Weekly Perspectives

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A Weekly View of Global Economies

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North America
The US economy appears to have weathered the storms quite well and according to leading indicators, it is set to rebound. Recently released data by the Institute of Supply Management, for the manufacturing sector, were quite upbeat. The overall index beat expectations and the forward-looking new orders index was up sharply. And, of course, the prices-paid index jumped on the back of soaring energy prices.

Based on previous recoveries from disasters, economic activity in the United States should pick up, in particular because Hurricane Rita did not wreak havoc on the energy infrastructure. However, consumers do face some near-term headwinds from high energy prices.

Public-sector spending will rise at local, state and federal levels, and housing investment should also increase. The federal government's reconstruction effort will swell the already large budget deficit and the bond market should expect an increase in Treasury issuance. If the economy continues to hold up well, this may be further inducement for the Fed not to relax the monetary brakes.

Europe
There is a more positive tone to business sentiment indices in a number of European countries. In particular, despite consensus expectations to the contrary, as well as political uncertainty, the German Ifo business confidence index has moved up rather than down. Also, the euro has been heading south versus the greenback over the past month, which should help exports - - offsetting some of the negative impact of high oil prices

Asia/Pacific
It appears that China's growth rate is still strong. As before, investment spending is outpacing consumption. Unfortunately, the resulting capacity expansion poses certain problems. Many firms find it difficult to exercise pricing power because of the imbalance between supply and demand. This puts a significant damper on corporate earnings.

Some of the investment in fixed assets is actually going into bottleneck areas such as power transmission and rail capacity where capacity expansion is essential. Obviously, that is a good thing. But a significant portion of spending is devoted to plant and equipment in the manufacturing sector. After taking into account the relocation of manufacturing activity to China from elsewhere in the world (i.e. expansion in China equals shrinkage elsewhere) it looks like capacity increase is still running ahead of growth in total internal and external demand.

So the overall picture is one of continuing bottlenecks in certain areas of infrastructure, even while domestic final demand is unable to keep pace with rising capacity in the manufacturing sector. At the same time the country is registering a large foreign trade surplus because of healthy external demand.

Chinese officials are well aware of the imbalances but haven't demonstrated the resolve to press down too hard on capital spending for fear of slowing down the overall pace of growth. We should remember that the economy is undergoing substantial restructuring, amid rising expectations, and the need to absorb more workers into the modern sectors of the economy. Fast growth helps to ease adjustment, and prevents rising political and social tensions from getting out of hand.

So the authorities have been trying to boost domestic consumption to redress some of the imbalance and maintain the rapid pace of growth. Data releases show that retail sales are still expanding at a strong pace but are also decelerating slowly. What the policymakers want is to reverse the trend, and this requires more effective policy measures.

Chinese households are sensitive to interest rate changes. With inflation down, real interest rates are up, enticing people to save more. In addition, tax policies, aimed at speculative property transactions, are also contributing to higher saving as households try to assess their effect on longer-run asset values.

To address the issue of low consumer demand, policymakers are discussing the implementation of new measures that are expected to produce notable results. One set of policies would be aimed at extending the social safety net. With the demise of the socialist model, lifetime employment and the welfare system pretty much fell by the wayside. But the consequences aren't surprising. Greater uncertainty and insecurity normally increases precautionary savings. Accordingly, a better social safety net should encourage households to spend more.

Another set of measures would aim at reducing the tax burden on middle-income earners. It is proposed to substantially increase the minimum threshold at which households begin to pay income tax. This would have a significant impact on increasing disposable income and allowing higher consumption by income categories that normally have a relatively high propensity to consume.

Currently, with domestic demand unable to absorb the extra output generated from expanding capacity, China remains dependent on export markets. Any slowdown abroad will add to deflationary pressures at home. At the same time, protectionist pressures in Europe and America are on the rise. But if Chinese policymakers manage to solve some of the imbalances it would be positive for the growth outlook, both at home and for the global economy.

As for the currency, given the contending forces at work, it looks like the appreciation of the renminbi is likely to be contained. Manufacturers' profits are under strain and they don't need further competitiveness challenges from a rapidly rising currency. Also, they aren't yet adept at handling currency risk by using hedging methods that are common in other jurisdictions.

Bonds
The jump in the ISM prices-paid index unnerved the US Treasury bond market. But higher yields have also been attracting buyers. The Federal Reserve stance is now being interpreted as being more hawkish on inflation, though the market is waiting to gauge what a number of Fed speakers have to say during the week.

Currencies
The ISM report was supportive of the US dollar. But most of the data releases over the next while will be clouded by hurricane effects. So the markets will be focussing more on the interest rate picture.

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