



# Economic Update

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We expect (1) a gradual calming of widespread concerns about an economic depression since we believe that policymakers have a correct diagnosis of the financial and economic risks and are taking proactive monetary and fiscal policy actions to reduce them in a basic policy stance of “whatever it takes,” (2) the deepest U.S. recession, G-7 recession and global recession of the Postwar period, (3) rising unemployment rates and falling capacity utilization worldwide, (4) global rebalancing with a drop in current account deficits in consumption-led economies and a drop in current account surpluses in export-led economies, (5) domestic rebalancing, (6) proactive monetary and fiscal stimulus worldwide, (7) an increased supply of financial liquidity from the Fed’s elastically expanding balance sheet, (8) a gradual recuperation of the financial sector as it moves from semi-orderly deleveraging to orderly deleveraging, (9) extremely low interest rates worldwide in the coming year, (10) the continuation of an intense global inventory liquidation in early 2009, which should ease as the year progresses, aiding the transition from recession to recovery, (11) a cyclical trough in the U.S. recession around mid-2009, followed by a sluggish economic recovery as deleveraging persists during the expansion, (12) a rise in the U.S. budget deficit in 2009 to about \$2 trillion--12% or more of U.S. GDP, (13) a permanent upward shift in Federal spending as a share of GDP and persistently high budget deficits, (14) low inflation worldwide with brief temporary episodes of consumer price deflation due to the global recession and the past drop in commodity prices, (15) the avoidance over the next several years of both a sustained deflation in consumer prices and a major inflation acceleration, and (16) rising protectionist risks as global unemployment continues to rise. The above text is from our March 2009 commentary.

Our outlook remains basically unchanged. However, there are a number of recent developments, with respect to (1) a somewhat improved consensus about the global and U.S. economy, (2) higher commodity price levels, notably including energy, (3) growing concerns about high structural budget deficits and their potential consequences for future inflation and real yields, (4)

reduced fears of deflation and rising concerns about potential future inflation, (5) narrowed risk spreads in the bond market and a recovery in the stock market, (6) an intensified debate about money supply growth and the potential exit path from special liquidity programs, (7) an upward shift in long-term government bond yields even as short-term yields have stayed extremely low, resulting in a steeper yield curve, (8) a continuing debate about global and domestic imbalances, and (9) concern about the outlook for the dollar. The main themes unifying these new developments are an easing of the financial crisis and reduced fears of a deflationary depression. As the consensus has started to abandon the superbear deflationary depression case, many markets have started to normalize. However, we disagree with the view that a quick return to a trend of accelerating inflation is likely. We believe that excess capacity worldwide is so great that the recent bounce in energy prices is unlikely to pass through into a broader rise in inflation. We believe that inflation fears are substantially premature.

It has been our forecast that monetary and fiscal stimulus would be successful in breaking the waterfall decline in global and U.S. economic activity and generating a trough to the Great Recession by around mid-2009. We have been expecting the longest and deepest of the Postwar recessions to end with a recession trough near mid-2009, followed by a subpar recovery accelerating to only somewhat above-trend growth in 2010. The end of economic decline should not be viewed as a return to prosperity, since the actual level of output and employment should remain low for an extended period of time.

Evidence in support of our thesis for a recession trough near midyear 2009 was negligible a few months ago, but is beginning to strengthen. Leading indicators and purchasing managers’ surveys have been rising in many parts of the world. Supportive evidence is widespread: risk spreads in the bond markets have narrowed, yield curves have steepened, stock prices and commodity prices have risen and consumer and corporate surveys have improved. The Great Recession has had three

phases: (1) a borderline recession from late 2007 to September 2008, (2) a post-Lehman economic freefall from September 2008 to the spring of 2009, and (3) a phase of decelerated decline and sequential bottoming in different countries over the last several months, with Asia leading the transition and Europe lagging.

Even if “policy is powerful” and the global and U.S. recession trough is near (as we expect), there is still uncertainty about the pace of recovery. The Postwar precedent is clear: mild recessions have been followed by mild recoveries and severe recessions have been followed by strong recoveries. Will this recur, with a powerful “V” shaped recovery in the U.S. and global economy? We don’t think so. Instead, we expect positive but below-trend growth in the second half of 2009 followed by somewhat above-trend growth in 2010 and beyond.

Carmen Reinhart of the University of Maryland and Kenneth Rogoff of Harvard University argue in “The Aftermath of Financial Crises” that (1) subsequent economic declines usually last about two years, (2) asset market collapses are deep and prolonged, (3) declines in output and employment are profound, and (4) “the real value of government debt tends to explode.” A related analysis can be found in Chapter Three of “World Economic Outlook,” April 2009, available at [imf.org](http://imf.org). As noted by the IMF, “The weakness in private demand tends to persist in upswings that follow recessions associated with financial crises...Private consumption typically grows more slowly than during other recoveries...Credit growth is faltering, whereas in other recoveries it is steady and strong.”

While monetary and fiscal policy was aggressively stimulative in this cycle, the pace of economic recovery should be held back by continued financial and consumer deleveraging and by continued weakness in sectors impacted by excess capacity (private non-residential construction and capital spending). However, the pace of inventory liquidation is now so severe that the rebound in the manufacturing sector should be substantial as inventory liquidation eases over the coming months.

We believe that the most likely outlook for the unemployment rate (a lagging variable) is a rise to about 10% by early 2010, followed by very slow improvement with the unemployment rate stalling in the 9% to 10% range for many months. While temporary census jobs

will limit the rise in the unemployment rate in 2010, these jobs will roll off in 2011, slowing the cyclical improvement in the labor markets. Overall, our outlook continues to be for a recession trough soon, followed by a somewhat subpar expansion characterized by a persistently elevated unemployment rate.

Short-term rates have remained very low but long-term Treasury bond yields have risen substantially, with 10-year Treasury bond yields rising from about 2% in late 2008 to about 4% recently. We regard the 2% yield on 10-year taxable U.S. Treasury bonds late last year as an aberrational level, only explicable by widespread fears of a deflationary depression. We believe that the subsequent rise into the mid-three percent area represents normalization of economic expectations, but the speed of the further rise to 4% was faster than we expected.

Our longer-term view is that a 28-year decline totaling about 1400 basis points in Treasury bond yields has ended, as 10-year Treasury yields dropped from 16% on September 30, 1981 to near 2% at the end of 2008. The secular bull market in Treasury bonds lasted more than a quarter century, but we believe that it is now over. While some will label the next decade or two a secular bear market in Treasury bonds since Treasury yields are unlikely to drop below their December 2008 lows, we believe the most likely outlook is better described as a secular neutral trend.

We would now expect a “secular neutral” center of gravity for 10-year Treasury yields over the next decade of around 4% to 4.5% with a normal range of about 100 basis points on either side of this center of gravity (and an extreme range of about 200 basis points on either side). With inflation currently low, lots of excess capacity and the Federal funds rate near zero, a Treasury bond yield closer to the lower end of the normal range (3% to 5.5%) should make sense. We believe that the cyclical rise in long-term rates has begun but believe that it is premature to expect substantial further increases soon, even with the large Treasury calendar. House prices are such a critical factor with respect to the continuing collateral deflation and the negative wealth effect that any faster pace of increase in long-term yields is likely to prove self-correcting via the impact of higher mortgage rates on the economy. We believe that any substantial overshoot to or through the upper end of our expected normal range for 10-year Treasuries probably lies some years in the future, after many years of

economic expansion finally generate tight capacity utilization again.

Views about future inflation in response to recent monetary policy and expected future monetary policy are at the core of many current debates about the economic and market outlook. Five key aspects of the inflation outlook are (1) the commodity supercycle thesis, (2) the money growth perspective, (3) the output gap perspective, (4) the inflation expectations perspective, and (5) the public opinion/political perspective.

Our interpretation of the sharp rise in commodity prices recently is that it resulted from a combination of several separate factors (1) a classic rebound off an extremely depressed recession low in commodity prices, (2) a reflection of aggressively front-loaded Chinese economic stimulus combined with oil cartel supply restrictions and government-sponsored stockpiling of commodities, (3) a speculative response to a recent phase of dollar correction, and (4) an echo of the inflationary psychology from the prior economic boom. Low short-term interest rates have encouraged purchases of commodities as store of value financial assets, with some governments with excess international reserves stockpiling some commodities and other investors buying commodity ETFs. This is similar to some brief phases in the past near the end of cyclical commodity rises (1974, 2008) when commodities were briefly treated as a money substitute.

We expect energy prices and other commodity prices to calm down relatively soon, as the supply/demand balance is adequate at this phase of the cycle. There is substantial capacity to produce most goods in the aftermath of a major global recession. The more normal cyclical phase in which commodity prices might be expected to continue to rise strongly would be when capacity utilization is high after many years of expansion, which is hardly the case today. The long-term commodity supercycle thesis tied to expected growth in emerging market demand for commodities is likely to prove more relevant after several years of economic boom than at the bottom of a global recession when the actual level of sustainable demand remains depressed. Ironically, however, confidence in the commodity supercycle due to potential emerging market demand may mitigate the usual cyclical pattern of halting supply expansions during and after recessions. Financing conditions for commodity producers have already

improved substantially, mitigating the need to cancel expansion programs.

The inflation pessimists expect a major acceleration of inflation in future years in response to the rapid acceleration of money supply growth that has occurred over the last year. But we believe that the story is more complex than that. At the same time that monetary growth accelerated, velocity (the ratio of current dollar GDP to money supply) has dropped sharply. One explanation is that there is a long and variable lag before fast money supply growth leads first to faster current dollar GDP growth and then potentially to inflation. In addition, a downward trend in velocity has emerged in response to the broad financial crisis. Velocity tends to accelerate when there is expansionary financial innovation. However, this process went into reverse over the last year. Financial innovation has reversed as (1) the shadow banking system of securitized instruments melted down and (2) financial regulation shifted from easy to tight. The rapid expansion in the size of the private financial system relative to the size of the economy came to a grinding halt.

The financial crisis created a spike in the demand for money balances, a demand that was matched by an increase in supply as monetary policy eased. As financial fear drops over time, the precautionary demand for money should drop. As that occurs, the central bank will need to slow money creation. If they are too quick, this will weaken the economy. If they are too slow, the level of liquidity could become excessive as precautionary demand drops below the available supply. Some mobilization of money balances for spending is necessary for economic recovery. If it becomes excessive, it could foster future inflation. We believe that the financial crisis was so severe that it is very hard to tell yet whether the rapid money supply growth will prove to have been appropriate or excessive. It is also too early to tell whether any exit strategy adopted by the Fed will prove to be too fast or too slow. We believe that the ultimate inflationary implications of recent strong money growth are much more uncertain and ambiguous than many inflation pessimists argue. The combination of a procyclical tightening of financial regulation and orderly deleveraging should contribute to a relatively sluggish recovery in private credit growth and a subpar pace of economic recovery. In this context, our most likely case is that core inflation should remain quite low, with occasional volatility in reported inflation due to volatile energy prices.

Another perspective on inflation is linked to the output gap, an economic measure of the degree to which actual output falls short of the potential capacity to produce goods and services. The severity of the recent recession is such that it is clear that the world faces a massive output gap with an excess supply of both productive capacity and labor. This is intensified by the continued government support in emerging markets for further increases in productive capacity and the continuing shift of low-skilled labor into the modern labor force in those countries. The result is likely to be downward pressure on core consumer prices in the near term, only partially offset by a higher level of energy prices. On any reasonable forecast of global economic growth, the output gap will remain quite high for at least another several years. The result is likely to be a persistence of a trend of relatively low inflation.

The third perspective on inflation is that of inflation expectations. There are occasions when self-feeding and unstable expectations of inflation and deflation can contribute to a vicious cycle of worsening inflation or deflation, sometimes reinforced by major currency swings. At other times, long-term inflation expectations are “anchored” near a certain rate, dampening the tendency for actual inflation to deviate for long from that norm.

Reliable central bank behavior can create expectations that their policies will eventually force the actual inflation rate to revert back towards a stable mean. Modern central banks usually have an explicit or implicit inflation target or anchor (often about 2%) and actively attempt to create anchored inflation expectations. To the extent these policies are credible, anchored inflation expectations among consumers, businesses and investors contribute to behavior patterns that raise the odds that inflation deviations prove temporary.

In this business cycle, the severity of the financial crisis and recession created the risk of a deflationary meltdown in expectations. This helps explain the very aggressive easing response from Chairman Ben Bernanke, who wished to drive inflation expectations back up into the normal zone. In response to this aggressive monetary policy ease, inflation expectations rose--as intended. So far, however, long-term inflation expectations have only risen back to normal--to about 2% from near zero as measured by the 10-year TIPS spread. Inflation pessimists point to the upward trend of inflation expectations and expect that it will persist. However,

Fed supporters argue that inflation expectations have merely returned to normal, as fears of a deflationary depression have calmed. It is too early to be sure which interpretation is correct. We agree with the optimists--this policy should support a normalization of the inflation rate rather than either a deflationary or inflationary spiral.

We believe that Chairman Bernanke’s goal is to stabilize inflation expectations near 2%. What is more uncertain is whether the Fed will have the independence to actually achieve this. The Fed knows there will come a time to tighten the provision of liquidity and raise rates to avoid excessive future inflation. There are several risks. First is “intellectual risk”--they can make a bad judgment about the right time to start raising rates. This should be self-corrective as the Fed is responsive to changing evidence. Second is “independence risk”--the Fed can decide that it is time to begin to tighten monetary policy but get political pushback preventing it from acting. Concerns about “independence risk” have risen as the long-term budget outlook has deteriorated. According to the CBO, the Federal share of GDP will rise from about 21% to about 25% by 2019 and Federal debt as a share of GDP should rise from 41% to 82%. Given the record of budget decisions in recent decades, there is a “fiscal policy credibility gap.” If some political interests place a high priority on increased Federal spending and other political interests place a high priority on resisting tax increases, the result could be a budget stalemate, resulting in persistently high budget deficits.

Many inflation pessimists argue that the Fed will be pressured to hold down interest rates to help finance these massive continuing deficits. This is a plausible fear. However, we believe that a more likely result may be a “crowding out” of some private sector economic activity if real yields (yields minus inflation) remain relatively high even in a low inflation context due to high deficit financing as consumer deleveraging continues.

It has been 30 years since Americans have felt the full pain of excessive inflation. They are currently experiencing the pain of excessive deflation, especially in real estate. In this context, many people do not see fighting inflation as a major priority. If the structural budget deficits are not addressed and the markets perceive that the Fed will lose its flexibility to pursue anti-inflationary policy when it is finally needed,

inflation expectations could become destabilized. We are hopeful that this can be avoided. For now, we believe that “monetary policy credibility” remains high, even if “fiscal policy credibility” remains low. Investors are likely to await policy actions to reduce the structural deficit before developing any conviction that it will be successfully addressed. In the meantime, the large global output gap implies that actual inflation is likely to remain low over the next two years with occasional volatility due to energy prices.

There have been widespread concerns about dollar weakness in recent weeks. We are less pessimistic about the dollar outlook than many observers appear to be. There has been a great deal of discussion about reserve diversification recently. Foreign countries have always had the flexibility to shift their currency reserves out of the dollar to other currencies or to utilize their excess currency reserves for other investments or for domestic spending. While the dollar has its issues, so do such competing currencies as the euro, the pound sterling, the yen, etc. We believe that the multiyear process of currency diversification will prove orderly as long as the Federal Reserve retains credibility with respect to its management of inflation risks.

After a major multiyear decline, the U.S. dollar rallied sharply during the financial crisis. Funds flowed from the periphery of the global financial system to the core of the global financial system. A correction of that dollar rally made perfect sense once the financial crisis began to ease. However, we do not believe that the dollar is overvalued against other industrial currencies. U.S. macroeconomic policy has been more stimulative than policy in some other industrial countries. Relative short-term interest rate spreads shifted against the dollar

as some countries had less room to reduce their rates (Japan) or refused to lower their policy rates to the same degree (Europe). However, the effect of the more aggressive stimulus in the U.S. is that U.S. economic recovery is likely to lead the European recovery and economic activity is likely to remain at a less depressed level in the U.S. than in Japan.

The U.S. current account deficit has come down as the price of energy imports is now below the 2008 peak and consumer goods imports have stalled. However, the current account surplus in a number of surplus countries has remained high. In the intermediate term, we believe that an appreciation of Asian currencies against the industrial currencies may prove more likely than further dollar declines against other industrial currencies. While it is true that the internal budget deficit in the U.S. has increased substantially, the external current account deficit has dropped substantially, reducing the need for external finance. We expect the bulk of the U.S. budget deficit to be financed domestically at a time when the yield curve is steep and private sector credit demand is weak. To the degree that surplus countries face potential foreign exchange losses on dollar-based reserves from a future change in the exchange rate between their currency and the dollar, this could occur either because their currency is now undervalued against most of the world’s currencies or because the dollar is now overvalued against most of the world’s currencies. We believe that the argument that the dollar is overvalued is not persuasive. We believe that the odds of disorderly foreign exchange markets are low. The DXY index of the financial dollar remains relatively close to its five-year moving average. Overall, we expect moderate volatility around a broadly neutral intermediate term path for the dollar.



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