OBSTACLES TO A QUICK RECOVERY

RISING OIL PRICES AND THE WAR WITH IRAQ IS DOING NOTHING FOR GLOBAL ECONOMIC MORALE. **NEIL MACKINNON** OF NEXUS CAPITAL FINDS OUT HOW THE CENTRAL BANKS ARE COPING.

The outlook for the global economy is deteriorating, partly reflecting the impact on business and consumer confidence from higher oil prices over the past year and the ensuing conflict with Iraq. In addition, the consequences from the decline in stockmarkets over the past two years is still having a knock-on effect. As a result, both governments and private economic forecasters have been compelled to gradually revise downwards their forecasts for real GDP growth for this year.

Fortunately, policymakers in the major economies have tended to respond to concerns about the economic outlook by ensuring that monetary policy remains accommodating and responsive to signs of deterioration in economic activity. Of course, policymakers in different economies have responded in different ways and at different speeds, depending on their perception of national economic conditions, as well as their respective policy mandates and objectives.

US MANDATE. In the US, the Federal Reserve has implemented quite exceptional, if not unprecedented, reductions in short-term interest rates to counter indications of economic slowdown. Typically, the Fed has a reputation for being proactive and very responsive to variations in the economic cycle. To some degree, this is helped by having a mandate that compels the Fed to take into account economic conditions in trying to achieve price stability.

Unlike some other major central banks, the central bank does not have a statutory inflation target, although its record in controlling inflation over the past 25 years or so has been quite good and certainly comparable with the record of other central banks which are mandated to achieve exclusively a specified inflation target. But that is not to say that inflation targeting is a mistake. The academic and empirical literature on this subject shows clearly that inflation targeting has proved successful for many economies and has allowed central banks, as a consequence, to enhance credibility and thereby bring short-term and long-term interest rates down to levels that help contribute to long-term productive potential. However, it does appear the Fed has a greater degree of flexibility, which in the current environment is welcome.

The US economy is the locomotive for the world economy, and should the US economy falter for any reason and fail to respond to the traditional medicine of policy stimulus, then the outlook for the world economy would consequently be darker. In this regard, the Fed currently stands vigilant.

Recent US economic indicators have pointed to a downturn in business and consumer confidence, as well as some softening in demand and output. In addition, a variety of labour market indicators suggest sluggish jobs growth and little appetite on the part of employers to recruit new workers. However, we should not be surprised that this is the case. Quite often in the early stage of the economic recovery cycle, jobs growth tends to be absent and results in many commentators describing the cycle as a "jobless recovery". Typically, employers prefer to work existing workers harder (resulting in an increase in both hours worked, as well as productivity) until there is hard evidence that demand has strengthened on a sustainable basis. At the time of writing, the US labour market shows no such signs of recovery and demand is still fairly soft.

Against this background, the Federal Reserve will take whatever measures required to ensure the US economy avoids a 'double-dip' recession. Of course, a key reason why the reduction in interest rates is taking time to come through is that corporate balance sheets are still going through an adjustment phase in which they pay down debt and try to adjust back to a pre 'dotcom' normality. This process will be completed at some stage this year but the corporate appetite for significant capital spending or M&A acquisition activity will likely remain subdued until next year.

BRIGHT SPOTS ON THE HORIZON. Fiscal policy is broadly stimulative, with extra federal spending measures and tax reductions likely to amount to 1% of GDP. However, there will be undoubtedly be some concern that the increase in the US budget deficit – with some market estimates for fiscal 2003 – looking for an outtuern out-turn of anything up to $425bn. Combined with a US current account deficit of $500bn (about 5% of US GDP), this may well raise market worries that the 'twin deficits' could be set on an unsustainable path that raises investor worries about financing. Clearly, in this scenario, concerns about financing these deficits could create difficulties for the medium-term trajectory of the US dollar.

LET'S NOT FORGET THE OIL PRICE. There have been remarkable gyrations over the past year reflecting the impact of the Iraq war , tight OPEC supply, disruptions to Venezuelan and Nigerian oil production, as well as low inventory levels in the major economies. History shows that prices above $30-$35 are not sustained for long. Supply and demand do matter here. Forecasting oil prices is a hazardous activity, along with economic forecasting in general. However, it is quite possible that, in six months time or so, oil prices could provide a pleasant surprise that helps the major economies secure a growth stimulus going into 2004.

In Europe, the outlook is less welcoming and, apart from cyclical economic considerations, there are structural issues relating to labour market flexibility and tax reform which have yet to be properly remedied. The German economy, in particular, is experiencing considerable difficulties. Economic growth is expected by the EU to be virtually stagnant for this year and will do little to reduce the German unemployment rate, which currently stands at about 10%. The European Central Bank has gradually been cutting interest rates and further reductions look likely, especially as an offset against a firmer euro. Unlike the US, fiscal policy is more restrictive and is unlikely to contribute little to economic growth this year, largely reflecting the guidelines imposed by the Stability and Growth Pact. Nevertheless, given the nature of the downturn in eurozone economic activity, there is likely to be some degree of flexibility in interpreting these guidelines.

In the UK, economic growth is in relatively better shape than the eurozone, but the deterioration in global economic conditions means there will inevitably be some impact that makes it difficult to repeat last year's GDP out-turn of 1.8%. Bank of England interest rate policy has tended to be responsive to both global and domestic economic conditions. However, a previously resilient housing market has contributed to buoyant levels of consumer spending through equity withdrawal. Now, there are increasing signs that the buoyancy of the housing market is deflating, which makes it easier for the Bank of England to reduce interest rates during the course of the rest of this year. Some offset will certainly be needed to compensate for planned tax increases coming into effect in April this year. So far, the UK's fiscal position has been reasonably good, both in terms of the budget deficit and the debt/GDP ratio. Radical changes in the fiscal stance look unnecessary in the medium term, but this is a difficult stage of the economic cycle and it is not surprising that the financial market will scrutinise more carefully the Chancellor's medium-term borrowing projections.

NO JOY FOR JAPAN. After a long period of economic stagnation and persistent deflation, there appears little sign of light at the end of the tunnel. In spite of remarkable monetary and fiscal measures implemented by the Japanese authorities, the monetary transmission mechanism has effectively broken down, largely because of the bad debt problems accumulated by the Japanese banking system. This has put Japan into a so-called 'liquidity trap'. The new governor of the Bank of Japan, Mr Fukui, is expected to remedy this situation through proposing new measures designed to circulate liquidity to areas of the economy previously not reached. These may include providing support for small- and medium-sized companies through support in the commercial paper (CP) market, as well as the setting of an inflation target and further support for banks through purchasing equity. But a quick and early resolution to Japan's problems looks demanding.

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