Weekly Perspectives

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A Weekly View of Global Economies

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North America
Analysts are still engaged in assessing the total impact of Hurricane Katrina on the economy. Obviously the effect on states in the Gulf Coast region is quite severe and full recovery will take place over an extended period of time. The overall impact on the US economy will be felt via a reduction in GDP growth in the third quarter, followed by a pickup in the fourth and first quarters, as reconstruction efforts boost activity.

What we have experienced is a short-term supply shock to the US economy and, to a lesser extent, the global economy. The primary means by which it has affected activity has been a spike in energy costs, a decline in wage income from hurricane-related job losses and disruption of import-export trade through some ports on the Gulf Coast.

Analysts are already factoring in a decline in payrolls for the month of September, which is expected to be reversed in subsequent months. This sort of volatility in output and employment is a normal pattern resulting from such shocks and the global economic environment is still robust enough to make an extended period of weakness a low-probability outcome.

Based on previous experience, it is reasonable to expect a rebound in activity. Meanwhile, the next set of monthly economic reports released in the United States will be interpreted with an eye for the bias introduced by the impact of hurricane Katrina.

However, the expected rebound in growth is premised on the assumption that the supply disruption in energy markets will not last. This depends on the speed with which the infrastructure, which includes refineries and pipelines, will be rebuilt and will start operating normally. Otherwise, oil prices which have started to ease may begin to pick up again and this will be troublesome for global growth.

A demand-driven rise in energy prices has now been supplemented by a supply shock and it would now be sensible to monitor prices closely because at these levels it is starting to become a burden on household disposable income - - even though there are offsetting factors in the form of still-low interest rates and decent job growth. We should note that consumer demand in the United States is still one of the main engines of growth for both the US and global economies.

Tapping of the Strategic Petroleum Reserves by the US government helps in boosting the supply of crude. In addition, the commitment of OPEC members to ensure a high rate of output is encouraging. But the main problem is centred on refining capacity, which was already tight before the hurricane struck.

Meanwhile, in Europe the reaction of some governments has been to put pressure on oil companies to reduce prices, oblivious to the fact that the main component of traditionally high petrol prices is the government tax take.

We should also be watching headline inflation if oil price increases are sustained. US consumer inflation was already boosted in July by energy costs, with the difference between the headline and the ex-energy number measuring the impact on household disposable income. If the supply disruption is not resolved soon, then the spike in inflation may become a stickier problem. The trend in unit labour costs is not encouraging, and a pickup in aggregate demand means that there is an upside to inflation risks.

Given the momentum of the US economy, the Fed has been on a tightening cycle. But as we have always said, policymakers are not dogmatic about rate increases and continue to feel the pulse of the economy to judge what is appropriate. Right now it may be telling them that the patient needs a little rest to catch its breath, but is otherwise in good health.

So there is now a rationale for the Fed to pause at the next FOMC meeting and monitor the situation. But the case for even a brief respite isn't decisive. If the base-case scenario is correct, that the supply disruptions are temporary and will be resolved soon, it is likely that the economy will rebound, boosted by reconstruction activity. And the Fed will be prompted to maintain the cycle of rate hikes.

The US equity market has been rising recently on hopes for higher economic growth and a softer approach from the Fed. At the same time, the bond market appears to be treating high oil prices as a burden on economic growth with low risk of a spill-over into higher inflation. Current low bond yields leave little room for surprises in growth and inflation.

Europe
It is evident that the future course of economic reforms in Germany will depend upon what sort of coalition takes power after the elections on September 18th. Right now, the outcome is too close to call. The best result from the equity market's point of view would be a centre-right coalition government, which would have a conservative bias. This is a grouping that would implement structural and labour market reforms fairly quickly.

Germany, with a persistently high unemployment rate and a Maastricht-busting budget deficit needs reforms badly. Foreign investors, who had earlier snapped up German stocks, may get cold feet if the political climate doesn't warm up.

Asia/Pacific
In Japan, Koizumi remains in power with an increased majority, giving him a mandate to accelerate reforms. Meanwhile, there was an upward revision of the economy's growth rate in the second quarter. The brighter economic and political outlook has been attracting foreign money into the equity market for the past few months.

Bonds
US producer prices rose less than expected in August, giving comfort to traders who wish to believe in a softer approach by the Federal Reserve. Accordingly, Treasury yields were also lower. However, at these levels, they do remain vulnerable to newsflow.

Currencies
The US trade deficit in July was narrower than expected but this led to only marginal gains for the greenback against the euro. Unfortunately, the deficit shrinkage isn't particularly impressive and is expected to widen next month on account of oil imports. Meanwhile, the yen has succumbed to profit-taking after Koizumi's landslide victory in the Japanese elections.

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