Weekly Perspectives

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A Weekly View of Global Economies

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North America
Last week's gabfest for central bankers and academics in Jackson Hole, Wyoming was an appropriate occasion for Greenspan to broach the topics of economic imbalances, asset inflation and risk. The Federal Reserve chairman is due to retire in January after an 18-year stint and we will probably hear more of his thoughts on economic and policy matters before he exits. Later on, of course, he will be a popular speaker on the talk circuit.

The consensus view is that Greenspan has a very good record as a central banker. And that's not far off the mark. He has been astute, diplomatic, adaptable and - - also - - lucky. But, as the saying goes, luck favours those who take calculated risks when an opportunity presents itself.

Best of all, he didn't lock himself into rigid modes of thinking, like many of his European counterparts, but was willing to entertain new ideas about structural change and the consequences for policy flexibility.

In the nineties, he was quite willing to see the unemployment rate fall below previously accepted levels - - the so-called natural rate - - without slamming on the monetary brakes. Another central banker faced with the same situation may have taken the safe and orthodox route by tightening, in order to head off the possible build-up of inflationary pressures.

The US economy benefited from this policy by having a higher growth rate, even as inflation stayed low. On the negative side, Greenspan has been criticised for allowing asset bubbles to develop without taking action. Analysts often point to the technology-led stock market bubble of 1999/2000 as an example.

Well, the chairman wasn't asleep on the job and was already aware of irrational exuberance when it manifested itself at an earlier stage. But he didn't feel that deflating a bubble was a matter for policy targeting.

There is undoubtedly an element of irrational behaviour in investor thinking and sometimes it can lead to excessive optimism. It can, of course, swing the other way too, resulting in great pessimism and an oversold market. In a bubble, investors may latch on to a theme and drive market valuations to unusual heights. Such moves in the market can be brief or extended but, eventually, they are always self-correcting.

However, timing these swings is difficult for investment professionals, and even more challenging for policymakers whose instruments are subject to both a decision lag and a long impact lag. So it's a tough judgement call for a central banker whether to nip a potential problem in the bud or to let it inflate burst, and then deal with the consequences. Being proactive carries the risk of overdoing it and hurting economic growth. The bubble may turn out to deflate and self-correct readily without intervention.

But if the bubble does grow to a substantial size and then bursts, the consequences for the economy and the financial system can be quite negative. Monetary policymakers will then have to ease substantially to promote a rapid recovery. In going so, over time, they will introduce moral hazard into the system. Investors will be willing to take excessive risk, comforted by the knowledge that authorities have a safety net in place.

Greenspan is still of the opinion that a central bank should not be targeting asset bubbles. But his position is now more nuanced than it was previously, because he recognises the greater risk posed for the economy and the financial system by asset inflation in today's global economy. At the very least, his successor will have to monitor the situation more closely and possibly take a more activist role.

Among other important issues on Greenspan's mind are the imbalances in the economy, characterised by the large US current account deficit and the government budget shortfall. Thus far, there hasn't been any indication of a tendency towards a rapid correction of the imbalances. This is so because the outcome depends to a significant extent on non-market decisions by foreign central banks and treasuries. So the hope and expectation is that the adjustment will occur slowly, but there are no guarantees.

Lastly, Greenspan is cautious about unusually low long-term interest rates that appear to include only a modest risk premium. There are suggestions that investors may be too complacent about the possibility of untoward events upsetting these calculations. At the same time, the low interest rates are having an impact on a wide range of assets. In consequence, any substantial increase in risk premia will affect all asset classes, leading to a significant re-pricing.

Europe
There has been a slight upward revision to second-quarter GDP growth in the UK. The stronger performance was largely due to exports, with consumer spending growing at a substantially slower pace than last year. Recent weak retail sales figures also show that consumers are more cautious than first thought. This means that economic growth will remain subdued until household consumption picks up again. Meanwhile, in the Eurozone, negative headwinds, in the form of a rise in oil prices and resistance to further euro depreciation, haven't abated.

Asia/Pacific
Increases in real compensation, are underpinning household confidence in Japan. In addition, business capital spending has been growing rapidly. Although some slowdown is expected in the current (third) quarter, it looks like domestic demand is on a better footing. However, there will be slips along the way, as the recent fall in household spending and a rise in the jobless rate demonstrate. Also, the recent spike in oil prices is hardly a positive development, though Japan has made many gains in oil efficiency.

Bonds
The spike in oil prices is expected to temper economic growth, and this has helped to keep downward pressure on the benchmark 10-year Treasury note yield. Meanwhile, the 2-year to10-year yield curve continues to have a flattening bias and may be close to inverting.

Currencies
A more subdued outlook for the UK economy boosted bearish sentiment towards the currency, with traders pushing sterling lower against the greenback. Meanwhile, a fall in Japanese household spending and a rise in the jobless rate have weighed on the yen.

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