

ECONOMICS: US PERSPECTIVES—MARCH 18, 2011

How Will Shocks from Abroad Affect the US?

■ **Joseph G. Carson**

US Economist and Director—Global Economic Research, (212) 969 6886

Rising oil prices and the disaster in Japan have added new risks to the global economy in 2011. We have not yet changed our forecast for US growth of 3.8% this year. But we're watching closely for signs of higher energy prices eroding consumer spending, and monitoring the potential disruption on US manufacturing if supply chains from Japan face prolonged downtime.

Just as the US economy was beginning to show signs of accelerating economic growth, two shocks emanating from abroad have clouded the outlook. First, oil prices rose sharply because of unrest in the Middle East and North Africa. Then, Japan was hit by a tragic earthquake and tsunami, with devastating human and economic consequences.

At this writing, we have not changed our US real gross domestic product growth forecast of 3.8% for 2011 or our growth estimates for key economic sectors. While both events are significant from a global macroeconomic perspective, it's too early to conclude that a significant change to the US economic forecast is warranted. However, it's important to identify the key risks now in order to ensure that our outlook is attuned to events unfolding around the world.

Our economic growth forecast for 2011 was originally based on a crude oil price of \$90 a barrel. Oil prices averaged \$89 in

January and February, but spot prices have jumped to nearly \$100 in March amid the escalating turmoil in Libya. Higher energy prices, higher inflation and reduced cash flow have the potential—if sustained—to dampen growth, especially through the impact to consumer spending (**Display 1**).

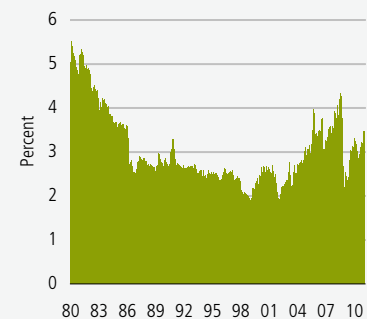
Fuel Prices May Eat into Savings

So far, the rise in crude oil prices has lifted gasoline prices by approximately 50 cents a gallon from the start of the year. That has increased the monthly gasoline bill for the average US driver by about \$30 a month, according to our estimates. Although that might not sound like a big hit to monthly personal finances, it actually amounts to roughly 12% of monthly saving, based on the current 5% personal saving rate and the level of after-tax income for each consumer unit, according to the Consumer Expenditure Survey.

This doesn't mean that consumer spending patterns will change overnight. History

Display 1
Household Energy Expenses Are Rising

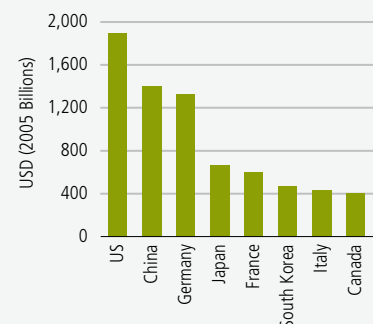
Household's Consumption of Energy Products as % of Disposable Income



As of January 2011
Source: Bureau of Economic Analysis and Haver Analytics

Display 2
Japan Is Important in Global Supply Chain

Real Exports of Goods and Services



As of December 2010
Source: Haver Analytics and Organisation for Economic Co-operation and Development

shows that when energy prices spike, consumers change their behavior slowly as they assess the environment. At first, they pay for the higher gasoline expenditures by saving less, prompting a short-term drain on liquidity and cash flow. Still, over time, consumers won't be able to ignore higher energy prices, which represent an accumulating drag on household spending power.

If high fuel prices persist for an extended period of three months or more, people may begin to curtail driving, which would probably result in lower car and truck sales. Our forecast for car and truck sales in 2011 of 12.9 million units is slightly below industry estimates of 13–13.5 million. Annualized sales in the first two months of the year averaged 13 million, slightly ahead of our forecast. So far, there is little indication from surveys or industry sources that the jump in gasoline prices has had a quick depressing influence on auto sales. However, as long as gasoline prices remain high, there's a real risk that vehicle sales may eventually suffer as well.

Japan Impact Is Hard to Assess

Assessing the unfolding situation in Japan and its potential impact on the US economy is much more complex. At first glance, the direct hit to the US economy would seem to be relatively small, since American exports to Japan are worth about \$5 billion a month—just 4.5% of total US exports. On the import side, Japan ships goods worth about \$10 billion a month to the US, about half of which is motor vehicles and parts. Of course, Japan is a major global exporter, which means it plays an integral role in the supply chain of manufacturing companies across the world **(Display 2, previous page)**.

With some Japanese auto manufacturers temporarily closed owing to power outages and parts shortages, US-based carmakers are well positioned to fill the product void and gain market share,

especially because they are operating with ample spare capacity. However, many US-based auto manufacturers—including foreign and American companies—rely on a global supply chain that is linked to manufacturing operations in Japan. So a shortage of key components could affect the ability of US manufacturing operations to increase production in the coming weeks.

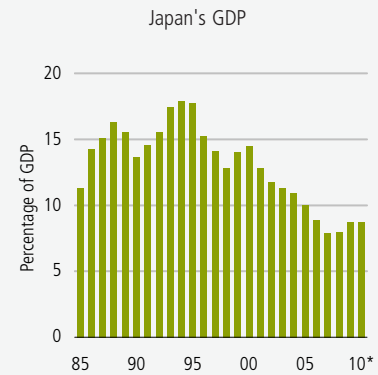
Supply Chains Are Vulnerable

The supply chain effect isn't limited to the auto sector. For example, Japan accounts for about 25% of semiconductor manufacturing capacity worldwide. Japanese companies are major suppliers of silicon wafers—the intermediate raw material for fabrication plants. Shutdowns of wafer production could have a significant impact not only on Japanese manufacturing, but also on worldwide production tied into the global supply chain. In addition, Japanese semiconductors are components in many key end-markets for products ranging from cars to industrial products.

At this point, it's extremely difficult to gauge the impact of the crisis in Japan because much depends on the resumption of the power supply. Many Japan-based auto manufacturing plants are closed at least until next week, although Toyota has restarted seven facilities that produce key parts and components. Bridgestone has also resumed tire production.

For the moment, US-based auto firms appear to have enough in-house inventory and in-transit inventory to keep production facilities running in the short term. There have been almost no changes to production at US-based automakers, except for limited closures at Toyota and GM. Toyota canceled weekend production and overtime in the US because it couldn't ship in parts from Japan. But the company is expected to resume parts production next week, so the impact on US output should

Display 3
Japan's Declining Role in Global Economy



*Preliminary
As of December 2010
Source: International Monetary Fund and Haver Analytics

be limited. GM also temporarily closed one plant in Louisiana because of a shortage of Japanese parts. If Japanese suppliers fail to resume component production quickly, more US manufacturers may be forced to close or slow production during the second quarter.

In the short term, the situation in Japan adds to the downside risk for US and global economic growth, even though Japan's relative position in the global economy has declined in recent years **(Display 3)**. However, history shows that the economic impact from earthquakes tends to be temporary. The lost output in key industries tends to be recovered fairly quickly—assuming power is restored—and then there is an additional boost from all the reconstruction efforts.

Still, the scale of the destruction, as well as the unresolved nuclear emergency, makes it difficult to gauge the short-term and longer-run impacts. The only thing clear is that the events in Japan will require close monitoring in the months ahead, as the macro- and micro-economic consequences will be a significant variable in the 2011 economic equation. ■

Levels (2000 Dollars)	Quarterly					Annual			
	4Q:10	1Q:11	2Q:11	3Q:11	4Q:11	2008	2009	2010	2011
Real GDP	13,370.1	13,496.2	13,654.2	13,832.2	14,006.2	13,228.9	12,880.6	13,245.6	13,747.2
Consumption	9,425.9	9,489.4	9,552.4	9,613.4	9,674.4	9,265.0	9,153.9	9,314.4	9,582.4
Durables	1,236.9	1,265.0	1,268.0	1,274.0	1,280.0	1,136.4	1,094.6	1,178.2	1,271.8
Nondurables	2,100.9	2,115.0	2,130.0	2,145.0	2,160.0	2,041.2	2,017.4	2,073.5	2,137.5
Services	6,098.7	6,120.0	6,165.0	6,205.0	6,245.0	6,082.3	6,032.7	6,064.7	6,183.8
Investment									
Nonresidential Structures	319.5	320.0	326.0	337.0	350.0	464.2	369.6	318.4	333.3
Nonresidential Equip & Software	1,098.9	1,120.0	1,160.0	1,195.0	1,245.0	1,082.0	916.3	1,054.7	1,180.0
Res Structures	325.5	327.0	335.0	344.0	355.0	444.2	342.7	332.4	340.3
Change in Inventories	7.1	35.0	50.0	70.0	85.0	-37.6	-113.1	60.4	60.0
Net Exports	-395.0	-395.0	-375.0	-340.0	-325.0	-504.1	-363.0	-421.9	-358.8
Exports	1,718.3	1,770.0	1,800.0	1,845.0	1,885.0	1,647.7	1,490.7	1,666.5	1,825.0
Imports	2,113.3	2,165.0	2,175.0	2,185.0	2,210.0	2,151.8	1,853.8	2,088.4	2,183.8
Government	2,579.7	2,591.3	2,597.3	2,604.3	2,613.3	2,502.7	2,542.6	2,568.6	2,601.6

Percentage Changes	Quarterly % SAAR					% 4Q/4Q				Annual			
	4Q:10	1Q:11	2Q:11	3Q:11	4Q:11	2008	2009	2010	2011	2008	2009	2010	2011
Real GDP	2.8%	3.8%	4.8%	5.3%	5.1%	-2.8%	0.2%	2.7%	4.8%	0.0%	-2.6%	2.8%	3.8%
Consumption	4.1%	2.7%	2.7%	2.6%	2.6%	-1.9%	0.2%	2.6%	2.6%	-0.3%	-1.2%	1.8%	2.9%
Durables	21.0%	9.4%	1.0%	1.9%	1.9%	-12.3%	4.8%	10.9%	3.5%	-5.2%	-3.7%	7.6%	7.9%
Nondurables	4.8%	2.7%	2.9%	2.8%	2.8%	-2.9%	1.1%	3.4%	2.8%	-1.1%	-1.2%	2.8%	3.1%
Services	1.4%	1.4%	3.0%	2.6%	2.6%	0.3%	-0.8%	1.2%	2.4%	0.9%	-0.8%	0.5%	2.0%
Investment													
Nonresidential Structures	4.5%	0.6%	7.7%	14.2%	16.3%	-1.5%	-26.5%	-4.7%	9.5%	5.9%	-20.4%	-13.8%	4.7%
Nonresidential Equip & Software	5.5%	7.9%	15.1%	12.6%	17.8%	-11.8%	-4.9%	16.3%	13.3%	-2.4%	-15.3%	15.1%	11.9%
Res Structures	2.7%	1.9%	10.2%	11.2%	13.4%	-24.6%	-13.4%	-4.7%	9.1%	-24.0%	-22.9%	-3.0%	2.4%
Net Exports													
Exports	9.6%	12.6%	7.0%	10.4%	9.0%	-2.9%	-0.1%	9.2%	9.7%	6.0%	-9.5%	11.8%	9.5%
Imports	-12.4%	10.2%	1.9%	1.9%	4.7%	-6.0%	-7.2%	11.0%	4.6%	-2.6%	-13.8%	12.7%	4.6%
Government	-1.5%	1.8%	0.9%	1.1%	1.4%	3.1%	0.8%	1.2%	1.3%	2.8%	1.6%	1.0%	1.3%
Domestic Demand	-0.6%	3.9%	4.0%	4.1%	4.6%	-3.3%	-0.9%	3.1%	4.2%	-1.1%	-3.6%	3.2%	3.2%

Key Macro Indicators	Quarterly					Annual			
	4Q:10	1Q:11	2Q:11	3Q:11	4Q:11	2008	2009	2010	2011
Nominal GDP (Levels)	14,861.0	15,045.7	15,276.9	15,546.4	15,811.3	14,369.1	14,119.1	14,657.8	15,420.1
% QoQ SAAR	3.2%	5.1%	6.3%	7.2%	7.0%				
% YoY	4.1%	4.1%	4.8%	5.4%	6.4%	2.19%	-1.74%	3.82%	5.20%
Industrial Production (Index)	94.4	96.0	97.5	99.0	101.0	96.7	87.7	92.7	98.4
% QoQ SAAR	3.0%	7.1%	6.4%	6.3%	8.3%				
% YoY	5.9%	5.9%	5.7%	5.7%	7.0%	-3.3%	-9.3%	5.7%	6.1%
Housing Starts (Millions)	0.53	0.58	0.59	0.65	0.68	0.90	0.55	0.59	0.62
Industry Auto Sales (Millions)	12.3	12.3	12.8	13.0	13.4	13.2	10.4	11.5	12.9
Personal Savings Rate	5.4%	6.0%	5.0%	4.5%	5.0%	4.1%	5.9%	5.8%	5.1%
Unemployment Rate	9.6%	9.0%	8.7%	8.5%	8.2%	5.8%	9.3%	9.6%	8.6%
Operating Profits (% YoY)	18.8%	10.7%	10.0%	9.7%	9.8%	-16.4%	-0.4%	29.3%	10.1%
After-Tax Profits (% YoY)	15.1%	12.2%	10.9%	11.9%	9.9%	-10.4%	5.1%	20.8%	11.2%

Inflation (% YoY)										
GDP Deflator	0.4%	1.1%	1.5%	1.8%	1.8%	2.2%	0.9%	1.0%	1.3%	
Consumer Price Index	2.6%	3.8%	2.2%	2.4%	3.1%	3.8%	-0.3%	1.6%	2.5%	

Key Interest Rates (End of Period)										
Federal Funds Rate	0.13%	0.13%	0.13%	0.13%	0.50%	0.13%	0.13%	0.13%	0.50%	
Three-Mo T-Bill (BEY)	0.12%	0.18%	0.20%	0.50%	0.50%	0.11%	0.06%	0.12%	0.50%	
Two-Yr Note	0.61%	0.65%	0.75%	1.00%	1.25%	0.76%	1.14%	0.61%	1.25%	
10-Yr Note	3.30%	3.40%	3.75%	4.10%	4.25%	2.25%	3.85%	3.30%	4.25%	
30-Yr Bond	4.34%	4.40%	4.75%	5.00%	5.25%	2.69%	4.63%	4.34%	5.25%	

Source: AllianceBernstein

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