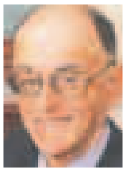

2005 WAS A BAD YEAR, BUT THE PREVAILING MOOD IS SURPRISINGLY UPBEAT, SAYS **DAVID KERN**

A world full of wobble

Growth in all the major economies has slowed in 2005. After a very strong performance in 2004, global activity was widely expected to decelerate, mainly in reaction to higher US interest rates and weaker housing markets. But unforeseen blows made last year more dangerous. Oil prices rose to levels previously considered unimaginable. Natural disasters caused massive damage and were hugely expensive, while terrorist attacks on London and other centres weakened confidence, heightened uncertainty and caused major disruption in sectors such as travel, tourism and retail. In the face of these setbacks, 2005 is ending on a surprisingly upbeat note, with strong financial markets and reasonably stable expectations for the next 24 months.

Executive summary

- **The financial markets have been surprisingly upbeat in the final months of 2005.**
- **In spite of a marked slowdown in global economic growth and the adverse effect of major shocks (high oil prices, hurricanes and terrorism), stock markets rose in November to their best levels for three or four years.**
- **Prospects for 2006 and 2007 appear stable and benign, albeit mediocre. But the stability is wobbly, and the global economy still faces serious dangers.**

MEDIOCRE GROWTH The world economy has avoided a number of potential disasters in 2005. Unprecedented upsurges in oil prices were less devastating than many feared. Lower growth has caused difficulties, particularly in Europe, but all the main global players have escaped recession. But while the prospects for most major economies appear relatively benign, global growth in both 2006 and 2007 is not expected to rise above the same mediocre pace as in 2005. Growth forecasts, outlined in *Table 1*, highlight a picture of pedestrian stability. But this stability is precarious. The most serious concern is that the global economy will continue to suffer from major geographic and structural imbalances. These imbalances, which will dampen growth prospects over the next few years, remain unresolved and may even have worsened over the past year.

GEOGRAPHICAL IMBALANCES The US remains unquestionably the main global growth driver, and the world economy is unduly dependent on US demand. China, India and a few other Asian economies have become major players; they enjoy remarkable growth rates, and their role is set to strengthen over time. But the US economy will remain pivotal in the next few years. In the period 2003-05, Chinese GDP growth averaged 9.4% a year, and Indian growth averaged 7.2%. But these dynamic Asian economies still lack sufficient critical mass. Asia is still overly dependent on exports to the huge US market. The affluent developed economies of North America, Western Europe and Japan still account for the bulk of world GDP, with a large and persistent gap in favour of the US. In the period 2003-05, US GDP growth averaged 3.5% a year, in contrast to anaemic euro zone growth of 1.3% and average Japanese growth of 2.2%. Japan and the euro zone are showing signs of improvement, but the gap in favour of the US is set to continue. In 2006 and 2007, GDP growth is forecast to average 3.3% a year in the US, 2.2% in Japan, and 1.9% in the euro zone. Inadequate growth in the euro zone and Japan will continue to exacerbate global risks.

STRUCTURAL IMBALANCES The US's ability to sustain strong economic growth is remarkable given the huge problems it faces: large trade and budget deficits (see *Chart 1*), low savings and a potential housing market bubble. But the persistent US tendency to grow faster

Table 1. GDP growth in the major economies 2001-07
% change on previous year

	2001	2002	2003	2004	2005	2006	2007
US	0.8%	1.6%	2.7%	4.2%	3.6%	3.4%	3.3%
Japan	0.2%	-0.3%	1.4%	2.7%	2.4%	2.2%	2.1%
Euro zone	1.7%	0.9%	0.7%	2.0%	1.3%	1.8%	1.9%
Germany	1.2%	0.1%	-0.2%	1.6%	1.0%	1.4%	1.5%
France	2.1%	1.3%	0.9%	2.0%	1.6%	1.8%	1.9%
UK	2.2%	2.0%	2.5%	3.2%	1.6%	2.2%	2.4%
China	7.5%	8.3%	9.5%	9.5%	9.3%	8.7%	8.6%
India	3.9%	4.7%	7.4%	7.3%	7.0%	6.9%	6.9%

than other G7 economies is one of the main reasons for the massive US external deficit. This deficit is not merely a domestic US problem, but remains a major unresolved global imbalance and a potential source of future trouble. High US imports, and the consequent huge external deficit, help to sustain global growth, but the scale of the US deficit poses risks. If sentiment changes abruptly, a sharp attack on the US dollar may force large US interest rate increases. In turn, this may weaken the overblown US housing market and trigger a major retrenchment by US consumers. The immediate outlook, both globally and in the US, is still benign. But even if a crisis can be avoided, the scale of the US external deficit is unsustainable in the longer term. Unless corrective action is taken in time, the global economy will face serious risks from a painful and disorderly adjustment.

FINANCIAL RISKS Concern over the US deficit was a key driver in the financial markets during 2004 and early in 2005. The US dollar fell sharply in this period, in spite of the steady increases in the US Fed funds rate since June 2004. But market perceptions have changed radically since March 2005. Interest differentials have become the key factor driving the markets. As the US Fed continued to raise rates gradually and other central banks kept official rates unchanged, the US dollar has risen sharply in recent months. But, as we enter 2006, the situation is becoming more fluid and potentially hazardous. One key question is how much further will the Fed take the tightening process, and at what level interest rates will peak. Alan Greenspan's retirement as Fed Chairman, and his replacement by Ben Bernanke, may unsettle the markets. The central forecast, presented in *Table 2*, assumes that the Fed funds rate will peak at 4.75%. Such a peak is just tolerable for the economy, although slightly too high in my view, given the limited risks of an upsurge in inflation. But growth could be seriously damaged if the Fed pushes interest rates to 5% or higher. There is also some risk of premature interest rate increases in the euro zone and Japan.

CURRENCIES The US dollar is set to stay strong in the next three to six months, due to a wide interest rate gap in the US's favour. But the dollar is now near its peak, and future increases will be modest only. I still believe that the massive US external deficit will trigger an eventual fall in the US dollar in the next two to three years, totalling 10-15%. But the US dollar will probably record larger falls against the major Asian currencies than against the euro. Following recent changes in Chinese exchange rate policy, the renminbi is expected to strengthen by approximately 5%-10% against the US dollar over the next two years. In contrast, sterling is very vulnerable in the next few months, as the UK is the only major economy where early interest rate cuts are still a realistic prospect.

KEY GLOBAL DANGERS The central scenario summarised in *Tables 1* and *2* points to mediocre but stable growth, and is benign overall. The US, China and India are set to record slightly lower growth in 2006 and 2007 than in 2005, but will remain the fastest-growing economies. The euro zone, the UK and Japan are likely to record higher (but still relatively low) growth in 2006 and 2007 than in 2005. The stability indicated in the central forecast is precarious and vulnerable. Although the US external deficit is still likely to force a US dollar fall in the medium to long term, short-term forces could push the dollar to new highs, making the correction more painful and disruptive. Sharp slowdowns in consumer spending as housing market bubbles burst, renewed sharp oil price increases, and terrorist attacks remain key global dangers in the next one to two years.

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Chart 1. External Imbalances
current account deficits/surpluses, 2001-07, US$bn

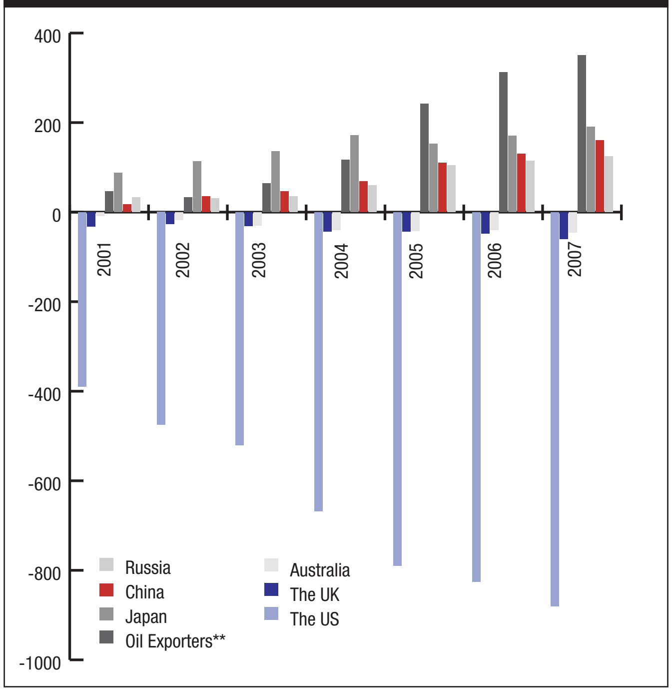

Table 2. Official interest rates
% forecasts for next 24 months

	Actual			Forecast				
	end 2003	end 2004	11/12/05	3-month	6-month	12-month	18-month	24-month
US Fed Funds Rate	1.00%	2.25%	4.00%	4.50%	4.75%	4.75%	4.50%	4.25%
ECB Refi Rate	2.00%	2.00%	2.25%	2.25%	2.50%	2.75%	2.75%	3.00%
Japan Overnight Rate	0.00%	0.00%	0.00%	0.00%	0.25%	0.75%	1.00%	1.00%
UK Repo Rate	3.75%	4.75%	4.50%	4.25%	4.50%	4.75%	4.75%	4.50%