SENDING OUT AN SOS

WEAK STOCK MARKETS, THE PROSPECT OF A WAR WITH IRAQ, HIGH OIL PRICES AND FALLS IN SHARE PRICES ARE JUST THE TIP OF THE ICEBERG, SAYS **DAVID KERN** OF KERN CONSULTING.

Last year ended on a gloomy note, with weak stock markets and high oil prices. Falls in share prices ranged from almost 35% in Germany, 25% in the UK, and some 17% in the US. Acute concerns over a war in Iraq have been accentuated by oil price rises to $30 per barrel. But worries over the general economic outlook, coupled with anxieties over the threat of new acts of terrorism, have also dampened confidence.

Recession and instability are clearly genuine risks. However, a major global downturn is unlikely. Indeed, 2003 and 2004 may see slightly stronger growth than the dismal 2001 and 2002 outcomes. But, overall, economic performances will be mediocre and below-trend. In particular, weak balance sheets, and bad debts in the banking and insurance sectors, will limit economic growth. A major financial crisis is unlikely in the Western economies. But governments and central banks will have to be vigilant in case the situation worsens.

THE US. Growth is set to remain stronger than in Japan and Euroland, both in 2003 and in the medium term. But there is renewed unease over whether the huge US imbalances (for example, massive debt, over-capacity, huge external deficit) can be corrected without a 'hard landing'. Against this background, collapsing share prices, a dollar crash, and a US recession cannot be ruled out. But, given the basic resilience and flexibility of the US economy, outright declines in activity will probably be avoided. The more likely outcome is a gradual correction, entailing below-trend (but still positive) growth over a period of years.

The policy of aggressive monetary easing, which the Fed has pursued since early 2001 played a major role in sustaining US consumer demand. But, following the recent unprecedented cut in the Fed Funds rate, to 1.25%, US official interest rates are set to remain around present levels for about six months. Rates should then edge up gently in the final months of the year, to reach a level of some 2.50% by the end of 2003, still very low by historical standards. The recent fall of the US dollar, to a level well below parity with the euro, highlights growing market anxiety that the huge US current account deficit is becoming unsustainable, at a time when foreign capital inflows into the US are falling steadily. A dollar crash, particularly against the euro, cannot be ruled out. But it seems more likely that the dollar will continue easing gradually over the next few months.

One key uncertainty is whether the over-indebted US consumer will be able to continue spending until businesses are ready to start investing. The answer is by no means clear, and the correction may be painful. My central forecast is that US GDP will grow 2.6% in 2003 and 3% in 2004, after 2.3% in 2002. While this is well below the US's growth potential, it still compares very favourably with the expected performance of Euroland and Japan. But, whatever the immediate uncertainties, the US's economic dominance (and the world's reliance on the US) will increase further in the future. Neither Japan, nor Euroland, nor China, can replace the US's leading role as global locomotive. If the outcome is more pessimistic than my central scenario envisages (and an outright US recession proves

FIGURE 1

THE WORLD'S MAJOR ECONOMIES 2000-04.

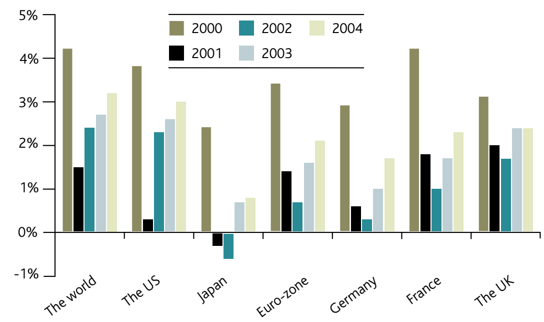
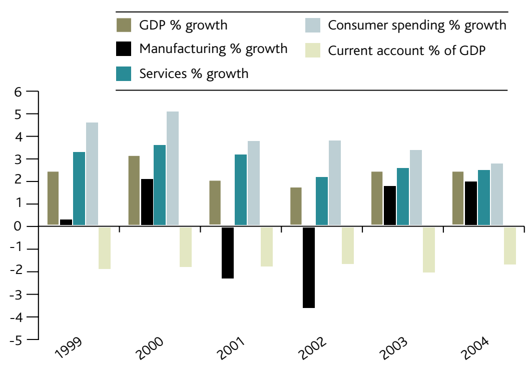


FIGURE 1

BRITAIN'S TWO-SPEED ECONOMY 1999-2004.



unavoidable), the damaging effects on Asia, Latin America and Europe would be much greater than on the US itself.

OTHER MAJOR ECONOMIES. Euroland growth is forecast to remain feeble, only 1.6% in 2003 and 2.1% in 2004, after a negligible 0.7% for 2002. This is particularly disappointing and lacklustre for an economic giant, which equals the US in size and wealth, and is not burdened by indebtedness and capacity constraints. Within Euroland, growth remains particularly low in Germany, only 0.3% in 2002 and 1% in 2003. But France and Italy are also expected to see growth of less than 2% in 2003, and any improvement in 2004 will be limited. One of the main factors hampering Euroland's performance is an unduly slow and inadequate pace of reforms. Euroland is committed to a misguided 'social model', which entails rigid labour and product markets, coupled with high social costs and a damaging lack of competitiveness. The inevitable result is low growth, lack of competitiveness and high unemployment.

Europe is further constrained by adherence to unjustifiably tight fiscal and monetary policies. Although the European Central Bank (ECB) cut its key interest rate in December to 2.75%, with additional modest cuts likely in the first half of 2003, policy has generally been too restrictive. More significantly, the Growth and Stability Pact forces members to increase taxes and cut spending just when the dangers of recession are at their worse. At a time when there are new risks of recession and deflation, primarily in Germany, Euroland's policymakers still appear unduly concerned with inflation and budget deficits. The recent rise in the euro is a welcome symbolic boost to the single currency, but threatens export competitiveness.

In Japan, the deep recession is ending. But the economy is set to stay weak, suffering from deflation, excessive debt in its banking and corporate sectors, and a rapidly ageing population. The recovery will be anaemic, and the best that can be hoped for is negligible growth of less than 1% in both 2003 and 2004, after outright GDP declines in 2001 and 2002. The stronger yen dampens export growth, while domestic demand remains hampered by deflation. With interest rates almost at zero and with a huge budget deficit, there is only limited scope for using conventional tools for stimulating activity. Prime Minister's Koizumi's leadership has so far been a disappointment. He has failed to address the huge bad debt problem that paralyses the financial system and worsens the deflationary pressures.

BRITAIN FACES NEW DANGERS. Economic performance has been reasonably satisfactory in 2002, and most consensus forecasts for 2003 suggest benign (albeit mediocre) prospects. I expect GDP growth of 2.4% in both 2003 and 2004, broadly in line with trend, after 1.7% in 2002. Britain is enjoying historically low unemployment and interest rates, with modest (but gently rising) inflation, and our growth is set to remain stronger than in other major European economies. Even so, the mood in the UK remains gloomy. Most immediately, there are heightened concerns over global terrorism and a war in Iraq. But there are also acute anxieties over the housing market bubble, worsening labour disputes, and excessive increases in taxes and public spending. It is unlikely that we will see a housing market crash, a sterling crisis, loss of budgetary control, or wild strikes. But the more realistic fear is that these problems will gradually worsen and the UK's position will be weakened in the longer term.

Consumer spending will remain the UK economy's main growth engine. But with the housing market cooling and the personal debt burden rising, consumer spending growth should slow gradually, from 3.8% in both 2001 and 2002, to 3.4% in 2003 and 2.8% in 2004. There is also realistic hope that manufacturing, after declining sharply in 2001 and the first half of 2002, is now stabilising and will recover modestly in 2003 and 2004, benefiting from a weaker pound against the euro. But growth in services, although moderating, will remain more robust.

TABLE 1
CURRENCIES AND INTEREST RATES END-2002 TO END-2004.

	ACTUAL	FORECASTS		
	end-2002	mid-2003	end-2003	end-2004
UK Base Rate	4.00%	4.00%	4.75%	4.50%
US Fed Funds	1.25%	1.50%	2.50%	3.00%
ECB Rate	2.75%	2.50%	3.00%	3.50%
$ per £	1.61	1.60	1.53	1.47
£ per euro	0.652	0.669	0.673	0.667
$ per euro	1.05	1.07	1.03	0.98
Yen(100s) per $	1.2	1.24	1.28	1.22

BASE RATE AND EURO ENTRY. A further Base rate cut, while possible if global risks worsen, is unlikely – given the concern over the housing market boom and higher Government borrowing. Given the conflicting pressures facing the MPC, I expect the Base rate to remain at 4% over the next four to six months, and then edge up to 4.50%-4.75% in the final months of 2003, as activity strengthens. Uncertainty over euro entry remains an unsettling factor, but there is growing consensus that a referendum will be delayed, at least until after the next General Election. It is extremely difficult to make a conclusive economic case supporting early entry, and a referendum appears unwinnable in the near future.

CONCLUSIONS.

- While global economic performance will be mediocre and below-trend, 2003 will see slightly stronger growth, with oil prices falling later in the year.
- Although the US faces serious problems, its growth (and also that of the UK) will be stronger than in Euroland and Japan.
- US economic dominance and world reliance on the US will increase further.
- China and East Asia outside Japan are a new centre of global gravity.
- Official interest rates will remain at historically low levels, falling further in Euroland, and rising modestly in the UK and the US.
- A dollar crash is unlikely in 2003.
- Stock markets will stabilise in 2003, but recovery will be modest.
- Bond markets will fall slightly, as long-term yields edge up.
- The UK is performing better than its EU competitors and growth should edge up in 2003.
- The UK economy faces long-term threats, however, from a housing market bubble, industrial disputes, and excessive rises in taxes and public spending.
- The UK Base rate will remain at 4% in the next four to six months and then edge up to 4.50%-4.75% later in 2003.
- A euro referendum is increasingly unlikely.

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