

The Global Economic Outlook

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Although a number of formidable challenges, both certain and uncertain, nearly always exist, I believe it is still reasonable to expect the United States' economy to extend its three-year expansion into 2005. The Federal Reserve, of course, is likely to continue on its now well-established course of lifting its benchmark interest rate from the "emergency" levels of 2004 toward something it considers more "neutral" – or a level that neither aids nor restrains growth. The pace of these increases and the future targeted fed funds rate depends on a continuation of the recently evolving trends toward moderately increasing inflationary pressures, slowing productivity growth, higher unit labor costs, improving labor market conditions, and, of course, whether above-potential overall growth is sustainable.

The twenty percent decline in crude oil prices across November and December is certainly constructive to the outlook for both inflation and growth in the near term. In addition, the Fed's preferred gauge of inflation, which is linked to personal consumption, has steadily held within a band widely judged tolerable. More threatening is the flow-through risk to higher general prices because of substantially higher import prices and higher corporate operating costs – both the result of broad-based dollar weakness.

Much has been made already of the dollar's two-edged decline. It is, primarily, a reflection of structural imbalances gaining momentum on a world scale. The U.S. current account deficit, or the net result of all trade and investment flows between the U.S. and its trading partners, has in recent quarters exceed \$600 billion, or considerably more than five percent of U.S. domestic product. Robust consumption combined with a relative lack of savings in the United States has made necessary the importation of the "excess" savings from other countries' less avid consumers. The risk to the U.S. is that this daily inflow of capital declines, or simply demands a higher return as the dollar falters. A gradually depreciating U.S. dollar together with a rise in interest rates, however, could begin to curb U.S. excess demand (especially with respect to the interest

sensitive or durable goods sectors of the economy) while benefiting the export sector and encouraging greater foreign consumption.

This dollar-led rebalancing of the world's economic order will be particularly felt among the leading export-driven economies as their own currencies appreciate. Early in 2004, Japan seemed to have made progress in stimulating domestic demand, but consumer spending slowed dramatically in the third quarter to a less than one percent annualized rate. Looking forward, business capital spending and exports alone will likely be insufficient to protect the nation's eighteen-month expansion, especially as demand in the U.S. and China moderates. Pressure on the Japanese economy will undoubtedly increase as the dollar buys fewer than one hundred yen and companies cut domestic capital spending in favor of investment in overseas production.

China, which for a decade has fixed its Yuan to the dollar at a predetermined rate of exchange, is likely at some point to participate in the world's market-driven rebalancing of economic forces. Of course, the necessary financial infrastructure—especially greater banking efficiency, flexibility, and reform with the appropriate central bank oversight—needs first to be firmly in place. China, though, is rapidly developing its domestic economy as imports, investment, and consumer driven retail sales increase at extraordinary rates. The country, though, has yet to negotiate its much-desired reduction in output growth from the previous two years' over-heated, nine percent rates.

Among the euro-sharing nations, growth in 2005, according to the European Central Bank as of 1 December 2004, is forecast to be a fairly modest 1.9%. The forecast is contingent upon an average exchange rate of \$1.24 per euro and an average per barrel crude price of \$39. Consistent appreciation in both the euro and in oil prices has done much to discourage business confidence in the region. It is now quite likely that the European Central Bank will either hold its key policy-setting interest rate at two percent or even reduce it if core inflation (expected to be 1.7% in 2005) remains contained, aided certainly by the stronger euro. The German export-led economy, which contributes a third of the euro region's output, expanded by just 0.1% in the third quarter. Current unemployment in Germany, higher now than when Chancellor Schroeder won election more than six years ago, remains a considerable restraint on any engineered growth in domestic demand. The threat now also of corporate cost cutting or of exporting productive capacity to less costly neighboring locales weighs significantly on the outlook for Germany's challenged recovery in 2005.

In Britain, with a slow down in housing and a contracting manufacturing sector, growth should only be close to trend or somewhat below, perhaps, particularly if falling property market prices discourage spending. Fortunately, inflation has remained quiescent over many years—a fact that should also encourage the Bank of England to hold steady or ease monetary policy in 2005.