

Global Economic Outlook

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At the start of this New Year there is sufficient reason, I believe, to remain optimistic about the prospects for improving world economic activity. The United States' economy is now likely to expand at a rate closer to its potential growth rate – something it has not done since the booming 1990's – as it continues to be underpinned and supported by the monetary, fiscal, and also foreign exchange policies undertaken over the past year to ensure its recovery from recession.

The Federal Reserve, which now views the disinflationary versus inflationary risks as substantially more balanced, will likely hold down short term interest rates in the United States somewhat longer than the markets expect. This Federal Reserve, unlike the Reserve Bank of Australia or the Bank of England which have already embarked on policies of stricter monetary growth or interest rate increases, will likely not move to preempt inflationary pressures in the U.S. as has been its practice in previous cycles. There is apparently already ample money growth, higher crude oil, gold, and industrial materials prices, in addition to higher early-stage production prices and select service economy (i.e. healthcare and education) price pressures; yet, there is not currently, nor is there likely to be throughout 2004, anything more than modest *wage* price pressures. Businesses continue to have too much unused or idle productive capacity, even as the nation's output, its *gross domestic product*, did ramp up its trajectory steeply, achieving a remarkable though unsustainable 8.2% annualized rate in the third quarter of 2003.

Currently in the U.S., a majority of business firms enjoy a most welcomed, but not all that unusual, post-recession combination of high economic profits and very high productivity growth rates. This condition, however, coupled with insufficient capacity utilization, has enabled businesses to meet increasing demand by doing more with fewer workers. Only recently have we begun to see some stabilization in the non-manufacturing labor market, with approximately four hundred thousand new jobs created toward the end of 2003. The

amount, though, pales in comparison to the 2.5 to 3 million jobs *lost* during and subsequent to the 2001 recession. It will take a consistent and vigorous upsurge in job creation, of between 200 to 300 thousand new jobs added per month in magnitude, to persuade the Fed to alter its course on monetary policy.

A quite modest increase in interest rates, presumably undertaken later this year, will have little effect on non-housing related consumer spending. Spending will likely be boosted in the immediate months, especially between February and May, on a new and enhanced (a potential US \$40 billion to US \$60 billion more than in 2003) round of Bush administration tax rebates.

In other regions of the world, the pace of economic activity is also on the increase. December's *Tankan* survey in Japan demonstrated that the short-term outlook on manufacturing activity achieved its highest reading in more than six years. Japan's exporters (auto and electronics makers) have led this recent expansion even as the Yen has continued to appreciate. As these large manufacturers invest in plants and capital equipment in Japan, and as Japanese consumers become encouraged by stabilization in their own labor market, the recovery in Japan will eventually strengthen and achieve balance.

Among the euro-sharing nations, investor optimism, business confidence, and industrial production have all risen. France, Germany, and Italy – producers of nearly three fourths of Europe's total output – will likely this year continue to build on their fragile expansions. This is especially probable if they manage to at least maintain their level of exports to the U.S. and the Far East while at the same time stimulating their domestic economies by means of tax cuts or spending incentives. The Euro's steady appreciation, which has to an extent been engendered not only by fairly wide interest rate differentials but also by the perception that U.S. deficits are potentially destabilizing, is likely the single biggest risk to growth.

In Brazil, the world's ninth largest economy, President Luiz Ignacio Lula da Silva's year-old administration has worked to reduce inflation (projected to be just 4.5% by 2005, down from 12.5% in 2002) while meeting payments on the country's extraordinary public debt and also managing incremental output growth. The opening of new markets beyond the United States and Europe, which receive over half of Brazil's exports, to the Middle East, India, Russia and elsewhere, would also support Brazilian job growth and currency reserves. It is believed that future financing from the World Bank, contingent upon spending restraint and growth goals, would, in part, help the nation achieve United Nations defined reductions in poverty. Argentina, which defaulted on its debt in 2001, is now likely to expand at its fastest pace in many years. Its Merval stock market index doubled in 2003, and the nation's currency has appreciated some 14%. There is still much work to do in Argentina, particularly with respect to its debt rescheduling or restructuring and its major utilities contracts; however, as in other parts of the world, 2004 seems likely to take on an even brighter aspect.