MEDIOCRE PICTURE

IRAQ, SARS, FEARS OF TERRORISM, AND A GLOBAL ECONOMY THAT FACES HUGE IMBALANCES POINT TO A SUBDUED OUTLOOK IN THE NEXT TWO TO THREE YEARS, SAYS **DAVID KERN** OF KERN CONSULTING.

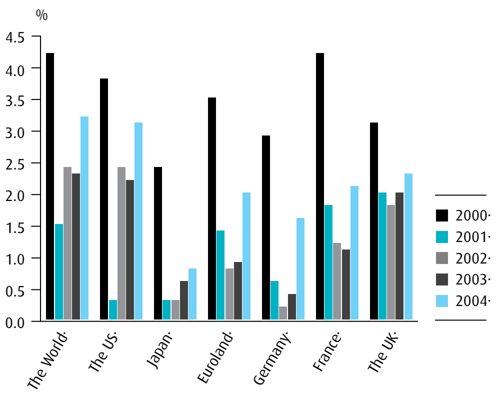
Global recession remains unlikely, but economic prospects are set to remain subdued. Fears of terrorism, Sars and wider economic imbalances will remain dampening factors. Britain will continue to enjoy satisfactory prospects in the near-term, but there are serious risks that the UK's longer-term position will gradually weaken, and euro entry will remain an unsettling issue.

GLOBAL BACKGROUND. The first half of 2003 was dominated by exceptional geo-political uncertainties, most notably the war in Iraq. The US/UK rapid military victory removed major anxieties, but the outlook remains uncertain. The Iraq war will alter the global balance of power and increase the US's military and strategic dominance. But economic factors are also likely to favour the US. In the short-term, the war's aftermath entails dangers, as lingering US/EU trade tensions (notably, the dispute over GM food) have been exacerbated by the row over Iraq. The dollar's sharp fall against the euro will help recovery in the US, while damaging further Euroland growth.

KEY REGIONS. In the US, there are tentative signs of rising confidence, and the economy is set to continue performing more strongly than its main competitors. The US clearly faces difficult adjustments and 2003 growth is expected to be only 2.2%, but its role as global engine remains unchallenged. US and UK growth will be stronger than in Euroland and Japan in 2003 and 2004. Germany and Italy registered outright falls in activity in the first quarter of 2003, while Japan was flat and still faces serious risks of recession and deflation. The euro zone and Japan will both see minimal growth (less than 1%) this year, and recovery prospects in 2004 are limited. While deflation is not a serious threat for the euro zone as a whole, in Germany the problem is more serious. China and East Asia will grow more strongly than the world average, but the Sars epidemic will reduce growth in 2003.

GLOBAL RISKS. With the oil price dipping well below its recent peaks, global recession is unlikely. But economic growth will remain mediocre and below-trend over the next few years. Fears of terrorism, Sars, and wider economic imbalances (massive debt levels, over-capacity, huge external deficits, fragile balance sheets, and weak banking and insurance sectors) will hamper recovery. Official interest rates will remain low in the major economies. But, while rates in Japan are near zero, and there is little scope for rates to fall in the US, further cuts are likely in Euroland. The US Fed has made it clear that it would not hesitate to adopt 'unconventional monetary techniques' (for example, outright

FIGURE 1
MAJOR GLOBAL ECONOMIES: 2000-2004.



money creation through bond purchases) if deflationary threats persist when interest rates fall to near zero. In contrast, the Bank of Japan has been ineffectual in fighting deflation; while in Europe, the European Central Bank (ECB) has refused to acknowledge the seriousness of the deflationary threat, and has been tardy in reducing interest rates. Against this background, stock markets will be broadly flat in the near-term, but modest rises are likely later in the year, particularly in the US and the UK, where exporting industries will benefit from currency falls against the euro.

UK BACKGROUND. UK prospects remain mediocre. Recent sterling falls against the euro will rebalance the economy towards investment and exports, and help reduce the external deficit, but further sharp and uncontrolled declines will be destabilising. The UK economy slowed sharply at the start of the year and current trends point to further sluggish growth. But Britain's labour market is strong and employment has risen recently to all-time highs, in spite of the below-trend output growth. While this is welcome, one implication is low productivity growth. The April Budget confirmed that public finances are worsening, but the new official forecasts are still too optimistic. On present trends, £10bn-£15bn in new tax rises will be needed after 2004, to avoid breaking Chancellor Gordon Brown's fiscal rules. The UK economy faces serious medium-term risks: industrial disputes, high-spend and high-tax policies, a housing market bubble, low skills, low productivity, weak manufacturing and a large external deficit. But the short-term outlook remains benign, albeit mediocre.

UK PROSPECTS. GDP growth averaged 1.8% in 2002, below-trend but higher than Britain's main EU competitors. The first quarter of 2003 saw minimal growth of only 0.2% and I expect the pace of expansion to remain modest in the next 12-18 months, with growth averaging 2% in 2003 and 2.3% in 2004. Both figures are better than the 2002 outcome and higher than in the EU but lower than the recent Budget forecasts. Consumer spending, the economy's main driver, will continue to expand faster than total GDP, but growth is set to slow to 2.5% in 2004, as the housing market cools and the higher personal debt burden fosters greater caution. If a gradual slowdown in personal consumption coincides with an upturn in investment and exports, it could rebalance the economy. But if consumer spending plummets, the threat of recession will worsen. The UK remains a two-speed economy. Manufacturing is still in recession, with output some 7% below its end-

FIGURE 2
THE UK'S TWO SPEED ECONOMY: 1999-2004.

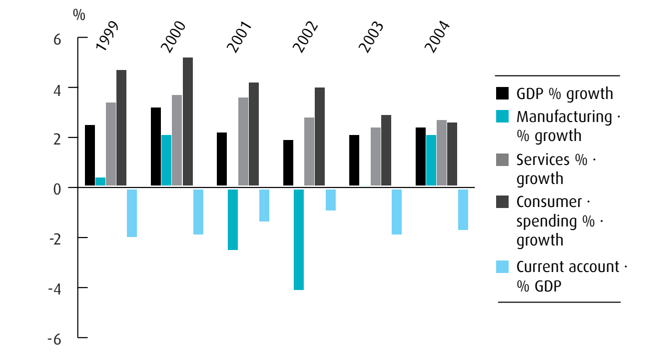


TABLE 1
CURRENCIES AND INTEREST RATES TO END-2004.

	ACTUAL		FORECASTS		
	end-2002	09 June 2003	end-2003	mid-2004	end-2004
UK Base Rate	4.00%	3.75%	4.00%	4.25%	4.50%
US Fed Funds	1.25%	1.25%	1.50%	2.00%	2.75%
ECB Rate	2.75%	2.00%	1.75%	2.25%	2.75%
$ per £	1.61	1.644	1.63	1.60	1.58
£ per euro	0.652	0.714	0.730	0.719	0.696
$ per euro	1.05	1.172	1.19	1.15	1.10
Yen (100s) per $	1.20	1.182	1.17	1.19	1.21

2000 peak, and almost 2% below its 1995 level. While the sector should now stabilise, and benefit from a weaker pound, recovery will be frail. Overall, I expect positive modest growth, low inflation, low interest rates and low unemployment.

BASE RATE AND STERLING. Following a surprise cut, from 4% to 3.75%, at its February meeting, the Monetary Policy Committee (MPC) left interest rate unchanged at the subsequent four meetings. The immediate outlook is uncertain. The Bank of England's immediate priority is to counter the threat of recession and deflation. There is still a possibility that the Base rate may be cut to 3.50%, if domestic demand weakens and/or global risks worsen. But given the risks of further sharp sterling falls, rising consumer debt, and higher Government borrowing, I believe rates are now near their cyclical low. The Base rate should start edging up later in 2003 or in 2004, rising towards 4.25%-4.50% next year, as activity gradually strengthens. Gilt yields, while remaining low by historical standards, will also start edging up. Sterling is likely to become more stable, weakening moderately against the dollar in 2004, while edging up against the euro.

THE EURO ENTRY DEBATE: As expected, Chancellor Brown confirmed that the two most important of the five tests for euro entry – convergence and flexibility – have not yet been met. However, while ruling out immediate entry, he acknowledged that we are nearer to meeting the five tests than in 1997, and the option of reassessing the tests next year has been left open. But, an early review and a referendum before the next election would lack credibility and worsen business uncertainties. The proposed reforms of the housing and labour markets, to remove obstacles to entry, are vague. There is no 'target date' for a referendum in 2006 or 2007. All the evidence suggests that a referendum supporting entry cannot be won in the near future. Indeed, British public opinion has become even more hostile to joining the euro following the Iraq war and the Government is facing severe criticisms because of its refusal to hold a separate referendum on the new proposed EU Constitution.

KEY POINTS.

- Global economic prospects remain weak. The dollar's sharp fall against the euro will help recovery in the US, damage further Euroland growth and unsettle international trade relationships.
- The Iraq war will alter the global balance of power and increase US dominance. There is a risk trans-Atlantic trade tensions will worsen.
- Global recession is unlikely but growth will remain below-trend. Fears of terrorism, Sars and economic imbalances will hamper recovery.
- US and UK growth will be stronger than in Euroland and Japan.
- China and East Asia will continue growing more strongly than the world average, but Sars will reduce growth considerably in 2003.
- Official interest rates will remain low, with further cuts likely in Euroland. Stock markets will rise modestly later in the year, mainly in the US and the UK.
- UK growth (2% in 2003 and 2.3% in 2004), while higher than in 2002 (1.8%) and stronger than in EU, is mediocre and below the Chancellor's forecasts.
- The UK Base rate, now at 3.75%, may fall slightly if risks worsen, but rates should edge up before the end of 2003, rising to 4.25%-4.50% during 2004.
- The UK Budget confirmed worsening public finances. £10bn-£15bn in tax rises will be needed after 2004, to avoid breaking fiscal rules.
- Sterling's fall against the euro will help to rebalance the UK economy.
- As expected, the verdict on the five euro entry tests was 'not yet'. A further assessment before the next Election is possible, but unlikely.
- UK risks: industrial disputes, high-spend high-tax policies, a housing market bubble, low skills, low productivity, weak manufacturing and a large external deficit.

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