Preparing for a global slowdown

With an economic growth slowdown on the cards for 2001, Neil MacKinnon of Merrill Lynch looks at the implications for the world markets.

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Economic growth in the key economies is slowing down from a peak in activity in the latter part of 2000. The reason for the slowdown is the lagged effects of previous increases in interest rates. In addition, the surge in the oil price above $30 may turn out to be deflationary, rather than inflationary. Higher energy costs act as a tax on both consumers and producers, resulting in a reduction in disposable income and company revenues, thereby culminating in a subsequent downturn in spending.

Higher oil prices usually result in recessions. In the past, we have seen the phenomenon of 'stagflation' where inflation co-exists with recession. In the current environment, the rise in energy costs has not been fully passed on to consumers and CPI inflation rates in the big economies are no more than 3-4%.

Sure signs of slowdown

Pricing power is still weak and there is no doubt that there has been a secular change in world inflation trends. This may have something to do with the impact of the internet revolution, which makes it difficult for companies to maintain uncompetitive prices in the retail and manufacturing sectors. As far as the US economy is concerned, growth has been spectacular, but there are signs of some slowdown.

The majority of City economists believe that the US will experience a 'soft landing', where economic growth will fall only slightly below trend (which is generally estimated to be in a 3-4% range). Consumer spending, which accounts for about 60% of the US economy, is still running at a solid rate of 4.5%.

Even the problems associated with overvalued tech stocks (witness the collapse in the Nasdaq stockmarket) is unlikely to prevent a fall in capital expenditure on IT. Indeed, there has never been a negative growth rate in spending here in the last two decades.

There is no doubt that 'hard landing' risks cannot be totally ignored and there may be the odd quarter in which US GDP growth sinks below the 2% level, especially given the arithmetic effect that a widening US trade deficit has on measured GDP.

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However, the Federal Reserve (the body responsible for US monetary policy) has a good track record in fine-tuning interest rates to ensure that recessions in the US economy are typically both mild and brief.

As a result, during 2001, the Federal Reserve is likely to reduce the level of US interest rates, and other key central banks (including the Bank of England) may follow suit. In the event of a Wall Street meltdown or credit crunch, in which there are severe problems with the provision of liquidity in the US banking system, then the Federal Reserve will simply make more extensive cuts in interest rates as it did during the hedge fund crisis in September 1998.

However, the interest rate sensitivity of the new economy will be put to the test during 2001.

Retaining strength

The underlying resilience of the US economy and the sharp increase in productivity growth continues to underpin the US dollar, which remains strong against all key currencies.

A new president in the White House is unlikely to change the strong dollar policy that was a feature of the previous administration.

Over the past few years, there have been sizeable capital inflows going into the US (mainly equities and corporate bonds) as global investors seek to take advantage of perceived superior investment returns.

This has been a key reason that the euro has lost 30% of its value against the US dollar over the last 18 months. The collapse in the euro has prompted foreign exchange intervention by the G7 central banks and the European Central Bank (ECB) to try and prevent further collapse. At the time of writing, the success of these attempts was uncertain. The best that can be hoped for during the early part of 2001 is that the euro consolidates in a $0.85-0.95 range. The US dollar was very overbought towards the end of the year 2000. A sharp correction in the dollar cannot be ruled out and this could take the euro above parity at some stage during the year.

The euro-land economy is still regarded as somewhat inflexible and undynamic. Unemployment is high at 9% of the workforce, reflecting widespread rigidities in European labour markets. Euro-land growth will slow to a 2.5% level during the current phase of economic slowdown.

As far as the UK is concerned, the economy is in good shape, but it will be difficult to avoid the impact of a global slowdown, given the strong export links with the rest of the world.

Of course, UK manufacturing is far more competitive now and better able to withstand the impact of a strong currency. Lower interest rates during 2001 and large public spending increases will act as a cushion. The main issue of joining the euro may be delayed for some time as it is difficult to persuade people of the 'benefits' of signing up to a weak currency. However, as UK interest rates start to decline then so will sterling start to depreciate against most of the major currencies. ■

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