AS THE RECOVERY MATURES, HIGHER INTEREST RATES ARE INEVITABLE. BUT RAISING RATES WITHOUT TRIGGERING A SETBACK IS A MAJOR CHALLENGE, BOTH GLOBALLY AND IN THE UK, ARGUES **DAVID KERN**.

AN INTERESTING

The current cyclical upturn has been stronger than expected, and it is widely acknowledged that 2004 is the strongest year for global growth since 2000. Confidence remains firm, and it seems likely that the recovery will continue. But there are considerable uncertainties about geo-political risks, such as terrorism in Iraq, and there are a number of unresolved major economic problems, such as deficits and debt. The financial markets have signalled their concerns about inflation, interest rate increases, and currency instability. Indeed, although inflation is still low, it is emerging as a potential problem for policy-makers.

The recent increases in interest rates clearly signal the shape of things to come.

US AND ASIA LEAD. Not surprisingly, the huge and dynamic US economy is acting as the locomotive leading the world upturn. With impressive GDP growth of 4.5-5% expected in 2004, followed by slower but still robust growth of 3.5-4% growth in 2005, America's position is pivotal.

But the increasing role of three Asian economies – China, India, and Japan – is a major event. Japan, the world's second largest economy, has staged a surprisingly strong upturn, with unemployment falling and household spending rising. The improving Japanese outlook has produced higher bond yields and share prices have risen to a 32-month high. Although bad debts and poor demographics remain medium-term obstacles, there has been a marked improvement in Japan's short-term situation and growth forecasts (3.1%, for 2004 and 2.1% for 2005) are higher than in the euro countries.

As for China and India, they have much higher growth rates than in the West (9.1% for China and 7.4% for India in 2003) and have graduated from being regional powers to countries with full global rank. Asia's economic status will continue to strengthen. Growing trade and investment links between Japan and China, and rapidly rising intra-Asian trade, are major contributors to Asia's growth.

THE EURO ZONE DISAPPOINTS. In contrast to the steady improvement in growth prospects for the US and Asia, the outlook for the euro zone has worsened. Growth remains anaemic and previous expectations of recovery have not yet materialised. Most recent euro zone indicators have been gloomy, with high unemployment levels. Domestic demand remains too low and activity still relies unduly on exports.

Some recent surveys have signalled rising confidence and, on balance, a slow improvement is possible. Even so, euro zone growth is forecast at 1.6% for 2004 and 2.0% for 2005 and looks set to remain weak and inadequate. There is growing pressure for the European Central Bank (ECB) to cut interest rates to stimulate growth. But, given their unduly cautious record, the ECB's response is unlikely to be sufficient, and inadequate reforms will continue to limit euro zone growth.

UNCERTAINTIES AND IMBALANCES. The most immediate concerns relate to interest rate increases. Clearly, as the recovery continues, pressures on resources will build and policy must be tightened to stabilise economic activity. However, managing interest rate increases without triggering a setback is hazardous. Housing markets and the emerging economies are most vulnerable to higher interest rates.

'THE UK FACES SERIOUS CHALLENGES, PARTICULARLY WITH INTEREST RATES, BUT THE BANK OF ENGLAND HAS AN EXCELLENT RECORD AND THE OUTLOOK IS SATISFACTORY'

But the US Fed, the world's premier central bank, should be able to manage the transition to higher rates very well. Beyond this, major geo-political uncertainties remain potential threats; but barring a major disaster, they will not derail the recovery. The most serious

Table 1 Currencies and interest rates outlook

	Actual			Forecasts			
	end 02	end 03	06.05.04	3mnth	6mnth	12mnth	18mnth
US Fed Funds rate	1.25%	1.00%	1.00%	1.25%	1.50%	2.25%	3.00%
UK repo rate	**4.00%**	**3.75%**	**4.25%**	**4.50%**	**4.75%**	**5.00%**	**5.00%**
US 10-yr gov bond	4.24%	4.26%	4.57%	4.90%	5.20%	5.40%	5.60%
UK 10-yr gov bond	**4.67%**	**4.77%**	**4.95%**	**5.20%**	**5.50%**	**5.75%**	**5.75%**
$ per euro	1.05	1.261	1.212	1.17	1.20	1.25	1.28
$ per £	**1.61**	**1.790**	**1.795**	**1.78**	**1.78**	**1.75**	**1.70**
£ per euro	0.65	0.70	0.677	0.66	0.67	0.71	0.75

CHALLENGE

dangers relate to huge economic imbalances such as budget and trade deficits, excessive debt and currency tensions. These imbalances, which are most acute in the US, can cause long-term damage. But if the US tries to slash its twin deficits, before other key players (notably the euro zone) can boost their own growth sharply, the cure could be even worse. On balance, a global crisis should be avoided; but it seems likely that GDP growth will slow down in 2005.

INTEREST RATES AND CURRENCIES. The dominant consideration in the global financial market is the concern over the adverse implications of higher US interest rates. The world's main stock markets, having risen markedly last year, have recorded a mediocre performance so far in 2004.

In Australia and the UK, official interest rates started rising before the end of 2003 and the upward trend continues. In the US, the markets expect official rates to start rising in either June or August. But in the euro zone area, where growth is still disappointingly weak, a small cut in rates is still possible.

In the US, the Fed funds rate is set to reach 1.75% before the end of 2004, and is then expected to rise further to 3% by the end of 2005. Prospects for the US dollar are unusually uncertain, as analysts and traders try to assess the relative importance of external deficits, growth prospects, and interest rates. Having reversed some of its previous sharp falls, the current consensus is that the US dollar may strengthen a little further in the near term, reflecting stronger US growth and early rises in US interest rates. But renewed dollar falls are likely towards the end of 2004 and in 2005, as concerns over the unsustainable US external deficit re-emerge.

UK BACKGROUND. The UK recovery remains on course, with high employment levels. My forecast for UK GDP growth is 3.1% in 2004 and 2.7% in 2005, after 2.2% in 2003. Although weaker than in the US, the UK's growth performance is set to remain considerably stronger than in the euro zone. Given the concern over house prices and consumer debt, it is widely expected that steady interest rate increases will continue, with the official repo (base) rate reaching 5.0% in 2005.

UK public finances are still stretched. Although the Budget deficit in 2003-04 was almost £3bn lower than the Chancellor had predicted in the March Budget, tax rises of some £8bn-£10bn may still be needed after the next General Election to avoid breaking the Chancellor's fiscal rules. UK activity remains over-dependent on the upsurge in public spending and recruitment. The much-needed rebalancing of the economy towards investment and exports is inadequate, and manufacturing is too weak.

The UK faces serious challenges, particularly in relation to interest rates, but the Bank of England has an excellent track record. Consequently, the outlook for 2004 and 2005 is satisfactory, with good growth, high employment, and low inflation.

David Kern of Kern Consulting was formerly Nat West's Group Chief Economist.
david.kern@btinternet.com

Figure 1 The world's major economies 2000-2005 % growth in GDP

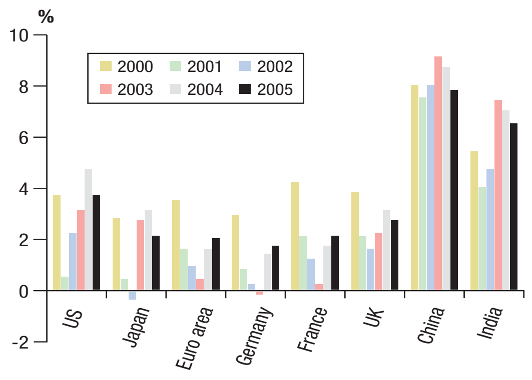

Figure 2 UK GDP – main components – % change year on year