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Recent statistics, the world economy and a look at risks

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1. The surprisingly low third quarter growth rate of US real GDP – 1.6% annualized (see table below), below the potential growth rate of about 3% - as well as the steeper-than-expected decline of the housing market make it **necessary to check whether the mainline scenario for the world economy still holds. The risk is that the US slows down further.** The heady days of late summer when the International Monetary Fund predicted that the world's real GDP would grow by 5.1% this year and no less than 4.9% next could be followed by a cold winter. American consumers were long regarded as the world's consumers of last resort, their spending underpinning the rest of the world's exports. What if the decline of US house prices and thus of net household wealth causes a shock comparable to the one Japan experienced in the nineties, but on a much larger scale? After Japan's stock and housing markets had crashed previously optimistic and highly leveraged consumers suddenly realized that their personal balance sheets were in bad shape and needed to be repaired. They then started to borrow less and save more, and they did this for more than a decade. Can the world economy really continue to expand briskly when US consumers are forced to the sidelines? Will they actually be forced to the sidelines? Does it matter much?

		recent growth rates of		
	weight in % [1)]	**real GDP** [2)]	**industrial production** [3)]	**consumer prices** [3)]
euro area	14.8	3.6	5.2	1.7
UK	3.0	2.8	0.7	2.4
US	20.1	1.6	5.6	2.1
Japan	6.4	1.0	5.9	0.6
China	15.4	10.4	16.1	1.5
India	6.0	8.9	9.7	6.3
Developing Asia ex China & India	5.7	7.0	8.0	2.5
Russia	2.6	7.4	4.1	9.6
central & eastern Europe, ex Russia	3.3	5.3	9.0	2.3
rest of the world	22.7	6.0	5.5	4.5
world total	100.0	5.3	7.5	2.9

1) purchasing power parity exchange rates, as calculated by the IMF
2) partly own estimates, annualized q/q in %, except for emerging markets and the rest of the world
3) partly own estimates, y/y in %.

2. The table shows that neither the reduction of US growth to 1.6% nor Japan's equally surprising slow-down to 1.0% in Q2 have brought down world GDP growth below 5%. **At 5.3% the rate is slightly higher than the IMF had forecast, and one of the highest ever.** It is still early in the game, though, so it is not surprising that other regions have not yet been hit by the fall-out from the economic slow-down of those two large countries.

3. One could argue that the weight of the US is not so big any more, as fast-growing emerging markets have gained in both relative and absolute terms. **The new players are less export-dependent than they used to be. Domestic demand has become their main engine of growth.** In China, for instance, real retail sales have recently been up by more than 12% from a year ago while the volume of capital spending has increased by almost 30%. Both have thus expanded at higher rates than GDP itself.

4. **The main emerging economies are also financially quite sound** as years of current account surpluses and interventions in support of the dollar have pushed their foreign currency reserves to unprecedented, sometimes even excessive levels. Their credit ratings and borrowing terms have improved correspondingly. This implies that **they have the means not only to maintain a high level of imports but also to stimulate their economies in case their exports to the US, or of exports in general, begin to slow.** Since capital spending in these countries is expanding so fast, their capital stock may be growing about as fast as demand which in turn implies that there is sufficient slack in their economies - which in turn tends to keep inflation low. The ample supply of labor works in the same direction. As long as inflation risks are so well-contained, additional stimulatory fiscal and monetary policies will be quite effective. But this is not an issue yet. They are still doing well.

5. **Japan is probably just experiencing a brief pause in an otherwise fairly buoyant expansion process.** Nominal orders to machine builders, for instance, have been up no less than 12.9% y/y in the three month-period June to August – in real terms, the number is not much different. Exports are also very strong: The depreciation of the yen, especially in real terms, the low rate of capacity utilization and the rapid growth of Asian export markets are the main reasons. The problems are public sector spending which is shrinking in real terms – government debt levels are still extremely high -, and subdued private household consumption. Employment is up only 0.4% y/y while nominal hourly wage growth of 0.9% y/y translates into just 0.3% in real terms. That is not much. Moreover, there is evidence that **deflation has not yet been eradicated.** The GDP deflator has been -0.8% y/y in Q2, and consumer prices ex seasonal food and energy have lately been below their year-ago levels. When prices are falling people tend to postpone purchases. So Japan has not yet safely entered the phase of self-sustained growth, but the economy is super-competitive and will probably roll along at rates of about 2 ½%. This would again lift, rather than pull down the world's average.

6. **The euro area is supporting world growth** these days, as corporate investment and demand for housing have finally begun to add breadth to the recovery. In its early stages, from 2003 to 2005, exports had been the main driver. As today's retail numbers from Germany have shown (-1.7% m/m, -0.6% y/y, s.a., volume terms), private consumption which is supposed to kick in sometime soon continues to disappoint. However, since employment growth is now in the order of 1½% while real wage growth is between one half and one percent annualized, households are becoming more confident. This morning we got the EU Commission's survey

results for October which showed that the upward trend since mid-2005 is well-established and now above average (but levels are still well below previous highs).

7. **Private consumption remains the missing link in the recovery**. Most analysts fear that the three percentage point increase in Germany's VAT next January will actually cause a large drop in consumer spending across the whole region and thus in the growth rate of GDP in the first half of 2007. In addition, rising interest rates mean that monetary policy accommodation is gradually being removed. However, with gross savings at 14.7% of disposable income, the finances of the average household are sound and would permit personal spending to increase much faster than during the past decade. The risks of a significant negative wealth effect from a large decline of stock and house prices are moderate, given the low degree of leverage.

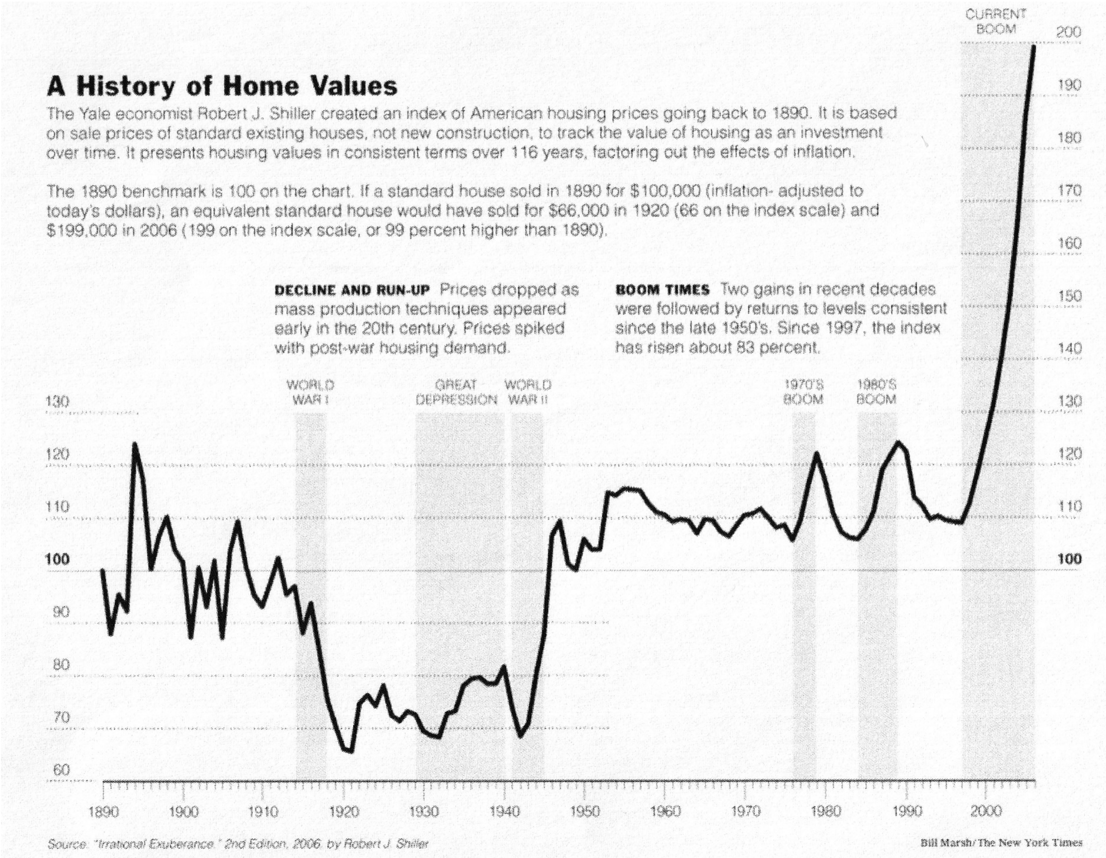
8. To turn to the **positive aspects of euroland's economy**, I am fairly confident that the euro area will continue to expand at rates between 3% and 4%. Business surveys, incoming orders to manufacturing and the housing market are all pointing up, the latter now even in Germany. Going forward, it helps that the dependence on the US economy has declined considerably in recent years. Take German exports: those to Asia now exceed those to the US by 31%. Euro area exports to America are presently the equivalent of about 2% of its GDP. This number admittedly understates the role of the US because it ignores indirect effects such as import substitution and negative repercussions on third-markets, but still suggests that the euro area is not overly exposed to a US slowdown, as far as trade (as opposed to capital flows) is concerned.

9. Together with the UK, Sweden and Denmark who keep their exchange rates in a narrow band vis-à-vis the euro, **euroland's economy is as large as that of the US and thus a comparably closed economy as well**. In other words, it has a large domestic sector and is thus not exposed as much to the outside world as the constituent countries used to be before the introduction of the euro.

10. **Another aspect which argues for a continuation of euroland's economic expansion is the absence of major imbalances**: house price inflation has been rather steady at around 7% for several years and has thus been considerably lower than in the US or in the UK; on the basis of p/e ratios, share prices are near their historical averages; the balance on current account is only slightly in red (around 0.6% of GDP), and the slope of the yield curve, as an indicator of future business activity, is still positive, while the recent fall of the oil price has put money back into consumers' pockets. So **euroland will at least partially compensate for weaker American demand.**

11. Of course, the **key question remains whether the US will indeed move into recession or just experience a few more quarters of below-trend growth.** The housing market which had been a key driver of consumer spending is certainly nose-diving: the median price of new homes has declined by 9.7% y/y, more than in the recessions of 1990/92 and 2001, new home sales are 14.2% lower than one year ago, and housing starts are down 17.9% y/y. The so-called wealth effect which had boosted consumption for so long has gone into reverse, and withdrawing cash from one's home as its value rises is no longer a viable strategy when house prices fall. There is also a lot of leverage, ie borrowing, among consumers which may have to be reduced in step with the declining value of the collateral (the home).

12. Going by the calculations of Robert Shiller of Yale, shown in the graph, **present house prices are at least as excessive as were stock prices in early 2000. Their downward potential is in the order of 35% or more. Since the value of the housing stock is about three times disposable income, such a decline would have massive effects.**



13. While all this looks fairly bleak, **some observers** such as Alan Greenspan and Jeffrey Lacker, president of the Richmond Fed, **are more upbeat** and continue to believe that a soft landing is the most likely course of events. Lacker who was the only dissenter at the last FOMC meeting actually thinks that the economy is so resilient that the present level of interest rates will not be enough to get core inflation back into the "comfort zone" of 1 to 2%, from 2 ½% now.

14. Indeed, there is a whole **range of developments which suggest that the US is not in real trouble yet:** Lower oil prices have boosted consumers' purchasing power again, the rate hiking cycle has most probably ended, corporate earnings are growing briskly, the stock market is in a mild rally, and real disposable incomes are up 4.6% y/y in volume terms. There is still full employment. Moreover, in case of trouble, the Fed could cut rates by up to 525 basis points, and the dollar could devalue and thus improve America's international price competitiveness. A low dollar would make US assets more attractive for foreign investors and thus create additional room for expansionary fiscal policies.

15. **To sum up: the world economy is still in good shape, with supply-side growth close to historical highs and at the same time more evenly distributed and therefore more shock-proof than in the past. Continuing strength in emerging markets and a new dynamism in Europe are likely to compensate for the weakness in the US. Inflation will remain subdued as productivity and wages grow at roughly the same pace.**

16. **So what are the implications for markets? Let's focus on the risks later.** A four to six quarter period of slow US growth followed by a new acceleration, as suggested above, would be a wonderful scenario (except perhaps for the environment). Commodity prices would be well supported, and oil would resume its upward trend toward 100 dollars because market participants realize that the growth pause is not only restricted to the US but also of fairly short duration. The increasingly globalized labor market continues to provide jobs for the hundreds of millions of workers who leave agriculture and inefficient state-owned firms for the urban centers. Until it is fully absorbed into the active labor force this reserve army will exert downward pressure on the wages of less-qualified people in rich countries. The process may last another ten years.

17. **All this is positive for inflation expectations and thus for bond holders**. Longer-term yields fall. The dollar would depreciate somewhat in reaction to more expansionary fiscal policies and, more importantly, lower interest rates. How far down it will go depends on the time path of interest rates. Since activity levels in this benign scenario would not decline much, US inflation may remain too high which in turn argues for only a moderate rate reduction. America's inflation stays high for at least two other reasons: the weaker dollar and the likely new increase of energy prices. Since many emerging countries are pegging their currencies to the dollar, the accumulation of foreign exchange reserves would continue while the freely floating currencies would appreciate by more than warranted by fundamentals alone. **Expect the dollar to fall to 110 yen and to 1.40 to the euro**.

18. **World liquidity would remain ample, and the US would not need to boost domestic savings. All asset markets would be strong** because surplus liquidity that is not needed for the purchase of goods and services (whose inflation rates will stay subdued) will be channeled into assets. This includes not only commodities and bonds but also real estate and the stock market.

19. A key element of this consensus scenario is the on-going redistribution of national income from labor to capital. **Profits are rising faster than wages**. One consequence of this is the low cost of equity which provides an incentive to step up capital expenditure and move toward more capital-intensive production, in spite of cheap labor.

20. **The above scenario of a soft landing is too good to be true, and therefore probably not true**. It is easy to see that it is based on a number of assumptions which may not hold. One is the unlimited appetite for US assets of non-US central banks. America's current account deficit might perhaps shrink for a while, in response to slower growth and a weaker exchange rate, but as soon as growth resumes, it will be heading toward 10% of GDP. This implies massive capital imports and an ever more expensive debt service. The resistance against accumulating more dollar assets will increase just as much as the resistance on part of the US to borrow more as time goes by. The larger the imbalances get, the likelier will be a steep fall of the dollar, far beyond the numbers suggested above.

21. **Another assumption that looks unrealistic over the longer term is that capital's share in national income will keep rising.** First, if capital investment is so profitable, it is likely that we get an oversupply of capital goods, not only of machinery, equipment, software, factories and office buildings but also of private homes. The returns on these investments are therefore bound to disappoint – their prices will then decline, possibly a lot, and the share of labor will rebound. Second, all the output must in the end be bought by workers and their families, not by machines. So it is also in the interest of business that wages don't get too depressed.

22. The ever-rising stock market is a myth. Earnings yields cannot fall below real government bond yields. **The longer the stock market rally persists, the lower will be the potential of high returns, and the likelier will be a major correction.** A similar reasoning can be applied to housing markets where expected rents will at some point fall below the cost of financing. The more houses there are the earlier will this point be reached. **Commodity prices will also hit a natural limit** – which is not the sky. Substitution by other materials, more exploration and output, and economizing by the consumers of commodities create an increasingly strong countervailing force as prices rise further.

23. **In other words, the longer the imbalances in world current accounts, in exchange rates, in the distribution of income, or in the inflation rate on goods and services on the one hand and on assets on the other persist, the more violent will be the eventual correction**. As we have seen in the thirties and more recently in Japan, asset price deflation creates extremely difficult problems for policy makers. Huge appreciations of yen and euro can also lead to recessions and deflation and long adjustment processes. This means the utilization rate of production facilities can remain depressed for many years, and the potential for growth and a better standard of living would be squandered away. Better to act early, for instance by letting the dollar depreciate (stop intervening), or by raising US interest rates further (ie take away the Greenspan put) to keep asset prices in check, and by maintaining relatively stimulative economic policies in surplus countries. But I do not get the impression that policy makers are actually planning to do that..

24. **As it stands, the benign mainline scenario will probably lead to more imbalances and an end in tears. The main requirement for a genuinely benign outcome is that the world outside the US continues to amass dollar assets for years to come, and be content with modest returns. How likely is that? If the risk scenario comes to pass, the only safe havens will be non-dollar cash and government bonds of strong-currency countries, including reserve-rich emerging markets. As far as the euro area and Japan are concerned I would suggest to investors to stand by to shift from export names which are doing well these days (because the exchange rate is so favorable) to import names such as retailers. In the US, the shift should be in the opposite direction.**