

INTERNATIONAL CYCLICAL OUTLOOK

RECOVERY AT HAND IN JAPAN, BUT NOT GLOBALLY

Building Steam

Impelled by massive economic stimulus, the U.S. economy is poised to accelerate. The probable rapidity of the shift may be sensed from the growth rate of ECRI's Weekly Leading Index ([WLI](#)), which, by early August, had soared to a 20-year high. Clearly, a step-up in economic growth is imminent.

The implication of the lofty WLI growth rate is not that the U.S. economy is about to enter a new boom. After all, the purpose of ECRI's leading indexes, including the WLI, is not so much to forecast the pace of growth, as to predict the timing of recessions and recoveries.

Thus, the strength in the WLI suggests that, unlike the situation some time ago when the U.S. economy was vulnerable to external shocks, the economy is now in a phase in which a new recession has become highly unlikely, absent the most massive of shocks. In other words, contrary to the lingering perception that this is a fragile recovery, it is, for the time being, an unusually resilient revival.

The U.S. economy is also the locomotive that is set to pull other major economies out of the doldrums. Still, the international recovery will be far from uniform in terms of strength and timing.

A Japanese recovery is finally at hand.

The Sun Also Rises

The Japanese economy is emerging from its longest recession on record. As we will discuss in detail ([pages 3 to 5](#)), the pattern of movements of ECRI's Japanese leading and coincident indexes, as well as their components, are in line with the experience in earlier business cycle recoveries.

It is also significant that ECRI's Japanese Future Inflation Gauge, after a long decline to record lows, has just risen to a two-year high. If this advance persists, then the growth rate of the Japanese CPI, which has become less negative and is already approaching zero, may pull out of deflationary territory for the first time in five years.

These are basically cyclical shifts, not secular ones. Still, if a business cycle recovery takes hold and lasts for some length of time, it could set in motion a dynamic that eventually makes it easier to resolve Japan's structural problems. If so, what we are now seeing may be a harbinger of much better times ahead.

Less Than a Global Recovery

As the U.S. recovery strengthens and the Japanese economy looks poised to emerge out of a long recession, optimism is mounting about a global recovery. After all, there are clear signs of revival in the English-speaking economies of the U.S., the U.K., Canada, Australia and New Zealand.

However, the outlook is only modestly brighter in much of Asia and continental Europe, and has actually dimmed in Italy. In Germany, a double-dip recession continues, but business and investor expectations about a recovery have soared, resulting in conflicting economic signals.

Part of the confusion stems from the fact that most of the better-known German leading indicators are either market-based or derived from business surveys, and thus based on expectations rather than reality. A prime example is the Ifo expectations index, which rose in August for the fourth straight month. While the Ifo index is a good cyclical indicator, ECRI's analysis has shown that it is, in fact, roughly coincident with growth rate turning points.

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TABLE 1: DIVERGENT OUTLOOKS

	Current Growth	Consensus Growth Outlook	ECRI Growth Outlook
<u>U.S.</u>	Slow/Average	Average	Average/Strong
<u>Canada</u>	Slow/Average	Slow/Average	Average
<u>Mexico</u>	Slow	Slow	Slow
<u>Germany</u>	Recessionary	Recessionary/ Slow	Recessionary/ Slow
<u>France</u>	Slow	Slow	Slow
<u>U.K.</u>	Slow/Average	Slow/Average	Average
<u>Italy</u>	Slow	Slow	Slow
<u>Spain</u>	Slow/Average	Slow/Average	Average
<u>Switzerland</u>	Recessionary	Slow	Recessionary/ Slow
<u>Sweden</u>	Slow/Average	Slow	Slow/Average
<u>Austria</u>	Slow	Slow	Slow/Average
<u>Japan</u>	Recessionary/ Slow	Recessionary/ Slow	Slow
<u>India</u>	Slow/Average	Average	Slow/Average
<u>Korea</u>	Recessionary	Slow	Recessionary/ Slow
<u>Australia</u>	Slow/Average	Slow/Average	Average
<u>Taiwan</u>	Slow	Slow/Average	Slow/Average
<u>New Zealand</u>	Slow/Average	Slow/Average	Slow/Average
<u>South Africa</u>	Slow/Average	Slow/Average	Average

FOCUS:
Japanese Recovery is Imminent
[pages 3 to 5](#)

RELATIVELY MODEST IMPROVEMENT IN EUROZONE OUTLOOK

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In other words, the upturn in the Ifo index is consistent with German growth turning up and starting to become less negative. But, as we pointed out in this publication some time ago ([Vol. VI, No. 8, August 2001](#)), turning points in the growth rate of ECRI's German Long Leading Index (GLLI) consistently anticipate turns in the Ifo index. Thus, it is not surprising that, following the December 2002 low in GLLI growth, the Ifo expectations index reached a cyclical trough in April 2003. In essence, even though German growth may become less negative, it is premature to assume positive growth, signifying an expanding economy.

The recent rise in German stock prices is consistent with this view. While it is true that "stock prices have predicted nine out of the last five recessions," that is merely because they have a much closer relationship with growth rate cycles than with business cycles. Thus, an upturn in the German growth rate cycle, which the GLLI and the Ifo index are both predicting, should naturally be preceded by rising stock prices.

In this context, it is useful to chart the Ifo expectations index against German consumer expectations for unemployment, the latter shown in inverted fashion (Chart 1). The cyclical swings in the Ifo index (upper panel) faithfully anticipate turning points in the German growth rate cycle (not shown). But it took a year and a half from the 1992 upturn in the Ifo index to the end of the 1992-94 business cycle recession (first shaded area). Unemployment expectations (lower panel), however, turned only a few months before the end of that recession.

Today, the Ifo index is in a clear upturn, but unemployment expectations remain near their worst levels since the last recession a decade ago. This is notable because analogous charts for the U.S. and Japan show business

expectations and employment expectations, while still below earlier highs, rising in tandem, in contrast to the German pattern.

The implication is that, while the U.S. is in an expansion and Japan is entering one, it is premature to predict one in Germany. The Eurozone as a whole is not sliding into recession as some pessimists fear ([page 10](#)). But neither is it poised to emerge from its slowdown in lockstep with the other major economies.

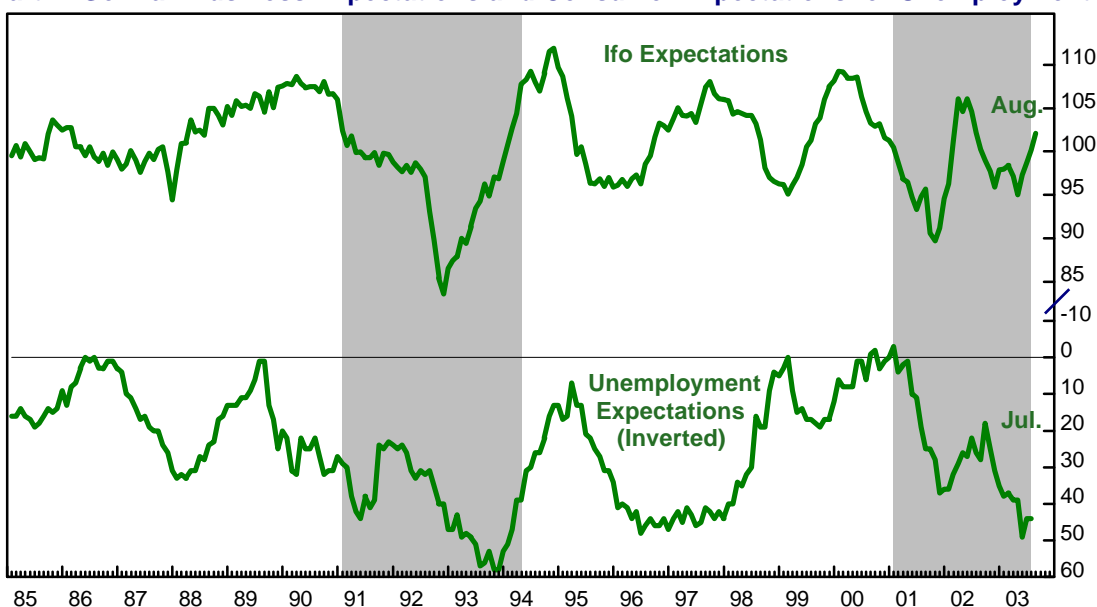
Clouds on the Horizon

Because the U.S. is the key driver of the current global recovery, it is important to try and see as far ahead as possible in terms of the U.S. outlook. Near term, the next step for the U.S. economy is clearly a speed-up in growth. However, there are already early hints of an eventual moderation.

What is interesting, for example, is not so much that WLI growth has eased over the last two weeks since hitting a 20-year high in early August, but that the pullback was driven by rising interest rates and falling mortgage applications ([page 6](#)). It is highly premature to draw conclusions based on a couple of weeks of data, but it is clear that it will be critical to watch the trajectory of interest rates and its impact on the interest-rate sensitive sectors of the U.S. economy.

Recall that in the past decade, the two periods of aggressive interest rate hikes by the Fed came during periods of synchronous global expansions, which drove up U.S. import prices. Paradoxically, therefore, if a synchronous global expansion does get underway, it could set the stage for interest rate hikes that cascade through the U.S. economy in ways that could well trigger the next downturn.

Chart 1: German Business Expectations and Consumer Expectations for Unemployment



Shaded areas represent German business cycle recessions.

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