

GROWTH IS SET TO STRENGTHEN IN THE NEXT SIX TO NINE MONTHS BUT POWERFUL OBSTACLES MAY PRODUCE A RENEWED SLOWDOWN IN 2004, SAYS DAVID KERN OF KERN CONSULTING.



PROSPECTS FOR A SHORT-TERM RECOVERY

Risks of recession and deflation have subsided, and a cyclical upturn is probable in the next six to nine months, but a strong and sustained global recovery is unlikely, and medium-term growth will remain subdued. In the UK, growth prospects have improved. However, overall, performance remains mediocre, and sharply worsening public finances highlight serious medium-term risks for the economy.

THE GLOBAL BACKGROUND. Indications of a global recovery have become more pronounced in recent months, particularly in the US and Japan. The improvement in Japan's short-term fortunes has been particularly dramatic, but the upgrading in US prospects is the key factor explaining the renewed hopes for the global economy. Global stock markets have recovered considerably since the March rally, as risks of recession and deflation have diminished, and bond yields have risen.

The current global cyclical upturn will probably gather momentum in the next six to 12 months. However, a strong and sustained global recovery is, on balance, unlikely, and medium-term growth will probably remain subdued, even if the short-term rebound in activity is robust. The critical fact is that geo-political and economic factors will limit the recovery in the medium term. The main dampening factors are: too much indebtedness, excess capacity, large budget and external deficits, trade tensions, currency instability, and fears of terrorism. The failure of the Cancun world trade talks, coupled with renewed trans-Atlantic trade disputes, will heighten global risks.

THE US, THE EURO ZONE AND JAPAN. US statistics are positive, and growth forecasts have been raised. But the huge US budget and trade deficits are worsening, while fears of a 'jobless recovery' in the US, driven by impressive productivity increases, could have adverse political consequences for President Bush. In the euro zone the economy is still weak, with Germany in particular facing difficult problems. In the second quarter of this year, GDP fell in Germany, France, Italy and in the euro zone as a whole. Survey indications of an early euro zone upturn are not yet confirmed by hard euro zone figures. Even so, hopes of stronger growth have also firmed in Europe. Japan's GDP growth in the second quarter of 2003, both quarterly (3.9%) and year on year (3%), was higher

than in the other G7 countries. However, this welcome rebound is largely cyclical. Japan's fundamental problems (deflation, bad debts and adverse long-term demographic trends), which are serious obstacles to long-term sustained recovery, remain unresolved. Japan is still suffering from the consequences of the early 1990s stock market bubble, primarily huge debts in the banking and corporate sectors.

CHINA, DEVELOPING ASIA AND OTHER EMERGING ECONOMIES. East and south Asia will remain the fastest growing global region. A rapidly expanding China is driving Asia's impressive economic dynamism, and, in spite of many economic and political risks facing China, its strong growth performance is likely to continue. Meanwhile, India is also gradually emerging as an economic giant, while South Korea and other regional economies are becoming increasingly important and assertive. Asia's forex reserves have registered spectacular growth in recent years and the relationship between the US dollar and the two largest Asian currencies (yen and renminbi) has become a critical global issue. Russia is set to continue performing strongly over the next year, but the economy remains unduly dependent on high oil prices, and

	ACTUAL		FORECASTS	
	end-2002	7-11-03	mid-2004	end-2004
UK Base Rate	4.00%	3.75%	4.25%	4.50%
US Fed Funds	1.25%	1%	1.50%	1.75%
ECB Rate	2.75%	2%	2%	2.50%
\$ per £	1.61	1.67	1.72	1.68
£ per euro	0.652	0.687	0.727	0.714
\$ per euro	1.05	1.15	1.25	1.20
Yen (100s) per \$	1.20	1.10	1.08	1.10

the forthcoming parliamentary and presidential elections may heighten Russia's political risks. In Latin America, growth will remain considerably slower than in Asia. However, regional giants Brazil and Mexico will make progress, and there are realistic hopes that the position in Argentina will stabilise.

INTEREST RATES AND CURRENCIES. Official interest rates are near their cyclical lows, although in the euro zone there is a case for a further modest cut. In the US and the UK, the next move is likely to be upwards, but rises will be gradual and modest. In contrast to official rates, longer-term bond yields have risen markedly, and further increases are likely, although at a more modest pace than in recent months. The fall in the US dollar has dominated the forex markets in 2003. Given the concern over the huge US external deficit, further dollar falls, mainly against the yen and the euro, can be expected over the next six to nine months. Tensions over alleged Asian currency undervaluation will persist. But while China will strongly resist a huge (20%-25%) revaluation of the renminbi, a gradual (5%-10%) strengthening of the Chinese currency is highly likely.

UK BACKGROUND. Major revisions to the UK national accounts show better than expected growth in the first half of 2003, and satisfactory growth (0.6%) in the third quarter. The scale of the revisions makes it difficult to interpret economic trends. On balance, UK growth is forecast at 2% in 2003 and 2.5% in 2004 (after 1.7% in 2002), stronger than in the euro zone. While it is possible that the Budget forecasts for 2003 GDP growth would just be met, UK public finances are worsening sharply.

Public sector net borrowing (PSNB) could total £38bn in 2003/04, some £11bn above the Budget estimate. With the deficit set to widen further, tax rises totalling some £10bn-£15bn will be needed in the next two to three years, to avoid breaking the Chancellor's fiscal rules. UK manufacturing still faces difficult structural problems, some global and some more specific to the UK. After falling 1.3% in 2001 and 3.6% in 2002, manufacturing output is likely to show zero growth in 2003, and expand 1.9% in 2004.

UK base rate will continue rising, but increases over the next year will be modest. Official rates rose to 3.75% in November 2003, and should reach 4.25%-4.50% by end 2004. Gilt yields, while still relatively low by historical standards, will also edge up further over the next year, but the scale of the increase will be less than the sharp increase seen in recent months. I expect sterling to strengthen against the dollar and weaken against the euro in the next few months. Thereafter, the pound is likely to ease slightly against both the dollar and the euro in the second half of next year, but should still end 2004 marginally weaker than at present. An early referendum on UK euro entry is extremely unlikely. A decision will almost certainly be postponed until after the next General Election at the earliest. Overall, UK prospects remain benign in the short term, but long-term risks persist: high spend and high tax, pensions shortfalls, housing bubble, low skills, low productivity, weak manufacturing, large external deficit and labour disputes.

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'THE CRITICAL FACT IS THAT GEO-POLITICAL AND ECONOMIC FACTORS WILL LIMIT THE RECOVERY IN THE MEDIUM TERM'

FIGURE 1
 GDP MAJOR ECONOMIES % GROWTH

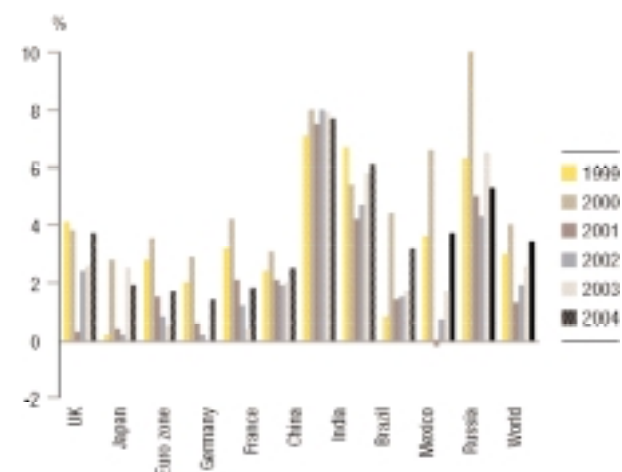


FIGURE 2
 UK GDP ANNUAL AVERAGES % CHANGE YEAR ON YEAR

