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Economic Outlook

The Year to Date

By John H. Makin

The array of postbubble stresses and uncertainties identified in the January 2010 *Economic Outlook* ("The Year Ahead") promised that the new year would see plenty of volatility in markets. That is exactly what is playing out as we move through the first quarter. As risks accumulate, it may be that 2010 is shaping up as a mirror image of 2009, reversing last year's down-then-up pattern with an up-then-down pattern this year.

The year began with substantial optimism and rising equity markets worldwide, but since late January, risk appetite has faded as the four major uncertainties discussed in the January *Economic Outlook* have intensified even more quickly than expected. Strains on the European Economic and Monetary Union (EMU) have escalated and spread, as the fiscal crisis in Greece has gained more international attention along with intensifying fiscal problems in Spain, Portugal, and Italy. China's overheating has become more acute, and its consumer price index (CPI) is on track to have risen at a 6 percent year-over-year rate by midyear, propelled upward by continued, rapid economic growth policymakers have not yet restrained. Japan's deflation has intensified further, but the current government and a new finance minister have had little success in pressing for a more reflationary response from the Bank of Japan (BoJ).

Finally, the sustainability of U.S. demand growth, the key to a solid recovery, remains in question as the improvement in employment data has stalled while consumer confidence has remained weak. The tensions surrounding the outlook for the United States have been heightened by an increase in production that, in order to be sustained, will require either substantial demand growth in the United States or continued strong growth in China. The Federal Reserve's modest quarter-point boost in the discount rate on February 18—billed as a move toward "normalization" of credit markets and not a harbinger of an imminent boost in the more important federal funds rate—has slightly unnerved markets.

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Strains in the EMU

The rising strains within the EMU serve as a stark reminder that it is not an optimal currency area. Revelations from Greece of a 2010 budget deficit at nearly 13 percent of gross domestic product (GDP), substantially higher than previous estimates, were the proximate cause of a minicrisis in the market for Greek bonds with spillover into other bond markets for governments facing intensified fiscal strains. (In a sign of the times, one table listing the cost of insuring various government bonds against default arrayed Greek bonds along a continuum that included emerging markets but also prominently included municipal bonds issued by the state of California, where fiscal strains have also been increasing rapidly.)

The problems of Greece and other euro fiscal naughties have arisen in part from their ability to borrow in euros and the lack of fiscal discipline that the resulting ease of borrowing encouraged. Now, with an overvalued currency and a rapidly slowing European economy, the fiscal outlook for Greece has clouded considerably. The Greek claim that it can reduce its budget deficit by 8 to 10 percentage points of GDP over a period of three years is simply

not credible in present circumstances, in which Greece suffers from chronic currency overvaluation and overall European growth is weakening. The same problems apply to Spain, Portugal, and Italy. Sharp budget-deficit reductions amount to contractionary fiscal policy, which slows growth.

With the devaluation route closed, Europe's weaker economies must experience a sharp reduction in real wages or, alternatively, a heavy migration of labor to the stronger economies in northern Europe. In an environment of rising unemployment in those countries, the latter is simply not an option. Northern Europe is understandably reluctant to provide additional funding to Greece and other European fiscal laggards for the obvious reason that more accommodation will simply result in higher budget deficits. These adjustments would be difficult enough in an environment of steady-to-rising growth, but in Europe, where growth estimates have been cut sharply over the past several months, the implied strains are immense.

Underscoring the strains on the European economy, and especially on those in southern Europe under pressure to cut their budget deficits, is a February 17 *Global Data Watch* report from JPMorgan, which shows a reduction in the fourth quarter 2009 growth forecast for the euro area dropping from a 2.5 percent annual rate in December 2009 to 0.4 percent by mid-February 2010. The report appeared just after the dismal fourth-quarter European growth numbers were released, showing virtually no growth at the end of 2009. The picture for 2010 is also bleak, with growth forecasts having been revised from a 3 percent annual rate early in December 2009 down to a 1.5 percent annual rate in mid-February.

Greece's problems were intertwined with revelations of abuses in the financial sector. Investment banks had helped the Greeks to flatter their fiscal picture by arranging some transactions that may or may not have been reported to European authorities. Goldman Sachs helped arrange for the Greek government to presell revenues (such as airport fees) and book the proceeds from such sales as income without booking the liability entailed by the obligation of the government to turn over the revenues later to the owners to whom they had been presold. Such revelations added to a lack of credibility attached to Greek official fiscal statistics and probably will complicate the country's problems going forward.

Around mid-February, European Union officials announced that they were prepared to support Greece without providing many specifics concerning the details of their support. It may be necessary for Greece to submit to highly intrusive oversight by EMU officials as a condition for additional loans. Whether this is politically acceptable or feasible in Greece will be determined partly by the intensity of national strikes scheduled for late February. One alternative for southern European countries is a quasi default on debt, labeled a restructuring, which results in substantially higher borrowing costs in the future. Alternatively, if the Greek debt crisis intensifies or spreads, European governments may avail themselves of support from the International Monetary Fund. So far, that route has been resisted, with European governments apparently determined to deal with the Greek problem on their own.

The fact that stresses within the EMU, and the rising uncertainty associated with these stresses, have pushed down the euro relative to other countries is, of course, a partial step toward resolution of the overvaluation problem in southern Europe. Indeed, many exporters in Germany and other European countries may be relieved to see the euro having dropped by 15 percent against the dollar since its highs earlier in the year. However, the determination of the European Central Bank to anchor the euro as a "hard" currency may limit such downward movement of the euro. More broadly, the stresses within Europe have dampened the risk appetite in other arenas.

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China's Overheating Progresses

China never really experienced a financial crisis in the fall of 2008, yet, ironically, its policy response to the negative fallout after the Lehman Brothers collapse was the most powerful among major economies. Fiscal stimulus worth nearly 10 percentage points of GDP during 2009—with more to come during 2010—and year-over-year credit growth of 35 percent last year now look like overcompensation for feared fallout from the bursting of the global financial bubble.

The result of China's powerful stimulus measures has been a substantial rise in inflation pressure that is becoming more obvious during the first half of 2010. China's

year-over-year CPI, which had been falling at about a 1.5 percent rate in mid-2009, rose sharply to a 1.9 percent rate of increase in December. The rate of increase slowed somewhat to a 1.5 percent year-over-year rate in January because of a slowdown in food price increases, but underlying pressures from continued strong domestic demand growth will probably boost the inflation rate to a 6 percent year-over-year level by midyear. Given that deposit rates in China are just above 2 percent, once inflation rises above that level, households are encouraged to hoard goods and take money out of savings in order to preserve the currency's purchasing power. Both measures tend to exacerbate upward inflation pressures.

Chinese authorities will need to tighten money and credit accommodation more sharply than expected, which will probably slow growth in China and—with it—the positive impulse for growth in much of Asia that has been emanating from China's highly stimulated economy. Some commodity prices have already begun to slow their increase, while Asian-based economies like Australia and New Zealand have begun to retreat from their plans for aggressive monetary tightening now that they foresee less growth from China for their exports. China's probable coming slowdown and the negative impact on Asian and global growth it implies will intensify trade tensions—especially since China's currency is undervalued. While the Chinese could allow a rapid surge in inflation inside China to eat away at the undervaluation of the renminbi, Chinese authorities are unlikely to tolerate such high inflation, so the internal and external pressure for renminbi revaluation will probably continue.

An accurate picture of China's growth rate and the degree of inflation pressure it entails will probably remain clouded until March or April. The Chinese New Year celebrations, which occurred this year in mid-February, always produce data distortions that make the Chinese authorities somewhat hesitant to step in with aggressive policy measures. That said, even with a slightly more benign year-over-year CPI inflation number appearing on February 11, Chinese authorities came forward with a surprise increase in reserve requirements by 0.5 percent on February 12, shortly before the start of the Chinese New Year holidays. This move probably signals that Chinese policymakers are concerned enough about rising inflation pressures inside China to fire a warning preemptive tightening signal earlier than most observers had expected.

Dismal Japan

Japan remains the sick man of Asia and the G7. China's likely tightening will intensify the prospective shrinkage of Japan's export-dependent economy, while intensifying deflation in Japan continues to boost the real burden of that nation's substantial debt load.

Japan's ongoing deflation problems were underscored by the release on February 15 of an initial estimate of fourth-quarter GDP growth. While the headline real GDP growth number seemed encouraging at a 4.6 percent annual rate, especially after the zero growth rate in the previous quarter, most of the real growth was generated by a sharp acceleration of deflation. Recall that the total money value of goods and services is measured by nominal GDP and that real GDP growth is estimated by subtracting inflation from the nominal number. The nominal GDP growth number was a mere 0.9 percent at an annual rate in the fourth quarter with the larger real number generated by a 3.6 percent drop in prices, as measured by the so-called GDP deflator.

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The best overall measure of the path of the Japanese economy in the current deflationary environment is year-over-year nominal GDP. At the end of 2009, the total money value of Japanese output of goods and services (nominal GDP) was 3.3 percent below the level a year earlier. While that is a modest improvement from the –5.8 percent year-over-year nominal growth rate in the previous quarter, it is still an extraordinarily weak num-ber with a larger deflation component—3 percent year-over-year—than the negative 0.7 percent year-over-year deflation rate in the third quarter. Beyond that, Japan's modest nominal growth is entirely dependent on net exports. The annualized contribution of net exports to nominal growth in the fourth quarter was 1.9 percentage points, with a –1 percentage point contribution from domestic demand. Those two figures together generated the overall 0.9 percent fourth-quarter nominal growth rate for Japan. The heavy and rising dependence of Japan's growth on net exports (the contribution of net exports in the third quarter was 0.3 percentage points) leaves deflationary Japan extraordinarily reliant on growth in China to sustain any future increases in output.

Japan's policy response to weak growth numbers and accelerating deflation, even under the new government led by the Democratic Party of Japan, has been tepid to nonexistent. Initially, Japan's new finance minister, Naoto Kan, hinted that the BoJ ought to consider setting a

specific inflation target underscored either by aggressive purchases of foreign exchange in order to fight deflation or by more BoJ purchases of long-term government bonds. BoJ governor Masaaki Shirakawa has specifically rejected inflation targeting while urging that the Japanese government ought to focus instead on reducing its mammoth budget deficits. It must be said that in view of the dire consequences of a deflationary implosion in Japan, any form of reflationary effort ought to be welcome. Perhaps the dispute between the BoJ and the Finance Ministry will itself weaken the yen. Needless to say, a stronger Chinese currency and a weaker Japanese currency would provide substantial rebalancing benefits in Asia, where Chinese overheating is juxtaposed with intensifying deflation in Japan.

Is U.S. Growth Sustainable?

While stresses outside the United States have risen rapidly, stock market confidence—if not consumer confidence—in a sustainable U.S. economic recovery has held up reasonably well. The report of fourth-quarter growth at a brisk 5.7 percent annual rate, although it was driven largely by a 3.4 percentage-point contribution to growth from inventory adjustments, helped buoy hopes for a continued U.S. expansion. However, doubts surrounding a troubling failure of employment data to improve have contained risk appetites and resulted in some hesitation in the equity-market rally that started this year.

The problem with the sustainability of growth in the United States is straightforward. Massive stimulus, both fiscal and monetary, was responsible for virtually all of the 4 percent annualized growth during the second half of 2009. Moving ahead into 2010, fiscal stimulus will turn to fiscal drag at midyear. Nevertheless, for the time being, the Federal Reserve prattles on about the need to prepare for an exit from highly accommodative policies that were put in place after the Lehman Brothers collapse, and the Fed underscored that exit talk with a twenty-five basis-point boost in the discount rate on February 18. Uncertainties surrounding the many initiatives of the Obama administration, including possible costly programs to raise energy taxes and to impose health care reform, have increased uncertainty (especially for small businesses) and, thereby, have suppressed hiring that might otherwise have occurred in that sector. That said, a loss of momentum for higher energy taxes and extensive health care reform may help mitigate some of the policy uncertainty U.S. businesses face. However, the specter of higher taxes specified in the Obama 2011 budget proposals remains.

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When intense efforts at stimulative policy were put in place in late 2008 and early 2009, the expectation was that private-sector demand would have recovered sufficiently by 2010 to sustain economic growth in the absence of further stimulus. At this point, that outcome is in doubt. First-quarter growth may be helped somewhat by further inventory adjustment and some spillover from the higher momentum of spending in the fourth quarter. Net exports may continue to contribute to growth, although surging imports may mitigate that contribution.

A substantial risk has emerged, however, of negative growth in the second or third quarter of 2010. That outcome is particularly awkward in view of the limited availability of additional stimulus measures, with the most likely alternative an expansion rather than a contraction of asset purchases by the Federal Reserve. If the loss of U.S. fiscal stimulus at midyear coincides with a sharp tightening of policy to combat inflation in China, the resultant slowdown in global growth would exacerbate the tendency toward weaker demand growth in the United States at midyear.

The persistent and substantial loss of employment in the United States, coupled with sustained growth of output and good profit growth for many U.S. companies, may have revealed another problematic feature of this unusual postbubble cycle. While employment losses have slowed, the January employment report showed that the year-over-year drop in U.S. payrolls was still 3 percent. Revisions to past employment data revealed that total job losses since the recession began, which had been pegged at about 7.1 million, were boosted by 1.3 million (based on revised data) to 8.4 million. Those revisions meant, among other things, that the cumulative loss of employment and incomes in the United States was substantially larger than had been expected. Further, about one in six U.S. households are experiencing either outright unemployment or underemployment.

The coincidence of falling employment and sustained growth of output and profits raises the possibility that many U.S. firms have discovered that they came into this

cycle with redundant labor. They have subsequently discovered that layoffs, while reducing costs, do not result in lower output. The result is a sharp increase in labor productivity growth and strong profit growth. Of course, the effort by individual firms to enhance profitability by laying off workers may only produce temporary benefits in the way of enhanced profits. If all or most firms, as appears increasingly likely, use layoffs to cut costs and enhance profitability, the attendant loss of income by unemployed workers tends to reduce demand growth and thereby constrain the market for output. The result is downward pressure on prices and relatively weak consumption growth. In fact, the core CPI (87.5 percent of the total CPI; excluding energy, tobacco, used vehicles, and lodging away from home) rose at only a 0.9 percent annualized rate during the last half of 2009, compared to a 1.8 percent annual rate during the first half of 2009. Core inflation actually fell by 0.1 percent during January. U.S. productivity growth accelerated sharply to an average of about 7 percent during the final three quarters of 2009, comparing very favorably to the long-run, five-year average of 2.2 percent. Meanwhile, consistent with weak employment data, U.S. real disposable income grew by only 1.5 percent between December 2008 and December 2009, even with substantial support from transfers and lower taxes.

The very sharp realignment of inventories that occurred during the fourth quarter probably left firms comfortable with some expansion of production at the start of the year. U.S. industrial production in January rose 0.9 percent with the annualized rate of the three-month period ending that month increasing at a 9.2 percent annual rate. U.S. firms, having eliminated redundant inventories and while expecting continued, stable demand growth in the export sector, have clearly boosted production early in 2010. Sustainability of the production boost depends, of course, on a steady increase in the demand for goods. This, in turn, may be in question in view of the weakness of income growth in the United States and a prospective slowing of China's rapid growth pace. The rapid slowdown in European growth, exacerbated by enforced tighter fiscal policy in southern Europe, reinforces the cloudy outlook for global demand growth.

The path of U.S. consumption, a critical source of U.S. demand growth, is probably consistent with an increase of about 1.5 percent in the first quarter based on the limited data currently available. Part of that growth is due to continued, albeit lessened, support from fiscal stimulus and part is probably due to improved financial circumstances for higher-income households. An acceleration seems unlikely in view of the absence of any positive trend in consumer confidence.

If demand growth continues to accelerate modestly, the United States may stay on a subtrend growth path at a rate of 2–2.5 percent growth. Given the substantial excess capacity that exists (capacity utilization is only at 72.6 percent, well below the 80 percent average during most sustainable expansions), U.S. core inflation will continue to drift lower while headline inflation may also be mitigated by stable-to-falling oil prices. If, however, demand growth is inadequate to validate the first-quarter production bounce, then the United States is vulnerable to another inventory cycle by midyear whereby inventories accumulate and expectations of a sustainable recovery have to be eliminated by cutting production and employment. The core CPI would drift closer to a zero trend reading. If, simultaneously, fiscal stimulus turns to fiscal drag by midyear while the Federal Reserve begins to shrink balance sheets, signaling a withdrawal of monetary stimulus, the underlying U.S. slowdown driven by inventory dynamics would be exacerbated. These would be the elements of a U.S. double-dip recession that would require the Federal Reserve to abandon its focus on exit strategies.

The Rest of 2010

The substantial turbulence in the global economy coupled with the as-yet-uncertain path of U.S. demand growth going forward will probably keep markets volatile and range-bound until some clear trends emerge. With weaker-than-expected growth in Europe, probable tightening in China, continued policy passivity in Japan accompanied by intensifying deflation, and some question marks about the health of the U.S. consumer tied to modest credit growth, weak income growth, and substantial real estate wealth loss, global macro risks abound. In this environment, one of the major reasons for an atrophy of risk appetite as we move further into 2010 will probably be the apparent eagerness of central banks to point toward the increasing likelihood that their next steps will be in the direction of removing quantitative easing rather than increasing it. The European Central Bank, notwithstanding problems in southern Europe, will probably not be deterred from rhetoric aimed at an eventual removal of monetary accommodation. At the Fed's January 27 Federal

Open Market Committee meeting, one of the voting regional Federal Reserve Bank presidents signaled more eagerness to move toward less accommodation by dissenting from the Fed's statement that the federal funds rate would remain low for "an extended period." On February 18, as already noted, the Fed raised the discount rate by twenty-five basis points.

The underlying message is that economic growth and risk appetite in financial markets remains too fragile to tolerate much talk about a removal of stimulative policies, let alone actual steps to remove monetary accommodation. These concerns are underscored, especially in the United States, by the fact that substantial fiscal stimulus will be removed during the first half of 2010 and replaced by fiscal drag thereafter.

Events so far in 2010 provide a stark reminder that the conduct of fiscal and monetary policy after an asset bubble has burst is highly complicated and fraught with risk. How those risks play out will determine the path of the global economy and markets in the rest of 2010.