THAT SINKING FEELING

IT'S NOT THE JUST THE US THAT IS SUFFERING AT THE MOMENT, CONFIDENCE IS DOWN IN GERMANY, JAPAN AND THE UK, TOO, SAYS **NEIL MACKINNON** OF THE ECU GROUP.

The slide in global equity markets (despite a partial recovery from the July lows) threatens to dent prospects for a sustained global economic recovery. Why? From the peak seen in the summer of 2000, the US's S&P 500 index has lost 40% of its value, the UK's FTSE 100 index has lost a similar amount, while Germany's DAX index has lost nearly 50%.

This destruction of financial wealth clearly has adverse effects on consumer and business confidence, reflecting the shrinkage in household and corporate balance sheets. US corporate earnings results for the quarter reflected the impact of previous cost-cutting measures rather than significant gains in revenue flows. Pricing power remains weak and widespread deflation risks persist.

A DISTINCT LACK OF APPETITE. As a result, the collapse in equity prices is likely to result in a slowdown in consumer spending, while companies will likely delay capital spending plans or even cancel them altogether. Capital overhang in the US economy has further to unwind and, until it is completed, the corporate appetite for fresh additions to the capital stock will remain low. Likewise, US consumer spending, which is becoming increasingly underpinned through mortgage refinancing, is likely to run out of steam.

The Federal Reserve will have to keep short-term interest rates low for a considerable period, though there is increasingly a lower bound for short-term rates coming into view and a question mark over the effectiveness of interest rate policy in a deflationary environment. The absence of jobs growth in the US will likely require some downward adjustment in the level of real wages, otherwise the unemployment rate will continue to rise, perhaps reaching 7% later next year.

Investment in the UK is already at a four-year low. However, like the US, consumer spending is the mainstay of economic growth. However, consumer debt levels are rising and do not look sustainable on a medium-term view. House price inflation, running at a double-digit pace currently, is likely to moderate in to the early part of next year, largely reflecting the impact of the recession in the City. In addition, planned increases in national insurance contributions in April 2003 will do little to enhance job prospects, at what could be a difficult juncture in the economy.

Against this background, policymakers in the key economies face new challenges to prevent the global economy from sinking into another recession, as well as preventing deflation (a sustained fall in consumer and producer prices) from creating an unwelcome depressionary influence. The most immediate policy response has to be a reduction in short-term interest rates. The Fed has led the way. The Bank of Japan has already embarked on a course of monetary base expansion and debt monetisation. Further liquidity injections are likely to be forthcoming, alongside some required depreciation in the yen to generate inflation (therefore reducing Japan's high level of real interest rates). From a treasurer's point of view, the policy environment is conducive to a further extension in the bull market for money market instruments.

WHY ARE WE IN THIS SITUATION? Back in 1996, the Fed's Chairman, Alan Greenspan, declared that stockmarkets were suffering from what he called "irrational exuberance". By this he meant that stockmarket valuations were out of kilter with fundamentals. It is interesting to note that, even now, stockmarkets are still above 1996 levels and valuation measures such as price/earnings (P/E) ratios are still above or close to historical averages. The collapse of the technology stock bubble in 2000 was a classic case of a stockmarket mania that turned sour. Subsequent cases of malfeasance and exotic accounting practises (think Enron and WorldCom) have also seriously dented investor confidence in the integrity of the market.

This has resulted in foreign investors gradually exiting US financial markets, especially equities (although the appetite for US corporate bonds and agency paper remains high). Previously, during the period between 1995-2000, investors believed that the US economy was experiencing a 'New Economy' phase, in which the US led the IT revolution. This superior lead in technological advance spawned the dotcom mania, but it was also real in the sense that technological advance, combined with a decline in the real price of computers, prompted an investment and productivity boom.

The US economy outpaced growth in the other major economies by a mile. Europe was seen as being hamstrung by restrictive monetary and fiscal policies related to the introduction of the euro

that resulted in sluggish growth, low productivity and high unemployment. Japan was stuck in a deflationary depression that kicked off after the collapse of its own stockmarket bubble in 1990. Zero interest rates in Japan and repeated packages of public spending increases simply failed to work and resulted in some economists saying that Japan was stuck in a Keynesian-type 'liquidity trap'.

No wonder international investment funds flooded into US financial assets to take advantage of what was seen as superior investment returns. Quite simply, US markets were regarded as the investment destination of choice while the dollar was the king of currencies.

'AT SOME STAGE, FOREIGN EXCHANGE INTERVENTION WILL HAVE TO BE 'UNSTERILISED' AND RADICAL POLICY MEASURES INTRODUCED TO SHIFT INVESTORS' CURRENCY EXPECTATIONS'

FIGURE 1
THE REAL FED FUNDS RATE – NOW NEGATIVE

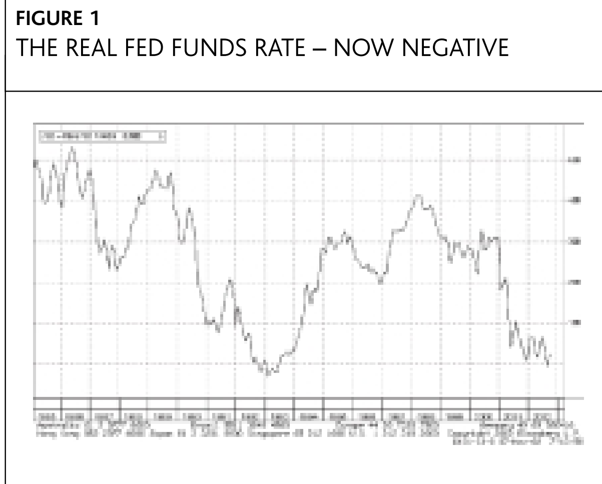
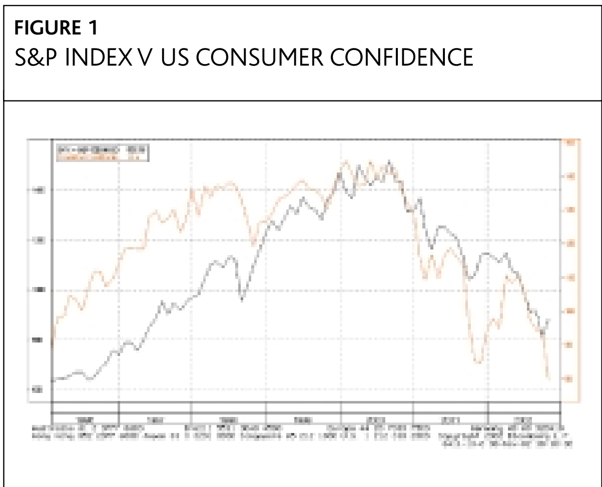


FIGURE 1
S&P INDEX V US CONSUMER CONFIDENCE



ALL THAT IS NOW CHANGING FAST. The financial excesses of the 1990s are unwinding and the retreat of international investors from US markets is denting the dollar on the foreign exchanges. The US now has a record trade deficit with imports rising at a faster rate than imports. Instead of a budget surplus, there is now a budget deficit as tax revenues nose-dive because of the stockmarket slump. The trade deficit and the budget deficit now amount to 6% of US GDP.

This looks unsustainable. Some further correction in the dollar looks likely and it would be no surprise if the US Administration quietly retreated from the commitment to a 'strong dollar' policy. The US has previously been able to attract foreign investment, which has easily financed such deficits. Now funding those deficits is becoming a growing problem and points to a medium-term decline in the dollar as part of the adjustment process to bring the trade gap back on track. From January to August this year, US capital inflows averaged $39.9bn a month, while the monthly current account deficit averaged $40.4bn.

In addition, the US administration's imposition of steel tariffs earlier in the year underlines a protectionist stance that can only backfire as retaliatory action elsewhere will only harm US exporters. A move away from free trade policies is not good for world trade and the world economy. Uncertainties over policy in the Middle East and Iraq do not help much either.

Of course, a weaker dollar creates complications for monetary policies elsewhere – not least in Japan, where a stronger yen can easily ruin the prospects for exports. Japan's Ministry of Finance has already intervened in the currency market using some of its vast $400bn foreign exchange reserves to try and prevent the yen from rising, but without success so far.

At some stage, foreign exchange intervention will have to be 'unsterilised' and radical policy measures introduced (such as negative interest rates on banks' reserve balances) to shift investors' currency expectations.

In the eurozone, the ECB can cut interest rates again, especially as the euro is back to parity again against the dollar. It certainly needs to act. At the time of writing, the ECB had left interest rates unchanged for exactly 12 months. The price that is being paid is slower economic growth. Germany is close to experiencing deflation, unemployment is more than four million and the German banking system is having difficulties. By Spring next year, my guess is that the ECB's intervention rate can drop to 2% from 3.25%, as it is now.

In the UK, the Bank of England's Monetary Policy Committee has expressed concern about the sustainability of the rise in UK house prices. However, there are some tentative signs that prices are moderating and the national housing market is certainly not exhibiting the type of 'bubble' that prevailed in the 1980s (although there are certainly 'bubblettes' in areas up and down the country).

As a result, the Bank of England can afford to act more cautiously than some of its other central bank counterparts. Nevertheless, the risk of global recession and deflation are too great to ignore and I would expect the Bank of England to bring its repo rate down towards 3.50% into the early part of next year.

Neil MacKinnon is Chief Economist at The ECU Group, a currency debt management and currency trading firm based in the City. The ECU Group is a subsidiary of ED&F Man.
neil.mackinnon@ecugroup.com
www.ecugroup.com