FIVE WISE MEN REPORT

WHAT LIES AHEAD FOR THE WORLD ECONOMIES IN 2004? HOW WILL THE MAIN CURRENCIES PERFORM? AT THE END OF A TURBULENT YEAR WE ASKED FIVE OF THE UK'S FOREMOST ECONOMISTS FOR THEIR PREDICTIONS...

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WHAT WILL BE THE MAJOR INFLUENCES ON ECONOMIC CONDITIONS IN 2004?

STEVEN BELL The biggest uncertainty in projecting 2004 is Asia, which is currently exerting a crucial influence on the global bond market and which will play an important, albeit reluctant, role in this Presidential election year. Asia's economic outlook is more uncertain than the US, but the latter, as ever, is a key influence. Continental Europe is trapped in a narrow range of sluggish growth, low interest rates and low inflation and should not produce serious surprises. In the UK, the Chancellor must grapple with a fiscal cycle moving rapidly into negative territory after years of surpluses, as higher taxes fail to reduce a deficit that looks increasingly out of control.

Japan produced the biggest growth surprise in both 2002 and 2003. The economy is showing the benefits of years of slow but steady structural adjustment to deep-seated problems. Serious negatives remain in the form of adverse demographics and an unsustainable fiscal deficit, but companies are cashflow positive, equity valuations have improved and the drag from deflation is easing. There are plenty of opportunities for things to go wrong, but my best guess is that Japan will again confound the pessimists by delivering another year of slow steady growth. In the rest of Asia, China has moved rapidly from deflation to over-heating and when an economy is growing at 8% a year, accidents are not only possible, but almost inevitable. For the rest of Asia and the region in general things are generally improving: India is one important bright spot.

President Bush is fully aware that the biggest threat to his re-election chances is the dire performance in the labour market, where his record on jobs is the worst for any president seeking re-election since Hoover, 70 years ago. Even if his advisers believe it is wrong, protectionism and a weak dollar policy are an obvious response to the jibe from the Democrats that three million jobs have been lost in manufacturing since he took office. We can only hope that this does not produce a dollar collapse, dumping of US treasuries and a lose-lose situation for both the US and Asia.

GILES KEATING Fuelled by expansionary monetary and fiscal policy, and with an enormous extra fillip from Chinese demand, the world economy is now firmly sloughing off the drag from earlier over-investment and entering into a phase of reasonably robust growth. The relationship between this economic recovery and the timing of US Federal Reserve tightening will be crucial in 2004. Monetary

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Forex rates at 31 Dec 2004	€ to £ ¥ to £ $ to £	1.39 175 1.75	1.4 189 1.66	1.4 185 1.68	1.23 205 1.72	1.41 174 1.70
UK annual rate of underlying inflation, by RPI (X) at 31 Dec 2004 (%)		2.5	2.5	2.5	2.0	2.5*
Lending rates at 31 Dec 2004 (%)	UK base US Federal funds Euro-repo Japanese discount	4.0 1.0 2.0 0.0	4.0 1.0 2.0 0.0	4.5 1.75 2.5 0.25	4.0 1.0 2.0 0.1	4.75 2.5 2.0 0.1
Annual average GDP growth in 2004 (%)	UK US Germany Euroland Japan	3.2 3.7 1.6 1.9 2.3	2.8 3.9 1.9 2.0 1.3	2.5 3.9 1.7 1.3 1.9	2.3 3.0 0.8 1.0 1.4	3.0 4.0 1.5 1.6 1.7
Stock market forecasts for 31 Dec 2003	FTSE 100 Dow Jones Nikkei index	4,600 10,500 11,000	4,750 1,050 (SPX) 900 (TOPIX)	4,850 11,000 11,650	4,500 10,200 12,000	- - -
10-year yields at 31 December 2004 (%)	UK Gilts US Treasury German Bunds	4.9 4.0 4.1	4.9 4.0 4.0	5.2 4.7 4.6	4.7 4.5 4.5	5.2** 4.6 4.4

**Average RPIX inflation rate in Q4 2004 **UK 10-year swap rate, average in Q4 2004.*

'STRONG AND SUSTAINED GLOBAL RECOVERY IS UNLIKELY, AND MEDIUM-TERM GROWTH WILL REMAIN SUBDUED'

policy has been quite deliberately set to a very expansionary stance for well over two years, especially in the US, and with the recovery now well under way, the continuation of easy money helps to underpin equity markets. Expansionary monetary policy was essential in the depths of the recession, when deflation risk loomed. However, with the economy now improving markedly, the risk is increasing of a new bubble in equity markets, fuelled by excess liquidity, which could then reverse very rapidly once it becomes apparent that Fed monetary tightening is imminent.

DAVID KERN Geopolitical constraints, such as fears of new acts of terrorism, political and trade tensions between the US and its allies, the aftermath of the Iraq war and the threat of regional conflicts, will all remain serious potential constraints, limiting the scale and duration of any global recovery.

The ability of the US economy to sustain faster growth, in the face of persistent and huge imbalances (too much debt, excess capacity, a huge external deficit, and inadequate savings), will remain the most important factor determining global conditions in 2004. US statistics remain positive and short-term prospects have improved as US growth forecasts are being upgraded. But the huge US budget and trade deficits are worsening. Fears of a US 'jobless recovery' could have adverse political consequences for President Bush. Looking ahead, a cyclical upturn is probable in the next six to nine months. But strong and sustained global recovery is unlikely, and medium-term growth will remain subdued.

A number of other questions need to be addressed. First, can Japan sustain its surprisingly strong recent upturn without radical measures to tackle the huge bad debts in its banking and corporate sectors? The recent rebound is largely cyclical and Japan's fundamental problems remain unresolved. On balance, a new recession should be avoided, but growth will slow again in 2004.

Second, will the eurozone demonstrate the ability to improve its anaemic growth performance, and assume its proper responsibility

'THE MOMENTUM WILL FADE AS THE YEAR PROGRESSES BECAUSE OF THE HUGE IMBALANCES STILL EVIDENT IN THE AFTERMATH OF THE EQUITY MARKET BUBBLE'

as a major force in the global economy? In spite of modest progress, the reform process remains timid and inadequate, particularly in Germany and France. The Growth & Stability Pact remains an obstacle to faster growth, and it remains to be seen whether the ECB will be prepared to adopt more flexible policies. On balance, I expect modest but disappointing improvement in the eurozone.

Finally, will China, India and other Asian economies make a significant contribution to global recovery? Asia's forex reserves have recorded spectacular growth, and the relationship between the US dollar and the yen and renminbi has become a critical issue. China will strongly resist a 'mega' revaluation of the renminbi, but a gradual strengthening of the Chinese currency is highly likely. On balance, Asia's rapid growth will continue in 2004, but the pace will slow and the region still remains over-dependent on the US.

JONATHAN LOYNES The performance of the UK economy will continue to depend heavily on the international environment and, in that respect, a key question for the year ahead will be whether the apparent pick-up in activity in the US in recent months will develop into a full-blown recovery or fade away again, as with several 'recoveries' in the past few years. My guess is that the momentum will fade as the year progresses because of the huge imbalances still evident in the aftermath of the equity market bubble.

The other key question for 2004 is how far and how fast the UK housing market slows. Most commentators expect some downturn, but just how severe it will be could have a major bearing on the shape and strength of the overall economy. I believe that the consensus view of the very soft landing is probably too complacent. After the enormous price gains of recent years, to escape with a gradual slowdown in house price inflation, but no falls in prices, would seem to be overly optimistic. And when it comes to the housing market, history suggests that it pays to make cautious assumptions, not optimistic ones.

JEREMY PEAT The key question remains the sustainability of the US bounce-back. It would also be excellent news, for the medium-term outlook, if the pace of structural reforms at the core of the eurozone were to be accelerated, preferably associated with reform of the Stability & Growth Pact and a more pre-emptive ECB under its new Governor, Jean-Claude Trichet. Signs of renewed vigour in Germany and France would make me more optimistic about the global growth outlook and would also help to unwind global imbalances, particularly the troublesome US external deficit. Otherwise, there is a major risk of destabilising volatility in key exchange rates, and also a risk of growing US protectionism in a Presidential election year.

Domestically, I am looking for a soft landing for consumer demand and the housing market, without undue intervention from the Monetary Policy Committee (MPC), coupled with a marked pick-up in business investment, as UK businesses respond to the global recovery and improving balance sheets.

■ HOW DO YOU EXPECT THE EURO TO PERFORM IN RELATION TO STERLING AND THE US DOLLAR IN 2004?

SB The euro is likely to appreciate significantly relative to the US dollar and to a smaller degree against sterling during the course of 2004. Despite the superior economic fundamentals in the US, the wide current account deficit and the Bush administration's 'weak dollar' policy mean that the euro is likely to see further strength. Sterling remains particularly firm since the UK has the highest interest rates of any major country and is raising them.

GK Sterling has seen significant strength in late 2003, reflecting the UK economic cycle being significantly ahead of that in the eurozone. This is likely to be reversed during 2004, as the euro zone economic upswing gradually catches up with that in the UK. Meanwhile, the dollar has tended to be weak against the euro in late 2003, reflecting the US administration's soft dollar policy, which has mostly affected Europe, since China has resisted an early rise in its currency and Japan has acquiesced in only a small move. This is likely to change during 2004. China should accept some revaluation, so although the dollar's overall trade-weighted level is likely to continue to decline, this would now be mainly against Asia rather than Europe.

DK The performance of the euro over the next 18 months will be driven by trade and investment linkages between the US, Asia and Europe. However, market sentiment, momentum and even fashion, can play an important role in determining currency values, and this can sometimes overwhelm the fundamentals.

The fundamentals will not change materially in 2004. The US external deficit will remain huge, while US growth will remain considerably stronger than in the eurozone. As for the mood of the markets, I expect concern with the external deficit to predominate until the middle of 2004. Thereafter, however, relative growth considerations will probably assume greater weight. Against this background, I expect on balance the euro to strengthen further over the next year against both the dollar and sterling. But the rise in the euro will be less pronounced than over the past 15 months. Moreover, after peaking around mid-2004, I expect the euro to ease slightly in the second half of next year, although it is likely to end 2004 slightly stronger than at present.

JL I think the euro can continue to strengthen in 2004. That is not an endorsement of the eurozone economy's likely performance, however. Rather, it reflects the still massive deficit on the US current account – close to 5% of GDP – which, in turn, suggests that a further depreciation of the US dollar is both needed and likely. Official policy on this issue has been confused recently, with conflicting signals from the US administration over whether its 'strong dollar' policy is still in place. But, ultimately, the economic fundamentals will determine the path of the dollar, not the policymakers.

JP I expect the euro to appreciate against both currencies next year. This is based on three factors: an anticipated strengthening in the eurozone recovery from the beginning of 2004; continued progress in structural reforms; and the impact of widespread dollar weakening as concerns grow about the sustainability of the US current account deficit.

'THE PACE AT WHICH GOVERNMENT SPENDING IS BEING INCREASED IS TOO RAPID FOR ECONOMIC EFFICIENCY AND THE DEGREE OF REFORM TOO SLOW'

WHAT IS, IN YOUR VIEW, AN APPROPRIATE MIX OF FISCAL AND MONETARY POLICY FOR THE UK, EUROPE AND THE US OVER THE NEXT 18 MONTHS?

SB The concept of an 'appropriate mix' of fiscal and monetary policy is much overrated in my judgement. With inflation low almost everywhere, and too low in some countries, monetary policy should remain loose. In Europe and Japan, where fiscal policy is on an unsustainable course, monetary policy could be eased further if serious action to reduce spending were undertaken. As the tax cuts end in the US during 2004, the Fed may yet ease further, but this would merely be a response to overall macro conditions. The UK's expansionary fiscal policy is not an immediate problem for the MPC, but it does mean interest rates will go higher than they would normally. The pace at which government spending is being increased is too rapid for economic efficiency and the degree of reform too slow. But given this pace of spending increase and the overall health of the economy, there is no case for borrowing to finance this expenditure. Unfortunately, for taxpayers, we believe that the budget deficit should be held to 1%-2% of GDP over the next couple of years. Monetary policy need not be 'mixed' with fiscal policy in this environment, but should continue to target inflation. This will involve increases in base rates, yet the scale is likely to be modest, given the acute sensitivity of the British consumer to short-term interest rates. Europe has a more difficult and constrained policy environment. The Growth & Stability Pact requires France, Germany and a number of other EU countries to reduce their budget deficit. This is an unattractive outcome for an economy growing sluggishly, with unemployment high. It also points to a lax monetary policy environment, although this is constrained by the persistent failure of inflation to head clearly below the 2% limit. Nonetheless, an easy money policy is the best approach for the ECB.

GK The years of fiscal probity have come to an abrupt end, with government deficits in almost all major nations swelling, even after adjustment for cyclical effects. This fiscal stimulus has, of course, been accompanied by expansionary monetary policy.

As economic recovery progresses into 2004 and beyond, it would certainly be desirable if a significant part of the necessary policy tightening could come about through contractionary fiscal policies, reducing the extent to which interest rates had to rise. But the actual outcome is likely to be different, with fiscal deficits likely, at best, to be cut by only a very narrow margin, at least in cyclically adjusted terms, eventually pushing more of the burden of tightening onto the central banks.

DK In the UK, as the cyclical upturn gathers momentum gradually, further policy easing is clearly no longer appropriate. In an ideal world, the correct response would be to start tightening fiscal policy as soon as possible, but this must be done through scaling down the swelling upsurge in public spending, and definitely not through tax increases, which would be highly damaging to the economy. Fiscal restraint would make it possible to delay for as long as possible any interest rate increases, therefore helping to sustain the increased competitiveness of UK exports, by avoiding upward pressure on sterling. Unfortunately, the political realities preclude any significant restraint on public spending growth. During 2004, we will probably see a combination of modest interest rises and moderate tax increases.

The US requires fiscal tightening through spending cutbacks, and only a modest and gradual increase in official interest rates, to avoid putting undue upward pressure on the dollar. However, early spending cuts are unlikely. Indeed, additional tax cuts are possible. Monetary policy is set to remain easy, and this means that the overall policy stance may be too expansionary in 2004 and the current account deficit may balloon further.

In the eurozone, the correct policy stance is to ease initially monetary policy, while maintaining a neutral fiscal stance during the first half of 2004, even if the 3% limits of the Stability & Growth Pact are breached. Eurozone growth is still too low, particularly in Germany, and although sustained recovery depends on structural reforms, domestic demand is too weak and there is no case for early policy tightening. However, in the second half of 2004, modest interest rate rises, and a degree of fiscal restraint would be appropriate. Unfortunately, much-needed monetary easing is questionable in the near term, and there is a risk that eurozone official interest rates may start increasing in 2004, earlier than is appropriate.

JL Given the worsening fiscal position of all three areas, a combination of tighter fiscal policy and looser monetary policy would seem to be the ideal prescription. However, the scope for such a policy mix is limited by the fact that, in the US at least, there is little scope for loosening monetary policy further. It is not really the precise mix of policy that is important, however, but rather the overall stance. After several years of below-trend growth and benign inflation pressures, my advice to policymakers would be to keep policy very loose until they are sure that a solid and sustainable recovery in the world economy is under way. Pushing rates up too soon in anticipation of future inflation that may never appear could threaten to snuff out the upturn before it really gets going.

JP Given substantial spare capacity in labour and capital markets, policy in the US should remain highly accommodative for some time to come – with the Fed Funds rate on hold until the second half of 2004. Fiscal policy needs some tightening within the 18 months' timespan, but in a Presidential election year that may be unduly deferred.

Given the limited signs of any upswing in the eurozone, interest rates need to stay at 2% – or below if the euro markedly appreciates – for a lengthy period, probably throughout 2004. Next year is not the time to tighten fiscal policy, despite what the Stability & Growth Pact says.

Economic policy should also stay accommodative in the UK, where there are no real signs of inflation pressure. Interest rates should rise but only gradually next year. The fiscal stance should similarly continue to support growth, although there will be a requirement before too long to limit the growth rate of public expenditure and government will have to keep a close watch on cost pressures and service delivery.