



**The Northern Trust Company**  
**Economic Research Department**  
**Daily Economic Comment**

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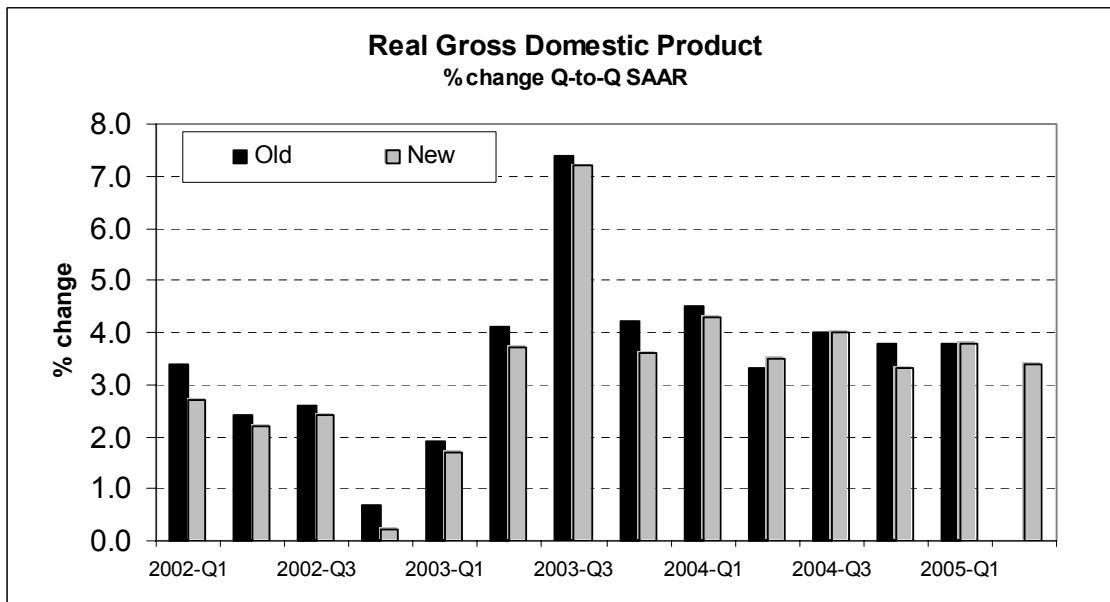
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**What's Not To Like?**

The U.S. economy grew at an annual rate of 3.4% in the second quarter after a 3.8% increase in the first quarter. In other words, the economic growth advanced at the trend rate in the first six months of the year. The second quarter GDP report included revisions going back to 2002.

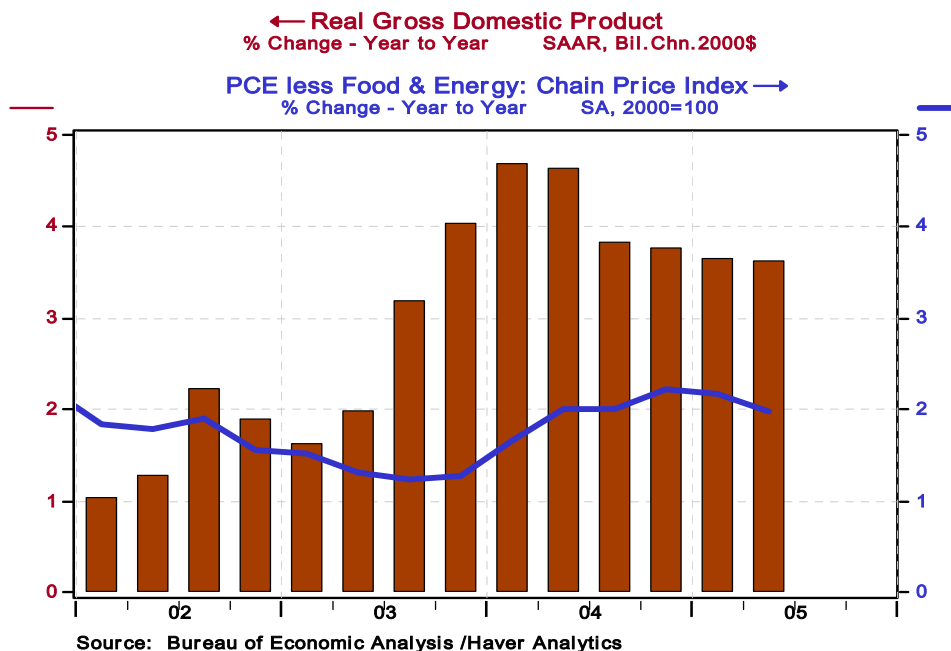
Chart 1



On a year-to-year basis, real GDP grew between 3.6% and 3.8% in the last four quarters. During the same period, inflation, as measured by the core personal consumption expenditure price index has stabilized in the 2.0%-2.2% range (see chart 2). These data indicate that the economy is experiencing a favorable mix of growth and inflation at the present time. The new and improved index of Leading Economic Indicators do not suggest that economic activity is poised for an upside break-out. It remains a "conundrum" to us, then, why Fed Chairman Greenspan is maintaining a hawkish stance pointing to higher federal funds rate in coming months. In the spirit of true transparency, we wish he would reveal his pet leading indicators so that we could test them against the Conference Board's.

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Chart 2



The details of the GDP report show that the major contributors to the increase in real GDP in the second quarter were personal consumption expenditures, exports, equipment and software, residential fixed investment, and government spending (see table below). The drop in inventories to -\$6.4 billion from \$58.2 billion in the first quarter was the largest negative contribution to real GDP. As result of this large decline, an inventory accumulation is most likely in the second half of the year. A pickup in imports is almost certain after the 2.0% drop in the second quarter. Final sales to domestic purchases rose 4.0% in the second quarter.

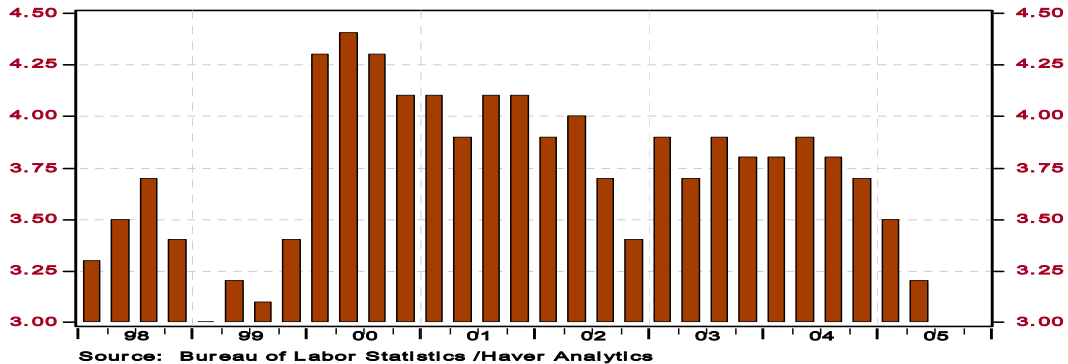
The GDP deflators show a noticeable deceleration in the second quarter. The Fed's preferred measure of inflation, price index of personal consumption expenditures excluding food and energy, was up 1.8% in the second quarter vs. a 2.4% gain in the first quarter. The Employment Cost Index (ECI) rose 0.7% in the second quarter, taking the year-to-year increase to 3.2%. Growth of the ECI (see chart 3) has slowed from a peak of 3.9% in the second quarter of 2004. Employment costs do not appear to be the genesis of an inflation problem. As noted earlier, it is not clear why the Fed would want to continue raising the funds rate. We believe that if the FOMC insists on pushing the fed funds rate up to 4% or beyond in 2005, there is a high probability that it will be cutting the rate in 2006.

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Chart 3

**ECI: Compensation: Civilian Wkrs**  
NSA, 12-Mo %Chg



**REAL GDP 2005:Q2 ADVANCE ESTIMATE**

	Levels (Billions of chained 2000 dollars)			Percent Change (SAAR)		
	04:4	05:1	05:2	From 04:3	From 04:4	From 05:1
	Final	Final	Advance	to 04:4	to 05:1	to 05:2
GDP	10897.1	10999.3	11092.0	3.3	3.8	3.4
CONSUMPTION	7698.8	7764.9	7828.3	4.3	3.5	3.3
DURABLE GOODS	1115.1	1122.3	1144.9	5.5	2.6	8.3
NONDURABLE GOODS	2236.5	2265.6	2283.9	5.5	5.3	3.3
SERVICES	4362.1	4392.0	4417.4	3.6	2.8	2.3
INVESTMENT	1863.9	1902.9	1879.0	6.8	8.6	-4.9
FIXED INVESTMENT	1811.3	1842.2	1883.6	7.2	7.0	9.3
NONRESIDENTIAL	1235.1	1252.2	1279.5	10.4	5.7	9.0
STRUCTURES	252.3	251.0	253.0	4.7	-2.0	3.1
EQUIPMENT & SOFTWARE	994.2	1014.2	1041.1	12.4	8.3	11.0
RESIDENTIAL	571.0	584.1	597.9	1.6	9.5	9.8
CHG. BUS. INVENT.	50.1	58.2	-6.4			
NET EXPORTS	-634.1	-645.4	-601.3			
EXPORTS	1144.5	1165.3	1200.3	7.1	7.5	12.6
IMPORTS	1778.6	1810.7	1801.6	11.3	7.4	-2.0
GOVERNMENT (Cons. & Invest.)	1962.8	1971.9	1981.6	0.9	1.9	2.0
FEDERAL	727.6	731.8	734.2	-0.6	2.4	1.3
DEFENSE	483.7	487.3	489.8	-3.3	3.0	2.0
OTHER	243.6	244.3	244.2	5.2	1.1	-0.1
STATE AND LOCAL	1235.0	1239.8	1247.2	1.8	1.6	2.4
DISP. PERS. INC.	8169.2	8110.0	8138.4	9.1	-2.9	1.4
FINAL SALES	10846.0	10940.3	11096.8	3.3	3.5	5.8
FINAL SALES TO DOM. PURCHASERS	11470.7	11576.2	11689.6	4.1	3.7	4.0
PRICE DEFLATORS:						
GDP CHAIN TYPE	110.1	111.0	111.6	2.7	3.1	2.4
GDP EX. FOOD & ENERGY				2.6	2.9	2.3
PCE CHAIN TYPE	109.3	109.9	110.8	3.1	2.3	3.3
PCE EX. FOOD & ENERGY	108.0	108.6	109.1	2.3	2.4	1.8

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## Chicago Purchasing Managers' Survey Posts Sharp Rebound

The regional factory sector survey of Chicago shows a significant improvement in activity during July. Indexes tracking new orders, production, and employment show a robust rebound in July. Typically, this regional survey is biased by events related to the auto industry and it represents an exaggerated picture of the national trend. The ISM manufacturing survey of July should give us a more realistic picture when it is published on August 1.

### Chicago Purchasing Manager's Survey

	<b>Feb-2005</b>	<b>Mar-2005</b>	<b>Apr-2005</b>	<b>May-2005</b>	<b>Jun-2005</b>	<b>Jul-2005</b>
<b>Business Index</b>	62.7	69.2	65.6	54.1	53.6	63.5
<b>Production</b>	68.5	75.8	68.9	56.0	57.8	70.5
<b>New Orders</b>	68.5	76.7	71.0	57.9	56.5	69.6
<b>Backlogs</b>	54.2	55.6	52.4	44.4	45.3	56.1
<b>Inventories</b>	53.2	47.3	53.6	51.2	50.9	56.4
<b>Employment</b>	57.7	66.0	62.3	54.7	48.9	56.1
<b>Vendor Deliveries</b>	53.4	51.3	59.5	51.7	48.5	49.6
<b>Prices Paid</b>	70.1	68.2	66.1	54.3	59.7	61.3

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## Brazil: Do the ends justify the means?

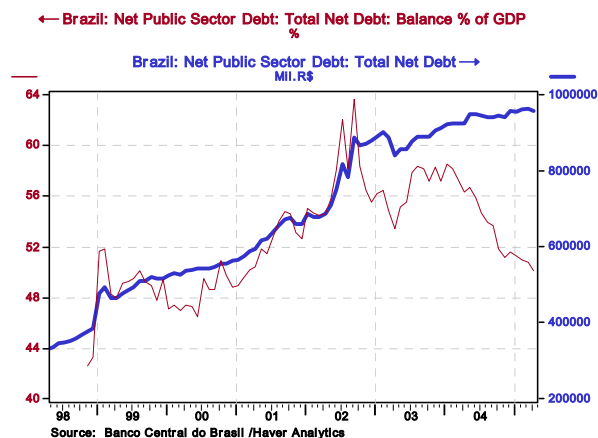
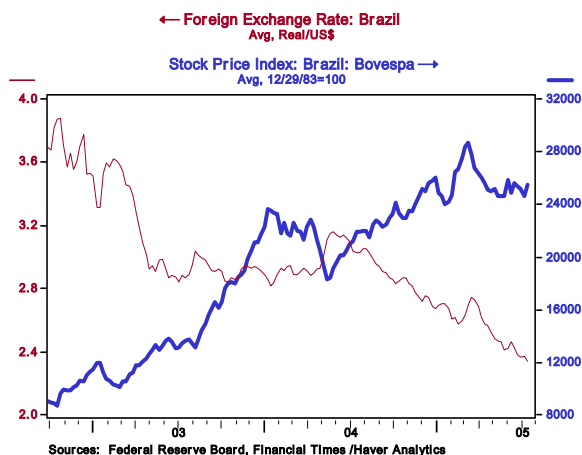
Countless reports over the years have examined the damaging effects of public-sector corruption. But what happens when corruption results in economic good? Unless you've spent the summer on a deserted island, chances are you're aware of the political scandal tearing through Brazil. After all, what makes a better story than a political aide trying to sneak \$100,000 out of the country in his underpants?

Details aside, consensus believes that the political scandal will have little, if any, significant economic impact. The rationale behind this statement centers on the supposed regime stability of the Brazilian government. An entrenched democratic process assures that the institution will not crumble under graft allegations. Besides, political corruption is hardly a new concept in Latin America. In 1992 former President Fernando Collor de Mello was forced to resign after a bribery scandal, and in 2004 the director of monetary policy at the central bank resigned after press allegations of tax evasion. As tongue-in-cheek as it sounds, the current accusations seem to be nothing more than business as usual.

But how can extensive corruption result in economic growth? The answer is relatively simple – it all depends on policy. President Luiz Inacio (Lula) da Silva committed his administration to IMF-prescribed policy measures aimed at reducing public-sector debt through fiscal discipline, a floating exchange rate, and inflation targeting. Strict adherence to these commitments facilitated an economic turnaround that led to the highest growth rate in a decade (4.9% in 2004), controlled inflation, a clean exit from IMF financing, and a return to current-account and trade surpluses. So, even if the allegations of vote-buying prove true, it doesn't change the fact that those bought votes helped implement a successful reform agenda.

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Brazil's external liquidity position has benefited from reforms through restructuring of public-sector debt, strong export earnings, and currency appreciation. Even as the scandal continues to unfold, the Brazilian real remains the best performer against the dollar this year among major currencies. Additionally, the Treasury recently announced a debt swap of up to \$5.6 billion outstanding on the country's Capitalization bonds for new notes with a longer maturity. The swap will improve the debt profile by extending out debt-servicing costs, and closing out a series of Brady bonds issued in 1994 to help Brazil emerge from a debt crisis.

Overall, President Lula and his governing coalition seem to have mastered the game that is Brazilian politics. They've played by the rules of a corrupt system to help push their agenda through Congress. The only difference between Lula's corrupt regime and his predecessors' is that Lula finally made some progress towards macroeconomic stability.

**Political allegations will have a significant impact on the economy *only if* policy becomes affected.** After the recent downward revision of government growth forecasts to 3.4% for 2005 from previous estimates of 4.0-4.3%, and an upward revision of inflation to 5.57% from 5.10%, particular attention should be paid to the Banco Central do Brazil's upcoming August 16-17 meeting. Minutes from the July meeting indicated that the central bank was willing to adjust policy 'quickly' to address inflation easing or concerns.

To end, I revert back to my original question - do the ends justify the means? Do economic gains justify Congressional vote-buying? Probably not, but at least it wasn't all for nothing.

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