DAVID KERN TAKES A DOWNBEAT VIEW OF THE ECONOMIC PROSPECTS IN 2005 AND 2006

Executive summary

- The economic environment will become riskier and more difficult over the next 18 months, both globally and in the UK.
- Businesses will have to cope with the consequences of lower growth.
- The central forecast still suggests that recession will be avoided but a more pessimistic outcome cannot be ruled out.

Heightened risks

Global growth in 2004 was very strong. Taken as a whole, 2004 was the strongest year for the developed economies since 2000. For the wider global economy, including India and China, 2004 was the best year for more than three decades. But global growth peaked in the first half of 2004, and we have seen a slowdown in recent quarters. The US, Japan, China and the UK, have all experienced marked slowdowns in activity, while the Eurozone has persisted with its anaemic and inadequate growth. Though growth may pick up from its recent lows, an underlying cyclical deceleration in activity is clearly underway. The economic agenda remains dominated by acute concerns over the destabilising and damaging effects of two major developments, which reflect deep-seated problems: i) sharp rises in oil prices; and (ii) acute weakness of the US dollar.

SUBDUED START TO THE YEAR 2005 has started on a cautious and subdued note. Share prices have eased, after rising in the final months of 2004, and the unease about future prospects is reflected in unduly low yields on fixed-interest bonds. The tsunami disaster, which contributed to the downcast mood, was a terrible human tragedy. But the macro economic effect is likely to be limited. The economies of Sri Lanka and the Maldives will be worst hit, mainly because of their dependence on tourism and fisheries. Indonesia suffered by far the largest number of casualties, but its economy should not suffer unduly, because the key oil and gas was not seriously affected.

OIL PRICES have fluctuated wildly in recent months, but prices are now below recent peaks. Although crude prices will remain volatile, and high by historical standards, the trend is now gently downwards, in spite of occasional attempts by OPEC to cut output. In reaction to reduced global growth, Brent crude (currently $44-45 per barrel) is set to fall further in the next 12 months, to $30-$35 per barrel in the second half of 2005, with West Texas Intermediate some $3-4 per barrel higher. While oil prices will limit global growth, the effect should not be too damaging.

UNDERLYING IMBALANCES The global economy is facing serious imbalances. These did not stop the strong 2004 upturn, but will limit

Figure 1. GDP Growth 2001-2006, The Major Economies % Change on Previous Year

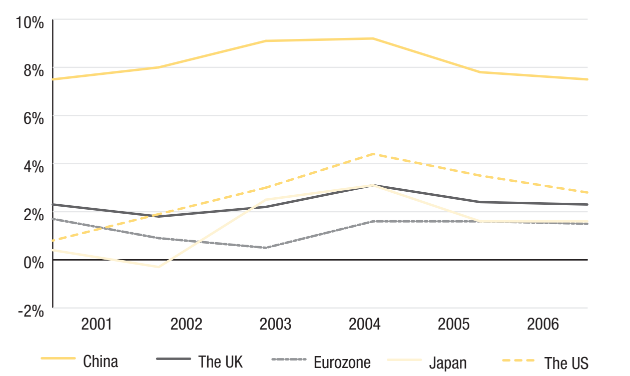

Table 1. OFFICIAL INTEREST RATES Forecasts for Next 18 Months

	Actual				Forecasts			
	end 02	end 03	31.12.04	19.01.05	3mnth	6mnth	12mnth	18mnth
US Fed Funds Rate	1.25%	1.00%	2.25%	2.25%	2.75%	3.25%	4.00%	3.75%
ECB Refi Rate	2.75%	2.00%	2.00%	2.00%	2.00%	2.00%	2.25%	2.50%
Japan OvrNight Rate	0.00%	0.00%	0.00%	0.00%	0.00%	0.25%	0.75%	1.50%
UK Repo Rate	4.00%	3.75%	4.75%	4.75%	4.75%	4.75%	4.50%	4.25%

growth in future years. The key factors are partly geo-political. Terrorism, Iraq, and clashes over foreign policy and trade between the US and Europe, are all exacerbating uncertainties, making it more difficult to plan and invest. But persistent medium-term economic imbalances, primarily originating in the US (e.g. huge budget/external deficits, currency tensions/upheavals, and excessive debt) will be the main factors limiting growth over the next few years. In addition, powerful short-term risks (which partly overlap with the medium-term imbalances) will reduce the pace of expansion: high oil prices, reduced fiscal and monetary stimulus (mainly in the US), weaker housing markets (in the UK, US and Australia), and lower growth in China.

Management summary

- Global growth was very strong in 2004, but will slow in year-on year terms in both 2005 and 2006. In quarterly terms, growth will decelerate until early 2006, then slowly improve.
- There are acute concerns over the adverse effects of high oil prices and a weaker US$.
- The global economy is facing serious imbalances. Some are geo-political (terrorism), while others reflect economic problems (debt, deficits, currency tensions).
- The growth gap in favour of the US is likely to remain large and persistent.
- The US Fed funds rate will rise considerably over the next 12-18 months.
- The UK repo (base) rate is at or near its peak and should fall in Q4 2005.
- Most longer-term bond yields will increase moderately over the next 12-18 months.
- The US$ is set to fall by about a further 10%, before stabilising and then recover slowly.
- £ is set to weaken over the next 12-18 months.
- Our central scenario points to lower global growth, but is still benign.
- However, there are clear downside risks, unlikely but possible, if some of the following events happen: new oil price hikes to over $60-65 per barrel; very sharp US$ falls, to over $1.80-1.90 per €, or $2.20-$2.30 per £; a collapse in house prices; hard landing in China.

GROWTH FORECASTS The underlying slowdown in global activity will probably continue for another year. Year-on-year GDP growth in most major economies is set to slow in 2005 and 2006, even though in quarterly terms a modest cyclical recovery is expected to start before mid-2006. The growth gap in favour of the US is likely to remain large and persistent, although the US economy is facing huge imbalances. In spite of its problems, the US economy will remain dynamic and competitive. In contrast, both the eurozone and Japan are suffering from deep-seated structural weaknesses that limit their growth potential, and neither will be able to assume the role of global locomotive. China's global role is rapidly expanding. But, in the near-term, China will have to retrench, in order to cool an excessive boom. World prospects will remain critically dependent on the ability of the US to sustain growth. (Figure 1)

OFFICIAL INTEREST RATES The financial markets will be dominated by the move to higher US official interest rates. The Fed funds rate will be raised steadily, reaching 4.0% in Q4 2005, and then easing to 3.75-3.50% in H2 2006. But the risk of steeper US interest increases is now higher. In the eurozone, the European Central Bank (ECB) rate is set to stay at 2.0% in the next few months; it should start to edge up in H2 2005, reaching 2.50% by mid-2006. In the UK, the repo (base) rate has probably peaked at 4.75%. A rise to 5.0% in H1 2005 is still a distinct possibility, but I now expert a cut to 4.5% in Q4 2005. (Table 1)

BONDS Government bond yields are too low, given the prospect of higher official interest rates. Inflation risks have not entirely disappeared and I expect longer-term bond yields (in most major centres) to increase moderately over the next 12-18 months. Yield spreads on relatively risky corporate bonds and sovereign paper are also unduly low, given the underlying global threats.

THE US DOLLAR Worries over the sustainability of the US external deficit will exert downward pressure on the US$ in the next 9-12 months. Admittedly, there are offsetting factors. In particular, the US$ is underpinned by foreign capital flows into dollar assets, which are attracted by the US's persistent tendency to grow more rapidly than Europe and Japan. But, on balance, continued concerns over the deficit, and increased reliance on Asian central banks to finance the deficit, may force further US$ falls of about 10%, before the dollar stabilises. At its low point, the US$ could fall to levels of around $1.43 per €, Y93 per US$, and $1.96 per £. But the US$ should recover in 2006, as the markets refocus their attention on superior US growth rates. (Table 2)

STERLING With UK growth slowing, with £ interest rates at or near their peak, and with the large UK external deficit worsening, £ will weaken over the next 12-18 months. The pound's decline will be initially mainly against the € and other non-US$ currencies; but, in 2006, £ will also ease against the US$.

David Kern of Kern Consulting, formerly NatWest's Group Chief Economist, is Economic Adviser to the British Chambers of Commerce (BCC) and to RSM Robson Rhodes
david.kern@btinternet.com

Table 2. THE MAJOR CURRENCIES Forecasts for Next 18 Months

	Actual				Forecasts			
	end 02	end 03	31.12.04	19.01.05	3mnth	6mnth	12mnth	18mnth
$ per Euro	1.05	1.261	1.359	1.301	1.33	1.38	1.43	1.38
Yen(100s) per $	1.20	1.072	1.025	1.028	1.00	0.97	0.93	0.96
$ per £	1.61	1.790	1.920	1.871	1.90	1.93	1.96	1.88
£ per Euro	0.65	0.70	0.708	0.695	0.70	0.72	0.73	0.73