THE CONFERENCE BOARD

StraightTalk®

Dear Reader,

As you can see from recent issues, we are continuing to transition *StraightTalk* as I assume fully the role of president of The Conference Board and since Bart van Ark has taken over the role of chief economist. This will be my last issue. Bart will assume full control of *StraightTalk* with the July/August issue, providing the same clear judgments and independent thinking that you have come to expect.

I will go silent for the next six months as we reorganize and expand our knowledge capabilities. I will return in January 2009 with a new publication that will address a broad range of strategic issues facing the global business community and will have a special focus on evolving executive challenges in a rapidly changing environment.

The Conference Board is developing a very new approach to economic and business issues—one that we believe offers a more flexible and interdisciplinary perspective. This approach will be laid out in my new publication in January, the same month a newly redesigned website will be introduced. The following discussion represents a selection from the topics that we intend to address and gives a sense of some of these new issues.

Deconstructing Free Markets

The free-market system appears to be undergoing a major transformation. One of the more prominent and possibly most disturbing trends is the erosion of competitive market structures and the transparency in pricing, capacity, and demand that supports these structures. The free-market system is a marvel in its ability to transmit information between buyers and sellers and workers and employers that helps them negotiate transactions and prices. The absence of transparency and the interventions of noncommercial actors (including governments) make it difficult for executives and regulators to identify actions (e.g., investing in new capacity and/or innovation, hedging prices and foreign exchange rates, setting rules in new and often global markets, building and restructuring organizations) that promote growth, create wealth, and foster competition.

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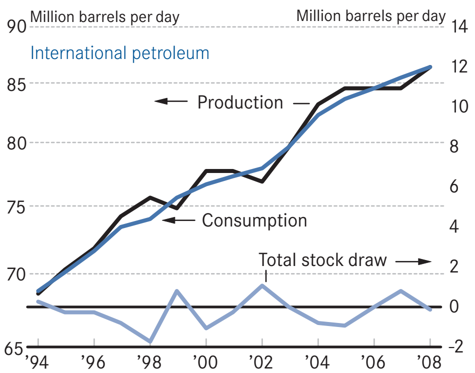
Gail Fosler president
Bart van Ark chief economist
Eliza Winger economist
Timothy Dennison editor
Peter Drubin design
Pam Seenaraine production

Chart 1

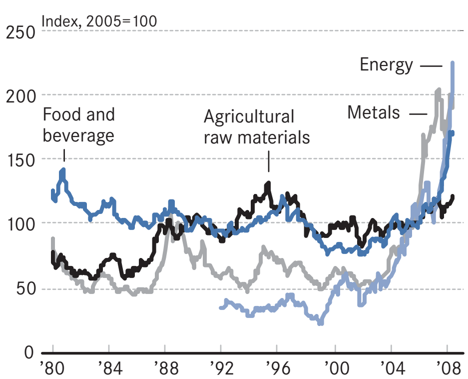
Trends did not change much



Sources: EIA, The Conference Board

Chart 2

Food prices have begun to follow oil and metals prices



Sources: IMF, The Conference Board

There is no better example at the moment of that lack of market transparency than oil. Although conventional wisdom holds that today's high prices arise from the danger of supply disruptions, surging demand from China and India, and even the possibility of running out of oil entirely, it is impossible to justify the current price from any reasonable analytical examination of the facts. The demand/supply balance trends over the past decade do not show either a persistent acceleration in the growth of total demand or an increase in precautionary inventories to protect against supply interruptions (Chart 1).

The composition of demand has shifted somewhat toward emerging markets, but not dramatically so. China's share of global demand has increased by three and a half percentage points, while India's share, frequently cited as a major source of new demand, is up less than one percentage point over the past 10 years. Although the oil producers themselves notably account for an increasing share of global demand, the demand shares of many other emerging markets are down.

The point is that no one knows what a reasonable price for oil really is or should be in the future. Metals markets suffer from the same uncertainty, and, more recently, food prices have begun to follow oil and metals (Chart 2). Both producers and consumers recognize the existence of "stealth" inventories that do not appear in official estimates, but no one knows how large they are.

How big a role does securitization play in these markets? Regulators in several countries are working hard to understand the role of derivatives and securitized instruments in commodity prices. Preliminary findings from The Conference Board indicate that commodities that have been securitized rose faster after securitization than those commodities that have not been securitized.[1]

These price and market uncertainties have led to all sorts of nonmarket responses. Many emerging markets have limited exports of critical food stuffs and/or experienced spontaneous public protests against free trade or in favor of fuel and other subsidies. Fuel is already subsidized in many emerging markets. China is aggressively acquiring oil, coal, and other mining operations to be able to control secure commodity supplies; other emerging markets have acquired arable land for food security. Export limitations, domestic market subsidies, government-set pricing, buying and selling cartels, and rapidly consolidating supply bases contribute to the new landscape of commodity pricing.

1 See Bart van Ark's discussion of the impact of securitization in the May 2008 issue of *StraightTalk*.

Do these forces portend an economic world where choices and outcomes are determined more by power than by efficiency and competition? Is the market losing its central role in allocating goods, income, and returns?

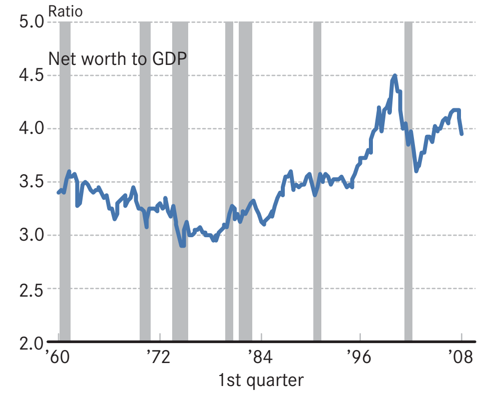
The Balance Sheet Economy

Correspondingly, the operating side of the global economy may be diminishing in importance relative to the balance sheet. If one looks only at the United States, household wealth is rising relative to GDP (Chart 3). Although the numbers are not available on a comparable basis globally, judging from emerging market bank deposits, stock markets, and real estate values, the trend of rising wealth relative to GDP is even greater in those countries. Interestingly, as globalization of financial markets has spread and financial innovation has become more common, the variability of wealth—at least in the United States—has risen relative to GDP (Chart 4).

There are many consequences of the explosion in wealth, including greater investment capacity and greater economic inequality. However, returns achieved in balance sheet transactions, which include mergers, spinoffs, privatization, and the sale of investment stakes, can be much greater than through traditional operations. Financial innovation has accelerated this trend. In the context of the previous market discussion, wealth represents a channel of market power to a greater degree than ever before.

Chart 3

Household net worth is rising relative to GDP...

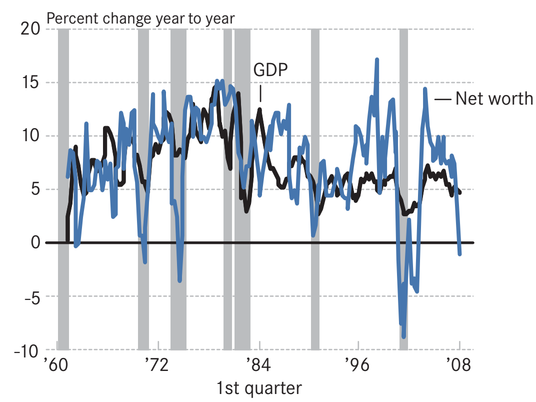


Note: Shaded areas represent U.S. recessions.

Sources: BEA, FRB, The Conference Board

Chart 4

...but at the same time has become more volatile



Note: Shaded areas represent U.S. recessions.

Sources: BEA, FRB, The Conference Board

Entering a New World

The economy of the immediate future is different from the economy of the not-so-distant past and introduces a number of perils, not the least of which are protectionism, mercantilism, and economic nationalism. Our task is to continue the century-old legacy of The Conference Board to articulate the important role of economic growth and market evolution in increasing social development and economic welfare.

After almost 20 years writing *StraightTalk*, I am entering a new role and we are entering a new world. I look forward to our reunion in January, when we can begin to explore this new world together.

Productivity Determines Resilience against Current Weakness

Weakness in Growth Is Spreading Beyond the United States

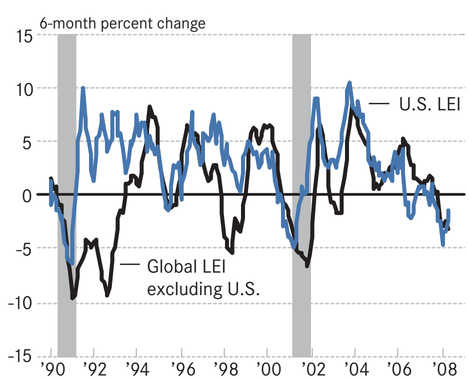
While much of the attention on the economic malaise of the past months has been focused on the United States, the question of how the rest of the world economy will be faring is becoming increasingly relevant. Doom scenarios of a collapse in global growth seem unwarranted. World economic growth for 2008 is still projected at pretty much the same rate as the average for 2000–2007 (i.e., about 4 percent) and, provided the risks of global inflation and a contagious financial crisis can be contained, it is likely to be about the same into 2009. Still, it seems that the tables may be tilting somewhat compared to the picture in recent months: going forward, the U.S. economy may not look as bad as was generally projected (see our assessment of the U.S. forecast on page 7), but major parts of the world economy will be bearing more of the brunt of the slowdown.

Europe Is Heading toward a Slowdown Sooner Rather Than Later

Globally, The Conference Board's leading economic indicators have moved in low growth territory and are either flat or have moved further down in recent months (Chart 5). In Europe, first quarter growth was still reasonable at 0.8 percent over the fourth quarter for the Euro area as a whole (Chart 6). Much of this rise was driven by very rapid growth in Germany, which was caused by a boost in construction that stemmed from a warm winter and by the aftereffects from

Chart 5

It's not just the United States! Signals of global slowdown ahead

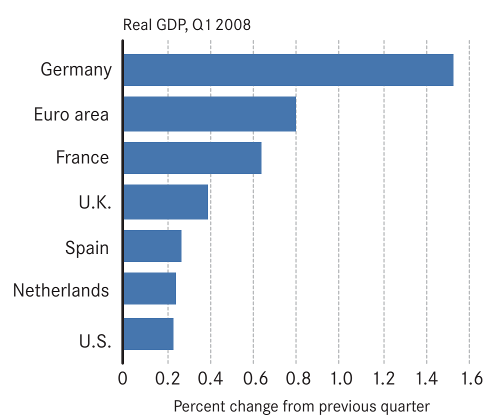


Note: Shaded areas represent U.S. recessions.

Source: The Conference Board

Chart 6

Much diversity in recent European growth performance



Sources: BEA, Eurostat, The Conference Board an uptick in investment at the end of 2007 due to anticipated changes in Germany's corporate tax regulation that took effect in 2008. We presently see a large diversity in growth performance across European countries. Notably, those countries, which saw the largest boom in housing prices (Spain, Ireland, Netherlands, and the United Kingdom), are already slowing down much more than countries with slower price increases in real estate (notably Germany).

The Conference Board's experimental leading economic index for the Euro area, which will be published on a regular basis beginning this fall, signals an imminent slowdown during the second half of 2008 (Chart 7). It is premature to interpret the position of this indicator as a recession signal. More important than the strength of the signal is the broader diffusion of indicators that point downward, with only 25 percent showing an upward movement in April. The projected slowdown in Europe is about as cyclical in nature as the uptake during the past two years. During 2006 and 2007, increased investment and (with the exception of Germany) increased consumption has been driving much of Europe's recovery, while productivity and employment growth accelerated only moderately. (Germany, which has shown accelerated employment growth recently, is again an important exception.) At present, the trends move the other way: lower forecasts for consumption and business investment will be driving much of Europe's slowdown later this year and into 2009, while productivity is expected to slow significantly in 2009.[2]

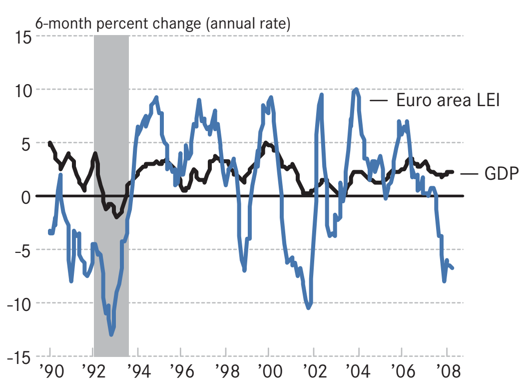
Productivity Can Help Pull Economies through a Slowdown

Productivity may turn out to be the most important factor that will help countries pull through during these bad times. As productivity is typically procyclical, one expects it to slow down currently, particularly in the United States. But a comparison of the current slowdown period with the recessions during the early 1990s and the early 2000s indicates this pattern may be changing. Leading into the 1991 recession, productivity growth in the business sector slowed strongly, followed by a contraction in output for four quarters (Chart 8). In 2000,

2 We will offer a more detailed overview of Germany in the September issue of *StraightTalk*.

Chart 7

LEI for Euro area as a whole shows sharp slowdown

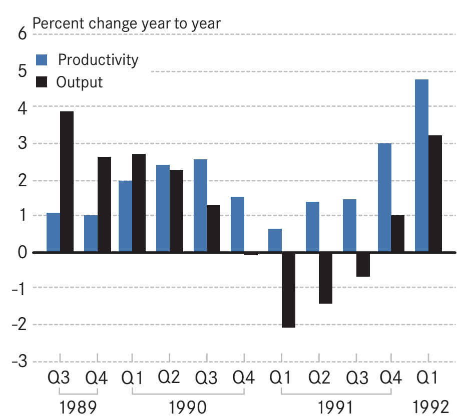


Note: Shaded area represents Euro area business cycle.

Source: The Conference Board

Chart 8

U.S. business sector productivity slowed and output declined during 1991 recession



Business sector productivity and output before, after and during the 1991 recession

Sources: BLS, The Conference Board

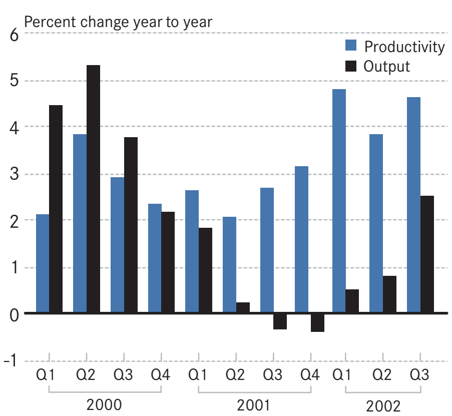
productivity growth remained reasonably healthy at 2 percent and the output contraction was only moderate in the second half of 2001 (Chart 9). Currently, we have seen virtually no reduction in productivity growth. Business sector productivity has been stable at a solid 3 percent during the second half of 2007, reaching even 3.4 percent during the first quarter of 2008 (Chart 10). If this strong productivity trend continues through the remainder of the year, this may be another reason why a contraction in GDP is not likely. For the whole year, The Conference Board projects productivity growth for the aggregate economy at around 1.5 percent, which is identical to a GDP growth rate of 1.5 percent with zero employment growth.

The absence of a slowdown in U.S. productivity growth is all the more striking since the contraction in employment also appears much less dramatic when compared to previous slowdown periods. While employment sharply declined during the first three months of the year, the fall was more moderate during April and May. Still, 324,000 nonfarm jobs were lost between January and May, a decline of roughly 0.2 percent. Compared to previous episodes, however, the current employment contraction is relatively modest. For example, during the previous two periods of decline, employment contracted by 0.4 percent on average after four months; in the past five declines, it had even fallen by 0.6 percent. Today's moderate decline in employment may be due to the fact that firms have already restructured so much that further cost savings through job cuts are difficult to realize without losing production potential.

Rapid productivity growth may help the United States more during this slowdown period than Europe. Potential productivity growth in the U.S. business sector is about 2.5 percent per year from 2005 to 2020, whereas Europe is unlikely to take labor productivity growth beyond 2 percent on a long-term basis (Chart 10). Paradoxically, the lower potential in Europe is in part related to the success of labor-market reforms in several European countries, which will begin to feed through in terms of faster employment growth during the next decade. Many newly created jobs are less productive than existing ones because

Chart 9

Higher productivity growth dampens cyclical downturn in output during 2001 recession

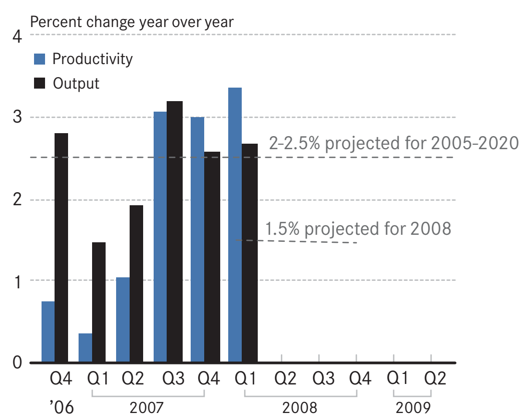


Note: Business sector productivity and output before, after and during the 2001 recession

Sources: BLS, The Conference Board

Chart 10

Continued high productivity and large potential suggest only moderate output slowdown in business sector



Business sector productivity and output before, during the current episode

Sources: BLS, The Conference Board

innovation and technological change have not translated into faster productivity growth—in particular, not in services.[3] Despite faster European productivity growth in 2006 (1.7 percent) and 2007 (1.4 percent), the addition of more low-productivity jobs means productivity in Europe will grow by no more than 1 percent in 2008.

[3] See Bart van Ark, *Performance 2008: Productivity, Employment, and Growth in the World's Economies*, The Conference Board, Research Report 1421, 2008.

The Conference Board Economic Forecast

Weak Conditions Will Continue into Summer and Fall

In May, The Conference Board's Leading Economic Index (LEI) moved sideways for the third consecutive month, showing no significant improvement. While the six-month average growth of the LEI is still in negative territory at -0.7 percent, the steepness of the decline has moderated significantly. However, the main signals that helped change the signal from red to orange—improved stock market prices and a positive yield spread—are not the ones that will restore the confidence needed for a rapid change to a green signal, which would indicate that a solid recovery is imminent. Indeed, the large decline in stock market prices during the second half of June witnesses that the end of the slowdown may not yet be in sight. In fact, business conditions have been worsening more recently, as industrial production and new orders are down. The Conference Board's measure of CEO Confidence has shown a further weakening during the first quarter as well. The Consumer Confidence Index also registered another decline of 7.7 points for June.

On the positive side, real consumer expenditure and exports have been showing up surprisingly strong. The trade balance continues to strengthen, so that many U.S. businesses, which have become globalized in increasingly large numbers, are finding some way to make up for a shortfall in domestic demand. While the stimulus checks of last month have had a fairly significant impact on real consumer spending, the effect on real growth may largely vanish during the second half of the year. The largest part of the tax rebates has gone into savings, and the acceleration in gas and food prices will make a long-term growth effect evaporate. The increased awareness that inflation will stay at an uncomfortably high level and may even reach 6 percent in the third quarter will incentivize the Federal Reserve Board to consider a rate increase perhaps as early as August.

All in all, the U.S. economy still looks to be heading for a meager but positive growth rate of 1.5 percent in 2008. Indications for further strengthening are not great, and 2009 may only look slightly better. Some of the structural adjustments in, for example, financial markets will take time before being implemented, let alone boosting growth through an easing of access to credit. A longer breath than usual is needed before positive factors, such as an improvement in the housing situation and a recovery in consumption and investment, will take the upper hand.

The Conference Board U.S. Economic Outlook, 2007–2009

Percentage change, seasonally adjusted annual rates
(except where noted)

	2008				2009		Annual		
	Actual	Forecast							
	I Q	II Q	III Q	IV Q	I Q	II Q	2007	2008	2009
Real GDP	1.0	1.2	0.4	1.2	1.7	2.6	2.2	1.5	1.8
Gross domestic purchases	0.2	0.3	-0.1	1.1	1.3	1.9	1.5	0.6	1.3
CPI inflation	4.3	5.1	6.2	3.0	3.5	3.5	2.9	4.6	3.8
Real consumer spending	1.1	2.2	0.5	0.7	1.9	2.7	2.9	1.7	1.8
Light vehicle sales (mil. units)	15.21	14.45	14.82	14.51	14.61	15.10	16.11	14.75	15.01
Housing starts (mil. units)	1.04	0.97	0.87	0.86	0.92	0.99	1.34	0.93	1.05
Real capital spending	0.5	-2.2	2.9	3.7	-1.9	0.7	4.7	3.2	0.2
Inventory change (bil. ’00$)	-19.6	-27.1	-37.0	-13.8	0.9	-1.8	4.5	-24.4	5.3
Real government purchases	2.1	1.2	1.2	0.4	-0.2	-0.8	2.0	2.0	0.0
Federal	4.4	3.7	3.5	2.6	1.3	-0.5	1.7	3.7	1.3
State and local	0.8	-0.3	-0.2	-0.9	-1.0	-0.9	2.2	1.0	-0.7
Net exports (bil. ’00$)	-480.2	-454.1	-436.6	-433.8	-422.6	-404.2	-555.6	-451.1	-398.1
Exports	5.5	7.2	9.1	8.1	7.9	8.6	8.1	8.3	8.3
Imports	-0.7	0.0	3.2	5.7	3.8	3.0	1.9	0.7	3.7
Pre-tax operating profits (bil.*)	1,564	1,551	1,558	1,549	1,537	1,526	1,595	1,555	1,540
Industrial production	-1.4	-3.1	1.8	2.1	1.6	2.9	1.7	0.1	2.0
Unemployment rate (%)	4.9	5.3	5.5	5.6	5.7	5.6	4.6	5.3	5.6
Federal funds rate	3.18	2.08	2.12	2.25	2.50	2.75	5.02	2.41	2.69
90-day T-bills (%)	2.15	1.62	1.96	2.09	2.34	2.59	4.38	1.96	2.67
10-yr. Treasury bonds (%)	3.66	3.88	4.22	4.32	4.57	4.82	4.63	4.02	4.94
Exchange rates									
$/Euro	1.50	1.56	1.53	1.49	1.45	1.40	1.37	1.52	1.38
Yen/$	105	105	104	107	110	112	118	105	114

*CURRENT $ LEVEL WITH IVA & CCA

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POSTMASTER: Send address changes to StraightTalk, 845 Third Avenue, New York, NY 10022-6600. E-MAIL: Send correspondence online to: **straighttalk@conference-board.org**

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The Conference Board, Inc. 845 Third Avenue, New York, NY 10022-6600, United States / 212 759 0900 / www.conference-board.org
The Conference Board Europe Chaussée de La Hulpe 130, box 11, B-1000 Brussels, Belgium / + 32 2 675 54 05 / www.conference-board.org/europe.htm
The Conference Board Asia-Pacific 22/F, Shun Ho Tower, 24-30 Ice House Street, Central, Hong Kong, SAR / + 852 2804 1000 / www.conference-board.org/ap.htm
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