Global Economic Outlook

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In testimony before the House Financial Services Committee on 30 April, Federal Reserve Board Chairman Alan Greenspan reiterated his previously expressed view that the U.S. economy is likely to expand at an annualized rate appreciably better than its recent trend (a quite modest 1.5% average across two quarters), particularly as it moves beyond the shock of higher oil prices and the curtailment of business activity throughout much of March and April. He did admit, however, "the timing and extent of that improvement remains uncertain."

As many of the economic reports being released at the time of this writing (mid May 2003), are likely still somewhat distorted by the dampening effects of poor spring weather and, certainly, the successfully completed Iraq campaign; the more promising, early indicators of a not-too-distant return to a sustainable, higher growth path include: sharply falling oil prices (from $40 to $25), a benefit to both businesses and consumers; rebounding consumer optimism, a months-long upturn in non-defense capital equipment orders, and, not least, a recently positive financial market performance overall.

All of the major U.S. stock indices have now recorded gains on the year, but their strong performance from the 11 March lows is especially encouraging (NASDAQ Composite +18.75%, S&P 500 +16.5%, Dow Jones Industrials +14.9% to 23 May 2003). Of course, continuing equity market gains can be supported, in the long term, only by steadily improving corporate profits, not merely the perception of such. Presently, with about 85% of the S&P 500 companies having reported their first quarter results, it appears, in the aggregate, profits will have increased approximately 14% from 2002's first quarter. In the corporate bond market, risk premiums, or the yield differential over comparable U.S. Treasuries, have narrowed substantially from last October's levels, benefiting both

issuers and investors as companies undertake balance sheet “repair” and work to enhance productivity.

Despite these quite favorable financial market developments, the Federal Reserve, at its Federal Open Market Committee meeting of 6 May 2003, redirected its balance-of-risks assessment toward weakness with respect to sustainable economic growth (it attempted no assessment at its March meeting) but seemed to want to condition that outcome largely on the risk of an “unwelcome and substantial fall in inflation.” In our previous issue of *MoneyTalk,* we highlighted the Fed’s interest in avoiding deflation, or a persistent decline in core prices and wages. Although certain businesses do lack pricing power, the likelihood of outright deflation taking hold in the United States is statistically remote. The Fed’s long-held accommodative stance (i.e., it has already cut rates from 6.5% to the current 1.25%) and its apparent willingness to cut rates even further, or to expand the monetary base by “unconventional” means (i.e., buying bonds outright from financial institutions) suggests the proper remedy, if needed, could be well and quickly applied.

Given this view from the Federal Reserve, it was indeed surprising that neither the Bank of England nor the European Central Bank cut interest rates at their respective May meetings. In Britain (Europe’s second largest economy), there had been concern about housing, the services sector, and more recently, manufacturing production. In Germany, where its $2 trillion economy represents fully one third of the euro-denominated nations’ output, unemployment reached 10.7% in March, or about 4.5 million people. Germany’s economy actually contracted during the first quarter of 2003, as did Italy’s and Netherlands’. Business confidence has waned as exports (a saving grace in 2002) continue to be seriously challenged by the U.S. dollar’s 25% decline versus the euro over the last year.

The dollar’s surprisingly persistent fall, though, perhaps, somewhat technical in origin, seems to have gained “currency” in recent months on fears of an ever expanding current account deficit in the United States. Foreign investors and traders, moreover, whose purchases of U.S. stocks and bonds are off some 30% over the last year, are quite comfortable holding higher yielding euros, pounds, or Canadian, Australian and New Zealand dollars. Of course continuing U.S. dollar weakness will make U.S. based exporters more competitive in international markets and should translate into higher earnings and higher GDP growth over the next several quarters.

As a small but I think interesting aside, it is worth noting that those countries whose central banks have voiced concerns over inflation, have, in fact, *less* expected inflation as described by their two-year to ten-year government bond slopes than does the United States (i.e., U.S. 2.24 percentage points; Netherlands 1.73; France 1.65; Germany 1.59; Canada 1.28; U.K. 0.58; Australia 0.56). Certainly, the best case for more monetary ease can be made to the European Central Bank, particularly if we add that in Germany prices have been falling, not rising.

In the far east, we would expect that the heightened concerns of disinflation in the U.S. would resonate favorably with select central banks that have, to this point, resisted rate cuts on inflationary concerns. The Bank of Korea did, however, cut its overnight call rate by a quarter percentage point on 13 May to 4% and indicated that further cuts may be in the offing. South Korea grew at an impressive 6.3% in 2002, but it is likely that growth will moderate by about a third in 2003 particularly as it depends on Hong and China for

about 20% of its exports. Especially troublesome to the economies of the region (particularly China's, Hong Kong's, and Taiwan's, but also Singapore's potentially) is the spread of SARS. Certainly, it is hoped that the disease will have peaked and diminished over the course of the summer months, and that a vaccine will soon be discovered so that its probable re-emergence next year or thereafter might be contained. It is likely, though, that the suspension of activity already caused by the disease, especially in travel and tourism, but also in production in certain places, will subtract meaningfully from the region's high growth rates in 2003.

On a brighter note, Washington appears to have made progress on the president's economic growth proposal, although its likely final configuration will have fallen well beneath the original $726 billion package. We would hope for a not-insignificant margin of stimulus to be provided for immediately, when it is most needed, as well as some preservation of the president's original intent on dividend exclusion.