

# SERIOUS CHALLENGES AHEAD



**DAVID KERN ARGUES THAT THE GLOBAL ECONOMY FACES BELOW-AVERAGE GROWTH AND DIFFICULT ADJUSTMENTS, WHILE BRITAIN'S TWO-SPEED ECONOMY POSES MAJOR PROBLEMS.**

Following an exceptionally sharp expansion in 2000, which was the strongest year since 1990, economic growth has weakened markedly in all the world's regions. However, early fears of global recession, and subsequent hopes that aggressive interest rate cuts will suffice to bring about a strong recovery, were both misguided. The sharp slowdowns in the US, Japan and Germany, the world's three largest economies, coupled with the crisis in the high-tech sector, highlight complex problems that will take time to be resolved. Global growth will more than halve in 2001 and remain relatively low for the next 2-3 years, (Figure 1).

The US economy, although dynamic and competitive, faces major imbalances that need to be corrected: minimal personal savings, excessive private sector indebtedness, a huge external deficit, and overstretched stock market values. The adjustment process will be difficult, resulting in a period of below-trend expansion and financial volatility. For 2001, I expect anaemic US growth of only 1.4%, a very sharp deceleration after 5% in 2000, followed by a still feeble 2.2% in 2002.

The euro-zone's performance remains pedestrian and disappointing, reflecting unduly slow reforms and the inadequacies of the European Central Bank (ECB). The euro-zone is clearly unable to replace the US as the leading global economy. Germany's particularly sharp weakening, with expected growth of only 1.1% in 2001 and 1.8% in 2002, heightens concerns over Europe's prospects. The euro remains weak against the dollar, and the changeover to euro-denominated notes and coins, early in 2002, is critically important.

Japan's prolonged crisis creates wider risks. Consumer confidence, weakened by deflation, remains depressed and worsening credit problems in the banking and corporate sectors could push the economy into deep recession. Unlike the US, Japan lacks the flexibility and political will to deal with deep-seated problems. My forecast is that Japan will decline 0.3% in 2001 and grow less than 1% in 2002, remaining the slowest amongst the major G7 economies.

The emerging economies are posing the most serious global threat. Growth has plummeted and there is a distinct danger that

some countries will be forced to default on their external debt. The threat is particularly acute in Argentina, but Turkey and Brazil are also facing speculative attacks. While a global financial crisis may be avoided, Asia, Latin America and Eastern Europe will all experience pressures.

**THE PRESENT CYCLE AND ITS RISKS.** Since 1960, cyclical downturns, both globally and in the UK, were caused by sharp rises in official interest rates aimed at breaking inflationary booms. In contrast, the current slowdown largely corrects the effects of over-investment and excess capacity, mainly in high-tech industries, while inflation and interest rates have remained at historically low levels. The bursting of the 'dotcom bubble' is a necessary adjustment that brings back overblown asset prices to more realistic levels.

However, one major risk is that consumer confidence may collapse in reaction to rises in unemployment. So far, domestic demand has remained strong, underpinned by the ability of many central banks to reduce official interest rates. However, the worrying sign that inflation is slowly rising is a serious complication, because the markets now expect interest rates to start edging up later this year or in 2002.

**BRITAIN WITHSTANDS GLOBAL SLOWDOWN, BUT TWO-SPEED ECONOMY CREATES PROBLEMS.** (Figures 1&2) The UK economy will avoid the most damaging effects of the global downturn. Performance remains fairly robust, with unemployment below 1 million and inflation marginally below the 2.5% target. UK GDP

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growth, although slowing, is forecast at a respectable 2.2% in 2001, considerably better than in the US, Germany and Japan, followed by a modest improvement to 2.5% in 2002.

However, Britain's two-speed economy, with manufacturing in decline while consumer spending and services grow strongly, is a serious imbalance, (Figure 2). Retail sales are expanding by more than 6% per annum, house prices are rising by almost 10%, while buoyant public spending adds further to excess consumption. Inflation, although marginally below its 2.5% target, is edging up and this must be a source of concern for the Monetary Policy Committee (MPC). The labour market remains tight and earnings are rising by almost 5% per annum, slightly above the 4.5% figure considered consistent with the 2.5% inflation target.

Meanwhile, the external deficit (the gap between imports and exports) is forecast to balloon to more than £20bn in both 2001 and 2002. This deficit, which makes it possible for us to consume, as a country, more than we produce, cannot be sustained indefinitely. If the pound falls precipitously, inflation may rise, forcing the MPC to respond by raising interest rates aggressively, thus worsening the imbalances in the economy. A collapse in sterling is by no means imminent. Indeed, the UK would benefit from a gentle fall in the pound against the euro, particularly if this coincided with a general recovery in the euro against the dollar and other currencies. However, sharp falls in sterling can be very dangerous.

**THE OUTLOOK.** (Table 1) Globally, while a major recession will be avoided, the next two years will be a period of weak, below-average growth. Correcting the underlying imbalances will necessitate difficult adjustments. Share prices may fall further and the dollar will weaken temporarily against the euro.

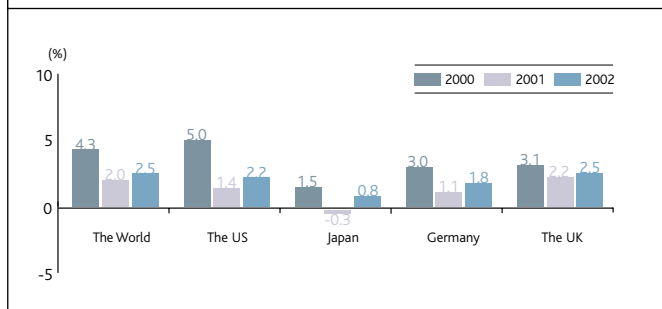
In the UK, the outlook remains benign, but the prospect of further base rate cuts has diminished. Even if we see a cut to 5%, there is a realistic prospect that Base rate will start edging up before end-2001, rising to 6% by mid-2002. This will add to the pressures facing those sectors exposed to international competition: manufacturing, agriculture and tourism. Sterling will fall only modestly against the euro and the imbalances inherent in Britain's two-speed economy may worsen before the situation improves.

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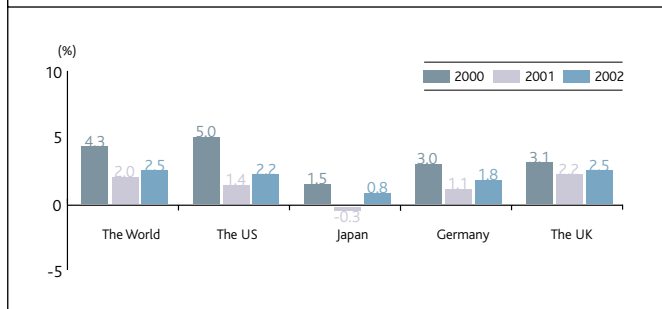
**TABLE 1**  
 CURRENCIES AND INTEREST RATES IN 2001 & 2002

	ACTUAL	FORECASTS		
	MID-2001	END 2001	MID 2002	END 2002
UK Base rate	5.25%	5.25%	6.00%	5.50%
\$ per £	1.41	1.46	1.49	1.46
£ per euro	0.60	0.65	0.66	0.66
DM per £	3.25	3.01	2.97	2.95
\$ per euro	0.85	0.95	0.98	0.96

**FIGURE 1**  
 THE WORLD'S MAJOR ECONOMIES 2000-2002.  
 ANNUAL % CHANGE IN GDP.



**FIGURE 2**  
 BRITAIN'S TWO SPEED-ECONOMY 1999-2002.  
 ANNUAL % CHANGE.



## SPOTLIGHT...

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