



Themes on the Economy®

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Decelerating Growth/Accelerating Inflation A Global Economic Quagmire

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A World Tour

I have spent the better part of the last two months traveling both domestically and abroad—meeting with economists, business leaders and policymakers, trying to make sense of where the global economy is going.

The crown jewel of those meetings was my annual trek to the International Conference for Commercial Bank Economists (ICCBE), which includes 25 top financial economists from almost as many countries. This year, the ICCBE meeting was held in Melbourne, Australia. It provided us with a unique perspective of the intersection between the developed and developing economies, especially that of Asia. I can't quote directly from any of those meetings, but I can provide a sense of the group's views of both the U.S. and global economies for the next six to eighteen months.

A Global Deceleration

The general sense is that the world economy is already in the process of slowing, even among the emerging markets of Asia. The only exceptions are parts of the Middle East, which continue to benefit from skyrocketing energy prices.

The arguments for a “decoupling” or major divergence in growth between the U.S. and its major trading partners, in particular, are being discredited. Europe's economic slowdown is lagging that of the U.S. by two-to-three quarters. Moreover, that slowdown will eventually affect the emerging markets of Asia, as much of Asia has shifted its reliance on exports from the U.S. to

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Europe. Indeed, one could argue that our economies are now more, rather than less, connected via trade and financial flows than in the past.

This is to say nothing of the real estate boom, which was a worldwide phenomenon. It is only a matter of time before rising rates and a slowdown in growth abroad trigger a bust in other countries. The housing markets of the U.K. and Spain are already suffering and placing a drag on overall economic activity.

The U.S. has suffered the most from the credit market crisis, which is not surprising, given its roots in our own subprime real estate market. Most economists believe that we are about half way through the adjustment, which means it will be another six to twelve months before we see any signs of “normalcy” in U.S. credit markets. The key uncertainty is additional write-offs tied to the cyclical weakening of the U.S. economy.

Europe is widely expected to feel the secondary effects of the credit crisis, although with a lag. European banks were among the most aggressive foreign buyers of

U.S. mortgage debt in recent years, but because of different accounting rules, have not had to write much of that debt down. Once they do acknowledge the depth of their losses, bank lending will be constrained.

There should also be a rise in the write-offs at European banks associated with the cyclical slowdown that the region is now experiencing. Denmark has already entered a statistical recession and the risk is high that the U.K. and Spain could soon follow. Germany is holding its own, but it is unclear how long that can last given the strength in the Euro and its dependence on exports.

Even Japan, which surged in the first quarter, is expected to come to a virtual standstill during the balance of the year—exports are the primary reason behind the weakness. In sharp contrast to the West, however, Japanese banks have emerged largely unscathed by the credit market crisis, which means that there may be some upside risk to growth in that economy. Indeed, domestic demand in Japan has shown signs of improving, which should make it more resilient to downward shifts in global demand going forward.

The only true optimists are the developing nations, which expect to slow but continue to post quite substantial gains. This includes everyone from developing Asia (with the exception of Vietnam) to Central Europe, (with the exception of Hungary) to much of Latin America.

On net, the world appears to be entering a slower phase of growth with some of the more developed economies slipping into recession. The developing economies are expected to hold up better, but not fully escape the troubles of the developing world.

The highest risk countries behind the obvious hot spots in the Middle East are Argentina, which is expected to undergo another financial meltdown within the next six to nine months; Venezuela; and the Baltic States, which do not look like they can continue to service their external debt without some sort of a major financial restructuring.

A Medium-Term Turnaround? Over the next two-to-five years, the outlook for the U.S. relative to the rest of world is somewhat better, with an overwhelming majority of foreign economists expecting the U.S. to regain its title as the “fastest growing industrial block.” It is unclear, however, what that accomplishment really means. Growth in the developing world is expected to continue to outperform that of the developed world over the next decade or so, which makes us a little more than a winner among the world’s losers in terms of growth going forward.

A Global Inflation Shock

The entire world is paying a price for the sharp run-up in commodity prices that we have seen in recent years. Inflation is accelerating nearly everywhere, but most dramatically in the commodity-based economies. The only exception is Japan, which is just happy that prices are no longer declining.

The sense is that at least a portion of the rise in commodity prices is speculative, especially in the market for agricultural products. Non-commercial contracts for corn and wheat, in particular, have surged over the last year as more financial bets are being made on the course of prices.

The market for oil is less transparent. One could argue that the fundamentals of rising demand and constrained supply explain much of the rise in prices over the last five and a half years. Political instability across many of the major oil producers is also a problem as it ups the ante on a supply shock. (Some Washington insiders have already upped the probability of a military strike against Iran before November to 50%.)

Subsidies and price caps in some countries have allowed world oil prices to drift higher than they would if consumers were allowed to react to a more market-driven price. This is especially true in China, which has accounted for much of the rise in demand for energy since 2003.

No one, however, can justify the sheer magnitude of the recent surge in oil prices. Some are even optimistic that prices will reverse in 2009. Economists from the oil-producing countries tended to expect the largest price declines over the next year.

However, much of the spillover from earlier increases in the price of oil have yet to make their way through to gasoline prices. Moreover, nations that currently subsidize oil demand are expected to end their subsidies this summer, which should curtail demand. Most notable is China, which has already curbed some of its subsidies on gasoline in order to direct resources toward rebuilding in the wake of the recent earthquake.

One might wonder why we care what is pushing prices, rather than just the fact that they are rising. The reason is that relative or structural shifts in price levels, like the ones that we are seeing across much the world via commodity prices, do not require the same policy response as a cyclical acceleration in price levels. Structural or relative price shifts, in particular, tend to be more self-correcting and require less central bank intervention than cyclical or overall price shifts.

The reaction to surging oil prices in the U.S. provides a good example of a largely structural or relative shift in price levels. Increases in prices at the pump are crimping other types of purchases. This, in turn, is reducing the prices of things like apparel and vacation packages. Discounts

have increased on everything from clothing to hotel rooms to clear unwanted inventories. Indeed, many U.S. retailers jumped the gun this year by launching their July clearance sales in June in an effort to make up for weakness earlier in the season.

This is to say nothing of the drag on inflation being created by housing in the U.S. Housing costs make up roughly one-third of our consumer price index, which has yet to reflect the full effects of the housing market depreciation. It takes at least a year for the full effects of a shift in home values to show up in the consumer price index.

A Conundrum for Central Bankers

Accelerating global inflation has clearly raised the hackles of central bankers around the world. Trichet and his team at the European Central Bank (ECB) appear to be among the most hawkish of their peers in the industrialized world. They tightened monetary policy last week, even as evidence of a slowdown in Europe was mounting. A pick up in wages, which are tied more to union contracts than overall economic conditions in Europe, is the primary reason for their concern. The ECB fears a return of the wage-price spirals we saw in the 1970s, and acted preemptively to avert such a crisis.

There are economists both inside and outside of the ECB, however, who disagree with Trichet’s recent action to tighten. They believe that Europe will weaken, and that the ECB will eventually (by year end) be forced to reverse course and ease.

The U.S. is experiencing more of a structural or relative shift in prices, which as argued above, will be somewhat self-correcting. This is especially true in the face of stagnating real wage growth, and the inability of most workers to get compensated for higher prices at the pump.

That said, it is unclear whether or not the Fed will pause as long as some would like before resuming a policy of monetary tightening. The Federal Reserve presidents, who tend to be significantly more hawkish and less concerned about financial market stability than their counterpart on the Federal Reserve Board, are expected to gain an upper hand in decision making once Governor Mishkin vacates his seat on the Board of Governors at the end of August.

Monetary policy across emerging markets is even less predictable. The more credible central banks in Latin America (specifically, those in Brazil, Chile, Mexico, and Peru) are going to tighten in response to the cyclical pressures that surging commodity prices have placed on their more commodity-driven economies; Argentina and Venezuela, which are both suffering double-digit inflation (30% in Argentina's case), are the clear exceptions.

Central banks in Asia have also begun to tighten. The Bank of China has increased rates and put a cap on bank lending several times in recent months. It remains unclear, however, how much the Bank of China is actually reining in credit growth—some \$20 billion a month is still coming into the country via foreign investment. The good news in terms of inflation for China is that it still has an abundance of cheap labor living in the rural areas to keep wages from accelerating too dramatically. Moreover, the wage acceleration it has seen has been matched with almost as stunningly strong productivity growth, which should help to temper the pass-through of commodity-based inflation to other prices.

Indeed, almost all of the inflation to date in China can be attributed to rising food prices, which are seen as more of a relative than cyclical shift. That may be debatable, however, given the role that increased incomes have played in increasing China's caloric intake of food in recent years.

The Bank of Japan is probably the most neutral of the bunch. They are hoping that inflation will accelerate enough to raise their target rate to 1% next year (which is hardly restrictive to growth).

Finally, there are the pessimists who worry that their economies are already either in or close to a recession and have begun to ease. The Bank of England falls into this category, along with some of the Nordic countries, which have already slipped into recession.

Other Issues

The Reserve Status of the Dollar

Most economists both at home and abroad still believe in the reserve status of the dollar. (I know, I was surprised too.) The Euro, of course, is the primary competition.

The fact that Europe is still largely controlled by the governments of individual countries that make up the Eurozone rather than a function of central government, however, is a major disadvantage for the Euro.

Dissolution of the Eurozone is also a risk, as the ranks of those predicting the Euro's demise have grown substantially in recent years.

After the Euro, there are few viable substitutes for the dollar. The yen has clearly lost the status that it once had in world markets, and there are considerable questions about whether Asia or the Middle East will be able to come up with common currency zones of their own. So, by default, it looks like the dollar will continue to enjoy its reserve status for some time to come.

The U.S. Elections

The Democrats are expected to gain a larger majority over Republicans, and Obama is expected to win over McCain in the bid for the White House. The bid for president, however, is expected to be much closer than recent polls in the U.S. suggest. Foreigners are particularly skeptical that Obama could win against a career military man if tensions with Iran intensify.

Foreigners seem utterly confused about either candidate's stance on economic policy, which should be expected given their inability to provide a substantive policy to date. Backtracking on globalization and free trade top the list of foreigners' economic concerns, which is understandable given the increased populist rhetoric we have seen in recent years. Threats that we may renegotiate current free trade pacts are particularly disturbing to those who trade with us. (The only bright spot is the free trade agreement with Columbia, which is expected to be ratified after the elections in November.)

Sovereign Wealth Funds

The Sovereign Wealth Funds (SWFs) and how we decide to restrict their activities were also of notable interest. Economists and business leaders among the developed nations tend to share our concerns about the goals of such funds. (Does China just want to diversify its assets or does it really want more control over the world's resources? Probably both.)

The developing nations view the contributions of the SWFs in a more favorable light. They argue that the benefits that SWFs bring to the commodity-based economies, in terms of stability, outweigh the costs.

Nobody, however, can seem to deal with the inherent problems associated with funds that may be driven as much by economic as political incentives to invest. The political goals behind the SWFs are particularly suspect in the U.S., and will come under greater scrutiny in the year to come.

A Crisis in Leadership

Finally, there is the issue of leadership, which seems to be desperately lacking in everything from politics to business. The loss of faith in our central bank leaders is particularly disturbing, as it could undermine their ability to provide stability in increasingly unstable times.

This marks a sharp reversal from the 1990s, when central bankers were seen as super heroes, able to stabilize even the worst of financial market crises. Indeed, Fed Chairman Alan Greenspan graced the cover of *Time Magazine* as one of the "men who saved the world" after the 1998 financial market crises.

The only good news is that our central bankers are attempting to learn from past mistakes. The bad news is that they may not learn those lessons in time to avert a more widespread and more destructive slowdown in the global economy.

On net, I still can't figure out why anyone would want to be president in this environment, but I take my hat off to those willing to apply for the job. We have had too long of a void in leadership at the top posts in this country, and could use someone with strong leadership skills as we navigate the economic turbulence of the next four years.

Mesirow Financial Economic Forecast (Numbers as of July 8, 2008)

	2007(A)	2008	2009	2007:4(A)	2008:1(A)	2008:2	2008:3	2008:4	2009:1	2009:2
National Outlook										
Chain-Weighted GDP	2.2	1.8	1.7	0.6	1.0	2.5	1.5	-0.1	1.8	2.4
Personal Consumption	2.9	1.6	0.3	2.3	1.1	3.2	0.8	-4.3	0.8	1.6
Business Fixed Investment	4.7	4.2	0.9	6.0	0.6	3.0	2.7	3.7	-2.2	-0.3
Residential Investment	-17.0	-20.4	-6.6	-25.2	-24.6	-15.3	-17.0	-17.8	-9.2	1.7
Inventory Investment (billions)	4.6	-14.9	14.9	-18.3	-19.6	-43.9	-17.9	21.7	17.5	13.9
Net Exports (billions)	-555.6	-449.0	-335.1	-503.2	-480.2	-454.5	-451.2	-410.0	-367.1	-338.4
Exports	7.9	8.4	6.8	3.9	4.4	8.7	7.7	8.3	6.6	6.4
Imports	1.6	-0.6	-1.1	-2.6	-1.9	-1.9	4.2	-3.4	-4.4	-0.6
Government Expenditures	2.0	2.4	1.7	2.0	2.1	2.8	1.5	1.5	1.8	1.8
Federal	1.7	3.4	2.0	0.5	4.3	3.5	1.4	1.8	1.9	2.2
State and Local	2.2	1.9	1.6	2.8	0.8	2.4	1.6	1.3	1.7	1.6
Final Sales	2.5	2.0	1.5	2.4	0.9	3.4	0.5	-1.6	2.0	2.6
Inflation										
GDP Deflator	2.7	2.0	2.1	2.4	2.7	0.8	2.4	2.3	2.6	1.9
CPI	2.9	4.5	3.0	5.0	4.3	4.6	6.6	3.1	2.5	1.9
Special Indicators										
Corporate Profits*	2.5	0.5	4.4	2.5	1.0	-3.5	-1.3	0.5	1.6	1.0
Disposable Personal Income	3.1	1.9	0.9	0.9	1.4	14.2	-11.0	-1.6	3.5	2.7
Housing Starts (millions)	1.34	0.92	0.88	1.15	1.05	0.97	0.86	0.81	0.81	0.85
Civilian Unemployment Rate	4.6	5.4	6.1	4.8	4.9	5.3A	5.6	5.8	6.0	6.1
Employment	0.8	-0.6	-0.1	-0.4	-1.5	-0.6A	-0.6	-0.3	-0.2	0.2
Vehicle Sales										
Automobile Sales (millions)	7.6	7.7	8.3	7.8	7.3	7.6A	7.7	8.0	8.1	8.1
Domestic	5.0	5.0	5.4	5.2	4.9	4.9A	5.0	5.2	5.3	5.3
Imports	2.5	2.7	2.9	2.5	2.4	2.7A	2.7	2.8	2.8	2.8
Lt. Trucks (millions)	8.6	6.6	6.2	8.4	7.9	6.4A	6.0	6.1	6.2	6.1
Domestic	7.1	5.4	5.0	6.9	6.5	5.2A	4.9	4.9	5.0	4.9
Imports	1.5	1.2	1.2	1.5	1.4	1.2A	1.1	1.2	1.2	1.2
Combined Auto/Lt. Truck	16.1	14.3	14.4	16.2	15.2	14.0A	13.7	14.1	14.3	14.2
Heavy Truck Sales	0.4	0.3	0.4	0.3	0.3	0.3A	0.3	0.3	0.3	0.4
Total Vehicles (millions)	16.5	14.6	14.8	16.5	15.5	14.3A	14.0	14.4	14.6	14.6
Interest Rates/Yields										
Federal Funds	5	2 ¹ / ₄	2 ³ / ₄	4 ¹ / ₂	3 ¹ / ₈	2 ¹ / ₈ A	2	2	2	2 ⁵ / ₈
10-Year Treasury Note	4 ⁵ / ₈	4	4 ⁵ / ₈	4 ¹ / ₄	3 ⁵ / ₈	3 ⁷ / ₈ A	4 ¹ / ₈	4 ¹ / ₄	4 ³ / ₈	4 ⁵ / ₈
Prime Rate	8	5 ¹ / ₄	5 ³ / ₄	7 ¹ / ₂	6 ¹ / ₈	5 ¹ / ₈ A	5	5	5	5 ⁵ / ₈
Corporate Bond AAA	5 ⁵ / ₈	5 ⁵ / ₈	6 ¹ / ₄	5 ¹ / ₂	5 ¹ / ₂	5 ⁵ / ₈ A	5 ³ / ₄	5 ³ / ₄	6	6 ¹ / ₈
Exchange Rates										
Yen/Dollar	116	118	109	113	105	105A	105	107	108	108
Dollar/Euro	1.26	1.37	1.47	1.45	1.50	1.56A	1.53	1.50	1.49	1.48

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2005, GDP was \$11,049 billion in chain-weighted dollars.

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