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Lead Left Interview – Mickey D. Levy

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This week we chat with Mickey D. Levy, chief economist of the Americas and Asia, Berenberg Capital Markets. Mickey is a long-standing member of the Shadow Open Market Committee and conducts research on a wide range of global economic, financial and policy issues.

The Lead Left: Mickey, we seem to be at an inflection point in the economy. If you were the Fed, would you raise rates?

Mickey Levy: The economy has been growing at a comfortable rate—not rapid, but OK—and the probability of recession is very low. Inflation is modestly below the Fed's longer run 2% target. Keeping the Federal funds rate anchored to zero is absolutely inconsistent with these conditions, and the Fed should definitely hike rates. Keeping rates artificially low has costs: economic and financial distortions and risks are mounting. And most people and even the Fed are seemingly unaware of history: in all prior Fed rate increase cycles, economic performance is unharmed, with sustained growth, and the stock market maintains recent gains or goes up further.

TLL: Where are we in the cycle? Relative to the next downturn, what inning are we in?

ML: Bottom of the 5^{th}. Troublesome imbalances that tend to emerge in the latter stages of prior expansions and provide cautionary signals are not apparent. Importantly, the real Federal funds rate is negative and the yield curve is fairly steep. In the real sector, unit labor costs are low, businesses are managing inventories, and there are no signs of excess employment relative to output. One troubling sign that's important to monitor is profits. They've flattened and are under pressure from the stronger US dollar and weaker Asia. The 7^{th} inning stretch is a ways off.

TLL: The concern seems to be about slowing growth in China. How do you measure that?

ML: China's potential growth is decelerating, and that trend will continue. Its earlier robust productivity gains stemming from its massive migration from an agricultural-based economy to manufacturing one is ebbing. Also, China's unit labor costs of production have increased significantly at the same time the trade-weighted renminbi has appreciated: no wonder its exports are declining. It's obvious that China is "managing" its economy toward specified growth objectives, so I also look around Asia's production supply chains to see if Asian nations' trade data with China are consistent with China's official data. So far, the data are consistent with China slowing moderately, not sharply, with strong consumption but falling exports.

TLL: How important is China to US growth?

ML: Because China has been the world's growth engine for 15 years and because it is the manufacturing hub of Asia, it's important for US and global economic performance. But remember, China's impact must simultaneously consider the associated impacts of lower oil and commodity prices and currency fluctuations because they are all related. The net impact on the US will be modestly negative, with sustained solid gains in domestic demand offset by weak exports. This means profits will be vulnerable. Europe will be little affected, benefiting from lower oil prices and the weaker Euro.

TLL: Are you worried about deflation as measured by falling commodity prices globally?

ML: No, I'm not worried about deflation risks stemming from lower prices of oil and commodities. These lower prices are clobbering oil and commodity exporting nations, but net importing nations reap economic benefits and their price declines only temporarily suppress inflation trends. That is, so-called headline inflation is lower, but that's a one-time impact. Historically, central banks worry that if people expect deflation, they will save rather than spend and hurt the economy. Japan has had difficulties getting rid of expectations of deflation, but core inflation in Europe and the US are modest, and I see absolutely no signs that expectations of deflation are deterring spending in the US.

TLL: What's your outlook for rates if the Fed opts to defer any action until next year?

ML: If the Fed delays raising rates, bond yields will drift up, but only modestly to reflect the moderate growth in the economy and low inflation, and because markets know that the Fed must eventually raise rates. Also, the Fed has committed itself reinvesting the proceeds of maturing assets on its balance sheet, so that it will continue dominate the Treasury bond market.

To be continued the week of Nov 23

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