Japan and Germany, home prices have risen significantly in all the largest OECD economies. Indeed, the performance of the US housing market has lagged many other countries.

These housing booms have been supported by strong fundamentals: robust economic growth, lower real interest rates, financial innovation and, in some economies, a pick-up in population growth. Yet, with financing conditions tightening and valuations more stretched than in the past, the downside risk to house prices has increased.

Past episodes of home price declines have typically been preceded by booms in construction. Thus, the fact that residential investment as a share of GDP has increased significantly across most major OECD economies requires close monitoring.

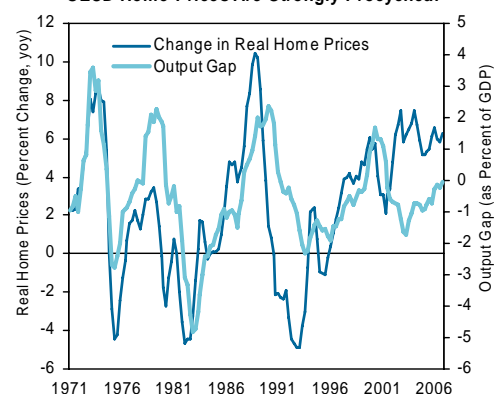
In addition to the US, recent data suggest that the housing markets in Spain, the UK and Ireland have begun to cool. It is still too early to call a turning point in the global housing market—one only needs to remember how the UK market slowed in 2005, only to rebound sharply the following year. But if the cooling trend we are seeing in some markets intensifies, this will have an adverse impact on growth. Moreover, if what is now a 'US-specific' housing shock becomes a global shock—a scenario that is not part of our core forecast—this will strain our global decoupling view.

Home Prices Across Much of the World Have Surged Since 1998



Source: OECD, Goldman Sachs

OECD Home Prices Are Strongly Proccyclical



Source: OECD, GS Calculations



Rising Risks to the Global Housing Market

The past decade has seen a boom in real estate prices and construction across many OECD and emerging economies. Given the ongoing downdraft in the US residential real estate market—and the fact that the US is often a leading indicator for what happens in the rest of the world—it is important to assess the outlook for real estate markets elsewhere.

Our long-standing view that the rest of the world will be able to decouple from slowing US growth has been predicated on the notion that the turmoil in the US housing sector is a ‘country-specific shock’ that will not generate large spillovers into other economies. But the spread of global credit risks has introduced a new potential transmission mechanism. Furthermore, while housing is more ‘local’ than other assets, we show here that there has been a substantial global element to the recent house price boom, with many countries seeing strong gains, helped by a common set of drivers. Where prices have run up more rapidly—in the UK, parts of Europe, Canada and Australia—there may be increased vulnerability to a deceleration in growth and a tightening of financial conditions.

As we set out last week (*Global Economics Weekly* 07/31, “Stress-Testing our Decoupling Thesis”, September 19, 2007), while our core forecasts continue to see global decoupling, potential vulnerability across a broad set of housing markets is one of the risks we think needs to be monitored.

Despite Much Variation, Housing Markets Have Become More Correlated

The term ‘global housing market’ is really a bit of a misnomer. As we have noted in the past, the global real estate market is a collection of national and regional markets, which respond strongly to local conditions. Hence, real estate prices across markets tend to be less correlated than the prices of other assets, such as stocks and bonds. Even within the US, the latest Case-Shiller

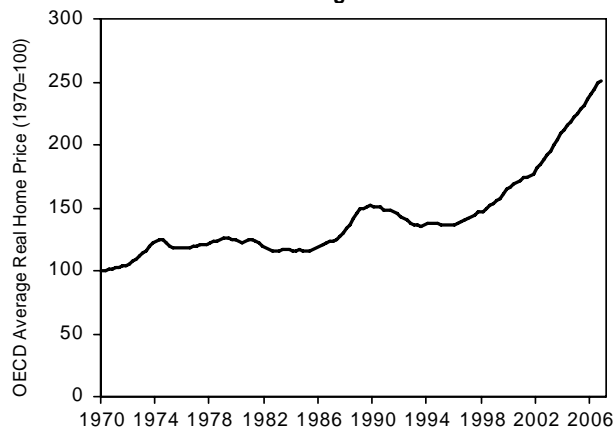
data indicate substantial variation in performance across various cities, ranging from year-over-year declines of 11% in Detroit and 7.7% in Tampa Bay to gains of 6.8% in Charlotte and 7.9% in Seattle. Similar variations in performance are evident across countries. Since 1990, Germany, Switzerland, Japan and Korea have experienced decreases in real home prices, while real home prices in Spain, the UK and Ireland have increased more than 300%.

However, despite these variations, statistical analysis indicates that the importance of a common ‘global factor’—a measure of the degree to which home prices across national markets are correlated—has increased over the past decade. The increase in this factor, from less than 50% of total price variance in the 1970s to over 90% over the past eight years, was driven by the concomitant large gains in real home prices in most markets. Indeed, the performance of the US housing market has lagged the rest of the OECD. Whereas home prices in the US increased by about 50% between 1990 and 2006, the average increase in the rest of the OECD was closer to 70%. The pace of price gains accelerated in the late 1990s, with many economies jumping on the ‘housing boom’ bandwagon. Since 1998, real house prices have more than doubled in France, and have increased by 60% in Italy, 55% in Canada and 72% in Australia.

Factors Behind the Global Housing Boom

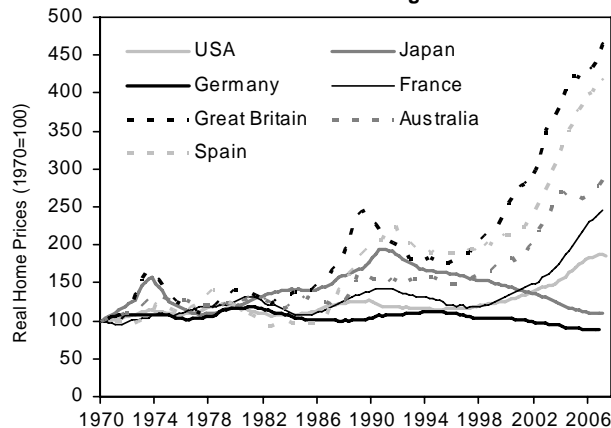
Such a widespread housing boom has little precedent in modern history. It is now common for people to talk about a global housing ‘bubble’. Yet the global housing boom was not without important fundamental catalysts. And to the extent many home markets have experienced contemporaneous booms, this is at least partly because the catalysts driving these booms have occurred across a wide cross-section of countries. In particular, the following factors appear to be most important in explaining movements in home prices.

Home Prices Across Much of the World Have Surged Since 1998

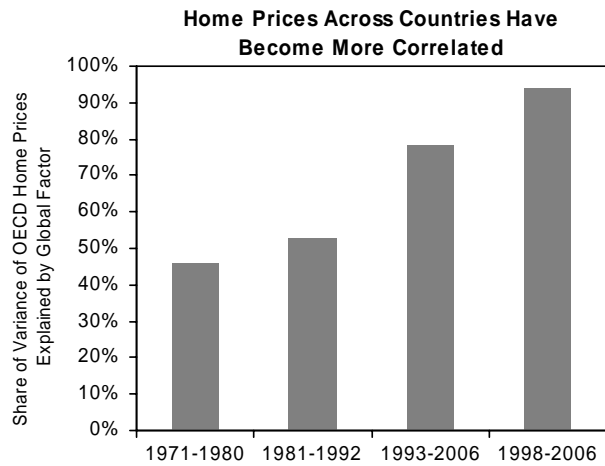


Source: OECD, Goldman Sachs

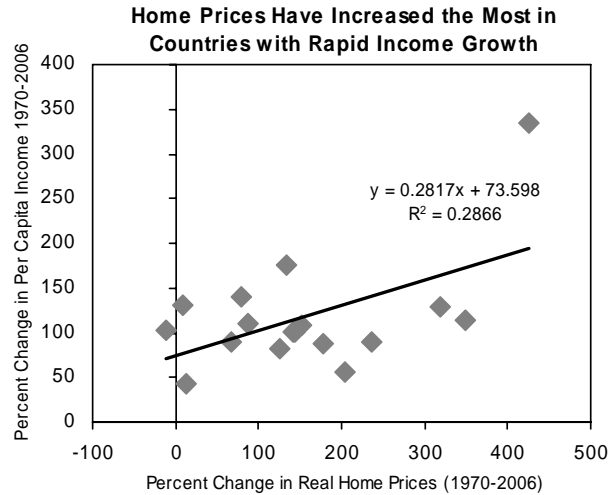
Japan and Germany Did Not Participate in the Latest Housing Boom



Source: OECD



Source: OECD, GS Calculations



Source: IMF, OECD, GS Calculations

Income growth: Over the long term, the most important driver of home prices is income growth. Countries that grow faster tend to see a more rapid appreciation in home prices. Hence, it is not surprising that, among the OECD economies, Ireland—where real home prices increased 444% between 1970 and 2006—also had the fastest income growth (real per capita income increased 334% over that period). In contrast, in Japan—where growth has been stop-go since the early 1990s—real home prices are still 40% below their 1990 high.

Declining interest rates: The decline in interest rates over the past decade has been an important contributor to rising home prices in many markets. Between 1990 and 2006, long-term interest rates in OECD countries decreased by about 7% in nominal terms and 4% in real terms. Countries where rates decreased the most tended to see the largest gains in home prices.

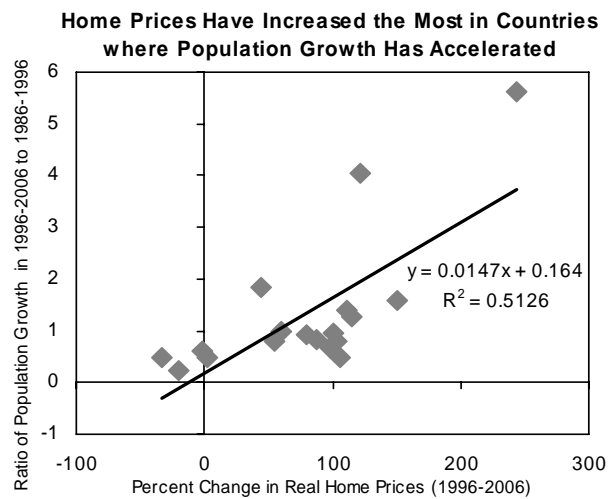
Financial innovation: In many countries, dramatic improvements in housing finance made homeownership more accessible to a wider cross-section of

society. This was facilitated by deregulation of mortgage lending, which opened the market to an increasing number of financial institutions. Furthermore, the introduction of new products, such as collateralised mortgage obligations, allowed risks to be diversified across a wide spectrum of investors, which helped reduce mortgage spreads in a number of countries.

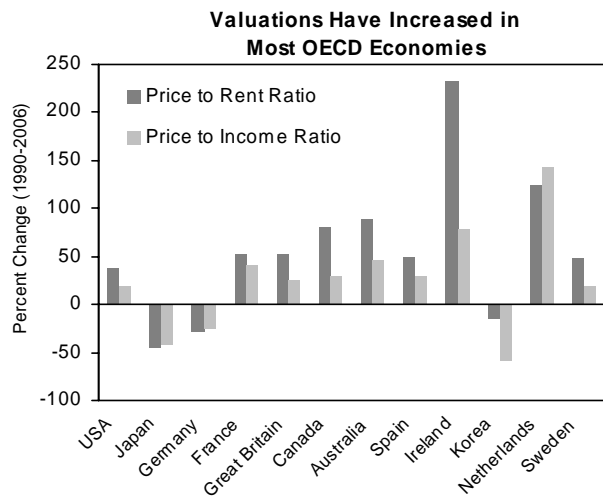
Population growth: According to conventional wisdom, countries with rapidly growing populations experience faster gains in home prices. But the evidence is rather more nuanced. There is little correlation between population growth—or population densities for that matter—and home prices. Rather, changes in population growth appear to be more important. Countries that experienced an acceleration in population growth rates are more likely to experience housing booms. For instance, annualised population growth in Spain increased to about 1% in 1996-2006 from 0.25% a decade earlier. In contrast, population growth in Japan declined from 0.37% to 0.18% over the same period, while population growth in Germany decreased from 0.48% to 0.11%.



Source: OECD, IMF, GS Calculations



Source: OECD, IMF, GS Calculations



Source: OECD, GS Calculations

A Question of Valuation

As the arguments above suggest, housing booms across much of the world were to some extent predictable responses to the fundamental catalysts pushing home prices higher. Nevertheless, in some markets the price response may well have been greater than the fundamentals suggest. Assessing whether housing markets are overvalued or undervalued is a tricky issue and one we have addressed before from various perspectives (see *Global Economics Paper*, “House prices: A Threat to Global Recovery or Part of the Necessary Rebalancing?”, July 15, 2005).

Two widely-used measures of valuation are: the home price to rent ratio—or its inverse, the rental yield—and the home price to income ratio. In the past four years, these have trended up sharply in many OECD economies. The biggest increase in the price/rent ratio was in Ireland, where the ratio has risen by over 200% since 1990. However, because the Irish economy grew so quickly over this period, the price/income ratio increased by (only!) 78%.

A critical issue is the interest rate at which one discounts future rents to assess the appropriate price/rent ratio. As

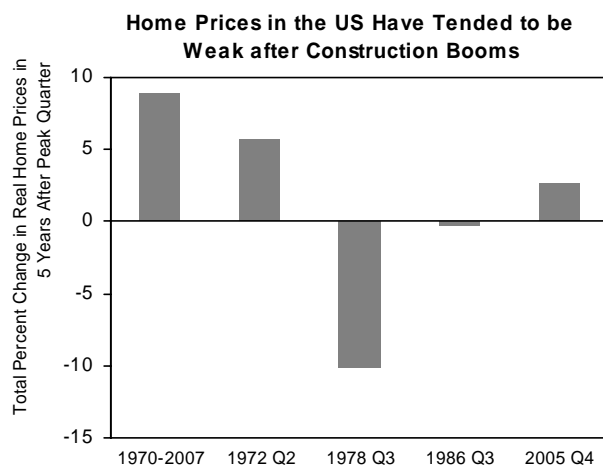
we mentioned earlier, in most of the economies where the price to rent ratios surged, real interest rates also declined markedly. In Ireland, real interest rates declined by about seven percentage points from 1990 to 2006. This suggests that the appropriate price/rent ratio should have increased substantially—and that is what happened. Similarly, real interest rates fell by about 8% in Spain, another market that experienced a large housing boom.

If They Build It, Will They Come?

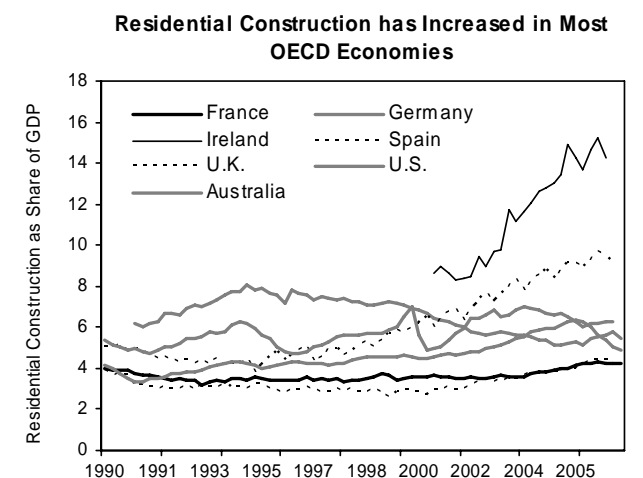
On a practical level, the question of valuation is of secondary importance. If housing markets outside the US do stumble, this will be because the supply of homes outstrips the demand. Thus, keeping a close eye on supply is critical for gauging the likely price trajectories in various housing markets.

Past episodes of home price declines have typically been preceded by booms in construction. In the US, peaks in residential construction as a share of GDP have been associated with below-average growth in real home prices over the subsequent five years. Looking at the past three peaks, the peak in 1980 was followed by a total decline in real prices of about 10% over the next five years; the peak in 1988 was followed by a decline of 0.2%. The last peak in the US occurred in 4Q2005 when residential construction reached 6.3% of GDP—the highest level since the baby boom in the early 1950s. Since then, real prices have increased a total of 2.6%, but have been declining since 1Q2006.

This pattern is reinforced by the experience of Germany and Japan—the only two large OECD economies where home prices have stagnated for more than a decade. In both countries, the sagging housing market was preceded by a major building boom. In Japan’s case, the construction boom ended about the same time that the stock market entered a long secular bear market and the economy began a protracted period of slow growth. In Germany’s case, home prices entered a secular bear market shortly after the construction boom that followed reunification.



Source: US Department of Commerce, OECD, GS Calculations



Source: National

Given the experience of the US, Germany and Japan, the increase in residential investment as a share of GDP across most major OECD economies requires close monitoring. In some economies, the rise in residential construction spending has been very pronounced. In the UK, Canada and Australia, construction spending as a percentage of GDP in 2003-2006 was more than one percentage point above the 1990-2002 average. In other economies, the pick-up in construction spending was even greater. In Spain, residential construction spending has averaged 8.7% of GDP since 2003, up from an average of 5.1% over the preceding 13 years. The surge in construction was most dramatic in Ireland. In 2005-06, construction spending averaged 14.2% of GDP, nearly three times the OECD average since 1990.

Some Economies Are Showing Signs of Weakness

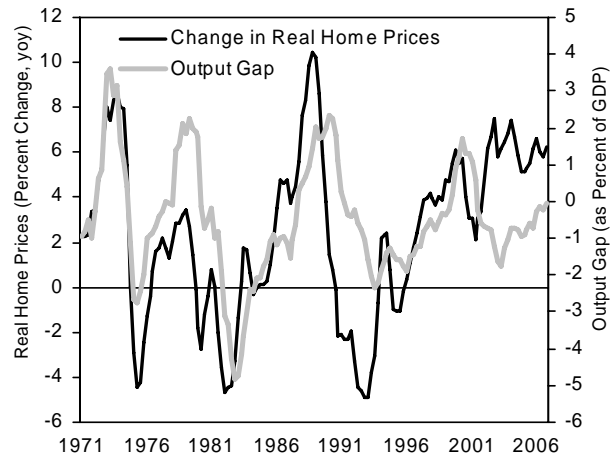
In the US, the housing market has yet to show any signs of bottoming. The Case-Shiller futures continue to price in large declines in average US home prices in 2008 and our US team expects home prices to decrease 7% this year and another 7% in 2008. The housing bust in the US began as excess supply began to overwhelm the market but has been reinforced by the ongoing problems in the mortgage market. With many mortgage lenders either shutting down or scaling back operations, the availability of housing finance is unlikely to revert to former levels any time soon. This will put further downward pressure on home prices.

But signs of softening are not limited to the US. In the UK, several recent surveys indicate the housing market is beginning to cool rapidly. It is still too early to call a definite turning point—one only needs to remember how the UK market slowed in 2005, only to rebound sharply in 2006. But the recent price data do suggest that the downside risks to UK housing have increased. We have recently revised down our UK growth forecasts and expect the Bank rate to fall by 75bp next year, significantly more than the forwards.

Given the construction booms in Spain and Ireland, it is also not surprising that the housing markets in both economies are showing signs of fatigue. In Spain, home prices have begun to decline. And with rental yields less than 3%—below that of any other major economy—Spanish housing appears to be richly valued. In Ireland, home prices have also slowed in recent months and, by some measures, have begun to decline.

Elsewhere in Europe, the picture is more mixed. We have long argued that housing is cheap in Germany (see, for example, *European Weekly Analyst*, October 13, 2005). Given that real home prices in Germany are still below where they were more than 30 years ago and rental yields are more than 5%, we think the downside risk to German housing is quite low. Outside the major OECD economies, a number of emerging economies have seen housing booms. These have been particularly large across much of eastern and central Europe, parts of Asia and South Africa.

OECD Home Prices Are Strongly Procyclical



Source: OECD, GS Calculations

If the Global Housing Boom Ends, Global Growth Will Slow

As we have noted, housing booms in many countries have been supported by strong fundamentals: robust economic growth, lower real interest rates, financial innovation and, in some OECD economies, a pick-up in population growth. Thus, the question is not whether fundamental catalysts can account for the run-up in home prices—they clearly do. Rather, the issue is whether these improved fundamentals fully justify the booms that we have seen.

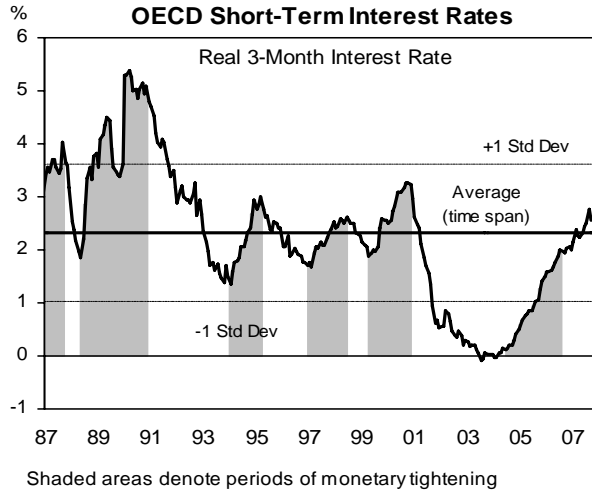
It is impossible to answer this question definitively, but in those markets where prices have run up the most and rental yields have fallen dramatically, the risks of a housing correction are likely to have increased materially.

Should housing markets outside the US begin to slow, this would present risks to our decoupling view. Home prices are quite pro-cyclical. With the notable exception of the 2000-01 recession—when aggressive interest rate cuts helped support home prices—real home prices in the OECD have decreased during every major economic downturn since the early 1970s. Indeed, there is evidence that home prices have preceded business cycle developments. This is not too surprising considering that residential property usually represents the bulk of financial assets for most households. Econometric studies suggest that the ‘wealth effect’ for housing is about twice as large as for equities, with consumption falling by about 2 cents in the short run for every US\$1 decline in home prices. Thus, if home prices in key economies begin to fall, this will have an adverse impact on global growth.

Peter Berezin

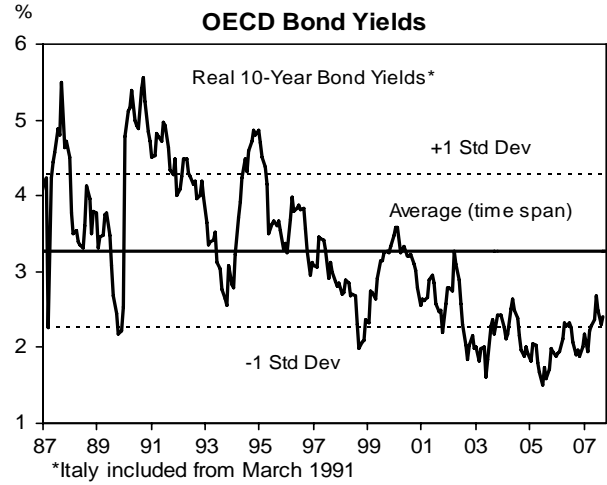
Global Economic Indicators: Policies and Markets

Short-term interest rates are now 22bp above their long-term average.

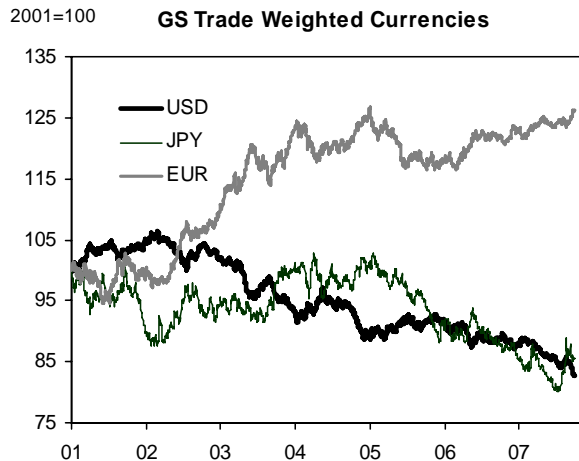


Shaded areas denote periods of monetary tightening

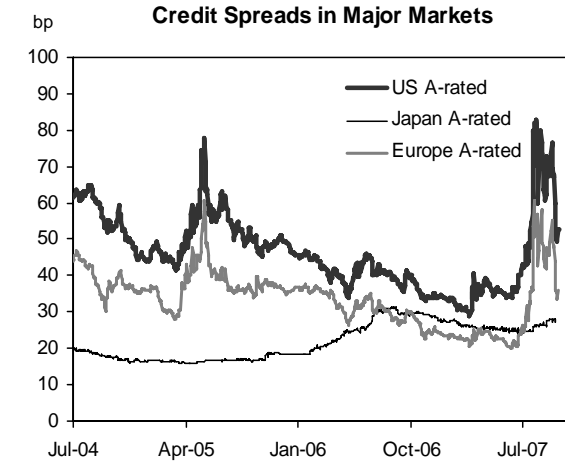
Real bond yields have risen in September, to about 100bp below their historical average.



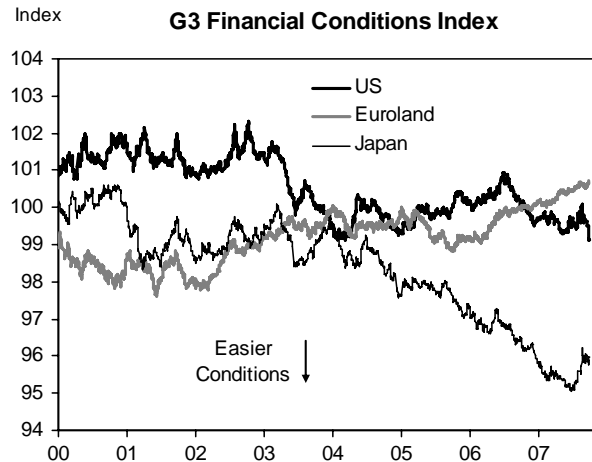
The Dollar remains weak, as concerns about US mortgage credit continue to dominate markets.



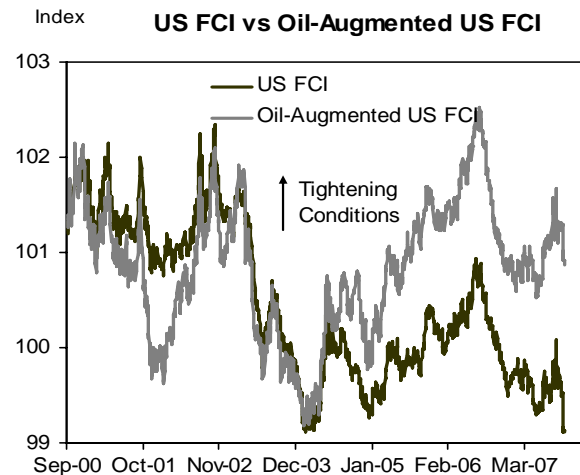
Credit market jitters continue, with US spreads having widened by over 20bp since the start of the summer.



US financial conditions have eased 95bp since the latest peak in mid-August.



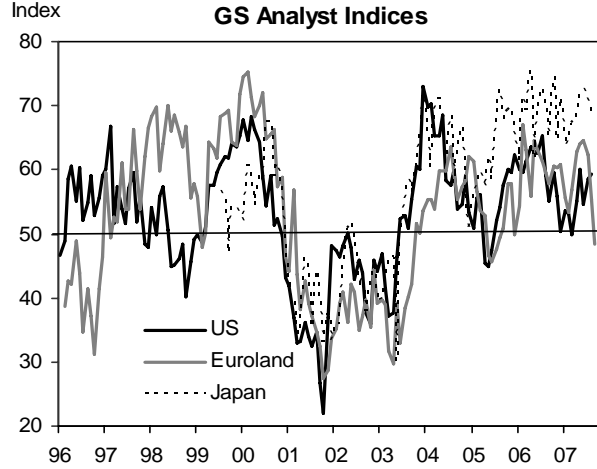
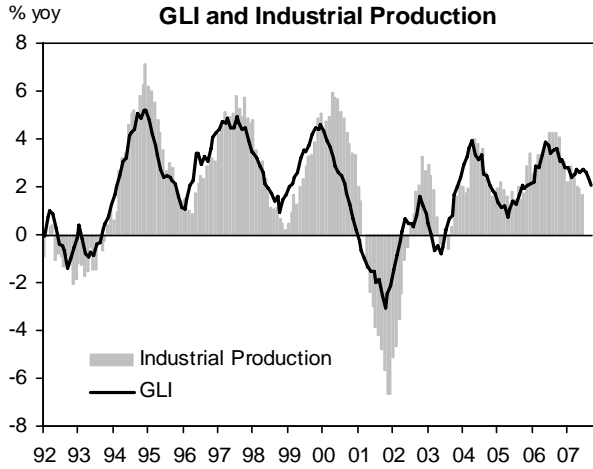
Our oil-augmented FCI has moved in line with the standard measure over the past week.



Global Economic Indicators: Macroeconomic Developments

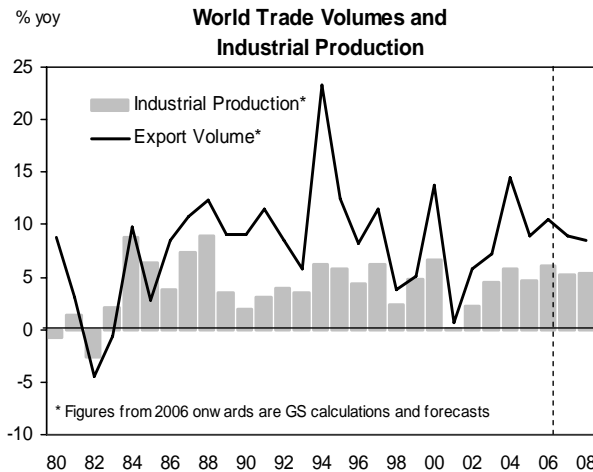
Our Advanced September GLI slowed further to 2.0%yoy, from last month's headline of 2.2%. Monthly momentum rebounded to 0.04%mom from the August reading of 0.00%.

The Japan GSAI declined slightly to 68.6 in August, from 70.6 in July, although it remains at a high level.



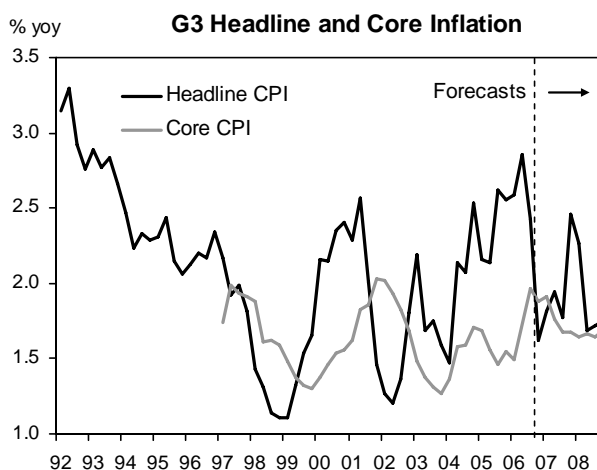
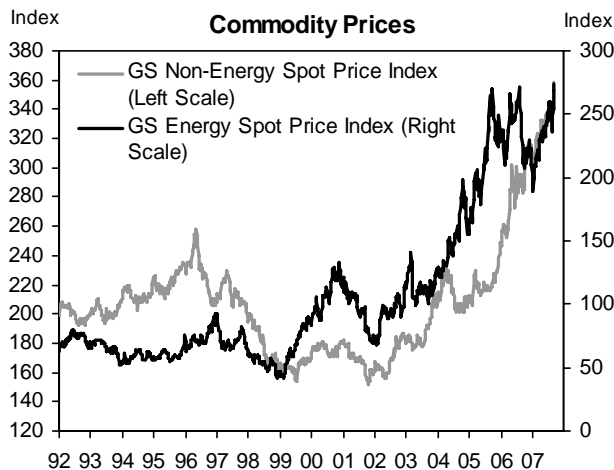
After this year's slowdown in industrial production, we expect a mild pick-up in 2008.

Our China GSCA grew 11.7%yoy in August, down from 12.7% in July.



Commodity prices have generally increased since last week.

We expect headline inflation to peak in 4Q2007 and gradually to converge on core inflation during 2008.



Global Economic Indicators: Market Valuations

The world Equity Risk Premium (ERP) is now about 30bp below its historical average.

Updated Estimates for the Equity Risk Premium*

	Real GDP Growth	Real Earnings Growth	Dividend Yield	Expected Real Return	Real Bond Yield	Implied ERP	Expected Inflation	Expected Nominal Return
US	3.0	3.0	1.8	4.8	2.3	2.6	2.0	6.8
Japan	1.5	1.5	1.4	2.9	1.2	1.7	0.5	3.4
UK	2.5	2.5	3.1	5.6	2.1	3.5	2.0	7.6
Europe ex UK	2.3	2.3	2.4	4.7	2.1	2.6	2.0	6.7
World	2.5	2.5	2.2	4.7	2.0	2.7	1.8	6.5

*Calculated as of 25 September 2007.

Source: Datastream; real GDP growth and expected inflation are GS Economics Research forecasts.

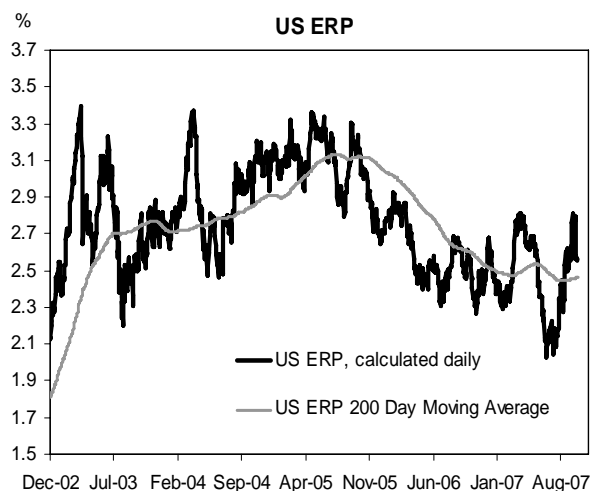
Global equities have mostly turned positive over the past week, except in the US.

Weekly Equity Market Performance

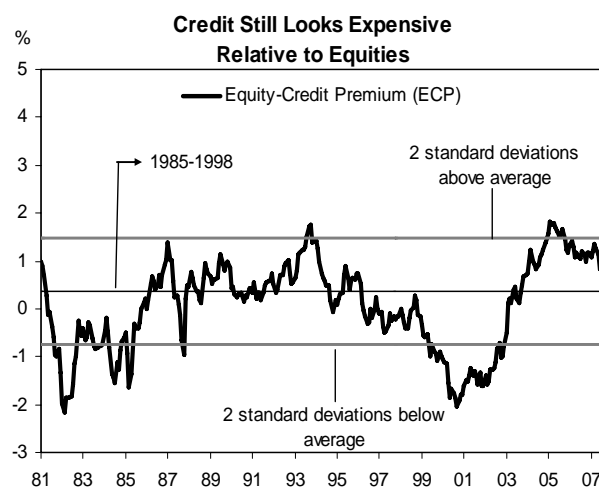
Price change for the week ending 25/09/07, % local currency terms				
	US	Europe	Japan	Hong Kong
Market	-0.25	3.08	3.57	6.56
Basic industries	2.08	9.55	10.97	-7.16
Oil & gas	-0.08	2.74	5.32	16.72
Industrial Engineering	-0.89	4.73	6.75	11.98
Financials	-2.09	2.88	3.31	5.01
Health Care	0.50	2.45	2.87	0.00
Utilities	0.65	3.19	-0.46	-0.23
Transport	-1.57	1.10	6.48	3.56
Travel & Leisure	0.42	1.42	1.15	6.91
Technology	2.10	3.00	0.21	2.41
Telecoms	2.55	2.40	-0.17	12.83
Media	-1.78	0.40	0.86	-3.64

Source: Datastream.

The US ERP has declined over the past week, as real bond yields have increased slightly.



Our ECP posted another fall in August, mainly driven by the lower ERP.



Bond and Currency Forecasts

Interest Rates

%		Current*	3 Month Horizon		6 Month Horizon		12 Month Horizon	
			Forward	Forecast	Forward	Forecast	Forward	Forecast
US	3M	5.2	4.9	4.7	4.5	4.2	4.3	4.1
	10Y	4.6	4.7	4.2	4.7	4.2	4.8	4.4
Canada	3M	4.9	4.6	4.7	4.4	4.7	4.5	4.7
	10Y	4.4	4.4	4.7	4.4	4.8	4.4	4.8
Australia	3M	6.9	7.0	6.7	7.0	6.7	6.9	6.7
	10Y	6.2	6.2	6.1	6.2	6.3	6.2	5.8
Japan	3M	0.8	0.8	0.8	0.9	1.1	1.0	1.3
	10Y	1.7	1.7	1.7	1.8	1.8	1.9	2.1
Euroland**	3M	4.7	4.6	4.5	4.3	4.2	4.2	4.2
	10Y	4.4	4.4	4.0	4.5	4.0	4.6	4.2
UK	3M	6.3	6.2	6.0	5.7	5.6	5.5	5.1
	10Y	5.0	5.0	4.5	6.0	4.4	5.0	4.6
Sweden	3M	4.3	4.4	4.2	4.5	4.4	4.5	4.7
	10Y	4.3	4.3	4.0	4.4	4.0	4.4	4.3
Switzerland	3M	2.7	2.8	2.8	2.8	2.8	2.9	3.0
	10Y	3.0	3.0	3.0	3.0	3.0	3.1	3.3

* Close 25 September 2007, mid-rates for major markets. We are currently using December 2007, March 2008 and September 2008 contracts for 3-month forward rates. ** Average of Germany and France, semi-annualised.

Exchange Rates

	Current*	3-Month Horizon		6-Month Horizon		12-Month Horizon	
		Forward	Forecast	Forward	Forecast	Forward	Forecast
EUR/\$	1.41	1.41	1.43	1.42	1.43	1.42	1.35
\$/¥	114.4	113.1	110.0	112.0	110.0	110.1	112.0
EUR/¥	161.5	160.1	157.3	158.6	157.3	156.0	151.2
\$/C\$	1.00	1.00	1.10	1.00	1.10	1.00	1.10
A\$/	0.87	0.86	0.85	0.86	0.85	0.85	0.82
EUR/GBP	0.70	0.70	0.70	0.71	0.70	0.71	0.72
£/\$	2.02	2.01	2.04	2.01	2.04	1.99	1.88
EUR/CHF	1.65	1.64	1.60	1.63	1.60	1.62	1.62
\$/CHF	1.17	1.16	1.12	1.15	1.12	1.14	1.20

* Close 25 September 2007

Main Economic Forecasts

	2005	2006	2007	2008
Real GDP, % chg, yoy				
USA	3.1	2.9	2.0	1.8
Japan	1.9	2.2	2.0	2.1
Euroland	1.6	2.9	2.6	2.0
Germany	1.0	3.1	2.6	1.9
France	1.7	2.2	1.7	1.7
Italy	0.2	1.9	1.6	1.3
Netherlands	1.5	3.0	2.3	1.8
Spain	3.6	3.9	3.8	2.6
Sweden	2.9	4.5	3.6	3.0
Switzerland	2.4	3.2	2.3	1.2
UK	1.8	2.8	3.0	1.9
EU27	1.9	3.2	2.9	2.3
Canada	3.1	2.8	2.6	2.7
Australia	2.8	2.7	4.3	3.0
G7	2.3	2.7	2.1	1.8
Advanced Economies	2.6	3.0	2.6	2.2
Asia	6.9	7.4	7.6	7.1
Central and Eastern Europe	4.5	6.2	5.9	5.1
Latin America	4.5	5.4	5.0	4.2
Emerging Markets	7.5	8.2	8.4	7.7
World	4.4	4.9	4.7	4.2

	2005	2006	2007	2008
Consumer Prices, % chg, yoy				
USA	3.4	3.2	2.7	2.3
Japan	-0.3	0.1	-0.1	0.5
Euroland	2.2	2.2	2.0	1.9
Germany	1.9	1.8	2.1	1.5
France	1.9	1.9	1.4	1.8
Italy	2.2	2.2	1.9	1.9
Netherlands	1.5	1.7	1.5	1.3
Spain	3.4	3.6	2.6	3.1
Sweden	0.5	1.4	2.2	2.3
Switzerland	1.2	1.1	0.6	1.0
UK	2.1	2.3	2.3	1.7
EU27	2.3	2.2	2.1	2.0
Canada	2.2	2.0	1.4	1.9
Australia	2.7	3.5	2.2	3.1
G7	2.3	2.3	1.9	1.8
Advanced Economies	2.3	2.3	2.0	1.9
Asia	2.4	2.7	3.2	3.1
Central and Eastern Europe	3.6	2.8	3.6	3.7
Latin America	6.1	5.2	5.0	5.3
Emerging Markets	5.1	5.0	5.3	5.0
World	3.3	3.3	3.2	3.1

	2005	2006	2007	2008
Real GDP, % chg, yoy				
China	10.4	11.1	12.3	10.9
India	9.0	9.4	8.7	8.0
Hong Kong	7.5	6.9	6.0	6.0
Indonesia	5.6	5.6	5.9	6.0
Malaysia	5.0	5.9	5.5	6.0
Philippines	5.1	5.5	6.2	6.7
Singapore	6.6	7.9	6.7	6.5
South Korea	4.2	5.0	4.8	5.3
Taiwan	4.1	4.7	4.5	5.5
Thailand	4.5	5.0	4.0	4.5
Brazil	3.0	3.7	4.5	4.2
Argentina	9.2	8.5	8.0	5.3
Mexico	2.8	4.8	3.0	3.3
Venezuela	10.3	10.3	7.1	4.9
Russia	6.4	6.7	7.5	8.0
Turkey	7.4	6.1	5.5	5.7
South Africa	5.1	5.0	4.8	4.6
Central and Eastern Europe	4.5	6.2	5.9	5.1
Asia ex Japan	8.5	9.1	9.8	9.1
Latin America	4.5	5.4	5.0	4.2
BRICs	9.0	9.6	10.3	9.4
Emerging Markets	7.5	8.2	8.4	7.7

	2005	2006	2007	2008
Consumer Prices, % chg, yoy				
China	1.8	1.5	4.5	4.0
India	4.4	5.5	4.8	4.4
Hong Kong	1.1	2.7	2.9	4.1
Indonesia	10.5	13.1	6.0	6.5
Malaysia	3.0	3.6	2.3	3.1
Philippines	7.7	6.3	2.8	3.3
Singapore	0.5	1.0	1.1	1.6
South Korea	2.7	2.2	2.4	2.4
Taiwan	2.3	0.6	1.5	1.8
Thailand	4.5	4.6	2.6	2.5
Brazil	6.6	4.2	3.6	4.3
Argentina	9.6	10.9	8.8	9.9
Mexico	4.0	3.6	4.0	4.0
Venezuela	15.2	16.1	17.7	19.8
Russia	12.5	9.7	8.3	8.3
Turkey	8.2	9.6	8.6	6.3
South Africa	3.9	4.6	6.3	6.4
Central and Eastern Europe	3.6	2.8	3.6	3.7
Asia ex Japan	2.9	2.8	4.0	3.8
Latin America	6.1	5.2	5.0	5.3
BRICs	3.9	3.6	4.9	4.5
Emerging Markets	5.1	5.0	5.3	5.0

For India we use WPI not CPI. Asia consists of China, Hong Kong, India, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand. Europe is EU plus Bulgaria, Croatia, Romania, Switzerland.

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The World in a Nutshell

THE GLOBAL ECONOMY		
	OUTLOOK	KEY ISSUES
UNITED STATES	We have cut our growth and interest rate forecasts and we now expect real GDP growth to drop into the 1%-1.5% range from the fourth quarter through the first half of 2008. After that, we expect a modest improvement, to a 2%-2.5% range. By sector, our growth cuts are focused in consumer and capital spending. On interest rates, we are adding 50bp to the amount of easing we have been expecting, which would bring the funds rate to 4% by early next year.	Employment data indicate that the labour market has been eroding for several months—even before the credit crunch began. Fed easing will be needed to keep the labour market downturn from becoming a full-blown recession. The bright spots in the economy should continue to be the sectors that are exposed to the global economy; solid foreign growth and a weaker Dollar mean that improved trade performance should be a key contributor to US growth over the next year.
JAPAN	We have revised our FY 2007-08 growth forecasts following revisions to April-June data, which showed GDP growth running at an annualised pace of -1.2%. This marks the first fall into negative territory in three quarters. We now expect growth of +1.8% in FY2007 and +2.4% in FY2008. We have pushed back our forecast for the next rate hike to January-March 2008 from our prior forecast of October-December.	Foreign direct investment (FDI) from Japan continues to grow, and increasingly profits generated through direct investment are repatriated to Japan, where they boost profit margins. Indeed, there is a strong correlation between FDI and the Yen/Dollar forex rate, and even if the interest rate differential narrows, growth in capital exports through FDI should offset upward pressures on the Yen to a considerable extent.
EUROPE	We have revised down our GDP forecasts for Euroland to 2% in 2008 from 2.6% this year, with broadly stable inflation. Despite the ECB's hawkish talk, we now think they will remain on hold at 4%, but the risk is skewed towards one more hike. In the UK, we have further accelerated the decline in growth to 1.9% in 2008 from 3% this year, and as a result, we now think that the MPC will cut rates three times next year.	Inter-country adjustment within the Eurozone is an important concern for the ECB. We find evidence of a long-term cycle of out/underperformance among EMU's three largest economies (Germany, France and Italy), with industry responding first to changes in the competitive environment and the household sector lagging one to two years behind. This process of country rotation has implications for equity markets.
NON-JAPAN ASIA	Despite the prospects of a weakening US economy, we believe that rising CPI inflation and asset inflation in China will continue to put pressure on the PBoC to raise rates and to allow the currency to appreciate. Following recent changes to rates and the reserve requirement ratio, we now expect one additional 27bp rate hike this year.	We believe the strong and improved fundamentals in China and in the rest of emerging Asia stand a good chance of decoupling from a further weakening of the US economy or its continued subpar performance. Because of rising uncertainties in the US economy and policy risks in China, some cautiousness for the near-term outlook is understandable.
LATIN AMERICA	Higher inflation risks and stronger domestic demand have significantly reduced the room for Brazil to cut rates further. With the central bank taking on a hawkish tone, we now expect the long easing cycle to come to an end, with rates remaining on hold at 11.25% through the end of 2008.	As Brazil's monetary easing cycle matures, the dispersion of forecasts for interest rates and the yield curve are likely to widen. It is more crucial than ever for the authorities to reinforce the credibility of the inflation targeting regime by making an extra effort to reach consensus on the future path for macro policies.
CENTRAL & EASTERN EUROPE, MIDDLE EAST AND AFRICA	We have revised our inflation forecast for South Africa and hence our expected path for policy rates, and we now expect the SARB to raise rates two more times to a peak of 11%. In light of the unexpected rate cut by the Turkish central bank, we have brought forward a further 75bp of cuts into 2007 from next year and lowered our end-2008 rates view by 50bp to 16%.	In the context of the recent market turbulence, we continue to believe that the economies in our region will be able to weather the storm, as macro-policy frameworks have become more robust, integration with the EU gathers pace, and the benefits of global trade and financial integration improve economic efficiencies.

CENTRAL BANK POLICIES			
	CURRENT SITUATION	NEXT MEETINGS	EXPECTATION
UNITED STATES: FOMC	Fed funds rate cut by 50bp to 4.75% on September 18, 2007.	October 30-31/ December 11	We now expect the FOMC to cut the fed funds rate by 75bp by early 2008.
JAPAN: BoJ Monetary Policy Board	The BoJ raised the overnight call rate by 25bp to 0.5% on February 21, 2007.	October 10-11/ October 30	We expect the BoJ to leave rates unchanged for the rest of the year, with the next hike in January-March 2008.
EUROLAND: ECB Governing Council	The ECB raised rates by 25bp to 4.0% on June 6, 2007.	October 4/ November 8	We expect the ECB to keep rates on hold at 4%.
UK: BoE Monetary Policy Committee	The BoE raised rates by 25bp to 5.75% on July 5, 2007.	October 4/ November 8	We expect rates to remain unchanged at 5.75%.