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Economic Update

Richard B. Hoey
Chief Economist, BNY Mellon



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We continue to expect a sustained global economic expansion along with two subcycle patterns: a subcycle slowdown in economic activity and a subcycle peak in reported inflation (including food and energy). We expect the subcycle peak in reported inflation to occur in the context of a gradual upward drift in core inflation in many countries. Economic growth should tend to be slow in countries suffering from a debt hangover and stronger in those countries without a debt hangover. We assume that the financial stresses in peripheral Europe will not disrupt the economic expansion in core Europe. We expect that the U.S. can avoid a serious disruption to its economy from the debt ceiling struggle by adopting a relatively loose mini-deal on future fiscal policy without major near-term fiscal tightening that might restrain the economic expansion.

Why should global growth be sustained? The main reason is the lagged impact of two years of stimulative macroeconomic policy. Except in peripheral Europe, current levels for the natural rate of interest (the interest rate relative to nominal GDP growth) and the real interest rate (the interest rate

relative to inflation) are stimulative in most countries. One consequence of two years of stimulative macroeconomic policy has been the reliquification of the corporate sector. Balance sheets have strengthened as profits have rebounded strongly and refinancing opportunities have been available on favorable terms.

Food and energy prices are already elevated and we now expect a subcycle peak in most countries in the reported rate of inflation as the pace of food and energy inflation slows (inflation is a rate of change in prices, not a price level). In most developed countries, we expect a "normalization" of inflation rates over the next two years, with the center of gravity in inflation rates moving closer to the target inflation rates of the central banks. In those emerging countries where capacity utilization is tight, the upward drift in core inflation could prove a longer-term challenge. If the subcycle peak we expect in reported inflation leads to a pause in central bank policy tightening in these emerging market countries, underlying inflation pressures could continue to drift higher over time. We expect

that the combination of somewhat slower growth in economic activity and a subcycle peak in reported inflation should motivate a “policy rate pause” in central bank interest rates in many emerging countries in late 2011 and early 2012.

There were three main causes of the current subcycle economic slowdown: (1) production overshoot, (2) Libya, and (3) Japan. In many countries, there was an overshoot of unsustainably rapid growth in the production sector in late 2010 and early 2011, creating the preconditions for the subsequent slowdown in orders. The peak in purchasing manager surveys (PMIs) in many countries earlier this year reflected an unsustainable boom pace in production growth. Those PMI peaks may not be achieved again in this cycle, but once the subcycle slowdown has run its course over the next few months, the pattern of weakening economic indicators should come to an end. As of today, the global economy remains in the slowdown.

The loss of Libyan oil exports tightened capacity utilization in the energy sector and drove up oil prices. The result was an inflationary drag on real incomes in many countries in recent months. More recently, however, energy prices have stopped rising and began to stabilize even before the recent decision to release oil from stockpiles. As a result, a higher proportion of nominal income growth can now be expected to flow through to real income growth.

The Japanese earthquake, tsunami and nuclear meltdowns had three effects, one of them permanent and two of them temporary. First, Japan lost substantial nuclear capacity and other countries decided to close nuclear plants or cut back further construction. This appears to be a permanent

reduction in current and future energy supply and has tightened the capacity utilization in the global energy sector.

Second, there was a sharp short plunge in the Japanese economy, with short-term spillover effects to other trading partners of Japan, especially in Asia. That effect was inherently temporary and evidence continues to accumulate that the Japanese economy has already bottomed. Its rebound should accelerate once the likely scarcity of electricity this summer in Japan begins to ease.

Third, disruption of the Japanese supply chain, especially of auto parts for new cars, has caused a temporary drop in production of Japanese nameplate cars. In the U.S., scarce supplies of new Japanese cars have lowered auto sales, increased the prices of new and used cars and contributed to the weakness in many economic indicators. However, this auto supply chain effect is inherently temporary and should be reversed in late 2011 and early 2012. Toyota has stated that it expects a return to full production in North America by September 2011. However, it should be some months before inventories of Japanese nameplate cars reach normal levels.

We believe China is beginning to achieve its objective of slowing an unsustainable pace of growth in its expansion and should see a subcycle peak in its inflation rate within the next several months. While there are symptoms of a real estate bubble in some major cities, consumer leverage in the country is relatively low, substantial down payments on real estate purchases have been required and incomes are growing rapidly. This is a much different reality than prevailed during the U.S. mortgage boom.

Longer-term structural problems remain, but we do not share the widespread pessimism about the cyclical outlook for China.

There have been recent concerns that financial stresses in peripheral Europe could trigger a broader financial crisis. Given the magnitude of the financial stresses in Europe, that is a legitimate concern. This is an extremely complex issue which is likely to go through many stages over the coming years. However, our assumption is that European leaders and other institutions will be successful in managing these stresses to avoid a broader financial crisis that would disrupt the cyclical expansion of the core economies in Europe.

In the U.S., the subcycle cooling of the labor market coincided with the disappointing spring selling season in housing. While new home inventories have been sharply reduced, a large overhang of existing homes continues to weaken housing prices. Mortgage financing is available and house prices are finally more reasonably priced relative to income. However, the U.S. housing market needs favorable job growth to strengthen the increase in new household formation which has recently begun. In our opinion, residential construction in some regions should begin to make a moderate but persistently positive contribution to economic growth over the next several years. However, this improvement in residential construction is unlikely to become evident until job growth reaccelerates.

Earlier in the U.S. economic recovery, increased demand for labor was partly met by a recovery in the average workweek towards normal from deeply depressed levels. This was a substitute for hiring new

workers. Now, however, the rebound to normal levels for the average workweek has largely occurred. Once the subcycle slowdown runs its course, this factor should provide some support to future employment growth.

We do not believe that QE2 had much of a net stimulative effect on the U.S. economy and doubt that its expiration will have much of an effect on the pace of economic growth. We believe that QE2 contributed to some portion of the rise in commodity prices which in turn weakened real income. In addition, we believe that procyclical tightening of bank capital and liquidity requirements offset much of the potential stimulus from QE2. In our opinion, the U.S. currently has a “damp firewood” financial system rather than a “dry tinder” financial system, so that further increases in excess reserves do little to stimulate spending. Credit demand for current spending is weak given the collateral deflation in the housing sector and the ample liquidity already available in the corporate sector.

The Congressional Budget Office estimates in its report, “The President’s Budgetary Proposals for Fiscal Year 2012” that the Federal budget deficit ten years from today (in 2021) is likely to be 4.9% of GDP. Thus the budget battle starts with a structural budget deficit estimate of about 5% for 2021, based on favorable assumptions which may prove overly optimistic. In a more recent report, “CBO’s 2011 Long-Term Budget Outlook,” the Congressional Budget Office estimates that Federal debt could reach 190% of U.S. GDP by 2035 under its “alternative fiscal scenario.” The CBO states that many budget analysts believe that the alternative fiscal scenario “presents a more realistic picture of the nation’s fiscal policies.” The logical implication of

this analysis is that a major modification of U.S. fiscal policy is necessary.

Our most likely case is that in order to resolve the debt ceiling struggle, there will be a mini-deal this year targeting future budget deficit actions. We do not expect any near-term component to be large enough to substantially weaken demand in the U.S. economy. While we doubt that any deal agreed to this year would fundamentally fix the structural deficit problem, the issue has risen higher on the public agenda.

We continue to believe that the budget deficit will be easy to finance in the near term, because monetary

policy is easy and private sector credit demand is weak. However, we are skeptical whether compromises this year to deal with the structural budget deficit will be substantial enough to avoid an eventual fiscal train wreck in some future year. The U.S. budget deficit is a problem for today from a political perspective. From a financial perspective, however, we believe that it is a problem, not for today, but for some future year.

Overall, we believe that, in the current midcycle context, the global expansion is likely to prove sustainable.



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