expenditures contributed about 2 percentage points to the 2007 change in U.S. real GDP.

The deep and ongoing correction in the U.S. housing market also helped push real residential investment down by 17 percent in 2007 thereby trimming U.S. economic growth by a full percentage point. Real investment in this sector has contracted over each of the past eight quarters and those contractions accelerated over the last two quarters of 2007. Private inventory investment also provided a negative contribution to U.S. real GDP, trimming one-third of a percentage point off the rate of U.S. economic growth in 2007. Partly offsetting the losses were gains to non-residential investment. Overall, gross private domestic investment contracted over the year and reduced GDP growth by just over 0.8 percentage points in 2007.

Foreign trade was the good news story of U.S. economic performance. The weaker U.S. dollar rendered U.S. exports more competitive and U.S. imports less competitive in 2007. Although the substantial trade deficit has been very slow to recede, the most significant contribution to U.S. growth over the past year has come from the improvement in real net exports. With export volumes expanding some 8 percent over the year, four times the pace of imports, the US$68.9 billion improvement in real net exports added 0.6 percentage points to GDP growth in 2007.

Finally, government expenditures added about 0.4 percentage points to the growth in U.S. economic activity in 2007.

Looking forward, the outlook is for further turbulence in the U.S. housing market. After peaking in the second half of 2005, the U.S. housing market has already undergone a major correction, with house prices falling by up to 10 percent, depending on the measure used, and housing starts in 2008 down by over 50 percent from their peak. The market remains far from equilibrium, with inventories of unsold homes close to record levels and home value indicators well above historical norms[4]. However, rising negative equity on home ownership and resets of variable-rate mortgages are likely to push defaults and foreclosures up even higher, putting downward pressure on house prices, which will raise incentives to default. Reflecting these concerns, prices in the U.S. housing market could fall from 14 to 22 percent during 2007-08.

The spreading financial market crisis has already induced a credit squeeze, but a full-blown credit crunch has not developed so far. Risk spreads have widened, prompting repricing and falling asset values. Overall economic expansion has weakened and labour market conditions have deteriorated. The U.S. economy is projected to slip into a modest recession in 2008, followed by a gradual recovery in 2009. All major components of domestic demand will be sickly during 2008: residential investment will continue to contract; consumption will fall in face of adverse wealth effects, tight credit, and a waning labour market; and business investment will also turn down. In 2009, consumption will remain sluggish as households raise their savings rates after a long period during which personal wealth was boosted by capital gains on assets. Net exports will continue to improve. On an annual basis, U.S. growth is projected to slow to 0.5 percent before edging up to 0.6 percent in 2009. The trajectory is clearer when measured on a fourth-quarter to fourth-quarter basis. On this metric, the U.S. economy is projected to decline 0.7 percent during 2008 before recovering to grow at 1.6 percent in 2009.

Euro area

After posting its best year since 2001, growth in economic activity in the euro area slipped slightly to 2.6 percent growth in 2007 from 2.8 percent a year earlier. Robust domestic demand was fuelled by steady employment growth and buoyant investment. Signs of strain increased toward the end of 2007, however. In the fourth quarter, GDP growth slowed to 1.5 percent on an annualized basis. Both consumer and business sentiment deteriorated in

4 *World Economic Outlook*, Chapter 2