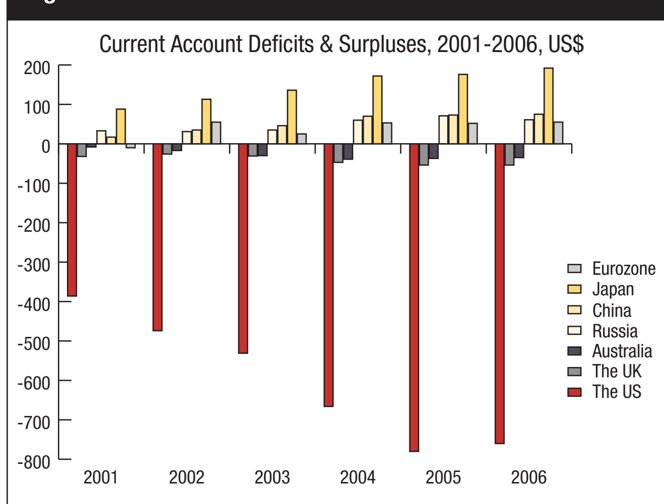
DAVID KERN ARGUES THAT A COMBINATION OF EXTREME CIRCUMSTANCES COULD PRECIPITATE A CRASH.

Economic risks set to worsen

Growth has slowed markedly in most major economies in the first half of this year, and the available evidence supports the view that 2005 will be a weaker year than 2004. Given the very strong growth recorded last year, some deceleration was to be expected. But prospects have worsened in recent months, mainly in the euro zone, and there is wide agreement that the downside risks have become more pronounced. Fears of recession are unwarranted at present. But the sharp fall in Government bond yields, despite the steady rise in the US Fed funds rate, has reinforced fears that the slowdown will prove longer than was originally expected.

RISKS The severe imbalances facing the global economy are mostly manifested in the huge US external deficit (see *Figure 1*). The deficit has swelled to unprecedented levels that are almost certainly unsustainable in the long term: $666bn in 2004, or 5.7% of US GDP. But instead of shrinking, the US deficit is ballooning further, and there is a clear risk that current trends will make the eventual correction more painful and prolonged. Against this background, the global economy is facing serious immediate threats: recurring oil price upsurges, persistent weakness in the euro zone, excessive increases in US interest rates, and extreme forex market volatility, including doubts over the euro's survival as a currency. Beyond these short-term risks, the key negative influences remain partly geo-political. Terrorism, and the growing rift between the US and Europe, will make it more difficult to plan and invest. But the main factors likely to limit growth are persistent economic problems: deficits and low savings in the US, and inadequate reforms and low growth in the euro zone and Japan.

Figure 1. External Imbalances



OIL PRICES Hopes that oil prices are set to fall are premature. We have seen recurring upsurges towards $60/barrel, and the markets have raised their assessment of future prospects. Oil prices will clearly remain higher than was expected until recently. The view that the oil price is set to fall over the next 12-18 months to $30-$35/barrel, has been replaced by a new consensus, which envisages a very modest fall only, from $50-$55/barrel currently, to $45-$50/barrel in the first half 2006. Indeed, falls are neither imminent nor inevitable, and many expect the oil price to stay above $50/barrel. Higher oil prices should not have disastrous effects, but will inevitably reduce growth and worsen cost pressures.

FED TIGHTENING FEARS The US Fed funds rate (*Table 1*) is expected to continue going up at a "measured pace", i.e. in 25 basis point steps, maintaining the pattern established since June 2004. Recent fears that the Fed tightening will become more aggressive, because of growing concerns over inflation, is now giving way to the view that reduced growth prospects will induce the Fed to stop raising interest rates earlier than previously expected. While the Fed is likely to persevere with its current "middle course", until the funds rate reaches 4-4.25% at end-2005 or early next year, we now expect the 2006 peak to be no higher than 4.25-4.5%. However, there is a small danger that US interest increases would be steeper, pushing the Fed funds rate towards a peak of 5% or higher. If this happens, the downside risks for the economy will become more pronounced, in the US as well as globally.

EUROPEAN RATES The European Central Bank (ECB) rate (see *Table 1*) has remained unchanged at 2.0%, for more than two years. In spite of the persistent weakness of the euro zone economy, the ECB has been too concerned over inflationary risks. However, the acute political and financial turmoil after the no votes in the French and Dutch referendums, and the downward revision of euro zone growth prospects, may persuade the ECB to consider an interest rate cut. The fact that the euro's very existence as a currency is being questioned will add to the pressure on the ECB. A cut in rates is clearly needed, but the ECB may try to resist. The UK repo (base) rate (see *Table 1*) has probably peaked at 4.75%. Although UK growth remains stronger than in the euro zone, there is increased evidence that the UK economy is decelerating. Consumer spending, traditionally the main driver of the

UK economy, has weakened sharply, and growth is likely to continue flagging, as the housing market softens further and the large burden of personal debt reinforces spending restraint.

BONDS Virtually all forecasters have failed to predict correctly bond and currency trends this year. Bond yields, which fell last year to what appeared unsustainable lows, failed to rise as predicted, and declined instead to even lower historic levels. Special factors may partly explain the unusual fall in bond yields, notably large special purchases – by Asian central banks building up their forex reserves and by pension funds under regulatory pressure to switch from equities to bonds. However, neither central banks nor pension funds can possibly provide an adequate explanation, and the prospect of low growth appears the most important factor. Looking ahead, I still expect net increase in bond yields over the next 12-18 months. But any rise will be more modest than previously envisaged, and many predict further falls in yields.

CURRENCIES The widespread belief that the US dollar (having weakened sharply in 2004) will continue falling this year in response to the huge US deficit proved very wrong. The US$ has strengthened instead, and many factors may account for this: persistently higher US growth than in the euro zone and Japan, rising US short-term interest rates, and political disarray in the euro zone. Many analysts, including large investment banks, have changed their views, and are now predicting a stronger US$ than in their earlier forecasts. But the US deficit is still swelling to record highs, and a significant US$ fall of more than 10% remains likely in the next 2-3 years. However, the US$ is likely to weaken mostly against Asian currencies, and much will depend on China's decision on the scale and timing of a renminbi revaluation.

Executive Summary

- Global economic conditions have become more difficult in the first half of 2005, both globally and in the UK. And a further worsening is likely over the next year.
- The threat of recession is low, and our central scenario points to a "soft landing".
- But the factors signalling lower growth are more pronounced, and the downside risks are increasing.
- Huge global imbalances are swelling, and the absence of corrective action limits medium-term growth prospects and could, in extreme circumstances, precipitate a crash.

WORLD PROSPECTS The "central scenario" summarised in Table 2 points to lower growth, but is still benign. Recession is unlikely. But world prospects remain too dependent on the US, while the euro zone is too weak. The outcome could be very much worse than the central scenario indicates, if some events, unlikely but possible, were to happen: sustained oil price hikes to over $70-$75/barrel; euro zone recession; hard landing in China; increases in the US Fed funds rate to levels higher than 5%; very sharp US$ volatility, with falls or rises in excess of 25-30%.

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Table 1. OFFICIAL INTEREST RATES, % FORECASTS

	Actual			Forecasts				
	end 03	end 04	12.06.05	3mnth	6mnth	12mnth	18mnth	24mnth
US Fed Funds Rate	1.00	2.25	3.00	3.50	4.00	4.50	4.50	4.50
ECB Refi Rate	2.00	2.00	2.00	1.75	1.75	2.00	2.25	2.50
Japan OvrNight Rate	0.00	0.00	0.00	0.00	0.00	0.25	0.50	1.00
UK Repo Base Rate	3.75	4.75	4.75	4.50	4.25	4.50	4.50	4.50

Table 2. GDP GROWTH 2001-2006, THE MAJOR ECONOMIES, % CHANGE ON PREVIOUS YEAR

	2001	2002	2003	2004	2005	2006
The US	0.8	1.9	3.0	4.4	3.6	3.2
Japan	0.2	-0.3	1.4	2.6	1.3	1.8
Euro zone	1.6	0.9	0.5	1.8	1.5	1.9
Germany	1.2	0.2	0.0	1.6	1.0	1.5
France	2.1	1.1	0.5	2.1	1.8	2.1
The UK	2.3	1.8	2.2	3.1	2.4	2.3
China	7.5	8.3	9.3	9.5	8.8	8.4
India	4.8	4.4	7.5	7.3	6.5	6.3