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Economic Update

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The global economy is rebalancing down, as the stresses on the developed economies have increased. Rather than a full-scale global recession, we believe that the odds favor a global growth recession. We expect global expansion at a reduced pace to be supported by continuing demand growth in emerging market countries, many of which have much greater macroeconomic policy flexibility than the developed countries. In addition, weaker energy prices are likely to help support real incomes. Europe is likely to be the nexus of weakness, the lagged result of its restrictive policies. We expect that the U.S. may be able to approach near-trend growth through the Presidential election.

We regard the global economy as fundamentally recuperative after the Great Recession, but vulnerable to shocks since private sector deleveraging and fiscal consolidation in developed countries is not yet complete. We believe that the global economic slowdown reflects the effect of three separate shocks: (1) the commodity price shock, (2) the shock to confidence from the U.S. debt ceiling battle and ratings downgrade and (3) the European

financial crisis. In those countries where growth slowed in the first half of 2011, it was primarily due to the commodity inflation shock. In addition, the commodity price shock motivated a tightening of monetary policy in many emerging market countries. The U.S. debt ceiling battle and ratings downgrade then weakened confidence. Finally, just as the effects of the inflation shock and the U.S. downgrade began to calm, the global economy was hit by an intensified European financial crisis.

Given the brief period of expansion in developed countries since the Great Recession, some of the normal cyclical excesses which usually precede full-scale recessions have not yet emerged. For example, corporate balance sheets have improved as profits have rebounded. Key cyclical areas of the economy, such as autos and capital spending, have only experienced the early stages of cyclical recovery. The oil price shock experienced earlier in 2011 has begun to fade. The trend of monetary tightening in the emerging markets is coming to an end and many of these countries should shift to an easing stance over the next year.

The key to the global economic outlook is whether the resolution of the European financial stresses evolves in an orderly, semi-orderly or disorderly way. We expect a semi-orderly pattern, which should be consistent with a global slowdown at a subdued pace rather than a full-scale global recession.

European macroeconomic policy is not currently supportive of economic growth. The European Central Bank, focused on headline inflation, tightened into a worsening financial crisis in 2008 and now has once again tightened into a worsening financial crisis in 2011. While the ECB is supplying liquidity to replace lost market funding, overall financial conditions in many parts of Europe are quite tight with widened risk spreads raising the cost of credit and reducing the availability of credit, especially in the countries under stress. The one offset is that the euro has begun to weaken as the markets discount European economic weakness and begin to speculate about a potential future easing by the ECB in response to a weakening European economy. While the U.S. policy rate is at zero, the ECB policy rate is at 1.5%, providing ample room for future easing moves if desired.

Germany is lowering its budget deficit, in keeping with its new constitutional “debt brake” rule. This is basically a balanced budget rule (a 0.35 percent limitation on debt increases beginning in 2016). From a long-term perspective, this is a rational response to an aging demographic. The short-term result, however, is that the strongest economy in Europe has a tight fiscal policy during a European financial crisis, when financially-stressed countries cannot delay fiscal consolidation despite their economic weakness. There is a forced fiscal

tightening under way in those peripheral countries which have lost access to market funding. There is also a voluntary fiscal tightening in “soft core” countries which wish to lower their risk of losing access to market funding.

In Europe, the markets have cut off funding for some countries, raised the cost of funding for others and flooded a few strong countries with liquidity. We believe that the economies of Continental Europe are at their moment of maximum vulnerability right now, with forced fiscal tightening in peripheral countries, voluntary fiscal tightening in core countries, tight monetary policy, a sovereign debt crisis, banking stresses and extreme policy uncertainty. As the risks of full-scale recession in Europe have grown, concerns have risen about the slow pace of decision-making about how to stabilize the European financial system.

We expect a semi-orderly pattern in which the fear of a worst-case outcome in Europe is likely to motivate policy steps to calm the financial stresses and limit the economic damage resulting from them. Confidence in the coherence of policy is critical to the stabilization of the European financial system. Our most likely case is a gradual clarification of policy and calming of European financial stresses once the decision-making roadblocks can be overcome. However, even in that case, we expect that the result of past delays in resolving financial stresses is likely to be an economic stall in Europe over the next several quarters, with recessions in the peripheral countries roughly matched by some expansion in the core countries. We believe that Europe is the area of the world at the greatest risk of full-scale recession.

In the U.S., pressures to deal with current and future budget deficits come from public opinion and politics, but not from financial market pressures. The U.S. faces little difficulty in financing its current budget deficits today at low Treasury yields. This makes the current U.S. fiscal situation different from the fiscal situation in many European countries.

U.S. fiscal policy is currently very controversial as the U.S. moves into the Presidential election campaign. There are three main uses for multiyear tax revenue increases or spending slowdowns: (1) as a multiyear offset to temporary tax cuts and spending increases which are designed to strengthen economic activity in the short run, (2) as an offset in tax reform to permit permanently lower marginal tax rates or (3) as a source of long-term deficit reduction to reduce the future rise in the debt-to-GDP ratio.

The deficit super committee has a specific mandate to reduce future deficits, but the President has suggested an additional assignment of actions to offset the \$447 billion of short-term stimulus in his proposed jobs bill. If passed, we believe that this short-term stimulus proposal would tend to shift economic growth from future years into the Presidential election year. In contrast, the political right has a different priority, preferring to use the proceeds of potential spending slowdowns or tax revenue increases to fund tax reform. They argue that a permanent reform of the individual and corporate tax system will contribute more to sustained expansion than would temporary fiscal stimulus.

We believe that a short-term stimulus bill of about one-third the size of the proposed \$447 billion jobs bill is likely to pass. Fiscal tightening is currently

scheduled in the U.S. for 2012, due largely to expiring tax cuts. We believe that this will be substantially ameliorated, notably by a likely extension of the 2% payroll tax cut. If the U.S. economy is weaker than we expect, a short-term stimulus bill of about one-half the proposed size could occur.

We are skeptical whether a large multiyear deficit reduction deal can be reached prior to the Presidential election. The two political parties sharply disagree about fiscal policy. The U.S. has not been able to pass an annual budget since control of Congress was split between the two parties after the 2010 election. The legal authority to issue Treasury bonds almost expired in August as the two parties battled over economic policy. There is a significant risk that the super committee will either fail to fulfill its full assignment or that its proposals will be rejected by Congress. If the super committee bill fails to achieve its full objective, a potentially disruptive partial or full sequester would be scheduled for January 1, 2013. This would occur at the same time that all the Bush tax cuts are scheduled to expire. If so, this would create the potential for a "2013 fiscal brick wall" of a major fiscal policy tightening on January 1, 2013. We would expect this risk to be addressed in a lame duck Congressional session in late 2012 after the Presidential election. In the meantime, we expect continued fiscal uncertainty in the U.S. However, the budget deficit is likely to be near the top of the public agenda during the election period. The U.S. budget deficit problem may not be solved, but it is no longer being ignored.

Federal Reserve policy remains easy in the U.S. and Chairman Bernanke appears willing to keep adopting new forms of easing. With the adoption of

Operation Twist, the Federal Reserve has decided to drive down long-term Treasury bond yields below their free market levels by a one-time purchase of long-term Treasuries funded by the sale of short-term Treasuries. The Federal Reserve has taken three actions to drive down mortgage rates: (1) the extension of maturities in its Treasury portfolio, creating a shortage of long-duration bonds, (2) a shift in reinvestment of its maturing mortgage-backed securities from Treasuries to mortgage-backed securities and (3) greater-than-expected planned purchases of the longest Treasury maturities.

While we regard current monetary policy as supporting continued economic expansion, the contribution of Operation Twist to economic growth may prove limited for several reasons. First, it is questionable whether there is a large pool of potential mortgage borrowers likely to purchase houses at a somewhat lower mortgage rate. However, another round of refinancing is quite possible, which would benefit those homeowners who refinance. Second, lower long-term yields are likely to raise required pension contributions, increasing the cost of labor in the U.S. Third, by artificially flattening the yield curve by driving down long-term yields, Operation Twist should decrease the profitability of financial intermediation. This will occur in a context where there are already difficulties in the monetary transmission of easy monetary policy to credit growth and spending due to a variety of factors. These include weakness in the demand for credit and the challenges facing the financial sector.

Our interpretation is that the U.S. is “short-funding” a persistent U.S. budget deficit rather than financing it by the sale of long-term bonds to the private sector. We view the sale of new bonds by the Treasury

followed by Federal Reserve purchases of Treasury bonds in the secondary market as the Federal government selling bonds to itself. After all, the profits of the Fed flow to the Treasury. At some point in the future, persistent deficits will need to be funded by increased sale (net of Fed purchases) of long-term Treasury bonds to the private sector. One can argue that it is crucial to adopt policies to help keep the U.S. out of recession today, but there will be a price to be paid at a later date. The Federal Reserve has now taken responsibility for the yield on long-term Treasury bonds, some 60 years after it won its independence from the need to support the long-term Treasury bond market. For details of that history, see “The Treasury-Fed Accord: A New Narrative Account,” published by the Federal Reserve Bank of Richmond.

The policy flexibility in the emerging market countries is one reason we regard a global growth recession as more likely than a full-scale recession. Many emerging market countries do not share the external debt burdens and the internal debt burdens which are creating problems for many developed countries. They have fiscal flexibility, if needed. In addition, as commodity price weakness generates a peaking in their inflation rates, they can choose to lower their policy interest rates, if they choose. There is likely to be some weakness in emerging economies short-term as the negative growth surprise from the developed countries should motivate some inventory de-stocking. But at a time of financial weakness and deleveraging in the developed world, the stronger finances and favorable long-term fundamentals in the emerging countries should help limit the downward pressures on the world economy.



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