The State of the Debate

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Reflation and Rebalancing

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GLOBAL REFLATION, GLOBAL REBALANCING

There is a major debate between the bulls and the bears on the U.S. and global economies, on the high trade deficit and current account deficit in the U.S. and on the implications of a weaker dollar. This is a status report on the debate between the optimists and the pessimists about these issues. In this report, we outline why we expect a positive outcome for three themes: U.S. reflation, global reflation and global rebalancing. The economic bears expect a disorderly "pay me now" scenario for correcting global and domestic imbalances. We expect an orderly "pay me later and pay me slowly" scenario for the gradual unwinding of domestic and global imbalances over a period of years.

Reflation and Rebalancing

We believe that the three main themes for the economy and the markets are U.S. reflation, global reflation and global rebalancing. Reflation is a rebound in real growth and does not imply any quick resurgence of consumer price inflation. We believe that U.S. reflation has already begun and global reflation is imminent. Led by the recent transition from below-trend to above-trend economic growth in the United States, we expect favorable growth in all major regions of the world in 2004, a successful global reflation.

This broad expansion should intensify a focus on the issue of global rebalancing. The U.S. has been importing, borrowing and spending while many other countries have been exporting, lending and saving. Over the past decade, the U.S. has been the growth engine of the world economy, with faster growth than Europe and Japan in real domestic demand (real economic activity excluding imports and exports). U.S. domestic demand growth has provided export growth opportunities both for other industrial countries and for such developing countries as China. Some pessimists expect a disorderly adjustment of the resulting current account deficit—a major financial crisis. However, we expect a gradual multi-year global rebalancing as (1) domestic demand strengthens within many foreign economies, (2) the mix of U.S. growth shifts from consumption to capital spending, and (3) the dollar resumes an orderly multi-year downtrend. The G7 statement embodied consensus support for a dollar decline to occur sooner rather than later. We believe that the early resumption of the multi-year dollar downtrend increases the odds that global rebalancing will prove to be gradual and orderly rather than abrupt and disorderly.

U.S. Reflation — Time-Shifting Demand from the Future

Our view has been that successful reflation (an acceleration from weak economic growth to above-trend economic growth) was much more likely than deflation, as we outlined in our State of the Debate report entitled "Reflation or Deflation" in the first quarter of 2003. Macroeconomic policy in the U.S. is more stimulative than it has been in many decades. The federal funds rate is 1% and the Federal Reserve has stated that "policy accommodation can be maintained for a considerable period of time," an extraordinary promise. Our most likely case is that the first Federal Reserve tightening will not occur until mid-2004. Tax cuts and federal spending increases have provided a large fiscal stimulus. The annual budget balance is widening by three quarters of a trillion dollars, from a prior surplus to a large deficit. The U.S. Treasury is using its strong credit rating to borrow to stimulate current spending. Although it may create some problems in future years, this stimulative fiscal policy should successfully time-shift economic demand into late 2003 and 2004. Finally, the U.S. is now encouraging a weaker dollar to stimulate competitiveness. Because inflationary pressures are currently muted, the dollar downtrend is likely to be accommodated by easy Federal Reserve policy. It is true that the rebound in long-term interest rates from their multi-decade lows in mid-2003 has stalled the refinancing boom. But broader weakness in housing is likely to be relatively moderate, given the low level of short-term interest rates and the still moderate level of long-term rates.

The U.S. labor market has been weak in the two years since the official bottom of the recession in November 2001. This is the result of a number of factors: (1) a subpar pace of economic recovery until recently, (2) rapid productivity growth, and (3) intensification of foreign competition and job outsourcing. Given the challenging labor market, aggressively stimulative macroeconomic policy has been necessary to accelerate economic growth. Under current conditions, a rapid growth in the U.S. economy is necessary to generate even a moderate improvement in the labor market. Fortunately, that strong growth is likely.

We expect above-trend real GDP growth in the U.S. in the last half of 2003 and four quarters of 2004. A consumer-led slowdown to a more moderate pace of expansion in 2005 and 2006 is likely as the benefits of current policy stimulus wear off. Successful time-shifting of demand into the last half of 2003 and 2004 is likely to be followed by a consumer payback period in 2005 and 2006. But we expect that this eventual slowing is likely to occur in the context of a well-established global expansion.

Global Reflation in 2004

Successful U.S. reflation in the coming quarters is a precondition for global expansion, but stronger domestic demand in foreign countries will also be required for global reflation to be sustained. Improvement in domestic demand in foreign countries is likely. We believe that one of the objectives of the new weak dollar policy in the U.S. is to force a shift to more stimulative macroeconomic policies abroad, a shift we do expect. The weak dollar should contribute to some beneficial sector shifts in the major countries. In the U.S., the troubled industrial sector is likely to benefit relative to the consumer sector. In Europe and Japan, the consumer sector is likely to benefit at the expense of the industrial sector.

We cannot identify a major region of the world that is likely to have below-trend economic growth in 2004. Estimated long-term sustainable trend growth rates are roughly 7-8% in China, 4%-5% in other developing Asia, 3% or somewhat higher in the U.S., 2% in Europe and 1% in Japan, with demographics a major determinant of differential growth rates. We expect that non-Japanese Asia is likely to have the fastest economic growth rate in the medium term.

China has been growing rapidly. From a worldwide perspective, China is a source of both increased supply and increased demand. There has been a sharp rise in China's trade surplus with the U.S. but its trade with the entire world is more balanced as both its imports and exports have been rising together. However, an important portion of those imports consists of capital goods intended to increase future export capacity in order to raise the Chinese export market share still further. We believe growth in China at close to an 8% rate may well be sustainable for several years, as long as weak capital discipline in the domestic allocation of credit does not create too many problems. The country's advantages are leveraged by an undervalued exchange rate, which China is likely to adjust only gradually.

We believe that other Asian countries (excluding China and Japan) should have strong growth in 2004. With expansion in the U.S., Japan and China, regional exports should grow. Asian consumers are increasingly anxious to spend. With economies that are expected to expand and currencies that are expected to appreciate, the region is being flooded with liquidity at a time when its growth is picking up.

Japan has begun to grow somewhat above its own long-term trend due to the worldwide expansion and an easing of the factors that have held back the economy in the past. Corporate liquidity has been rebuilt and there is some willingness to increase capital spending. Monetary liquidity has improved, the stock market has rallied, there is some progress on reform and economic fear has eased as a banking crisis has been avoided. While China is hyper-competitive as a producer, it is also helpful for Japan to have a booming economy in the regional neighborhood. Longer term, the aging of Japan should hold the sustainable trend growth rate down close to 1%. Near term, however, we expect a faster pace of expansion in Japan despite the recent strengthening of the yen.

We expect a pickup in European economic growth from a mild recession in the first half of 2003 to near-trend growth in 2004. European expansion should start later and be less robust than elsewhere due to policy inflexibility. As the IMF recently put it: "macroeconomic policies…have been constrained—monetary by inflation persistence and fiscal by past failures to adjust." In addition, strength in the euro is a challenge for the economy. The European central bank has been reluctant to ease monetary policy, but it does have the flexibility to do so if necessary. We believe that cyclical weakness has run its course in Europe and the overall world economy is expanding, so some cyclical recovery is likely.

Rising External Deficits

The G7 statement and its aftermath have focused attention on the outlook for the dollar, U.S. trade deficit and the current account deficit (the balance of trade plus other items including the balance on services and on investment income). The basic causes of rising external deficits have been a high dollar in the past and more rapid growth in domestic demand in the U.S. than in many foreign countries. The U.S. has had strong growth in domestic demand over the last decade due to stimulative macroeconomic policy and a willingness to take on debt. Europe and Japan have been stagnating in recent years due to passive policies and a reluctance to adopt free market reforms. China and other developing Asian countries have adopted policies (including foreign exchange intervention to maintain hyper-competitive currencies) to generate strong growth in exports. The result of strong U.S. domestic demand and the high dollar has been lower U.S. exports (now about $1.0 trillion per year) than U.S. imports (now about $1.6 trillion per year). With the current account deficit already above 5% of GDP, U.S. external debt is rising rapidly.

Future Debt Burden

The U.S. is the spender, importer and borrower of first and last resort, while Asia is the saver, exporter and lender. This is the case despite the fact that America is aging more rapidly than non-Japanese Asia. Unless something changes, an aging America will go deep into debt to non-Japanese Asian countries with younger demographics. The U.S. is headed for a deterioration in the ratio of workers to non-workers in the coming years. The resulting problems in financing Social Security and health care benefits will become much more difficult if there is a large cumulative rise in U.S. external indebtedness. Unless this external debt accumulation slows, there will be a heavy future burden of servicing the external debt, reducing the future spending of workers and non-workers alike.

Correcting the External Deficit

There are several paths by which the trade deficit and current account deficit can be reduced. They could be reduced by a drop in imports if there were a consumer-led recession in the U.S., but the cure would be worse than the disease. It hardly makes sense to slow down the U.S. economy to the pace of other industrialized countries with disappointing growth. Tighter fiscal and monetary policy could slow U.S. demand growth, thus weakening imports. However, it is unlikely such policies would be adopted any time soon, given the weakness in the U.S. labor market. Alternatively, foreign growth could surge relative to U.S. growth. This could occur in 2005 and 2006, but in 2004 both U.S. and foreign growth are likely to strengthen, with minimal relative change. With a lag, a broad-based dollar decline would tend to reduce the trade deficit for two reasons, one good and one bad. A dollar decline under conditions of low inflation would improve U.S. competitiveness, stimulating exports. However, it would also slow real income growth.

Multi-Year Dollar Bear Market

The U.S. current account deficit is above 5% and still rising. We believe that the U.S. can continue to run a high current account deficit given the attractiveness of its economy and financial markets. The U.S. starts with a strong external balance sheet due in part to profitable corporate investments overseas over the decades. The ratio of external debt to GDP has not yet risen to an extreme, although it is trending higher. At today's low interest rates, the debt service burden of the U.S. external debt is low. What will probably prove unsustainable, however, is the trend of higher and higher current account deficits as a share of GDP.

Some bearish analysts have focused attention on the huge adjustments that would need to occur to completely eliminate the U.S. current account deficit. But we would challenge the assumption that this is necessary. Among industrial countries, the U.S. should remain the growth leader in the long run due to free markets and less severe demographic challenges. The U.S. economy can support some continuing rise in its external debt, as long as it is not too rapid. Because of the probable continuation of strong trend growth in the U.S., we believe that a current account deficit of 3% of GDP or somewhat higher should prove sustainable in future years.

We do not expect an improving trend in the trade deficit and current account deficit until 2005, given the lagged effects of the past dollar bubble and the import demand likely to accompany the above-trend economic growth we are expecting in the U.S. in late 2003 and 2004. The key to confidence is not any specific level for the external deficit, but rather a rational expectation that its future path can be financed. For that reason, we believe that an orderly, gradual multi-year correction is the most likely case. While fears of protectionism are likely to rise, we do not expect any major disruption of the world free trade system.

China and the Dollar

China is a key issue in the dollar debate. China is growing very rapidly as the world's markets have opened up to its exports while it retains its hyper-competitive exchange rate by government intervention. The Chinese currency should eventually move higher, but we believe that China will be reluctant to permit a major rise soon, since the cheap renminbi facilitates the shift of labor from the rural agricultural sector and the sluggish state-owned enterprises. One reason cited for Chinese reluctance to revalue is the troubled state of their banking system, which might deteriorate further in the event of revaluation. The banking system lacks capital discipline, reflecting both the legacy of Communist capital allocation practices and more recent financing of speculative ventures, including real estate. The Chinese banking system needs to be reformed rather than protected by currency intervention.

The Dollar and the Fed

What are the likely consequences of a weak dollar for monetary policy? A weak currency country often experiences upward pressure on inflation. Ten or twenty years ago, the response of the Federal Reserve to a weak dollar probably would have been to tighten to prevent an acceleration of inflation. However, central bankers today believe, rightly or wrongly, that their countries face greater risks of deflation than inflation. Monetary policy responses to a weak currency are likely to be different in a deflation-prone world than in an inflation-prone world. The weak dollar is likely to be welcomed for some period of time by the central bank as mitigating disinflationary or deflationary tendencies. We believe the Federal Reserve is unlikely to resist the dollar weakness by an early tightening. In the past, anti-inflationary tightening in the face of dollar weakness has raised the risk of recession, triggering a negative impact on the stock market. But in the current environment, we expect dollar weakness to be accommodated by the central bank.

The Dollar and Interest Rates

There are several channels by which a weak dollar might put upward pressure on interest rates. The inflation channel and the central bank response to rising inflation may not be that powerful in the near term. A slowing of the intense demand for Treasury securities from foreign central banks could be more important eventually. However, the U.S. Treasury is currently able to fund the deficit at low interest rates because both inflation and the federal funds rate remain low. Irrespective of the behavior of the dollar, we expect a persistent upward drift in long-term interest rates over the next several years as economic activity strengthens. U.S. macroeconomic policy is reflationary on many fronts (monetary, fiscal, currency) and we believe that successful reflation implies a combination of strong economic activity and rising long-term interest rates. If the Fed holds down short-term rates, as we expect, there will be a steep yield curve, a traditional precursor of strong economic activity.

The Dollar and Stock Prices

What about the link between the dollar and stock prices? It is not true that a weak stock market always accompanies a weak dollar. It depends on the balance of favorable impacts on profits and unfavorable impacts on inflation or interest rates. The net balance is likely to be more positive when the main risk is perceived to be deflation rather than inflation. Countries with a strong currency tend to experience downward pressure on both inflation and export profits, while countries with a weak currency tend to experience upward pressure on both inflation and export profits.

A lower dollar helps U.S. profits three ways: (1) a more favorable translation of profits earned abroad, especially once currency hedges roll over, (2) improved profitability for exports and (3) reduced price competition from cheap foreign imports, especially those from the other major industrial countries. Companies that are large exporters and multinational companies with large foreign operations should tend to be beneficiaries of the weak dollar, while retailers and others facing profit pressures from rising import prices should face greater challenges. Changes in corporate taxes and reflationary macroeconomic policy have already generated a major recovery in operating profits in the U.S., increasing the odds of a broader economic recovery in the coming quarters.

Conclusion

U.S. reflation is well underway, global reflation is beginning but global rebalancing may unfold more in 2005 and 2006 than in the next few quarters. In the end, we expect a positive outcome for all three of our themes: U.S. reflation, global reflation and global rebalancing.

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This report represents the general economic overviews of Mr. Richard Hoey, Chief Economist of Mellon Financial Corporation, and does not constitute investment advice, nor should it be considered predictive of any future market performance.

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