American Enterprise Institute for Public Policy Research

Economic Outlook

June 2011

Another Slowdown

By John H. Makin

Market conditions in the United States, Japan, China, and Europe portend a weakening global economy. While not dramatic in any one region save an earthquake-burdened Japan, these conditions could accumulate to create a problematic loss of momentum for global growth, especially compared to current upbeat consensus views for the second half of 2011.

The global economy is losing momentum as we move through the second quarter—at least that is what markets are signaling. Oil prices are off their highs, suggesting weaker growth of demand for energy. Weak energy demand in turn reflects a global slowdown in industrial production in response to an earlier inventory buildup. The inventory buildup indicates that producers boosted output too much during the first four months of 2011, perhaps having overestimated the pace of demand growth. It also may reflect some of the supply disruptions tied to the Japanese earthquake.

Turning to securities markets, stocks of US companies declined by about 3 percent during the first three weeks in May. That drop came as interest rates on government securities fell by more than forty basis points, from an early-April high around 3.6 percent to around 3.15 percent in late May. The drop in US interest rates, which has been accompanied by lower interest rates in most other major markets, reflects falling inflation expectations as measured by the "break-even" inflation rate, which is derived by comparing yields on Treasury notes with and without inflation protection. Investors expected inflation to be about thirty basis points lower in mid-May than they did in early May. That shift is consistent with a drop in oil prices that reflects somewhat slower growth and weaker momentum in demand for energy.

John H. Makin (jmakin@aei.org) is a resident scholar at AEI.

The thirty-basis-point drop in inflation expectations accounts for about three-quarters of the drop in Treasury yields over recent weeks, with the balance reflecting lower "real" (inflation-adjusted) yields. Lower real yields in turn suggest a modest reduction in expected growth on the part of bond holders, which is consistent with the signal being sent by lower stock markets.

Policy Issues

A drop in expected inflation implied by lower yields in the bond markets flies in the face of

Key points in this *Outlook*:

- The US economic outlook has darkened as oil prices, equity prices, and home values have fallen during the second quarter.
- Japan, China, and Europe face similar outlooks. Japan has experienced a sharp slowdown following its earthquake and nuclear disaster; China's efforts to curb inflation have dampened growth; and Europe is still struggling with the sovereign-debt crisis in Greece.
- With monetary and fiscal stimulus fading, the United States has no politically viable policy options left. The loss of global economic momentum spells trouble for the second half of 2011.

claims made by critics of the Federal Reserve's second round of quantitative easing (QE2) that the central bank was risking an enduring rise in inflation by adding $600 billion of Treasury securities to its balance sheet between November 2010 and June 2011. It is true that headline inflation, as measured by the consumer price index, has risen above 3 percent, measured on a year-over-year basis. But the Fed has argued, with considerable evidence to support its view, that the sharp increases in food and energy prices that have boosted headline inflation are temporary and that tightening monetary policy in response to such increases risks reducing economic growth unnecessarily.

The Fed's central view (I acknowledge dissenting views shortly) is that core inflation, which excludes food and energy prices, is a better measure of future inflation than overall inflation is. The basis for this counterintuitive and controversial view is that spikes in food and energy prices tend to be temporary. The oil price spike of mid-2008, to choose one pertinent example, turned out to be short-lived. Of course, if the Fed had tightened monetary policy in response to the temporary jump in headline inflation tied to higher energy prices just a couple of months before Lehman Brothers collapsed, that would have substantially exacerbated the systemic threat to the global financial system that resulted from the Lehman panic.

The Fed's benign inflation outlook is further supported by the drop in inflation expectations described above. As long as inflation expectations remain stable and well anchored, we can expect the Fed to maintain its current accommodative stance on monetary policy.

Empirical support for the view that the headline rise in inflation is temporary is holding up well, despite attacks from some of the regional Federal Reserve bank presidents. However, the stock market is beginning to wobble even with no inflation signals from bond markets to date that the Fed may have to begin exiting its current accommodative stance, either through fewer purchases of securities or, eventually, by raising interest rates. Given the signal that global growth may be weakening because of weaker consumer demand that has driven an inventory buildup, a more aggressive tightening stance by the Fed or some other central bank could result in a more pronounced global growth slowdown.

> It seems difficult to escape the conclusion that Greece will default on some of its debt, thereby destabilizing the debt markets in Ireland and other southern European countries, including Portugal, Spain, and even Italy.

All this said, the risks that inflation expectations could rise sharply from current modest levels—driven by, say, a rise in core inflation from its current 1.3 percent year-over-year rate to closer to 2 percent—have been widely highlighted for markets. In mid-May, James Bullard, president of the St. Louis Federal Reserve bank, directly challenged the view that core inflation is a better predictor of headline inflation than headline inflation itself. Bullard pointed to the risk that persistently higher headline inflation may push up expected inflation, forcing the Fed to tighten policy abruptly to maintain the credibility of its public commitment to low and stable inflation. As Bullard argues correctly, once persistently higher inflation erodes the Fed's credibility, it is costly to regain. His view that it is better to preempt the rise in expected inflation before it actually occurs is shared by many economists and some members of the Fed's policymaking committee, the Federal Open Market Committee.

Tension is rising over the Fed's current accommodative stance. The outlook for US inflation is closely tied to the path of energy prices, and that path in turn is tied to the pace of global growth as we move into the middle of 2011. If the drop in energy prices is signaling slower growth, then tightening US monetary policy would risk exacerbating that slowdown. The emergence of slower growth would tend to vindicate the view of Chairman Ben Bernanke, New York Fed president William C. Dudley, and Vice Chair Janet Yellen that it is correct to focus on core inflation and keep monetary policy highly accommodative.

Growth Outlook in Major Economic Regions

As is almost always the case, the debate over the correct path for monetary policy is closely tied to the outlook for growth and the implied pressure on prices. A review of the growth outlook in four major economies (those of Japan, China, Europe, and the United States) yields a mixed picture, with some tilt toward signs of slower growth.

Japan. The Japanese economy has experienced a sharp slowdown tied largely to major disruptions from the March 11 Tōhoku earthquake. Japanese policymakers

have been mostly focused on the supply disruptions tied to the earthquake, as have producers worldwide. Although the earthquake occurred just twenty days before the end of the first quarter, recent reports show a sharp 3.7 percent annualized drop in Japan's first-quarter growth rate. Looking at the country's other first-quarter economic statistics, most unexpected and perhaps most troublesome is the sharp drop in private consumption at a 2.2 percent annual rate. Japanese consumers, stunned by the earthquake and the nuclear risks that followed it, have sharply reduced their spending. While Japanese production will recover, the negative consequences for global activity in the automobile and electronics sectors have been substantial and are not yet fully repaired. To give a sense of the severity of these problems: Japanese industrial production fell 15.5 percent during March alone.

The global effects of the earthquake include a reduction in scheduled US vehicle production for the second quarter by more than 10 percent. Similar disruptions have occurred in auto sectors elsewhere. Much depends on two things: how rapidly Japan remedies its supply-chain disruptions resulting from the earthquake, and how rapidly Japanese consumers resume spending enough to mitigate Japan's extreme dependence on more rapid export growth.

China. Chinese growth also shows signs of slowing. Measures to stem property speculation and stabilize China's accelerating inflation have combined with power shortages to dampen the pace of Chinese growth. Chinese industrial production was unchanged in April after a robust start to the year. Likewise, Chinese auto sales are slowing, falling 4.7 percent month-over-month in April, which partly reflects the removal of extra government stimulus measures introduced after the financial crisis to encourage automobile purchases. China is also facing a severe drought along the Yangtze River, the worst in fifty years, which threatens to reduce production of rice and other agricultural products, thereby keeping upward pressure on food prices.

While annualized Chinese growth is slowing to closer to 8 percent than the 8.8 percent rate in the first quarter, much depends on how long it takes for inflation to fall back below 5 percent. If the inflation outlook moderates and some of the credit-tightening measures are relaxed, China may resume growing later in the year. That said, growth acceleration appears unlikely, and the drought, by boosting food prices, complicates efforts to slow inflation.

Europe. The major difficulty in the European economy is tied to Europe's failure to resolve the sovereign-debt crisis centered in Greece. Predictably, the austerity program imposed on Greece has resulted in a worsening rather than an improvement of its deficit and debt problems. Slower growth and the attendant revenue loss, along with rising interest rates as default risk rises, are a toxic combination. It seems difficult to escape the conclusion that Greece will need to reschedule—that is, default on—some of its debt, thereby destabilizing the debt markets in Ireland and other southern European countries, including Portugal, Spain, and even Italy.

The major question regarding US growth going forward relates to the viability of a self-sustaining recovery.

Amid the global manufacturing slowdown and the uncertainty tied to Europe's sovereign-debt problems, European growth is likely to slow from the robust first-quarter 3.3 percent annualized pace. German exports to a slowing Asia, especially China, are likely to moderate. Ongoing fiscal tightening in parts of Europe will also be a drag on growth.

Should a European financial crisis reemerge, the growth outlook for the eurozone would be further jeopardized. The rising tension among Greek authorities, the European Central Bank (ECB), and the European Union (EU) over resolution of Greece's intensifying debt crisis has already put greater stress on the Portuguese, Spanish, and Irish debt markets.

United States. The US economy is slowing during the second quarter, much as it did during the first, when expectations for annualized growth fell from about 4 percent early in the quarter until the release of actual 1.8 percent growth at the end of the quarter. Most US forecasters had predicted 3.5 percent in the second quarter, but as weaker regional manufacturing surveys, weaker industrial production, and weaker durable-goods reports have appeared, most growth forecasts have dropped sharply to below 2.5 percent. On the positive side, the April employment report was stronger than March's, though not robust by the standards of a normal recovery. Much will depend on whether employment increases of over two hundred thousand per month can be sustained in May and June. Higher unemployment claims since April, however, suggest that employment growth may slow in coming months. That would jeopardize the

already-modest first-quarter annualized consumption growth rate of 2.2 percent.

Monetary and fiscal policy has played a large part in supporting US growth during the first half of 2011. Both QE2 and a substantial additional fiscal stimulus package were enacted late in 2010, causing most growth forecasters, including myself, to raise their projections for first-half growth for 2011 to 4 percent. As we approach midyear, it appears that growth is averaging somewhere around 2.2 percent—too low to reduce the unemployment rate, currently at 9 percent. The major question regarding US growth going forward relates to the viability of a self-sustaining recovery. The estimated 2.2 percent growth rate in the first half of the year is not robust. It has been enhanced by substantial monetary and fiscal stimulus. It is uncertain what will happen to growth during the second half of the year when monetary policy is expected to move to neutral or slightly less accommodative, while fiscal drag increases. The fiscal drag about to appear is related to the substantial spending cuts and tax increases underway at the state and local levels, to be followed by payroll tax increases and the termination of extended unemployment benefits at the end of the year. Beyond that, the US Congress looks set to enact more fiscal drag in the form of additional deficit-reduction measures for the 2012 fiscal year, which begins in October 2011.

Finally, the US growth outlook is not supported by the housing sector, which continues to struggle. Home prices are still falling, weighed down by a heavy supply overhang in most markets. For US households that do not have significant investment in stocks, directly or indirectly, major wealth losses persist.

Overview with Policy Risks

The modest reversals in oil prices and equity markets are at present providing only hints of a loss of steam behind global growth during the second half of 2011. Taken separately, a moderate loss of growth momentum in the United States, Europe, China, and Japan does not yet constitute a compelling case for a sharp growth slowdown in the second half of the year. The real risks lie in the pervasiveness of the global loss of economic momentum that is emerging somewhat unexpectedly during the second quarter—especially in the United States, where substantial policy stimulus, soon to be reduced, is still in place. Policy risks abound. If the ECB and the EU mishandle the Greek crisis, a substantial dislocation in financial markets would jeopardize European growth. If the Japanese fail to pursue measures to encourage consumption, or move toward fiscal consolidation at a time when full stimulus is in order, the much-expected rebound of the Japanese economy in the second half of 2011 may not materialize. If China mishandles its battle against inflation, especially in view of the substantial excess capacity buildup in the manufacturing and real estate sectors over the past two years, China's slowdown could be sharper than expected. And finally, if dissent at the Federal Reserve forces a premature tightening of monetary policy, or too much fiscal stringency is imposed on the American economy during the second half of the year, US growth could falter as well.

The probability that all these tricky policy measures will be handled well is low, and a mishandling of one probably increases the likelihood of disruptions from another. For example, another European financial crisis would make it more difficult for China to navigate to a soft landing, or for the United States to avoid another midyear growth scare. Added to that, we have the just plain bad luck tied to Japan's earthquake and nuclear disaster.

Perhaps all these uncertainties, while not overwhelming when taken separately, together constitute one of the reasons for the combination of lower oil prices, lower equity prices, and lower interest rates that we are currently observing. Markets know that the chance that everything will go right is perhaps not very high. They also know that the instruments available to repair problems, especially additional QE or additional US fiscal easing, are not only unavailable this year, but if anything may be used to move toward a *less* accommodative stance.