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Global Outlook: Something's Gotta Give

**Federal Reserve Bank of San Francisco
The Changing Landscape: Asia's Role in Global Finance**

A few weeks ago, ten-year real rates on inflation protected government securities in both Japan and the United States traded at an identical 1.39 percent. This was not likely to endure and already U.S. real rates are 25 basis points higher than Japan's. It reminded me of the day early in 2000 when US real ten-year rates traded at the same level as Italian nominal ten-year rates. Both then and now, it seemed to me, that the tectonic plates underpinning the global economy would not stay settled long and could shift abruptly, simply put, that something would have to give.

Over the last few weeks, the words and deeds of policy makers around the world have suggested a stronger collective response to the risks of accelerating inflation than was previously evident. But the outcome - how and in what way the plates will shift - remains in doubt.

Today, in contrast to much of the last ten years, the global outlook will be significantly determined by the path of inflation and the policy responses to that path. Having taken significant steps to ease its policy rate and to provide liquidity to the banking system, the Federal Reserve will or will not win its bet that, over the next 12 months, aggregate demand will be sufficiently weak for the U.S. to avoid a sustained acceleration of inflation. At the same time, over the coming year developing Asian economies will or will not restrain their already-elevated levels of inflation. Something has got to give in the tension between aggregate demand, inflation and policy.

I think it likely (but not certain) that the Federal Reserve will be able to avoid a sustained acceleration of inflation and that a year from now U.S. inflation will be falling not rising. This positive outcome will come at a price: domestic demand in the U.S. will start 2009 on a very weak note, as the drags on consumption reassert themselves.

It is harder for me today to see the forces that will restrain and ultimately reverse the inflationary pressures on the Asian continent. I don't know whether inflation will be contained in Asia, but I do know that it will require policy actions or a sequence of events that I cannot now clearly anticipate.

The U.S. economy faces significant drags on consumption that will likely endure the temporary impact of fiscal stimulus. Negative residential fixed investment, reflected in still-falling housing starts, has been subtracting roughly one percent from GDP for over one year. Consumer confidence and personal consumption are being weighed on by the exhausting combination of falling home prices, tighter lending standards, unchanged mortgage rates, rising

energy and food prices, and the threat to incomes reflected in rising unemployment and decelerating growth in average hourly earnings.

Federal fiscal stimulus, combined with less extreme swings in inventory and employment levels than many forecasters presume, will provide somewhat stronger growth over the next few months than many have expected, in the range of one to two percent growth in the second and third quarters. But toward the end of the year and going into 2009, as the effects of the stimulus wane, the drags on confidence and consumption are likely to reassert themselves and slow the U.S. economy back toward a zero rate of growth. As these underlying forces of restraint take hold, aggregate demand will likely be sufficiently weak going into next year to avoid a sustained acceleration of inflation and, indeed, to bring inflation down.

There are three important risks to this outlook.

First, in the near term, energy prices might remain elevated for long enough to cause a greater pass through to core inflation and inflation expectations that would be hard to reverse. Exacerbating the situation might be the unintended consequence of fiscal stimulus keeping demand just high enough to sustain energy and food prices at levels that could cause a pass through to core inflation - even if the economy eventually weakens again going into 2009.

Second, if business fixed investment were to pick up over the next few months, this could provide the U.S. economy with greater momentum and correspondingly less likelihood of there being sufficient slack in resource utilization to bring down inflation in 2009.

Third, residential fixed investment and housing prices might bottom sooner than I expect. If housing starts were to bottom before year end, we would avoid this continued drag on GDP. If home prices were to bottom, we might stabilize consumer confidence.

While most housing recoveries have been sharp and V-shaped, it is hard for me to see how this occurs without there first being in place more generous financial conditions for consumers. Thus, a significant factor influencing my outlook for the U.S. economy to weaken again, in addition to a payback from stimulus, is my expectation that our financial system will remain quite weak and consumer credit relatively scarce and costly.

Despite the Federal Reserve's low nominal and negative real funds rate, and its heroic efforts to support and liquefy credit markets, financial conditions (other than through the exchange rate channel) remain firm. The household sector faces significantly tighter lending standards and mortgage rates are at the same level as a year ago. Moreover, while I am confident that our system for underwriting credit will eventually heal itself through a combination of ingenuity and necessity, I expect this process to be measured in years not months and will more likely follow than lead an expansion of aggregate demand.

If energy and foods prices appeared to be passing through to core inflation or drags restraining growth abated, the Federal Reserve might then need to consider whether to firm policy before the end of this year. If, however, the housing market remains weak and financial conditions tight, the extent and pace of interest rate increases, in any, would likely be limited.

An additional reason why I expect the U.S. to be slowing again as we enter 2009 is that net exports are unlikely to be providing much if any momentum to growth - which brings me to the outlook for Asia.

The policy reaction now unfolding in a number of countries on the Asian continent - of increases in reserve requirements, of rising official interest rates, of engineered firming of exchange rates and of reductions in energy and food subsidies - combined with the somewhat-unexpected firmness and inertia in ECB and Bank of England interest rate policies, will slow the world economy as it goes into next year, noticeably more, in my view, than is now reflected in many forecasts and market prices.

I can see how this reduction in global growth will be sufficient to dampen the upside for U.S. net exports, but given the pace of activity in Asia, it is harder for me to see how the policy actions to date will be sufficient to contain or reverse the pace of Asian inflation.

Growth in Asia - especially emerging Asia - was extremely strong last year, even as the U.S. entered the credit crisis and slowed abruptly. While expected to decelerate this year, growth in the region remains quite healthy, with both India and China growing briskly at 10.6% and 8.8% so far this year, respectively. While there are signs of slowing, these are mainly evident in the export channel and in Japan, rather than in the components of regional demand

Inflation in Asia is high and accelerating. It is being driven particularly by the global rise in food and energy prices but is now appears to be passing through to core inflation in a number of countries. While energy prices might have room to stabilize or come down, it is much harder to see how the structural and cyclical forces pushing up food and soft commodity prices might be so easily reversed by any near-term changes in supply.

Despite the policy actions to date, real rates remain negative in some countries and overall monetary conditions still appear accommodative in much of the region. While this brief survey cannot do justice to the differences among Asian countries, monetary, fiscal and exchange rate policies are generally moving in the direction of tightening. However, they do not yet appear to be acting as much of a restraint on either consumption or overall resource utilization.

The slow down in the United States, as well as in Europe and Japan, will likely weigh on the level of Asian exports. But both the extent and the timing of any such impact are unlikely to open sufficient slack in resource use soon enough to contain inflationary pressures so evident in Asia right now.

Almost one year after the onset of the stresses in the LIBOR funding markets, in August of 2007, there is relatively little evidence of a negative spillover to Asia from the crisis among North Atlantic financial intermediaries and the relatively tight credit conditions in the United States. Equity markets around the world have traded in rough sympathy with one another since last October. But capital market linkages with Asia appear to be flowing from Asian surpluses to the distressed investment opportunities in the United States and the United Kingdom. Thus, given the still-accumulating Asian current account surpluses, there seems little prospect of restraint on Asian demand coming from tight western credit conditions - at least, so far.

The linkages between our economies that now appear to be most powerful and most clearly synchronized are, regrettably, those tending to accelerate our respective rates of inflation.

Strong Asian demand for both soft and hard commodities is adding to pressures on food and energy prices in the United States at just the time the Federal Reserve is concerned with the risk of these price pressures passing into core inflation. At the same time, weakness in the U.S. dollar in recent years has contributed to rising prices for those commodities that trade in dollar terms, adding to inflation pressures for those countries that manage their currencies against the U.S. dollar.

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Two months ago, Paul Volcker was asked what he thought the odds were of a dollar crisis and he answered that there was no need to predict it; we were already in a dollar crisis. With some trepidation, I will take the other side of that argument.

Over the course of this decade, we have seen the dollar rise and fall in a manner that I believe is entirely consistent with the cyclical position of the U.S. economy versus our major floating-rate trading partners. The dollar has both moved in line with anticipated, risk-adjusted real growth differentials and has played exactly the part of allowing for an orderly adjustment of global imbalances - albeit an incomplete one. The ebb and flow of the dollar has not reflected a loss of its reserve currency status but, rather, has reflected that status as funds have flowed to and from our capital markets.

A dollar crisis, if we see one, would feel quite different and would most likely be the consequence of a sustained acceleration of U.S. inflation. This is why it is so important for the Federal Reserve to resist a further rise in inflation and, why, I suspect, that Chairman Bernanke was recently so explicit about the Federal Reserve's focus on the implications of changes in the value of the dollar for inflation and inflation expectations.

As I said at the outset, the Federal Reserve will either win or lose its inflation bet and Asian countries will or will not be able to contain their current inflation rates. Something has got to give. It is unlikely that Asian countries can be successful if the Federal Reserve is not. It may even be that the Federal Reserve cannot be successful unless Asian countries are also successful.

I am an optimist about Asia's future. Over the next 20 years, I expect that Asia will grow more quickly than the United States. I am also an optimist about America's future in that I expect us to return to our potential rate of growth within the next couple of years. But given the differential in those outlooks, while I expect that U.S. real rates will be higher over the next decade than markets now reflect, I think Asian real rates need to be higher sooner for us all to live up to our potential.

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