The Global Macroeconomic Situation and Potential Risks in 2007-08

UNECE Timber Committee and International Softwood Conference Market Discussions

October 2007

Robert C. Shelburne, Ph.D.

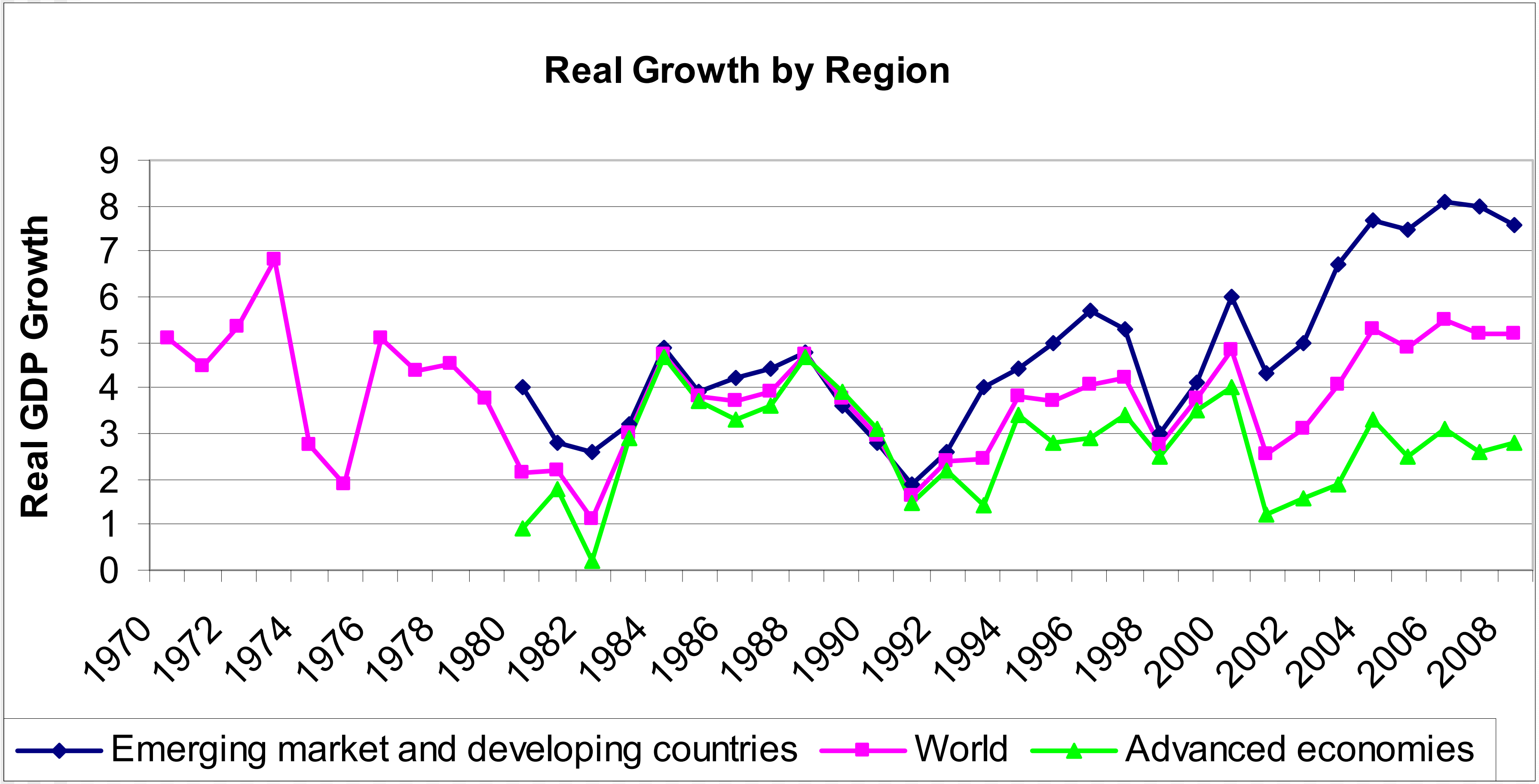
UN Economic Commission for Europe

Strong Global Growth

- Global growth (5.2% in 2007) remains strong
  - Significantly above trend for last four years
  - Robust growth of 5.2% also expected for 2008
  - Since 2000, per capita growth higher than during the golden age of 1950-1973
- Growth is geographically balanced
  - Slowing in U.S.;levelling off in Europe & Japan; Latin America, Africa, Asia are doing extremely well

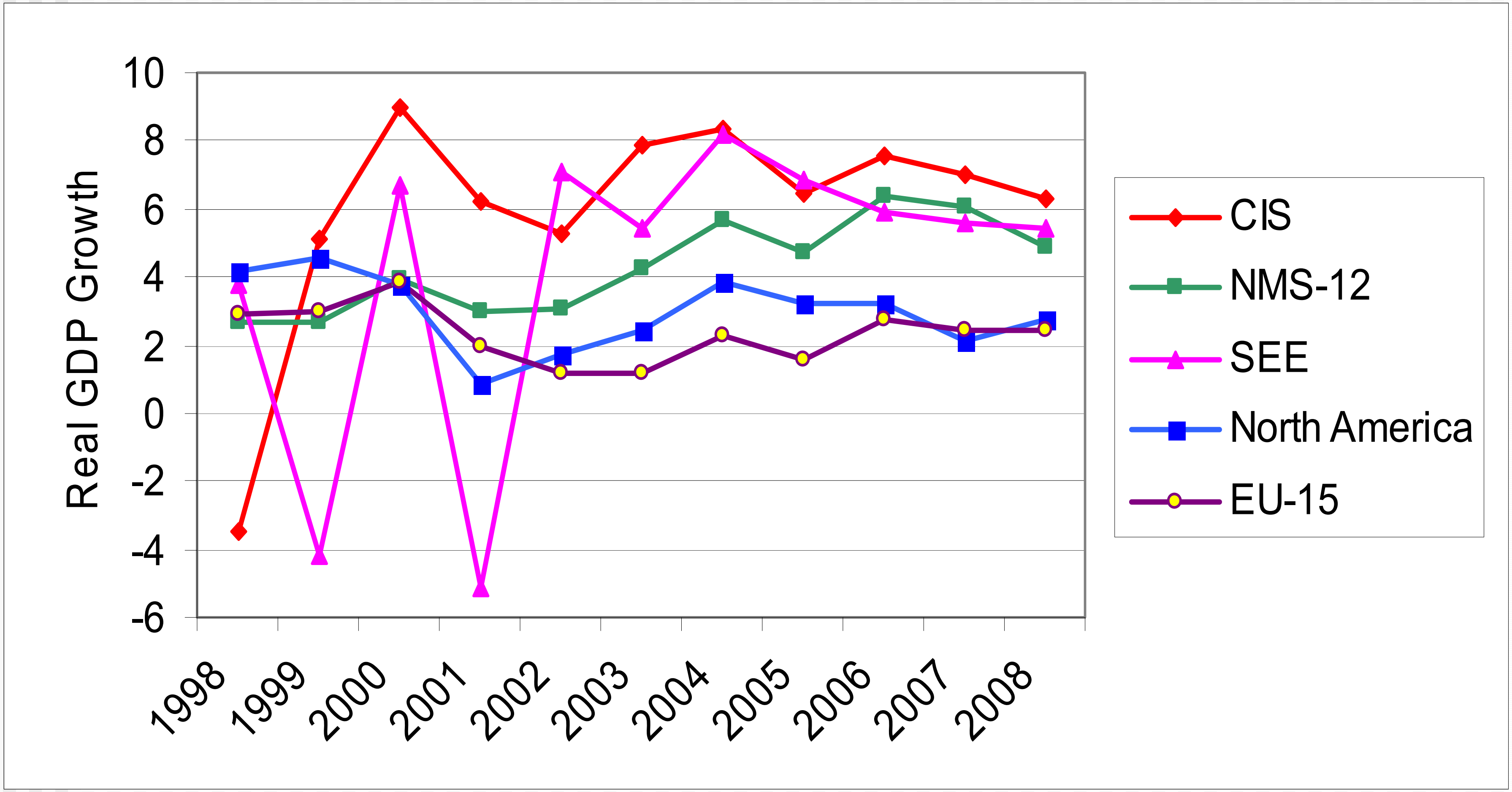
Solid Global Real Growth Increasingly Due to the Emerging Markets

Trade & Employment Have Also Increased Significantly



Solid Real Growth in the ECE

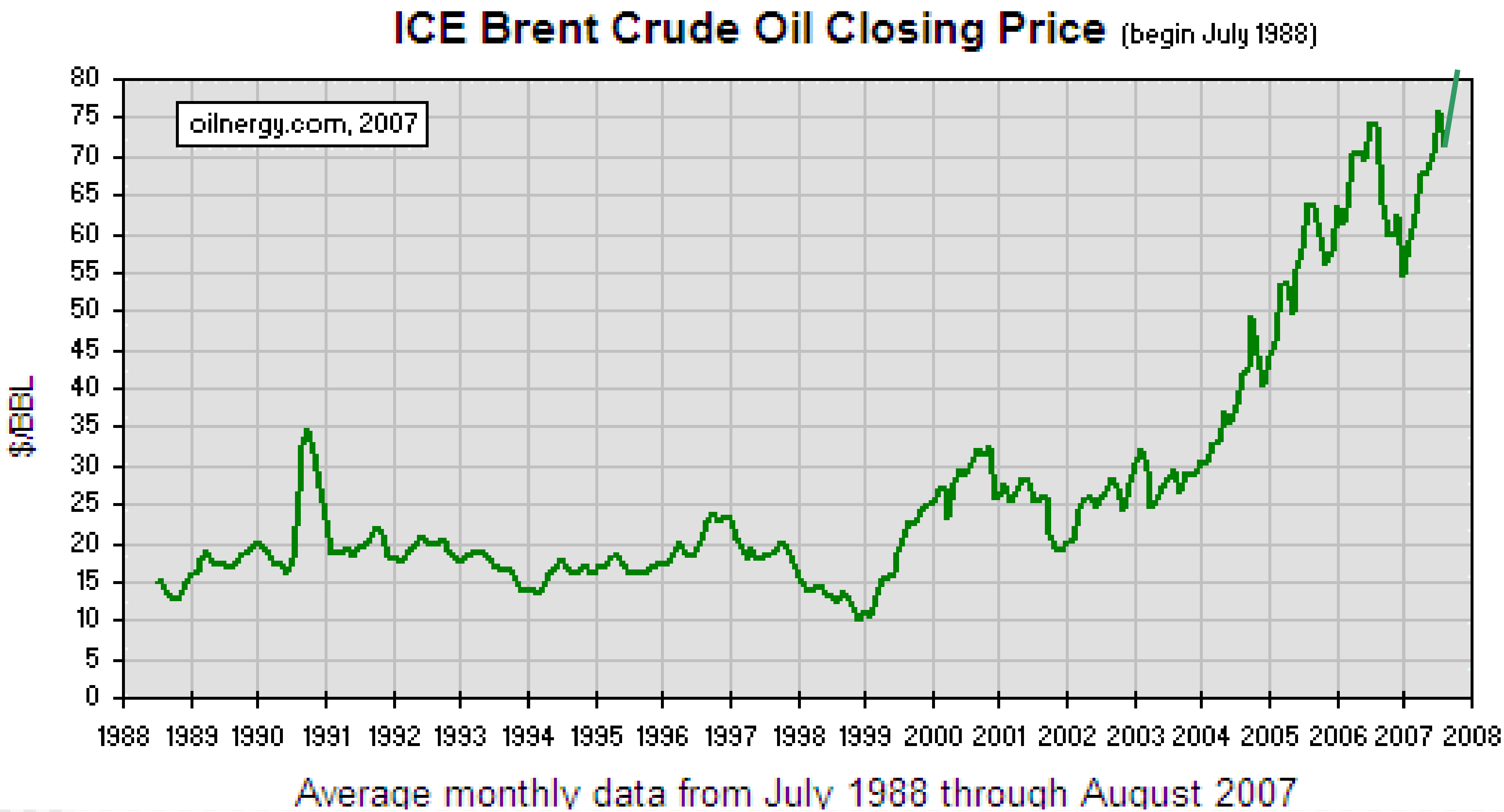
After a Difficult Decade (1990s) There Is Now Solid Growth in the Transition Economies especially since 2002; 2008 Projections Likely to be Revised Slightly Downward.



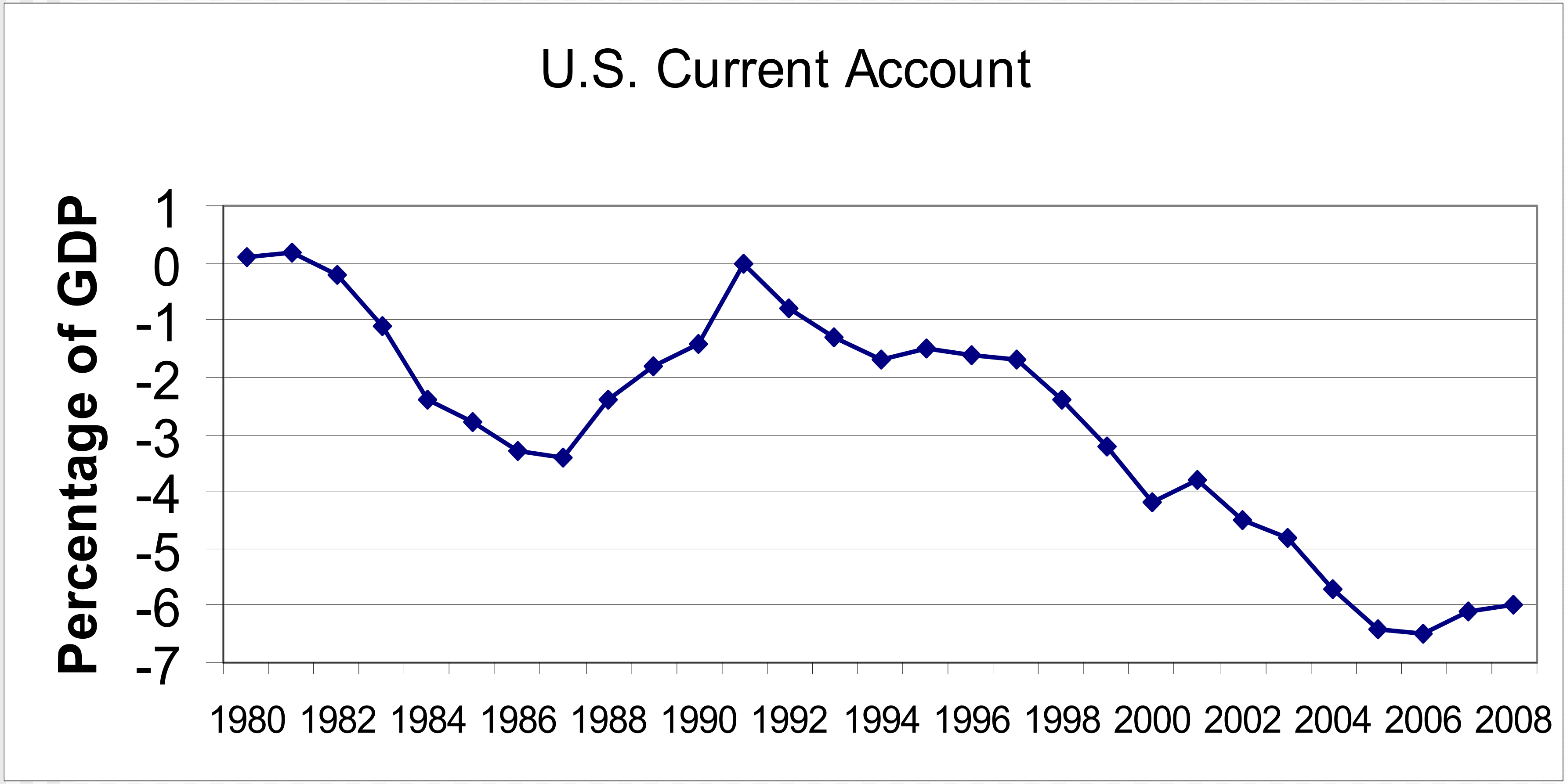
Major Risks to Global Economy

- Four Problems of Misaligned Prices
  - The Largest Traded Commodity – Oil
  - The Major Currency – U.S. Dollar
  - The Largest Asset – Housing
  - The Basic Price of Time Preference- Interest Rates
- Two Problems of Unknowns
  - Hedge Fund or Derivative Collapse
  - Bird Flu Pandemic: WHO When not If

The World Economy Was Able to Absorb Higher Oil Prices Over the Last 5 Years



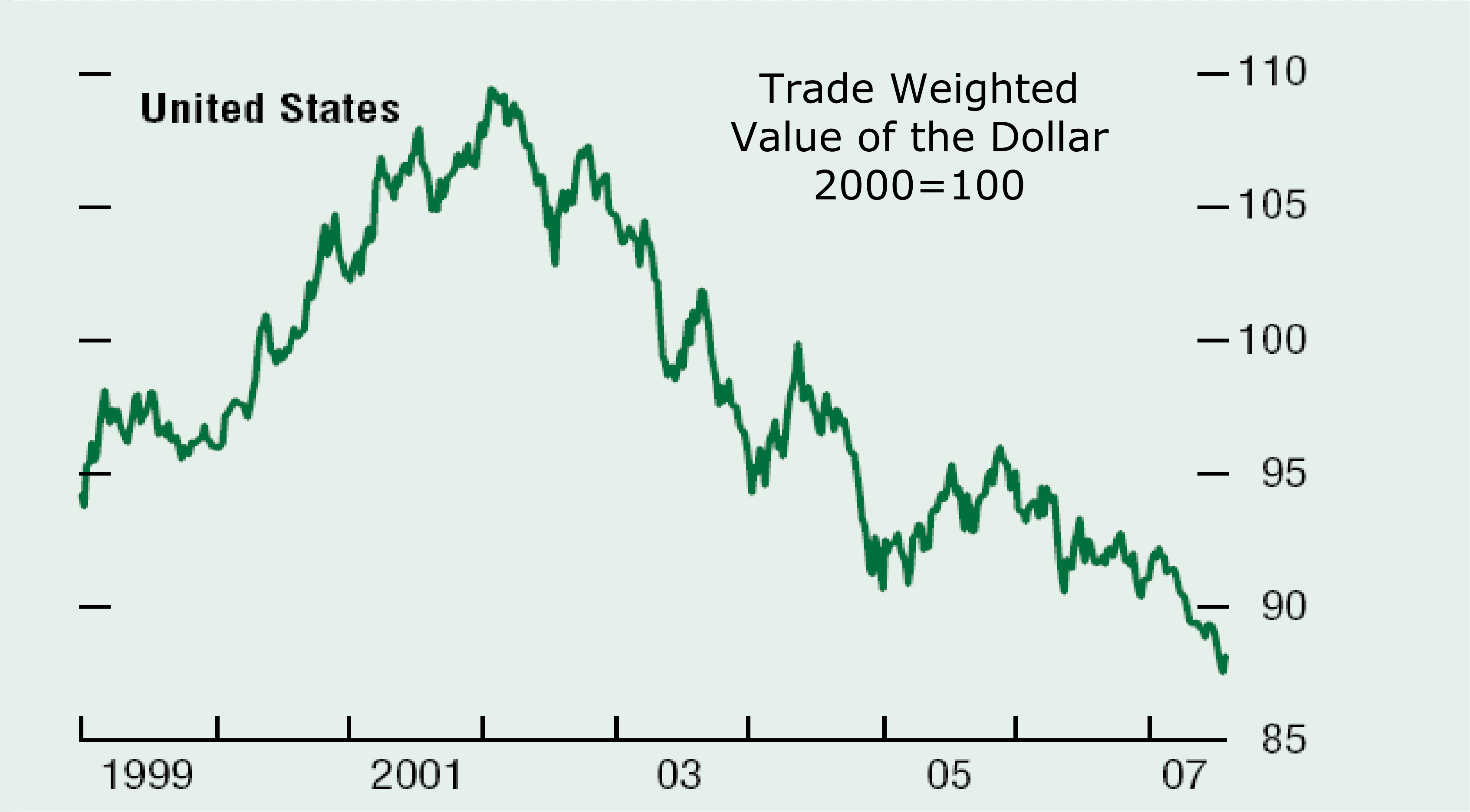
Elimination of U.S. Current Account Will Require a Dollar Depreciation of About 25%



U.S. Current Account Deficit

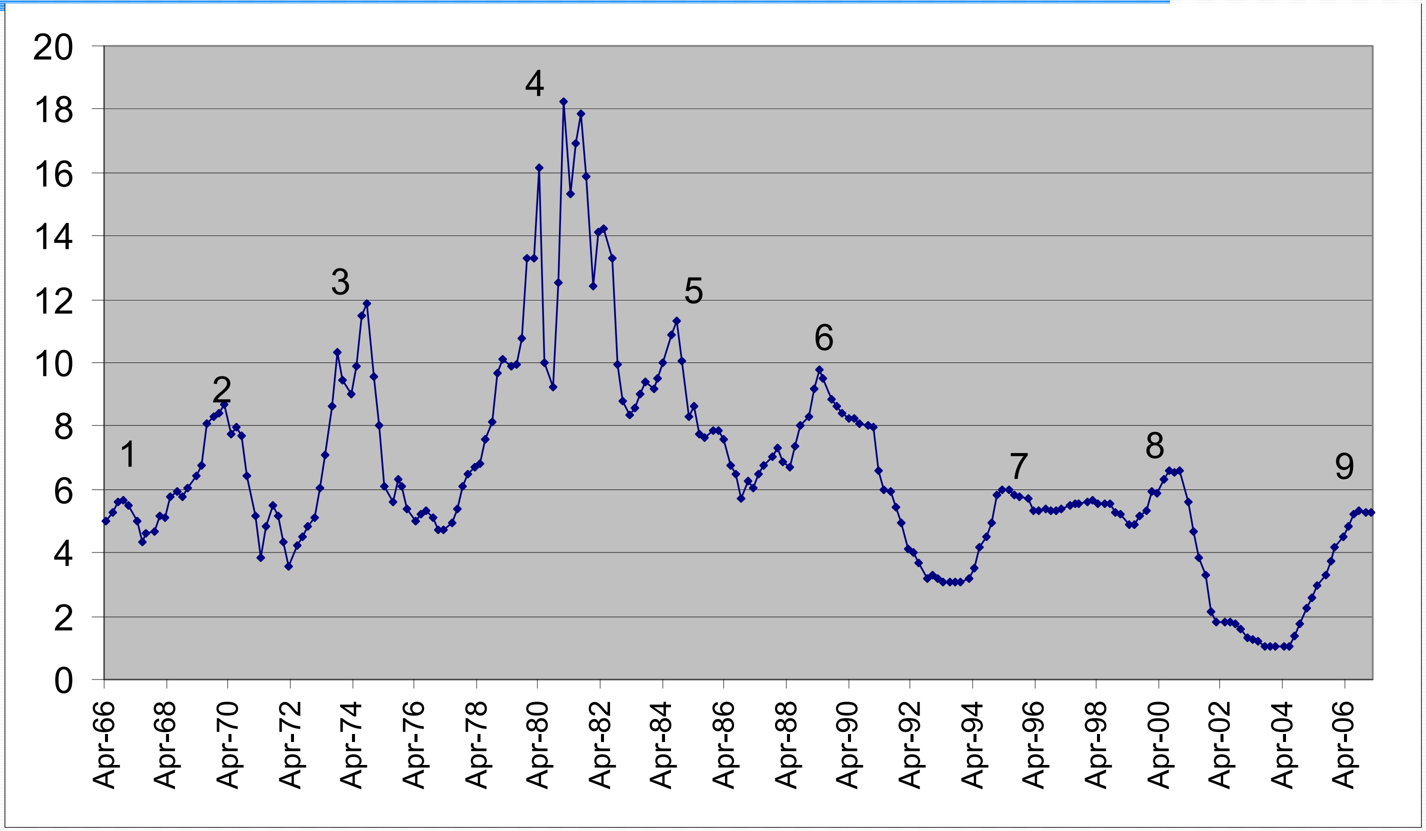
- The only way to reduce the U.S. current account deficit is with a dollar depreciation
- This knowledge along with a decreasing interest rate differential has resulted in a dollar decline of about 25%; it’s now the lowest in over 25 years.
- Dollar reaches record low against the euro $1.42/1
  - Euro up 70% vs. dollar since 2000
- Parity with Canadian dollar, not since 1976, 62 cents in 2002

U.S. Dollar Has Declined by 25%; A Further 10-20% Is Needed



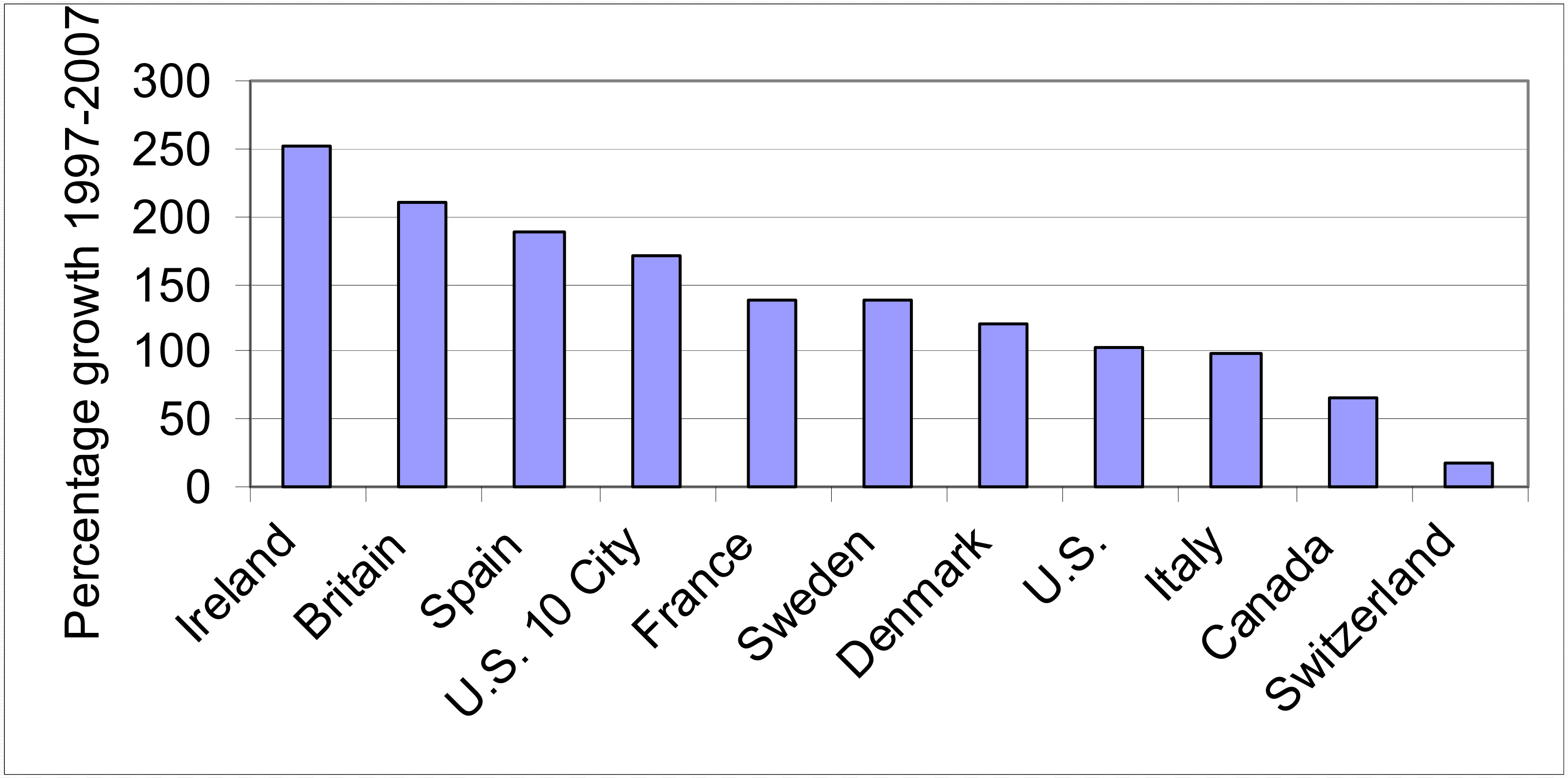
Source:Global Stability Report, 2007

Higher Interest Rates Create Crises



1.Gold exchange standard ends, 2.Bretton Woods ends, 3.Smithsonian Agreement fails, 4.Latin American debt crises, 5. South African, Chile, Mexico, Singapore financial crises, 6.U.S. savings and loan financial crisis, 7.Tequila crisis, 8.High-tech stock market bust, 9. Possible housing market collapse.

Global Rise in House Prices: The Bubble in Much of Europe is Bigger than U.S.



In eastern Europe, the increases have been even larger.

Housing: This Time Is Different

- Current Housing Price Cycle Is Different
  - Price Gains Have Been Much Larger
  - The Duration of Boom Is Longer
  - More Globally Synchronized
  - Less Connected to the Business Cycle
  - Financial Market Innovations Have Fed the Boom and Increased the Potential for a Bust
- Is a Bust Coming?
  - 2/3rds of Booms Followed by a Bust where 33% of Previous Gains Are Wiped Out
  - If a Bust, Residential Investment Will Fall for About 3 Years.
  - A Bust is Likely to Have Significant Implications for Global Economy

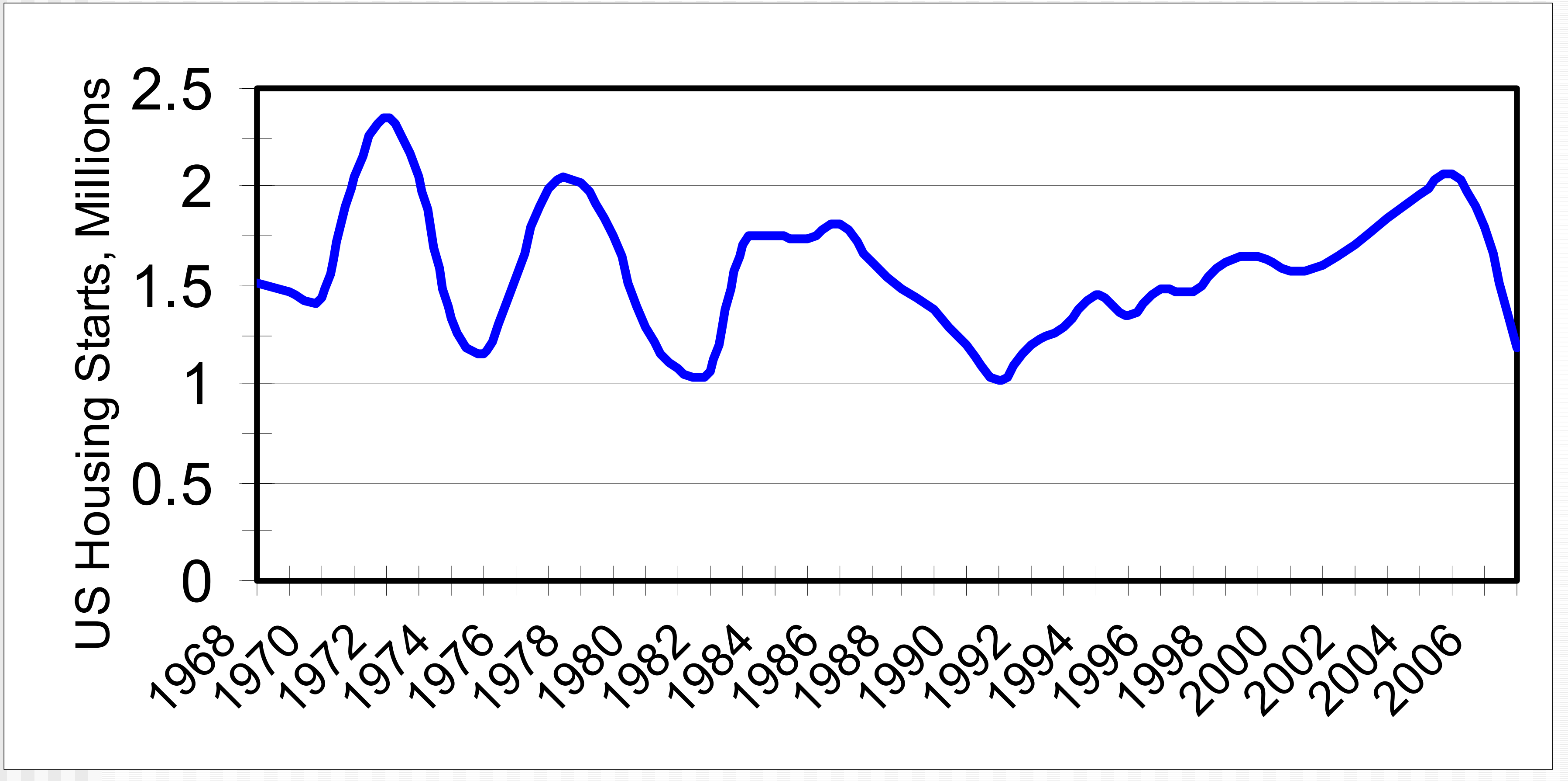
The U.S. Bust Has Started with the Sub-Prime Segment

- Sub-prime borrowers
  - Poor credit rankings
  - Low or undocumented income
  - High debt levels
  - ½ are Afro-Americans
- Sub-prime loans
  - High loan to value ratios
  - Adjustable rates with low initial teaser rates
  - 1/5 of U.S. mortgages; 10% of the total stock of mortgage debt
  - Owners of the loans are not the originators.
  - Delinquency rate 14.8% (was 11.7% one year ago); is expected to reach over 20%
  - FDIC estimates that 1.5 million will default

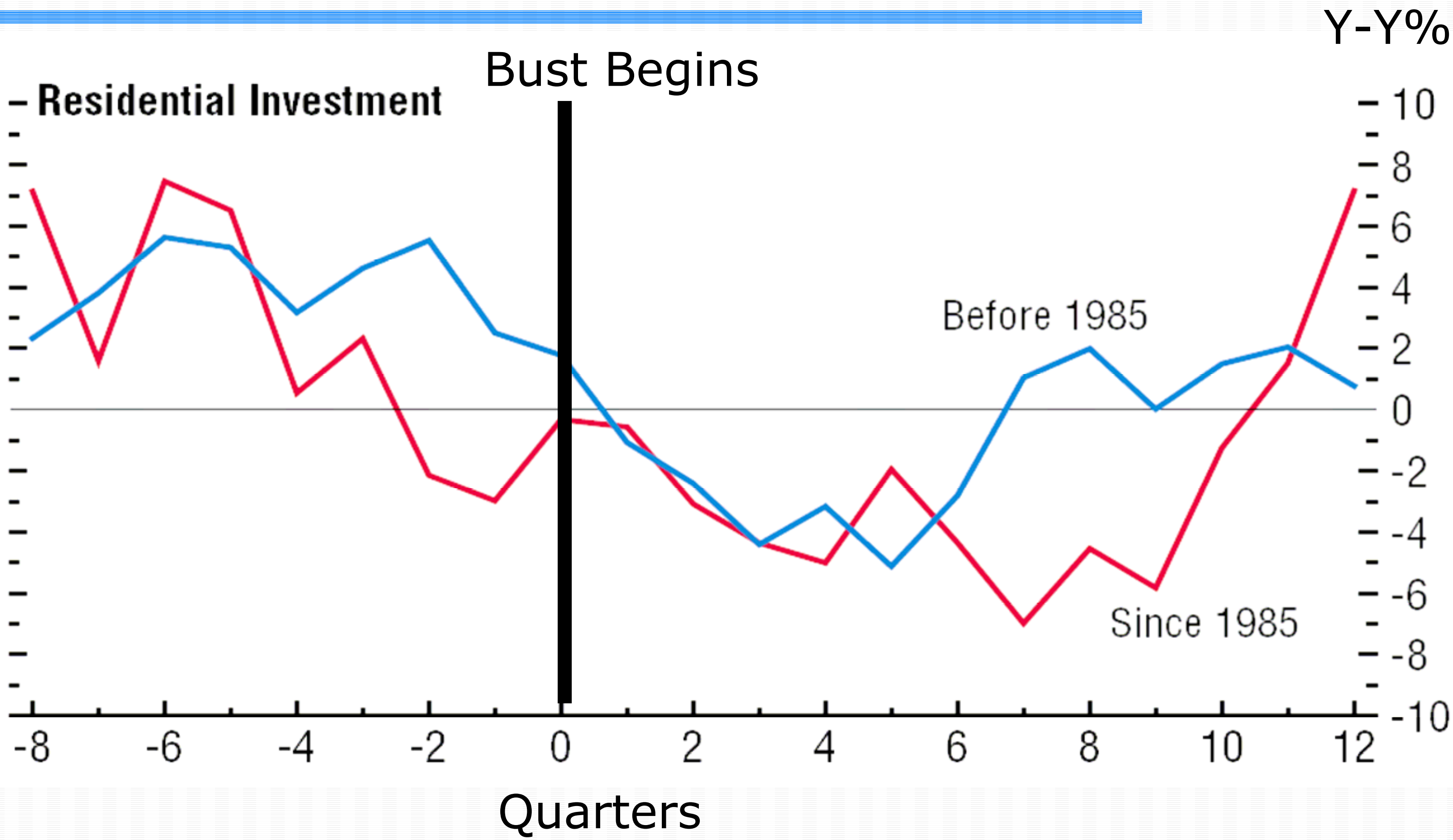
The Current U.S. Housing Situation

- Prices fell 3.9% from July 2006 to 2007
  - Future markets predict another 4.6% decline
- Inventories are growing (16 Year High)
  - 9.8 months supply
  - August pending home sales down 22% from last year
- Housing starts down by 1/3 from their peak in 2005.
  - Similar to levels of previous downturns
  - Current rate less than a million a year
  - August 2007 building permits down 41% from August 2005

U.S. Housing Starts, Millions:
Will Probably Fall by 1/2 of the 2005 Level



Housing Busts Lead to Declines in Residential Investment for 3 Years



Source: IMF. Includes U.S, U.K., Canada, Australia, Italy, Denmark, Sweden, Norway, Netherlands.

Higher Interest Rates and Housing Price Declines Will Affect the Economy Through Three Main Channels

- Reduces the demand for new homes so construction falls, unemployment for these workers.
- Reduces consumer wealth & equity withdrawal, so decline in expenditures by consumers for most goods.
- Increases mortgage defaults which reduce the value of mortgage backed securities, this creates financial market turmoil as those who bought these, using credit, default.
- *However inflation is low so the Federal Reserve has flexibility to deal with this.*

Does Europe Have a Sub-Prime Problem?

- Similar in some respects
  - Housing is even more overpriced by historical standards; but so far prices still rising
  - A high percentage of adjustable rate loans
- Better in other respects
  - More stringent loan requirements
  - Less financial market innovation
- Worse in other respects
  - In east Europe, foreign currency denominated loans could complicate matters

Contagion to Europe and the Rest of the World

- Although Europe may not have a sub-prime crises, it will feel the financial market effects from the U.S.
- Europeans own a lot of U.S. sub-prime debt.
- Of $600 billion, we only know who owns $100 billion, who has the other $500 billion has made markets nervous.
- If the sub-prime market was miscalculated, maybe other risky markets have been similarly miscalculated; risk spreads will increase.
- Many east European & CIS banks have been borrowing short-term on global markets to make long-term mortgage loans domestically. A credit crises means trouble.