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GLOBAL CHIEF ECONOMIST DEUTSCHE BANK ASSET MANAGEMENT	**KERN CONSULTING** – FORMERLY CHIEF ECONOMIST AT NATWEST	**CHIEF UK ECONOMIST** CAPITAL ECONOMICS	**CHIEF ECONOMIST** THE ECU GROUP	**GROUP CHIEF ECONOMIST** THE ROYAL BANK OF SCOTLAND

FIVE WISE MEN REPORT

WILL THE US BE ABLE TO RESOLVE ITS CURRENT FINANCIAL WOES, WILL THE UK FINALLY SUCCUMB TO EU MEMBERSHIP AND WHAT WILL BECOME OF GERMANY AND JAPAN IN THE YEAR AHEAD? THESE ARE JUST SOME OF THE ISSUES WE SPOKE TO FIVE OF THE UK'S TOP ECONOMISTS ABOUT. TO FIND OUT WHAT THEY THINK, READ ON...

WHAT WILL BE THE MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2003?

SB Iraq, oil and equities are likely to be the major influences. More generally, companies are struggling to maintain profitability, with widespread over-capacity and a lack of pricing power. This will depress investment, employment and wage growth as companies restore their balance sheets.

DK Geopolitical developments, such as new acts of terrorism and a war in Iraq, could seriously harm the global economy if they weaken consumer and business confidence and produce sharp oil price rises. However, a conclusive US victory in Iraq, and successes in the war against terrorism, will have positive economic results.

The ability of the US economy to continue growing and avoid recession, while correcting its huge imbalances – too much debt, excess capacity, a huge external deficit and inadequate savings – will remain the most important single factor determining global economic conditions in 2003.

The US consumer will continue playing a critical role in sustaining demand, while the Federal Reserve's willingness to cut rates further, if conditions worsen, remains a vital defence mechanism.

Can Japan tackle the huge bad debts in its banking and corporate sectors, while easing at the same time the threat of damaging deflation? Without radical reforms, there is a clear danger that Japan will be unable to avoid even worse economic decline.

Euroland's inability to improve its anaemic growth performance exacerbates global instability and worsens trade tensions. The world's reliance on the US will increase further, as neither Japan nor Euroland can assume the role of global locomotive. Euroland must pursue more aggressively structural reforms, but it must also cut interest rates and ease the onerous restrictions of the Growth and Stability Pact.

Will major emerging market economies be able to avoid debt default, political instability and deep recession? The biggest risks are in Brazil, Argentina, Indonesia and Turkey.

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Forex rates at 31 Dec 2003	€ to £ ¥ to £ $ to £	1.10 135 1.60	1.54 189 1.48	1.45 175 1.57	1.54 205 1.60	1.52 195 1.57
UK annual rate of underlying inflation, by RPI (X) at 31 Dec 2003 (%)		2.5	2.2	2.0	1.5	2.6
Lending rates at 31 Dec 2003 (%)	UK base US Federal funds Euro-repo Japanese discount	3.75 1.25 2.50 0	4.50 2.25 3.25 0.25	4.0 1.75 2.75 0.1	3.75 1.25 2.00 0.01	4.50 2.00 3.25 0.10
10-year yields at 31 Dec 2003 (%)	UK gilts US treasury German bunds	4.5 4.2 4.5	5.1 4.5 5.0	5.0 4.6 4.7	3.85 3.75 3.55	4.8 4.0 4.6
Annual average GDP growth in 2003 (%)	UK US Germany Euroland Japan	2.8 2.7 1.2 1.5 0.5	2.5 2.6 1.3 1.7 0.5	2.5 2.0 1.0 1.5 0.5	2.0 3.0 0.8 1.0 0.8	2.5 2.7 0.9 1.5 1.2
Stock market forecasts for 31 Dec 2003 *FTSE all share	FTSE 100 Dow Jones Nikkei index	4,700 9,500 9,500	4,400 9,100 9,300	4,500 9,500 9,000	4,500 9,200 10,000	2,350* 9,500 10,500

JL The behaviour of consumers, both at home and abroad, will be crucial in 2003. With a decent recovery in investment and exports still some way off, the economy will remain dependent on consumer spending as the main engine of growth for at least the first half of the year. And yet there are growing signs that consumers are starting to feel the strain of propping up the economy almost single-handedly. Savings are low, debt burdens are high and house prices are vulnerable to a sharp slowdown. With falling stockmarkets and the Middle East situation likely to weigh on sentiment – particularly if the latter sparks a new bout of terrorist attacks in the West – policymakers will need to give households plenty of encouragement in the form of very low interest rates to keep them spending. If they stop before other parts of the economy recover, growth could slow sharply.

NM Economic conditions will continue to be affected by the loss of financial wealth associated with the severe decline in equity prices during the past two years. This is continuing to have adverse effects on business and consumer confidence. In addition, the overhang of capital investment in the US economy is likely to depress investment throughout 2003, despite a lower cost of capital. Corporates, not just in the US, will likely remain focused on balance sheet adjustment. In addition, global policymakers will become increasingly focused on the risks of deflation. The Fed is alert to the dangers of failing to anticipate this danger. However, the ECB still looks as though it is stuck in a policy 'time-warp'. Nevertheless, short-term interest rates in the key economies are likely to remain in a downward trend throughout 2003. The likelihood of any major central bank raising interest rates during 2003 is exceedingly slim. The other key influence will be currency developments. Weakness in the US dollar complicates the conduct of monetary policy in the eurozone and Japan, where implied currency appreciation in the euro and the yen either dampens growth and increases deflation risks, therefore forcing a loosening of monetary policy. For Japan, though, monetary base expansion has to be accompanied by currency depreciation in order to be effective in combating deflation and generating inflation.

JP The prospects for the global economy in 2003 are primarily dependent upon what happens in the US – and to the US consumer in particular. There is no other significant source of dynamism, with the outlook for Japan remaining bleak and Euroland – Germany in particular – seemingly incapable of generating domestic momentum.

HOW WOULD YOU ASSESS THE LIKELIHOOD OF THE UK MEETING THE 'FIVE ECONOMIC TESTS' FOR EURO ENTRY DURING 2003?

SB With opinion polls showing a clear 'no', the Treasury is likely to conclude that whilst there has been progress on the five tests, this is not yet sufficient to justify the government recommending that we join the euro.

DK Although the Treasury will undoubtedly conduct a thorough economic analysis, the decision will ultimately be taken on wider political considerations, the most important being the government's ability to win a referendum. If one takes the two most important tests, convergence and flexibility, one can argue that we are now much nearer to meeting the tests than in 1997. But it would be extremely difficult to argue that we have achieved a sufficient degree of sustainable convergence, and enough flexibility to respond to economic shocks and changes, to enable us to live permanently with a fixed exchange rate versus the euro and with interest rates set by the ECB. If the convergence and flexibility tests are satisfied, the government will have no difficulty in arguing that the other three tests (the benefits for investment, financial services and growth and employment) have also been passed.

While joining the euro offers many benefits, the permanent loss of the interest rate and exchange rate weapons could have devastating consequences. Joining is fundamentally a political decision, which cannot be made purely on economic grounds. By insisting that the economic case for joining must be 'clear and unambiguous', the government faces an almost impossible burden of proof.

Given the poor economic conditions in Euroland and the lack of policy credibility – both of the ECB and the Growth and Stability Pact – it is extremely difficult to argue that the UK is losing out by not joining immediately. Unless there is a miraculous shift in public opinion in favour of joining, the government's conclusion will be that the five tests have not yet been met, and the referendum will be postponed at least until after the 2005 election.

JL This is more a question of politics than economics, since the tests are vague enough to mean that they could be judged to be passed or failed under a range of different scenarios. My own view is that the conditions laid out by the tests will not be passed in 2003 – nor anytime soon after. Although there has been a notable convergence of the UK and eurozone economic cycles in recent years, structural differences, such as the pattern of trade and the housing market, remain as wide as ever. As such, we are not yet in the position where the UK could live permanently with the same level of interest rates as Europe. I expect the Treasury, under the strong guidance of the Chancellor, to reach the same conclusion, but for different reasons.

With public opinion still against entry, the exchange rate still awkwardly high and European economic performance disappointing, while the UK fares relatively well, political conditions are clearly not in place for the government to make a concerted push towards entry just yet.

NM The Treasury's convergence tests are qualitative rather than quantitative and it is well known that the eventual decision is political rather than economic. Indeed, it will likely be essential political considerations that determine whether the Treasury eventually endorses UK membership of the euro. From an economic point of view, there is still a question mark about structural convergence between the UK and eurozone (in terms of taxation, labour market flexibility and the like).

Indeed, there is a question mark about structural convergence within the eurozone area, especially given the EU's plans for enlargement in 2004. But to answer the question, I believe the Treasury will endorse the five economic tests, therefore paving the way for a referendum in 2004.

JP Whether the UK is deemed to have 'passed' the five tests will depend more on politics than economics. The odds on an early referendum may be receding, but nothing can be ruled out. The government will be most reluctant to be seen to be opting for a prolonged period as an EMU 'out'.

WILL EU ENLARGEMENT IMPACT ON EU MONETARY POLICY, ESPECIALLY FOLLOWING IRELAND'S RATIFICATION OF THE NICE TREATY?

SB EU enlargement will require major changes to the constitution of the ECB when more countries join the euro. The ECB is likely to reform itself anyway next year and may change its inflation target. Policy could see aggressive rate cuts from the ECB, but this will have little to do with enlargement.

DK EU enlargement should not impact immediately on EU monetary policy. But the long-term effects could be highly significant and potentially harmful. Enlargement will complicate the ECB's problems and unleash forces that could hamper growth. It will not start until 2004 or (more likely) 2005 at the earliest, and even the most advanced new EU entrants would very probably have to wait some time before they join the euro.

While the ECB's interest rate policy will not be affected until the euro is enlarged, the need to divert more resources towards the new EU members could worsen the budgetary pressures that existing members already face in adhering to the highly restrictive Growth and Stability Pact.

Moreover, once some of the new members from Central and Eastern Europe join the euro, and the single currency's membership grows, the divergences inherent in the euro's 'one-size-fits-all' monetary framework will worsen. Since income and cost levels in the new members are below the Euroland average, their growth and inflation levels (as part of the 'catching-up' process) will be higher than among existing members for some years. However, this will push up average Euroland inflation, forcing the ECB (which will remain committed to the present low-inflation target) to increase interest rates to levels that would be even more inappropriate for low-inflation Euroland economies such as Germany. In recent years, ECB interest rates were too high for Germany and too low for Ireland, Spain and the Netherlands.

These damaging contradictions will become even more pronounced after the euro's enlargement.

JL Insofar as new members of the EU will, in due course, also join the single currency, there are potentially important implications for monetary policy and for existing members of the eurozone. Most, if not all, new members will have faster growth rates and higher inflation than the eurozone average.

This means that, for the ECB to continue to adhere to the existing inflation target of 2% or less, there will need to be even lower inflation in some of the existing member economies such as Germany. Indeed, it is not impossible to envisage an extreme situation in which the 'one size fits all' policy arrangements actually require deflation in Germany – Europe's largest economy – for the ECB to meet its inflation target. This could obviously increase the pressure for radical changes to the ECB's policy remit.

NM I believe that EU enlargement certainly highlights the problems associated with a 'one size fits all' interest rate policy, although the immediate issue of the appropriate management of interest rate policy is less of a problem when most economies (globally, not just within the EU) are experiencing a synchronised downturn in economic activity. I think that enlargement actually poses more problems with regard to fiscal policy, especially the Common Agricultural Policy.

JP EU expansion increases the importance of the area as an economic relationship, while adding to the euro-governance risks and uncertainties. However, monetary policy should not be influenced until the new members join EMU – and I trust that this eventuality is many years in the future.

■ DO YOU ANTICIPATE A GLOBAL RECOVERY IN 2003 OR DO YOU SEE SIGNIFICANT DIFFERENCES BETWEEN THE US, THE UK AND EUROPEAN ECONOMY?

SB There will be a global recovery in 2003. The UK and the US are likely to outperform Europe.

DK I expect a modest improvement in economic performance in 2003, but it is an exaggeration to talk about a sustained recovery. The good news is that neither a serious US recession, nor a global crisis caused by a war in Iraq, are likely developments. While many prices are falling, general deflation outside Japan is unlikely. Indeed, growth is likely to improve slightly across all the major regions.

However, GDP forecasts for 2003 have been significantly lowered recently, mainly in Euroland, and global growth in the next few years is likely to be below-trend and well below the 1990s average. Deflation, while not imminent, is a real danger, particularly in Germany. There is also increased concern with banking sector bad debts.

The US and the UK will perform more strongly in 2003 than Euroland and Japan. The US economic dominance will increase further. If the US weakens, or if the dollar collapses, Europe and Asia may well suffer worse effects than the US.

JL I anticipate a modest global recovery in 2003, but with quite significant differences in performance between different areas. I believe the UK will probably do best, growing close to its trend growth rate of 2.5% to 2.75%. The US will lag behind, still weighed down by the major imbalances built up during five years of excessively fast growth in the second half of the 1990s. Europe will bring up the rear, thanks to a combination of structural rigidities and over-cautious policymaking.

NM No, I do not see a global recovery in 2003. However, the US can certainly return to sustainable trend rates of economic growth by mid 2003. Economic policy co-ordination throughout the G7 area remains disjointed, however, and the price to be paid for previous policy mistakes and inaction is stagnation in Euroland and Japan. Fortunately, US policymakers are pro-active and pre-emptive, and are willing to use traditional monetary and fiscal policy instruments in response to signs of slower economic growth.

The same cannot be said about eurozone policymakers. The ECB will be compelled to reduce interest rates sharply and a reduction in the repo rate to 2% in 2003 looks likely. Indeed, aggressive interest rate reductions are required just simply to offset the impact of the euro's appreciation during the course of 2002. However, fiscal policy is unlikely to contribute any significant stimulus in the eurozone area in 2003. As a result, I expect real GDP to expand by an average of 1.0% in 2003, with growth picking up in the second part of the year. In the UK, fiscal expansion amounting to 0.7% of GDP on my estimates can help underpin GDP growth of 2%. The eurozone lags well behind, with GDP growth of 0.8%, not far away from projected growth of 0.5% in Japan.

JP I see a sustained global recovery in the first half of next year, led by the US, as a 65% probability. The UK needs to benefit from that global upswing and then re-balance by tempering consumer strength, but is far better placed than the bulk of the Eurozone, where the only prospect of returning towards trend growth will come from exports leading.

■ DO YOU BELIEVE THAT BONDS WILL ONCE AGAIN OUTPERFORM EQUITIES IN 2003?

SB No. If, as I expect, equities rally in 2003, bonds yields will rise. But the background of low inflation and weak private sector capital demands will limit the damage

DK The recent outpeformance of bonds over equities will probably continue in the next few months. However, taking the entire period between now and the end of 2003, I believe equities will prove to be a better investment than bonds, although the performance of both asset classes will be unimpressive.

Bond yields (in the US, Europe and Japan) fell recently to historically low levels, both in nominal and real terms, and, although now slightly above their troughs, yields are still very low. In the near future, fears of deflation and negative output gaps – that is, output below trend – in many economies will keep bond yields around their current low levels, particularly if (as seems probable) central banks decide to push short-term rates even lower.

However, even the mediocre upturn in activity expected over the next one to two years will probably result in bond yields starting to edge up from Spring 2003 onwards, and, by the end of 2003, I expect 10-year Government bond yields in all the major centres to be some 50bp higher than at present. While modest, this rise in yields will result in capital losses of some 10-15% on bond holdings, implying negative total returns of some 5-10% in 2003. As for equities, the current lower and more realistic price levels are now offering some attractive opportunities. But equity valuations are by no means cheap, and, at least on some measures, equities are still expensive in the US. Overall, I expect equities to produce positive total returns of some 8%-12% in 2003.

JL No. I believe equities will probably outperform bonds marginally in 2003 overall, although I suspect bonds will perform better in the first half of the year. That is not to say I expect equities to perform particularly well and I think they can certainly fall further in the early months of the year, if only because of continued uncertainty over the Middle East situation. However, on most valuation measures, they now look fairly valued, if not cheap, while bond yields are very low. Accordingly, provided the war uncertainty does not drag on for too long, and that the global economy shows some signs of improvement in the second half of the year, I would see scope for some modest upward progress in stockmarkets, while bond yields are likely to move up a little.

NM The prospect of lower short-term interest rates throughout the G7 area will certainly help prolong the bull market in bonds, at least for the first half of 2003. There is value at the short end of European markets as the ECB plays catch-up with the Fed and we expect yield curve flattening trades to prove profitable in those markets. The low point in global bond yields will likely be established later in 2003 when market concerns about rising bond issuance and widening budget deficits start to become dominant. In the meantime, there are sufficient uncertainties about global economic growth and worries about deflation to maintain downward pressure on bond yields. Equity market recoveries will derive some benefit from a low interest rate environment, but the main risk is the potential for earnings disappointment so volatility can persist.

JP Given the sustained US-led recovery, equities should stabilise and experience mild appreciation. In a low inflation environment, bond yields will stay low, but without the extra downward pressure on yields – upward pressure on prices – seen in 2002 as a result of a massive flow of funds from equities in search of a safe haven.

■ HOW DO YOU FORESEE UK PUBLIC SECTOR PAY DEMANDS IMPACTING ON PUBLIC SPENDING AND DO YOU ANTICIPATE ANY RESULTANT FUNDAMENTAL CHANGES IN UK FISCAL POLICY?

SB The government has to pay public sector workers more to expand public sector services. But it is being too hesitant about reforming the NHS and this will limit the benefits from extra spending. The fiscal deficit is likely to be much wider than is generally expected and taxes are likely therefore to go up. But the scale will be limited and we must not forget that a tax rise equal to 1% of GDP is already planned for 2003.

DK UK public finances are set to worsen at a much faster pace than forecast by the Chancellor in the last Budget. Larger fiscal deficits will be caused by lower than expected economic growth and weaker share prices. The Chancellor assumed GDP growth of 2-2.5% in 2002 and 3-3.5% in 2003. But more recent trends now suggest growth of only 1.5% in 2002 and 2.5% in 2003. In the case of share prices, the Chancellor assumed rises in line with growth in money GDP – that is, some 5% a year. However, share prices have fallen by more than 20% since early April 2002, and will remain below those levels, even if they recover next year.

As a result, Public Sector Net Borrowing (PSNB) will exceed Gordon Brown's Budget forecasts, by £5bn-£6bn in 2002/03 and by £10bn-£12bn in 2003/04.

More significantly, the current budget balance is also now forecast to move into deficit, and this could breach the Chancellor's 'Golden Rule', which permits borrowing only for investment.

Admittedly, there is no need for taxes to rise immediately, because the Golden Rule applies over the whole economic cycle, not in any single year. But, given the government's over-ambitious spending plans, adhering to the fiscal rules will very probably require taxes to rise from 2004 onwards. Higher public sector pay demands, and the accompanying labour militancy, should not have a major immediate impact on public finances. But higher pay settlements will dent the government's image of prudence, make it more difficult for the MPC to keep rates low and, in the longer term, increase the risk that the huge spending rises will fail to improve public services.

JL Despite one or two high-profile cases in recent months, I do not believe we are on the verge of an explosion in public sector pay that will do lasting damage to the public finances. There are few other groups of public sector workers who are likely to demand a 'catch-up' in pay on the scale of that sought by the fire service, and the government seems determined to resist such demands.

In any case, the Chancellor's latest spending review already allows for some decent annual increments in public sector pay over the next few years. A far more serious threat to the public finances is simply that the economy continues to disappoint compared with the fairly optimistic assumptions upon which the Chancellor's spending promises are founded. But even then, there is scope for borrowing to rise sharply without threatening the fiscal rules, so I do not expect any key changes to fiscal policy – in the form of large tax rises or cutbacks in spending – as a result.

NM I expect no change in the basic stance of UK fiscal policy, although the market may become worried about medium-term budget deficits and an increase in tax/GDP ratios. However, the Chancellor's fiscal stance is unlikely to require remedial action just yet. Pay demands will certainly escalate, but not to a degree in my view that upsets public spending plans or triggers an upsurge in broader measures of inflation.

JP The UK should continue to grow closer to trend than most other key economies, thanks to better macro management and micro flexibility. Fiscal prudence will be challenged but, given the low debt position achieved through the late 1990s, that challenge should be met without undue risks to the economy – provided a firm hand is maintained on public sector pay bargaining and recurrent expenditure.