# SIX WISE MEN

THE TREASURER'S SIX WISE MEN, WHO PROVIDE US WITH THE 'WHAT NEXT' FORECASTS EACH MONTH HAVE AGAIN BEEN ASKED TO PROVIDE THEIR FORECASTS FOR 2002. THE STATISTICAL FORECASTS CAN BE FOUND IN THE TABLE BELOW. THE WISE MEN WERE ALSO ASKED SOME KEY QUESTIONS:

- ☐ WHAT WILL BE THE MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2002?
- ☐ WHAT WILL BE THE IMPACT OF THE INTRODUCTION OF EURO NOTES AND COINS IN THE SHORT-TERM AND LONG-TERM?
- ☐ WHAT ASPECTS OF EUROLAND CONVERGENCE DO YOU THINK WE WILL SEE IMPACT THE UK ECONOMY IN 2002?
- ☐ WHAT WILL BE THE APPROPRIATE MIX OF FISCAL AND MONETARY POLICY FOR UK, EUROPE AND US OVER THE NEXT 18 MONTHS?

THEIR RESPONSES ARE GIVEN ON THE FOLLOWING PAGES.

| | | STEPHEN BELL | GILES KEATING | DAVID KERN | JONATHAN LOYNES | NEIL MACKINNON | JEREMEY PEAT |
|---|---|---|---|---|---|---|---|
| Forex rates at 31 Dec 2002 | € to £ | 1.54 | 1.61 | 1.52 | 1.45 | 1.54 | 1.59 |
| | ¥ to £ | 182 | 182 | 186 | 185 | 180 | 182 |
| | $ to € | 0.96 | 0.88 | 0.96 | 1.1 (*sic*) | 0.96 | 0.94 |
| UK annual rate of underlying inflation, by RPI (X) at 31 Dec 2002 (%) | | 2.2 | 2.5 | 2.5 | 2.0 | 2.2 | 2.1 |
| Lending rates at 31 Dec 2002 (%) | UK base | 4.5 | 5.0 | 5.0 | 4.0 | 3.5 | 4.25 |
| | US Federal funds | 3.0 | 2.0 | 3.0 | 2.0 | 2.0 | 2.25 |
| | Euro-repo | 2.75 | 2.75 | 3.75 | 2.5 | 2.75 | 3.25 |
| | Japanese discount | nil | 0.02 | 0.5 | 0.1 | 0.25 | 0.18 |
| 10-year yields at 31 Dec 2002 (%) | UK gilts | 4.6 | 4.6 | 5.1 | 4.5 | 4.5 | 5.8 |
| | US treasury | 4.3 | 3.95 | 5.0 | 4.3 | 4.75 | 4.5 |
| | German bunds | 4.5 | 4.25 | 4.9 | 4.4 | 4.0 | 4.5 |
| Annual average GDP growth in 2002 (%) | UK | 1.5 | 2.5 | 2.3 | 1.7 | 1.0 | 1.9 |
| | US | 0.0 | 0.2 | 0.9 | -1.0 | 1.2 | 0.5 |
| | Germany | 0.5 | 0.6 | 0.7 | 0.5 | 0.7 | 1.0 |
| | Euroland | 0.5 | 1.2 | 1.1 | 0.5 | 1.0 | 1.2 |
| | Japan | -1.5 | 2.0 | -0.7 | -1.0 | 0.5 | -1.0 |
| Stock market forecasts for 31 Dec 2002 | FTSE 100 | 5,900 | -0.7% | 5,800 | 5,000 | 6,000 | - |
| | Dow Jones | 10,400 | 6,350 | 10,100 | 9,000 | 10,500 | - |
| | Nikkei index | 11,400 | 11,600 | 10,800 | 10,000 | 11,800 | - |

**STEVEN BELL**
GLOBAL CHIEF ECONOMIST OF DEUTSCHE BANK ASSET MANAGEMENT

☐ **MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2002?** Terrorism is obviously a key factor, but the US consumer is the crucial economic factor. Rising unemployment will limit spending in the US but the world can survive a slowdown: a serious downturn would be more of a problem. For corporate spending it is important that companies arrest the free-fall in profitability. Business investment will be a casualty in this process.

☐ **IMPACT OF THE INTRODUCTION OF EURO NOTES AND COINS IN THE SHORT TERM AND LONG TERM?** For ordinary people this will signal the real start of EMU. I also expect significant benefits in terms of transparency and increased competition. Inflationary threats are overstated. Speaking personally, I will keep a stack of euro travellers cheques.

☐ **ASPECTS OF EUROLAND CONVERGENCE THAT WILL IMPACT ON THE UK?** The UK has been re-positioning itself away from the old empire and the US, towards Europe, for 30 years or more. This trend will continue. There is a 50% chance that the government will hold a referendum on the euro and an 80% chance, if it does, that the answer will be "no".

☐ **APPROPRIATE MIX OF FISCAL AND MONETARY POLICY?** The UK has a pre-planned fiscal stimulus but needs monetary stimulus too. Rates may well go lower than 4%. Europe has limited fiscal room for manoeuvre so should cut interest rates aggressively. The US has both fiscal and monetary policy on full steam ahead. This is the right policy until the economy responds, at which point interest rates should be pushed back up again. ☐

'THE WORLD CAN SURVIVE A SLOWDOWN: A SERIOUS DOWNTURN WOULD BE MORE OF A PROBLEM'

**GILES KEATING**
MANAGING DIRECTOR AND GLOBAL HEAD OF FIXED INCOME RESEARCH AND ECONOMICS AT CREDIT SUISSE FIRST BOSTON

☐ **MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2002.** Monetary and fiscal stimulus looks set to underpin worldwide recovery in 2002. But because Asia is so weak, the current cycle is likely to produce the lowest real global economic growth over any two-year period in the last 50 years. Spare capacity is widespread and slack has emerged in labour markets. These cyclical forces are compounded by the structural effect of the rapid rise in cheap Chinese exports, which seem set to play the disinflationary role in Europe and the US that trade with Japan played in the late 1970s and 1980s. The result is that nominal GDP growth will be very subdued even once the recovery is well underway, making it likely that profit expectations will be disappointed.

☐ **SHORT-TERM AND LONG-TERM IMPACT OF INTRODUCTION OF EURO NOTES AND COINS?** Even before the end of 2001, the euro is a reality for many retail activities. Petrol sales, utility bills and many other transactions are already denominated in euros. Bank accounts will mostly have switched to euro denomination well ahead of January 2002. And sample packs of euro notes are already on sale. This underscores the likelihood that fears of major disruption from the switchover are likely to prove as unfounded as were concerns over the Y2K. Long-term, the pricing of everything in euros rather than legacy currencies will boost price transparency and should reduce price discrimination by big producers across markets. More tentatively, the successful introduction of notes and coin may perhaps have an effect on sentiment in the UK towards the euro, where the existence of the single currency will only become a reality for many people once they start using it on journeys abroad.

☐ **ASPECTS OF EUROLAND CONVERGENCE THAT WILL IMPACT ON THE UK?** Aspects of Euroland convergence that will impact on the UK? The UK, like the euro area, is now in a phase of cyclical slowdown, but even so a growth gap is likely to remain in the UK's favour. The UK seems to have been less affected by the global slowdown – in some respects, it is actually less open than the euro area economy – and it has been quicker, and more successful so far, in offsetting its effects. Notably, the UK has more scope for large fiscal expansion, and is using this. Against that background, progress towards short rate convergence or a lower exchange rate is likely to be limited.

☐ **APPROPRIATE MIX OF FISCAL AND MONETARY POLICY?** Fed Funds seem headed down to 1 to 1.5%, while fiscal stimulus over 2001 and 2002 should amount to about 1.25% to 1.5% of GDP. Since very low interest rates can cause problems (notably for defined benefit pension schemes), it is good that part of the stimulus is coming from fiscal policy. But the ending of the previous political consenus on deficit reduction could become worrying if it leads to fiscal profligacy later. In Europe, further reductions are likely to see the ECB's repo rate fall significantly below 3% next year, while the scope for fiscal policy is limited and we envisage a stimulus around just 0.5% in 2001 and 2002 combined. This policy mix will probably be appropriate, though the stimulus is slightly late. The UK has much more scope and is using it. The fiscal stimulus in 2001 and 2002 will probably exceed 2%, higher even than in the US, and likely to be very helpful, alongside monetary policy, in staving off recession. ☐

'THE UK SEEMS TO HAVE BEEN LESS AFFECTED BY THE G LOBAL SLOWDOWN AND IT HAS BEEN QUICKER, AND MORE SUCCESSFUL IN OFFSETTING ITS EFFECTS'

**DAVID KERN**
KERN CONSULTING – FORMERLY CHIEF ECONOMIST AT NATWEST

☐ **MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2002?** The US-led anti-terror campaign. Further attacks against the US, or a collapse of pro-Western Muslim regimes, could weaken confidence, unsettle the oil market and damage recovery prospects. Even if US actions are successful, the global economy will have to adjust to the high-tech collapse and the sharp cutbacks in business spending.

Some other influences include the resilience of US consumers and their ability to sustain demand, while business retrenches. The ability of Japan, which already faces recession, to avoid a massive collapse. The ability of leading emerging market economies (notably Argentina, Brazil, Turkey and a few Asian countries) to avoid debt default and deep recessions. And the ability of euroland to improve its growth performance.

The nastiest effects of 11 September should be short-lived. But the world economy faces painful adjustments for 12-18 months, with below-trend growth and higher unemployment.

'IN THE UK AND THE US, INTEREST RATES SHOULD START EDGING UP IN SPRING 2002. IN EUROLAND, RATES SHOULD ONLY START RISING NEXT AUTUMN'

☐ **SHORT-TERM AND LONG-TERM IMPACT OF THE INTRODUCTION OF EURO NOTES AND COINS?** This is a huge and hazardous undertaking. One key risk is that the critically important public acceptance will be undermined, either by technical failures when the notes and coins are introduced, or by the euro's persistent weakness. However, if the introduction is successful, lingering fears over the euro's future would be removed and its status as the world's second key currency would be consolidated. In the longer term, the euro is set to strengthen against other currencies, as its role in global trade, reserves and capital markets increases. Notes and coins may also help to change UK attitudes.

☐ **ASPECTS OF EUROLAND CONVERGENCE THAT WILL IMPACT ON THE UK?** Two aspects are relevant. First, divergences within the euroland (between acute weakness in Germany and high inflation in Ireland, Spain and the Netherlands) will limit the ECB's ability to cut interest rates, dampen euroland growth and reduce demand for UK exports. Second, increased convergence (in terms of 10-year yields and GDP growth) between the UK and the euroland average will put pressure on the British government to conclude that the UK is near to meeting its five economic tests for joining the euro. However, UK public opinion may remain hostile, if euroland's poor performance highlights the disadvantages of a 'one-size-fits-all' monetary policy, which is inherent in joining.

☐ **APPROPRIATE MIX OF FISCAL AND MONETARY POLICY?** The sharp global slowdown, accentuated by the events of 11 September, requires further monetary easing. Over the next few months, I expect official interest rates to be cut to 1.5% in the US, 2.75% in the eurozone and 3.75% in the UK. The ECB, which has been too cautious, has the greatest scope for aggressive easing. Some fiscal expansion is also appropriate, particularly in the US.

But the scope for additional tax cuts or spending increases is limited. Fiscal expansion is difficult to reverse, and deficits can cause long-term damage. Both monetary and fiscal policies will have to become more restrictive in 2002. Policy easing in 2001 has rightly been sharp, to counter threats of recession, and it was necessary to take risks with future inflation. Therefore, policy will have to be tightened early in the upturn, even though 2002 growth will be below trend. In the UK and the US, interest rates should start edging up in spring 2002. In euroland, rates should only start rising next autumn. ☐

**JONATHAN LOYNES**
CHIEF UK ECONOMIST, CAPITAL ECONOMICS

☐ **MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2002?** As in 2001, the key influence on the UK next year will be the behaviour of the global economy. In an open economy like ours, this is paramount and will continue to have a dampening effect on activity at home. This should be partially offset, however, by the effect of this year's aggressive reductions in interest rates and any more we see early next year. Together with a fairly sizeable fiscal loosening, this should ensure that the UK fares relatively well in a very weak global environment.

☐ **IMPACT OF THE INTRODUCTION OF EURO NOTES AND COINS IN THE SHORT-TERM AND LONG-TERM?** In the UK, the short-term effects will be small, although they could be negative for sentiment towards the euro if concerns over teething problems are realised.

Longer-term, it is possible that UK residents will start to warm to the euro once they get used to handing it on holiday, as the enthusiasts are hoping. But I suspect that this will be outweighed by other factors such as continued worries about the ECB and the performance of the euro itself.

☐ **ASPECTS OF EUROLAND CONVERGENCE THAT WILL IMPACT ON THE UK?** At a cyclical level, the UK economy has already

' IT IS POSSIBLE THAT UK RESIDENTS WILL START TO WARM TO THE EURO ONCE THEY GET USED TO HANDLING IT ON HOLIDAY, AS THE ENTHUSIASTS ARE HOPING' moved closely into line with euroland in the past several years. Although we expect UK growth to outperform that in Europe next year, there is a good chance that the gap between UK and euroland interest rates will narrow further as inflation remains lower in the UK and the MPC continues to act more aggressively than the ECB.

□ **APPROPRIATE MIX OF FISCAL AND MONETARY POLICY?** In a major global slowdown of the type underway, the appropriate stance of all types of policy everywhere is loose – the mix is of secondary importance. Still, the strong budgetary positions of the UK and US suggest that fiscal policy should do much of the work in those areas and that is indeed what current tax and spending plans allow for.

This should not come at the expense of lower interest rates, however, particularly in the UK where a key consideration should be a weaker exchange rate. In Europe, stability pact considerations suggest that lower interest rates will have to be the key defence against the global slowdown – ECB willing! □

**NEIL MACKINNON**
SENIOR CURRENCY STRATEGIST AT MERRILL LYNCH

□ **MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2002?** The global economic downturn that started in 2001 is likely to extend well into 2002 despite an aggressive loosening of US monetary policy.

Lower oil prices also provide support. However, the unwinding of US corporate debt is likely to act as a restraint on the economy and so growth expectations look disappointing.

□ **IMPACT OF THE INTRODUCTION OF EURO NOTES AND COINS IN THE SHORT-TERM AND LONG-TERM?** Short term, it is unclear just how quickly the convergence process will be successfully completed throughout the eurozone. There may be some teething problems initially. Long term, the euro becomes accepted as a real currency.

□ **ASPECTS OF EUROLAND CONVERGENCE THAT WILL IMPACT ON THE UK?** There is likely to be some convergence between growth, inflation and interest rate differentials reflecting the global slowdown. However, structural convergence still looks slow, which makes the UK entry into the euro uncertain.

□ **APPROPRIATE MIX OF FISCAL AND MONETARY POLICY?** UK – loose money, loose fiscal. Europe – loose money, neutral fiscal. US – neutral money, loose fiscal. □

‘THE UNWINDING OF US CORPORATE DEBT IS LIKELY TO ACT AS A RESTRAINT ON THE ECONOMY AND SO GROWTH EXPECTATIONS LOOK DISAPPOINTING’

**JEREMY PEAT**
GROUP CHIEF ECONOMIST, THE ROYAL BANK OF SCOTLAND

□ **MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2002?** Developments in the US will be the prime determinant of how the global and UK economies progress next year. I expect recovery in the US economy to be underway in the first months of 2002. That should include a return to consumer confidence, followed by some recovery in business confidence and a pick-up in investment. Unfortunately, it is difficult to see either the eurozone or Japan as independent positive influences – at least until US recovery commences.

□ **IMPACT OF THE INTRODUCTION OF EURO NOTES AND COINS IN THE SHORT-TERM AND THE LONG TERM?** In the very short-term, there is a risk of disturbance as notes and coins come into retail use, legacy currencies are withdrawn and all systems transform. Thereafter, there should be a marked increase in transparency, yielding some efficiency gains and stimulating, potentially, an acceleration of the single market process. For at least some sectors, decisions first on purchase then on production should be increasingly based on the most cost-effective location.

‘THE GAP BETWEEN UK AND EUROLAND INTEREST RATES WILL NARROW FURTHER AS INFLATION REMAINS LOWER IN THE UK AND THE MPC CONTINUES TO ACT MORE AGGRESSIVELY THAN THE ECBA’

□ **ASPECTS OF EUROLAND CONVERGENCE THAT WILL IMPACT ON THE UK?** If there is a more dynamic phase for some eurozone traded sectors, following the introduction of notes and coins, then there should be opportunities for UK companies to take advantage of flux and gain market share. Also there is likely to be some increase in the extent to which euroland companies prefer tendering and invoicing in euros through the supply chain, pressing for more transfer of exchange rate risk to third country relationships.

□ **APPROPRIATE MIX OF FISCAL AND MONETARY POLICY?** In the UK, the extent of fiscal loosening should be limited – permitting the ‘automatic stabilisers’ to operate but not entering into any additional public expenditure commitments. The main stabilisation should come via monetary policy – and there should be scope to further reduce the repo if US recovery is delayed. In Europe the stability and growth pact limitation of deficits to 3% of GDP looks set to become an increasing constraint in some lower growth economies, unless the ECB adopts a more active policy. In the US, the fiscal easing, at least on the scale recently introduced, should be time-limited, with a return as soon as feasible to a balanced budget. As in the UK, the central bank and monetary policy should be the main means of policy intervention and economic stabilisation. □