# The Global Economic Outlook

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First quarter and subsequent reports of business activity clearly demonstrate that the three-year economic expansion in the United States continues solidly into the first half of 2005. The U.S. Commerce Department's second estimate of first quarter real gross domestic product, or the sum total of all goods and services produced, was revised from a previously estimated 3.1% annualized rate to 3.5%, down slightly from the fourth quarter's 3.8%. Part of the upward revision to growth was attributed to a somewhat narrower, though still outsized, U.S. trade deficit. Consumer spending edged only modestly lower from the fourth quarter, but business fixed investment and inventory accumulation slowed more sharply.

Residential investment, in contrast, accelerated further in the January-to-March period with home construction advancing again at last summer's pace. In many markets, median home prices, doubtless lifted by favorable supply and demand factors, local economics, and low long-term interest rates, have already exceeded 2002's median home price by a full third. Stock prices, on the other hand, have largely meandered without meaningful progress so far in 2005 (S&P 500 +0.99%; Dow Jones Industrial Average -0.6%, NASDAQ Composite -3.6% through June 21st )* even as corporate earnings growth shows little sign of faltering. During the first quarter, corporate profits comprised nearly 11% of gross domestic product, the highest percentage since 1968.

Certainly the first quarter report on U.S. output growth together with more recent Federal Reserve Bank surveys characterizing business activity as "well-sustained" suggest to Fed officials that their year-long policy of removing "monetary accommodation," or increasing the benchmark federal funds rate at a measured pace, is still the correct course. In his remarks to Congress on June 9th, Federal Reserve Chairman Greenspan said, "The U.S. economy seems to be on a reasonably firm footing…[but that]…the alternating bouts of rising and falling oil prices have doubtless been a significant contributor to periods of deceleration and acceleration of U.S. economic activity over the past year." On June 20th crude oil futures prices exceeded $59 per barrel for the first time, and are now up nearly 50% from last year as production capacity strains to meet current refining demand and an immediate need for inventory adjustment against a likely further increase in world consumption over the balance of the year. So far, dramatically higher oil prices have had a much more limited impact on both growth and inflation expectations than had been the experience of decades past. In any case, the risk of sustained high oil prices or a move, perhaps, to still higher clearing price levels remains.

Excepting, of course, the leading oil producing nations, the oil shock risk is a global, immediate concern. Economic growth in Germany slowed in the second quarter as higher oil curbed demand for the nation's exports, according to the German Finance Ministry. Both exports and factory orders have posted multiple monthly declines in 2005 with growth likely to remain positive by only the narrowest of margins. The euro's recent rather sharp break versus the dollar may help stem further export deterioration, but the currency decline itself reflects difficult underlying problems in Europe unrelated to oil. The larger, western European economies seem, in general, to be in retreat (Italy is in recession) and the people's strident opposition to broad based economic liberalization and cohesion (partly out of fear of forgone entitlements) suggests continued political uncertainty or worse. On June 21st, Sweden's Riksbank reduced its base interest rate to a record 1.50%, the lowest in the European Union. The European Central Bank, moreover, might also be forced to consider lowering its 2% benchmark interest rate as growth forecasts continue to be trimmed and political pressures mount. It is quite likely, however, the bank also envisions, and clearly wishes to avoid at all costs, the sort of "liquidity trap" experienced over many years in Japan.

Japan, which, incidentally, is completely dependent on external sources of oil, has over the last six years maintained an effective zero interest rate policy with only limited success as deflationary pressures remain a fixture of the economy. Growth in Japan is up just 1.3% year-over-year as overall exports fell last quarter for the first time in more than three years. Meanwhile, China, which is striving to rebalance growth away from its booming property and steel sectors and to encourage consumer spending, also accepted fewer imports from Japan. China's slowing import growth over the first four months of the year will likely also negatively affect the economies of Taiwan, Korea, and Singapore. Importantly, China's successful management of its ongoing economic transformation requires its further commitment to market-based as opposed to administrative policy measures.

The year's firming of industrial commodity prices, metals, and energy has certainly had a substantially positive impact on the resource rich countries of Latin America, notably Mexico. The country's equity market is up now 15%, in peso terms, from the April low and the peso itself has steadily firmed against the dollar despite narrowing U.S. interest rate differentials. In Brazil, significant challenges, such as the highest real interest rates in the world, lie in the way of the government's 4% overall growth target for 2005. Nonetheless, the country's recent success building sequential year trade surpluses and reducing its annual budget deficit suggests the long run prospects for the country are brightening.

*According to Bloomberg