

The Global Economic Outlook

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In the year since the European Central Bank and the U.S. Federal Reserve first acted to stabilize the global financial system, the U.S. economy has withstood an unusual accumulation of extraordinary shocks, and, in doing so, has demonstrated a largely unanticipated degree of resiliency. Of course, it remains whether all or any part of 2008's economic performance will eventually meet the National Bureau of Economic Research's (NBER) formal recession standard, but after a small contraction in the final quarter of last year, real output accelerated sharply toward the end of this year's first half propelled mainly by the nation's best net export result in almost thirty years. The effect of large scale increases in both capital and consumer goods exports is likely to lift annualized real output growth close to 3% in the second quarter, or back toward the U.S. economy's long-term potential growth rate. While the persistence of positive contributions from net exports is dependent on a host of uncertain variables (including a favorable trade and global growth dynamic, expanding overseas capital and infrastructure investment, and sustainable growth in consumer classes world-wide) such cycles are generally multi-year events and may be even further supported by continuing trade-weighted dollar depreciation—a factor of considerable import over the last several years.

With respect to monetary policy, the Federal Reserve, at its second FOMC meeting of summer in early August, again held its main policy instrument at 2%, citing financial market turbulence and implicitly affirming that ensuring the viability of the global financial system remains a universal objective. To that end, the Fed extended the term of certain bank liquidity facilities it had first created and implemented last year and added enhancements to others. Under usual circumstances, the current negative real federal funds rate should prove massively *accommodative*, or promote significant increases in overall economic activity. Today, however, as liquidity-deprived banks have sharply curtailed extensions of credit to mortgagors, businesses, and consumers, the Fed's normal policy transmission mechanism to the real economy has become obstructed. The effect remains a chief reason, over the medium term, the Fed can afford to maintain a neutral rate bias in the face of inflated consumer, producer, and import prices. Longer term, such a policy stance will have been judged successful only if, as anticipated, the countervailing deflationary forces in evidence throughout much of the economy (i.e., bank and consumer deleveraging, business inventory liquidation, falling asset prices, increasing industrial capacity and unemployment etc.) overwhelm their opposites.

In Europe, the ECB, while most recently proclaiming a neutral bias with respect to the direction of its next interest rate adjustment, remains unequivocally steadfast in its decade-long effort to achieve meaningful price stability. As recently as July, the bank increased its policy rate to 4.25% as inflation accelerated at more than twice the permissible rate. Even as the bank continues to make hundreds of billions of euros available to its own strained financial institutions, the risk of sharply higher supply chain prices spreading into general prices and sparking seriously adverse wage-price spirals has not receded. Although growth among the euro sharing nations contracted modestly for the first time ever in the second quarter, slowing potential growth rates in Europe are likely to limit beneficent disinflationary effects. Recent material declines in energy prices and the euro together with increases in business sentiment might be enough to help Europe avert a technical recession or more serious contraction even under risk of higher interest rates. In the U.K., growth risks would appear especially imminent as its economy is substantially more exposed to housing and financial services than Europe's export oriented economy. Although the majority of U.K. banks have been able to adequately recapitalize after sustaining steep mortgage related write downs, home price declines have recently accelerated along with bank repossessions. Mortgage rates, however, remain nearly a percentage point lower than in the U.S., which fact, combined with lower housing costs, offers the twin corrective mechanisms of credit availability and increasing home affordability. In addition, personal bankruptcies have actually trended *lower* in the U.K. in recent quarters, and unemployment at 5.2% remains one-half percentage point lower than in the U.S.

In Asia, the region's largest economy contracted at an annualized rate of 2.4% in the second quarter, ending Japan's longest post-war expansion. Most disconcerting, perhaps, to the Bank of Japan is the recent precipitous decline in personal incomes which augurs poorly for domestic demand at a time when exports are also faltering. Somewhat surprisingly, residential investment also declined during the quarter as new construction prices advanced while credit contracted. On the whole, however, Japan's banks seem to have mostly avoided the contagion affecting U.S. and continental banks, aided, perhaps, by structural reforms implemented over the last decade. Imported inflation, though, is still likely to continue to pressure manufacturers' margins as they are nearly entirely dependent on external resources. Higher input prices will likely be met by greater productivity enhancements to maintain global competitiveness—risking higher national unemployment in the process. Given the strains emerging in the Japanese economy, the Bank of Japan is unlikely to increase interest rates beyond the 0.5% rate not exceeded since 1995. As of yet, there is little evidence of second round effects emanating purely from higher commodities' prices, and core consumer prices remain exceptionally well-contained. In China, with consumer prices easing somewhat in July, the Peoples Bank of China is likely to redirect its main policy objective toward maintaining growth in coming quarters. Although Chinese output expanded more than 10% in the second quarter, industrial production is likely to weaken with export growth as external demand softens. Even marginally weaker GDP expansion in China would present particularly unwelcome policy challenges such as large increases in unemployment. The central bank, therefore, is likely to oppose further Renminbi appreciation, cut bank reserve requirements from the current 17.5%, and also maintain an unchanged interest rate policy. China's substantial budget surplus and currency reserves would also readily permit increased government spending on infrastructure and transport projects (beyond what it has already committed to the earthquake affected areas) as a means of stimulus.

Back in the Americas, the Bank of Mexico continued its series of interest rate hikes in August, raising its policy rate to 8.25% against expectations of further price increases affecting wage and contract negotiations. President Calderon also imposed industry approved price controls and removed tariffs on select agricultural imports. Total inflation in Mexico has advanced at a slower rate than in the U.S., but policymakers have only recently acknowledged the likely impact slowing U.S. demand growth will have on Mexico's non-oil exports. In Brazil, rapid gains in

personal consumption, spurred by sharp reductions over previous years in both interest rates and inflation, helped the country achieve a 5% overall growth rate in 2007. Industrial wages, though, have also accelerated from less than 7% in 2006 to more than 10% by the spring of this year. The nation's central bank, therefore, remains predisposed toward increasing its 13% policy rate in its effort toward holding inflation close to its central target of 4.5% by the end of 2009 in order to extend the considerable economic gains won in recent years despite the difficult experience of prior decades.