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# Economic Update

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A lot has been going on. So what are the crucial issues now? We believe that the six key issues are (1) contagion risk in Europe, (2) contagion risk beyond Europe, (3) the implications of the peak in Chinese property prices, (4) the outlook for global economic growth, (5) the outlook for U.S. economic growth and (6) the outlook for inflation and interest rates. We outline them below, along with our most likely case for each.

First, how serious are the risks of further financial contagion within Europe? We believe that the risks are more for a prolonged period of financial stress than for an intensified crisis. We do not expect a more severe crisis, but the easing of European financial stresses over the coming months is most likely to be tentative and gradual.

Second, how serious is the risk that European financial problems will generate substantial financial stresses outside of Europe? We believe that there will continue to be some moderate financial contagion beyond Europe, resulting in a period of somewhat elevated risk spreads. However, our most likely case is that the magnitude of the stresses outside Europe should be limited. We do not expect them to disrupt the sustainability of the global economic expansion. Unlike the prior crisis, the European crisis occurred when the global economy had begun an economic expansion. In most of the world, economic expansions are well established, profits and cash flow are

in a rising trend and policy remains stimulative. As a result of the European crisis, interest rates are likely to stay “lower for longer” in many parts of the world. Our most likely case is that the financial stresses in the sovereign debt markets and banking systems of Europe will not disrupt the global expansion in a major way.

Third, will the peak in the Chinese property boom substantially damage Chinese economic growth and the global economic expansion? We believe that the peak in the Chinese property boom will contribute to a slowdown in China that will be moderate rather than severe. China has a great deal of flexibility to shift its policies in response to changing cyclical realities. While the peak in the Chinese property boom should have a substantial sectoral impact on building-related materials, it is unlikely to disrupt the sustainability of the global economic expansion.

Fourth, what are the prospects for global economic growth over the next two years? Policy should remain stimulative, interest rates should be “lower for longer” and roughly stable energy prices should help bolster real income growth. The debt burdens restraining growth in the developed economies are generally not a problem for the non-European emerging markets. We do not expect a double-dip recession. The recent Manpower survey showed a global improvement in hiring intentions. Of the

19 countries surveyed, the only declines were in Italy, Ireland, Spain and Greece. We continue to expect a sustained global economic expansion over the next two years.

Fifth, is the U.S. economic recovery stalling, based on such evidence as the weakness in the May 2010 payroll report? We don't believe so. Private sector labor demand has been growing in recent months as indicated by the persistent rise in hours worked. Some of that increased demand has been met by increasing the workweek for existing employees rather than hiring new full-time workers, but that pattern has some natural limits. In our opinion, the source of income growth in the U.S. is shifting from government-financed transfers to private sector wage and salary income. There is evidence of rising labor market demand, most recently in the rise in job openings in the Job Openings and Labor Turnover Survey (JOLTS) release from the Bureau of Labor Statistics. We believe the U.S. economic expansion is sustainable, although the pace of expansion should be subpar relative to the past pattern of strong recoveries from severe recessions.

Sixth, what is the outlook for inflation and interest rates? We expect consumer price inflation in 2010 and 2011 to average about 1%, possibly lower. We have shifted our expectations on Federal Reserve policy. We had previously expected the first overt rise in the Federal funds rate to occur at the end of 2010. In the aftermath of recent financial stresses, we would now expect the first tightening to occur in the spring or summer of 2011.

In our opinion, the most likely economic outlook continues to be a gradual easing of financial strains and a sustainable global expansion at a 4% to 4.5% global growth rate in both 2010 and 2011, with a sustainable U.S. economic expansion at a 3% to 4% growth rate in both 2010 and 2011. However, the risks to our most likely outlook are not symmetrical. There are more downside risks than upside risks, given the risks of intensified financial strains. We are assuming a gradual calming of the financial markets. More severe financial stresses, which are still a risk, could result in a slower growth rate. In any case, we expect confidence in a sustainable expansion to only gradually be rebuilt, due to continuing concerns about a worst-case outcome.

We believe that the most fundamental issue for the global economic expansion is the financial stress in the sovereign debt markets of peripheral Europe and the European banking system. Facing the reluctance of the markets to fund the debt of the most vulnerable countries in Europe, notably Greece, the European authorities adopted a rescue package for Greece as well as a broader one designed to lower the risk of financial contagion to other sovereign borrowers in Europe and to the European banking system. We believe that these actions should help stabilize the European banking system in the short run, providing time for it to be strengthened over the next several years. While this should calm the liquidity stresses, resolution of the longer-term issues will depend on politically difficult policy actions within Europe. The risk that differing political perspectives could generate a policy mistake in Europe is worrisome to the financial markets. Our most likely case is that the economies of peripheral Europe will weaken substantially but that the actions taken should prove sufficient to prevent severe financial contagion.

Cyclically, the impact of fiscal tightening and tighter credit conditions in the peripheral countries of Europe should be partially offset by improved exports to other parts of the world, especially from the core countries of Europe. We believe that the key risk to global growth is not the direct impact of slower European growth on other parts of the world economy. Prior expectations for the contribution to global growth from the European economies were modest in any case. However, if a wider financial contagion substantially raises the cost of equity and debt capital in other major countries on a sustained basis, the global growth rate would be slower than we expect.

We believe that a severe global financial crisis has a low probability of occurring but would obviously have a very large impact if it did occur. Until there is greater confidence that it can be avoided, investors are demanding greater compensation for risk. As a general rule, markets do not tend to price into securities prices only the most likely outlook. Instead, they tend to price in the most likely scenario plus other plausible scenarios which appear less likely. The markets do not tend to ignore plausible disaster scenarios even if their probability of occurring is reasonably low. We expect a gradual drop

in market fears of a disaster scenario over the coming months rather than a quick restoration of confidence. In summary, we doubt that the overall European growth outlook will deteriorate enough to significantly threaten the global expansion but the restoration of confidence is likely to be a gradual process.

When they first joined the euro, the peripheral countries of Europe benefited from a form of “borrowed credibility.” The perception of the ECB as a hard money central bank resulted in low yields for all the countries within the euro. With minimal differentials for credit risk, interest rates were lowered in peripheral countries relative to their own history. In peripheral Europe, this contributed to both favorable growth and easy financing of government debt at low interest rates. However, the competitiveness of peripheral countries lagged behind that of Germany due to high wage inflation and high government spending. They became increasingly uncompetitive. If they had borrowed in their own currency, they probably would have devalued, temporarily restoring their competitiveness. However, since they have been borrowing in the euro rather than in their own currencies, devaluing out of the euro would raise the real value of their debt and sharply increase the odds of default. Even some of those countries that remained outside the euro, and thus had the flexibility to devalue, saw a buildup of private sector debt in hard currencies. For them, devaluation would also tend to trigger a wave of defaults.

In a variety of ways, the European financial crisis is occurring in a different context than prevailed in the subprime crisis. Three key differences are that (1) a global expansion is underway, (2) the policy response is less stimulative and (3) there are risks of unintended consequences from regulatory tightening.

First, the cyclical phase of the global economy is now more favorable. Many borrowers worldwide were financially illiquid when the subprime crisis hit. The subprime crisis occurred during a recession after tight monetary policy had triggered the reversal of a housing boom into a housing bust. Borrowers had been so confident prior to the subprime crisis that they permitted deterioration in the strength of their balance sheets just prior to a severe drop in their cash flows. The situation

today is different. The current European financial crisis is occurring during a global economic expansion, which followed a period of aggressively stimulative monetary policy worldwide. A period of easy monetary policy worldwide over the last year has permitted many vulnerable borrowers--both financial and non-financial--to strengthen their balance sheets over the last year, lowering their vulnerability to financial shocks and contagion.

Second, however, a less favorable contrast between this crisis and the last crisis is in the policy response. In response to the subprime crisis, both monetary policy and fiscal policy became aggressively stimulative in many parts of the world. This was politically popular, as it offered the hope of a future improvement in the economy, which in fact did eventually occur. In contrast, financially-stressed countries in the periphery of Europe are now tightening fiscal policy. This is designed to improve market confidence in their long-term sovereign debt sustainability. However, this is a painful policy both economically and politically. Some core countries are also considering fiscal tightening. The response of monetary policy has been much less stimulative in this crisis than the last crisis. To preserve its anti-inflationary credibility, the ECB has been reluctant to ease too aggressively, in contrast to the more aggressive monetary stimulus in response to the subprime crisis.

Third, there is some risk that recent financial stresses could be aggravated by anticipation of multiple sources of regulatory tightening in the financial sector. Following a period when regulation was too minimal and too loose, financial regulation is now tightening on many fronts (financial reform bill, bank taxes, Basel III capital and liquidity requirements, proposed replacement of amortized cost loan accounting with mark-to-market accounting, withdrawal of expectations of systemic support for core banks and the prohibition of certain activities). The global financial system is very complex. There is some potential for negative economic consequences of regulatory tightening, which may not be fully anticipated by those narrowly focused on designing specific and complex regulatory changes. There is the potential for unintended consequences for the availability of credit and the geographic location of financial activities.

There is a long history of new legislation and regulation producing unintended negative consequences.

The ECB is the unified monetary authority of a currency bloc without a unified fiscal authority. In recent years, the ECB has been regarded as a highly credible central bank, benefiting from the perceived legacy of the Bundesbank as the core central bank of Europe. Because it values its credibility highly, the ECB has been reluctant to monetize the debt of weak sovereign credits. However, in the end, it has a role as the short-term lender of last resort in Europe. We believe that it was cyclically appropriate for the ECB to implement its lender of last resort role as the financial crisis worsened this year, but it did so in an awkward way. There are clear disagreements among European policymakers about the proper role of the ECB and the rules for economic decision-making in Europe, disagreements that contribute to market uncertainty.

We believe that it is important to differentiate between the negative causes of a weak euro and the potentially positive effects of a weak euro. The causes of a weak euro are a set of negative developments (weak economy, sovereign debt concerns, banking system concerns). The euro tends to trade down whenever there are intensified concerns about European financial stresses. While it is this bad news that drives the euro down, a lower level for the euro should have some favorable effects. It is cyclically appropriate for the region of the global economy which is likely to have the weakest domestic demand to have a depressed currency to help stimulate exports.

A low level for the euro is nearly the only source of macroeconomic stimulus for the European economy. Traditional indices of financial conditions often include the following as elements of ease: (1) monetary policy ease, (2) fiscal ease, (3) tighter credit spreads that provide cheap financing and (4) a weaker currency. ECB concern about its hard money credibility means that an aggressively easy monetary policy seems unlikely. Peripheral Europe is tightening its fiscal policy. Germany is also tightening fiscal policy and has adopted a constitutional commitment to a more balanced budget. Recently, credit spreads have widened rather than tightened in Europe. The one realistic path to financial conditions supportive of positive economic growth in

Europe is a low level for the euro, to help stimulate exports from Europe to other parts of the world.

There has been growing concern about a potential boom/bust scenario in Chinese property prices and its possible consequences for the Chinese and global economies. We do expect a stall in property prices with sharp corrections in the most overheated property markets in China. The cooling of property price inflation is consistent with the shift in the Chinese macroeconomic policy stance from aggressively stimulative to stimulative. We expect that Chinese government policies designed to halt the upsurge in property prices, especially in the high profile luxury sector, will succeed. As a result, the pace of construction should weaken, limiting the demand for domestically-produced and imported building materials.

We do not believe that weakening property prices in China will generate a major negative wealth effect in its overall economy, in the way that it did in the U.S. and some European countries. Most Chinese consumers are underleveraged relative to overleveraged developed country consumers, a reality which helps explain why mortgage loan-to-value ratios in China are usually lower than they are in the developed countries. In addition, the developed country property booms often occurred in a context of stagnant median incomes, while incomes were rising rapidly in China even before the recent acceleration of Chinese wage inflation. Strong demand for housing in China reflects both a rising standard of living and the scarcity of other attractive investments in a country with low real interest rates, a high savings rate and capital controls which discourage investment in overseas assets. We believe that there are low odds that weak property prices in China will badly damage the global economy, even if there may be important shifts in sectoral demand and commodity price patterns.

There should be a sharp deceleration in the 12-month and four-quarter rates of change for many Chinese economic statistics. Much of this deceleration is likely to be attributable to base effects. The rapid growth that occurred in the second quarter of 2009 has been included in these growth rates recently but is about to roll out of the measurement period. Chinese macroeconomic policy remains stimulative and is now likely to remove stimulus

more slowly than previously expected. We expect that the underlying economic pattern is likely to be a slight moderation of the overall Chinese economic growth trend, with the economic expansion moderating slightly to about a 9% pace.

We believe that it is crucial to recognize that, unlike European policymakers, Chinese policymakers have many more degrees of freedom of action. China is an international creditor not an international debtor and the Chinese consumer is underleveraged rather than overleveraged. The ability to take unified decisive policy action is much greater than in Europe. This does not preclude structural inefficiencies or policy mistakes, but it does mean that policy mistakes can be corrected quickly, if desired.

Does the disappointing May 2010 payroll report in the U.S. show that the U.S. economic recovery is stalling? Actually, we don't think so. What the data reveals is a pattern of rising wage and salary income and increased demand for labor, albeit a tendency to meet that demand for labor by increases in the hours worked of existing employees rather than by a rapid increase in full-time workers.

Over the last three months, private sector payroll jobs increased at about a 140,000 monthly rate. Private employment has stopped declining and has finally made a transition to a moderate pace of expansion in keeping with our expectation of a "job-light" recovery rather than a "jobless" recovery. While U.S. monetary policy is growth-stimulative, tax policy includes higher corporate taxes, higher maximum income taxes, capital gains taxes and dividend taxes. Debt-financed fiscal stimulus has bolstered both total incomes and consumer spending but we believe that the prospect of both increased regulation and increased corporate taxes and capital taxes have contributed to a hesitancy to quickly add full-time workers, especially in the small business sector. Nonetheless, we believe that the forces of cyclical expansion will dominate these drags, resulting in a slow but persistent strengthening of employment.

There should be several months of weakness in the leading indicator indices, given the recent deterioration in

key financial indicators (stock prices, credit risk spreads, yield curve). However, we would expect less weakness in those leading indicators derived from the real economy (orders, workweek). In the near term, we expect measured confidence among businesses and consumers, which had barely recovered from the subprime crisis, to weaken temporarily. For example, CFO confidence in the Duke/CFO Magazine survey dropped as the European financial crisis developed. Any stall in the confidence surveys could last several months. However, we would expect this to be temporary.

We expect that (1) auto sales will continue to trend higher, helping to sustain growing consumption, (2) private wage and salary incomes should continue to rise, supported by rising hours worked, some modest wage gains and some rise in private payroll employment, (3) the negative wealth effect from lower stock prices should be partially offset by taxpayers accelerating income into 2010 in anticipation of future tax hikes, (4) rising corporate cash flows and strong balance sheets should foster substantial growth in equipment and software spending, irrespective of inventory swings in the supply chain, (5) residential construction should rise in the second half of 2010, expanding outside the regions with the greatest oversupply, (6) non-residential construction should halt its decline and begin to rise over the balance of this year and (7) domestic private sector demand should be strong enough to offset the drag from both the state and local sector and net exports. In summary, we expect a sustained expansion in the U.S. economy.

Is there a broader context for the European financial crisis? We believe so. A number of developed countries face serious challenges of rising ratios of government debt to GDP. To some degree, the problems in Europe are the "canary in the coal mine" for a much broader set of debt sustainability issues in many developed countries.

According to analysis in chapter 4 of the recently released preliminary edition of the OECD Economic Outlook entitled Prospects for Growth and Imbalances Beyond the Short Term, "Fiscal consolidation is essential to prevent unstable debt dynamics...Slow fiscal consolidation implies a massive increase in debt...OECD general government net and gross debt is projected to increase by about 30

percentage points of GDP by 2011 relative to pre-crisis levels and by about a further 20 percentage points of GDP before it stabilizes thereafter. The number of OECD countries with gross debt levels that exceed 100% of GDP would rise from three prior to the crisis to eleven by the next decade...the increase in debt by 2025 compared to pre-crisis levels for both the United States and Japan is greater than 50 percentage points of GDP."

Government debt sustainability is a complex subject. Unfortunately, there are a number of developed countries (and local governments within them) that are not yet on a credible path to government debt sustainability. The long-term trend growth rate of various developed countries

is likely to be influenced by success or failure in the attempt to move onto a credible path to debt sustainability. In the race for economic success, not every country will get a trophy.

Those wishing to pursue the issue of debt sustainability further are referred to (1) IMF "Fiscal Monitor" May 14, 2010, available at [www.imf.org](http://www.imf.org), (2) "The Future of Public Debt: Prospects and Implications," March 2010, available at [www.bis.org](http://www.bis.org), (3) "Preparing Fiscal Consolidation" 2010, available at [www.oecd.org](http://www.oecd.org), and (4) "Preliminary Analysis of the President's Budget Request for 2011," March 5, 2010, and "The Long-Term Budget Outlook," June 2009, both available at [www.cbo.gov](http://www.cbo.gov).



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