

Global Economic Outlook

The US and Asia: Something's Gotta Give

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Below is a summary of Peter Fisher's remarks from his address at The Annual Conference on Asian Banking and Finance at the Federal Reserve Bank of San Francisco. The topic was "The Changing Landscape: Asia's Role in Global Finance."

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Introduction

Across the global capital markets, relative financial and economic relationships can become misaligned at times. When a misalignment is particularly pronounced, it usually doesn't stay that way for very long, and instead, something "gives". For example, a few weeks ago, 10-year real rates on inflation-protected government securities in both Japan and the United States traded at identical levels of 1.39%. At the time, it was clear that US real rates should go higher, and today, they are about 25 basis points higher than Japan's. This situation is reminiscent of another obvious misalignment in early 2000 when US real 10-year rates traded at the same level as Italian nominal 10-year rates. Both then and now, it seemed that the tectonic plates underpinning the global economy would not remain in place for long. They could shift, possibly abruptly, and simply put, something would have to give.

Policymakers around the world have begun to suggest a stronger collective response to the risks of accelerating inflation than has been previously evident. But the outcome – how and in what way the plates will shift – remains in doubt.

Today, in contrast to much of the last 10 years, the global outlook will be significantly determined by the path of inflation and policy responses to that path. Having taken significant steps to ease its policy rate and to provide liquidity to the banking system, the Federal Reserve either will or will not win its bet that, over the next 12 months, aggregate demand will be sufficiently weak for the US to avoid a sustained acceleration of inflation. At the same time, in the coming year developing Asian economies either will or will not restrain their already-elevated levels of inflation. Something has got to give in the tension brewing among aggregate demand, inflation, and policy.

It is likely (but not certain) that the Federal Reserve will avoid a sustained acceleration of inflation, and that a year from now US inflation will be falling. This positive outcome will come at a price: domestic demand in the US will start 2009 on a very weak note, as the drags on consumption reassert themselves.

For Asia, it is harder to identify the forces that will restrain and ultimately reverse inflationary pressures. Whether inflation will be contained in Asia is highly uncertain, and containing it will require policy actions or a sequence of events that are very difficult to anticipate clearly.

US Economic Outlook

The US economy faces significant drags on consumption that will likely outlast the temporary impact of fiscal stimulus. Negative residential fixed investment, reflected in still-falling housing starts, has been subtracting roughly one percent from GDP over the last year. Both consumer confidence and personal consumption are saddled with an exhausting litany of challenges – falling home prices, tighter lending standards, unchanged mortgage rates, rising energy and food prices, rising unemployment, and decelerating growth in average hourly earnings.

Federal fiscal stimulus, combined with milder swings in inventory and employment levels than many forecasters presume, will provide somewhat stronger growth near term than many expect, approximately 1% to 2% GDP growth in the second and third quarters of 2008.

Toward the end of 2008, however, and into 2009, as the effect of the stimulus wanes, the drags on consumer confidence and personal consumption are likely to reassert themselves and slow the US economy toward a zero rate of growth.

As these underlying forces of restraint take hold, aggregate demand going into next year should be sufficiently weak to avoid a sustained acceleration of inflation and, indeed, to bring inflation down.

The Risks

There are three key risks to this outlook for the US economy.

Energy prices. Near term, energy prices might remain elevated long enough to impact core inflation, and to raise expectations of further inflation that would be difficult to reverse. Exacerbating the situation might be the unintended consequence of fiscal stimulus fueling demand just enough to sustain energy and food prices at levels that could affect core inflation – even in a weakening economy.

Business fixed investment. If business fixed investment were to pick up over the next few months, this could provide the US economy with greater momentum and less likelihood of sufficient slack in resource utilization to bring down inflation in 2009.

Residential fixed investment and housing prices. These might bottom sooner than expected. If housing starts were to bottom before year end, we would avoid the continued drag on GDP. If home prices were to bottom, we might stabilise consumer confidence.

Most housing recoveries are sharp and V-shaped. It is hard to see how such a recovery can occur unless more generous financial conditions are in place for consumers. Thus, underscoring the view that the economy will weaken again, in addition to a payback from stimulus, are expectations that that our financial system will remain fragile and consumer credit scarce and costly.

Despite the Federal Reserve's low nominal and negative real funds rate, and its heroic efforts to support and liquefy credit markets, financial conditions remain tight. The household sector faces significantly tighter lending standards, and mortgage rates are at the same level as one year ago. While confident that our system for underwriting credit will eventually heal itself through a combination of ingenuity and necessity, the process will be measured in years, not months, and it will more likely follow than lead an expansion of aggregate demand.

If energy and food prices appeared to be passing through to core inflation or the drags that were restraining growth were to abate, the Federal Reserve might then need to consider whether to firm policy before the end of this year. If, however, the housing market remains weak and financial conditions tight, the extent and pace of interest rate increases, if any, would likely be limited.

An additional reason why the US economy will slow again as we enter 2009 is that net exports are unlikely to provide much momentum to growth – which brings us to the outlook for Asia.

Asian Economic Outlook

In response to higher inflation, the policy reaction now unfolding in a number of Asian countries includes increases in reserve requirements, rising official interest rates, engineered firming of exchange rates, and reductions in energy and food subsidies. As these elements combine with the somewhat-unexpected firmness in European Central Bank and Bank of England rates and policy inertia, the world economy will slow as it enters 2009, noticeably more than is now reflected in many forecasts and market prices.

This reduction in global growth will be sufficient to dampen the upside for US net exports. But, given the pace of activity in Asia, it is hard to see how these policy actions to date will be sufficient to contain or reverse the pace of Asian inflation.

Growth in Asia, especially emerging Asia, was extremely strong last year, despite the US credit crisis and abrupt slowness in the US economy. While expected to decelerate this year, growth in Asia remains quite healthy, with India and China up 10.6% and 8.8%, respectively, so far this year. There are signs of slower growth, although these are mainly evident in the export channel and in Japan, rather than in the components of regional demand.

Inflation in Asia is high and accelerating. It is being driven primarily by the global rise in food and energy prices, which appears to be affecting core inflation measures in a number of countries. While energy prices might have room to stabilise or decline, it is much harder to see how the structural and cyclical forces driving up food and soft commodity prices might be reversed by any near-term changes in supply.

Despite policy actions to date, real rates remain negative in some countries and overall monetary conditions still appear accommodative in much of the region. While this brief economic outlook cannot do justice to the differences among Asian

countries, monetary, fiscal, and exchange rate policies across the region are generally moving in the direction of tightening. However, the policies do not yet appear to be restraining either consumption or overall resource utilization.

The slowdown in the US, as well as in Europe and Japan, will likely weigh on the level of Asian exports. But, neither the extent nor the timing of the slowdown is unlikely to cut sufficient slack in resource use soon enough to contain inflationary pressures so evident in Asia right now.

It is almost a year since the onset of the stresses in the LIBOR funding markets that began in August 2007 among North Atlantic financial intermediaries that led to tight credit conditions in the United States. Surprisingly, there is relatively little evidence of a negative spillover to Asia from this. Equity markets around the world have traded in rough sympathy with one another since last October. But given global capital market linkages, Asian surpluses appear to be flowing to the distressed investment opportunities in the US and the UK. Thus, with the still-accumulating Asian current account surpluses, there seems to be little prospect of restraint on Asian demand due to tight western credit conditions – at least, so far.

The linkages between the US and the Asian economies that now appear to be most powerful and most clearly synchronised are, regrettably, those tending to accelerate our respective rates of inflation.

Strong Asian demand for both soft and hard commodities is adding to pressures on food and energy prices in the US just at the time the Federal Reserve is concerned with the risk of these price levels impacting core inflation. At the same time, weakness in the US dollar has contributed to rising prices for those commodities that trade in dollar terms, adding inflation pressure in those countries that manage their currencies against the US dollar.

The US Dollar

Two months ago, Paul Volcker (Chairman of the US Federal Reserve from 1979 to 1987) was asked what he thought the odds

were of a US dollar crisis. He answered that there was no need to predict it because we were already in it. With some trepidation, I will take the other side of that argument.

Over the course of this decade, we have seen the dollar rise and fall in a manner that is entirely consistent with the cyclical position of the US economy versus our major floating-rate trading partners. The US dollar has moved in line with anticipated, risk-adjusted real growth differentials and has played exactly the part of allowing for an orderly adjustment of global imbalances – albeit an incomplete one. The ebb and flow of the dollar has not reflected a loss of its reserve currency status, rather, it has reflected that status as funds have flowed to and from our capital markets.

A dollar crisis, if we see one, would feel quite different and would most likely be the consequence of a sustained acceleration of US inflation. This is why it is so important for the Federal Reserve to resist a further rise in inflation and, why, I suspect, Chairman Bernanke was recently so explicit about the Federal Reserve's focus on the implications of changes in the value of the US dollar for inflation and inflation expectations.

Conclusion

As I said at the outset, the Federal Reserve will win or lose its inflation bet, and Asian countries will or will not be able to contain their current inflation rates. Something has got to give. It is unlikely that Asian countries can be successful if the Federal Reserve is not. It may even be that the Federal Reserve cannot be successful unless Asian countries are also successful.

I am an optimist about Asia's future. Over the next 20 years, I expect that Asia will grow more quickly than the United States. I am also an optimist about America's future in that I expect us to return to our potential rate of growth within the next couple of years. But given the differential in these outlooks, while I expect that US real rates will be higher over the next decade than markets now reflect, I think Asian real rates need to be higher sooner for us all to live up to our potential.

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