



BNY MELLON

# Economic Update

Richard B. Hoey  
Chief Economist, BNY Mellon



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Our outlook continues to be for a sustained global and U.S. economic expansion at an above-trend pace. This is the result of the success of simultaneous macroeconomic stimulation adopted by nearly every country in the world over the last year. The lesson of the last year is that "policy is powerful."

We expect global real GDP growth of 4% in 2010, possibly higher. We also expect sustained U.S. economic expansion at a 3% to 4% pace in 2010, following a similar pace of growth in the last half of 2009. The economic expansion should be subpar relative to a normal recovery from such a severe recession (real GDP recovering at a growth rate of 8% or more) but above trend relative to trend growth near 2.5%.

The global economic expansion is being led by countries which are benefiting from one or more of the following characteristics: (1) a broader diffusion of technology and modern business practices so that better-tooled workers can generate a favorable rise in productivity, (2) increased global demand for commodities due to the rise of the global middle class and (3) strong external and domestic finances with limited constraints from past debt excesses. We believe that it is these underlying fundamental characteristics that should contribute to strong growth in 2010. Many emerging countries fit this profile, especially in Asia. There are some exceptions among the emerging countries, notably in parts of Eastern Europe and parts of Latin America. Once again, policy is powerful, via both the legacy of past policy decisions and the appropriateness of current policy decisions. The economic expansion is likely to be slower in developed economies such as the U.S., Europe, Japan and the U.K., all of which have one form or another of a "debt hangover."

Some economists expect a weak economy in 2010 for several reasons. First, the cumulative weakness in the labor market has been severe. The result has been a low level of consumer income, especially of underlying income before the effect of government transfers. Second, house prices might remain somewhat vulnerable in coming months to the overhang from the inventory of vacant houses. Third, the small and mid-sized business sector faces numerous challenges. The easing of the credit crunch has been much more tentative in the small company sector than in the large company sector. Small firms and new firms are the critical source of new jobs in the economy. A major concern of small and new businesses appears to be the many uncertainties about future policy changes (taxes, health bills, cap-and-trade) that could impact business costs. This is reflected in weak results for the National Federation of Independent Business surveys. Fourth, the state and local sector and the private structures sector remain quite weak.

However, we believe that cyclical forces are quite expansionary. At the worst of the credit crisis, it was not clear how quickly the main financial channels would reopen. In fact, the improvement in the debt cost of capital and the equity cost of capital has been quite rapid. Now that profits are rising rapidly, the availability of internal and external sources of finance for increased spending has improved substantially. Within the U.S. economy, key cyclical sectors such as autos, housing, capital spending and inventories overshot on the downside during the recession and their recovery should generate economic growth at an above-trend growth rate, albeit one that is subpar relative to past recoveries from severe recessions.

We believe that employment in the U.S. economy is at the bottom and about to start a gradual increase. Within the labor market statistics, leading indicators such as temporary worker payrolls and the workweek have begun to improve. We expect rising employment to be accompanied by a high unemployment rate in 2010, with a probable peak near 10.5% early in 2010 and only a gradual decline in the trend of the underlying unemployment rate thereafter. However, the large surge of temporary Census employment this spring could confuse the interpretation of the underlying trend, especially in April and May 2010, when total payroll gains could exceed one-half million.

We expect low inflation in 2010, reflecting decelerating wage inflation and weak rents. The path from consumer price deflation to an accelerated pace of consumer price inflation passes first through the reflation of demand.

Some analysts are also worried that persistent deleveraging in the aftermath of the consumer debt expansion and the boom/bust pattern in housing will disrupt economic expansion. We do concur that a secular peak has been reached in housing and consumer leverage and that the negative wealth effect will be a drag on the economy. We agree that some longer-term deleveraging of the consumer should prove necessary over the coming years. However, in our opinion, much of it is likely to occur in the form of somewhat slower growth of consumer and housing credit in the future, consistent with a domestic rebalancing of the U.S. economy.

There are several recent developments that add to the probability that the deleveraging drag can be absorbed gradually over a period of years. First, stock prices have risen sharply, restoring a portion of lost net worth. Debt becomes more burdensome when asset prices decline, but becomes less burdensome when asset prices rise. While house prices are probably near fair value and are not likely to replicate the rally in stock prices, they could rise in synch with overall inflation over the next decade. Second, current dollar GDP has begun to grow again after its decline during the recession. Positive growth in current dollar GDP cumulated over time can contribute to an easing of debt ratios. The longer-term trend growth rate of current dollar GDP is likely to be at least 4% to 5% (trend real GDP growth near 2.5% plus trend inflation near 2%, the Fed's implicit inflation target). Current dollar GDP growth could easily be higher than that in the next few years as excess capacity and stimulative policy should permit above-trend real GDP growth followed by an eventual upward drift in the inflation rate. The accumulation of increases in current dollar GDP plus some rise in asset prices in the coming years should assist in a gradual improvement in debt ratios and net worth.

The state of the housing market today is somewhat complex. Inventories of new homes have dropped sharply in response to prior cutbacks in new building and government support of housing purchases. However, the inventory of vacant existing houses remains high. For house prices, we believe the basic story is that house prices have made an inflection to the flat part of an L-shaped pattern. The major decline is over and we now expect a sawtooth pattern around a neutral trend. We are suspicious that some of the reported rise in house price indices in recent months might have represented inappropriate seasonals and other statistical artifacts. If so, a few months of weak house prices during the seasonally challenging period should not be a surprise.

How troublesome is the budget deficit? We believe that it depends on the time horizon. In the short run, a high budget deficit is appropriate in the context of weak private sector economic activity. Conditions are cyclically favorable for financing the budget deficit. Inflation is low, the Federal funds rate is zero, the yield curve is steep, major corporations have reliquified their balance sheets and financial intermediaries are willing to expand their holdings of Treasury securities. The domestic demand for Treasury securities should be able to absorb a substantial portion of new Federal debt, although some upward drift in yields may be required to absorb the supply.

The long-term or structural budget deficit outlook is much more worrisome. Demographics and the demand for new government spending programs are putting upward pressure on the path of Federal spending while a somewhat slower pace of trend economic growth should restrain the growth of Federal revenues. Interest rates are likely to rise to more normal levels over time, increasing the debt service cost of the higher levels of Federal debt. We believe that the odds of a grand budget deficit compromise to substantially reduce the structural budget deficit are low. The fundamental political disagreement about the appropriate size of the Federal share of GDP is likely to generate a standoff. We don't believe that the odds of a fiscal crisis in the next year or two are high, but the risks should rise in a few years when inflation risks rise and private sector credit demand increases at a later stage of the cycle. For now, however, we believe that the high budget deficits will not interfere with the economic expansion.

Monetary policy in the U.S. and most other countries remains quite stimulative. There are many measures of monetary policy, but two key indicators are real short-term interest rates and the steepness of the yield curve. With positive inflation and a zero Federal funds rate, short-term real yields are negative. At the same time, the

yield curve is very steep and the financial system is flush with liquidity. Monetary policy is aggressively stimulative today by design.

When will the Federal Reserve first raise the Federal funds rate? Our most likely case is in late 2010. Chairman Bernanke is pursuing an anti-deflationary policy, attempting to limit the negative spillover risks from the collateral deflation in real estate. As long as long-term inflation expectations are well behaved and credit growth is weak, the Fed is likely to remain aggressively stimulative.

The IMF has reviewed the economic aftermath of banking crises. It found that “for the average country, the output level is still around 10 percent below its pre-crisis trend seven years after the crisis.” It also found that “economies that apply macroeconomic stimulus in the short run after the crisis tend to have smaller output losses over the medium term.” We believe that the decision to adopt an aggressively stimulative policy in the U.S. in response to the financial crisis was correct and should generate sustainable economic expansion over the next several years.

We are not significantly concerned about the trend of the dollar against other financial currencies. We expect the U.S. economy in 2010 to be much stronger than Europe, Japan or the U.K. As a result, we expect increased anticipation of future increases in U.S. interest rates over the course of 2010.

We would divide monetary policy into five stages: (1) aggressively stimulative, (2) stimulative, (3) neutral, (4) restrictive, and (5) aggressively restrictive. Most countries entered 2010 with either a Stage One policy (aggressively stimulative) or a Stage Two policy (stimulative). Over the next two years, we expect a gradual transition from aggressively stimulative and stimulative policies towards neutral (Stage Three). This is a normal pattern for the early and middle phases of an economic recovery and we do not believe that monetary policy will become restrictive enough to undermine the case for sustained economic expansion.



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