ROOM FOR OPTIMISM

JONATHAN LOYNES OF CAPITAL ECONOMICS PUTS INTEREST RATE PREDICTIONS INTO PERSPECTIVE AS THE GLOBAL MARKETS LIMBER UP FOR ANOTHER YEAR OF HIGHS AND LOWS.

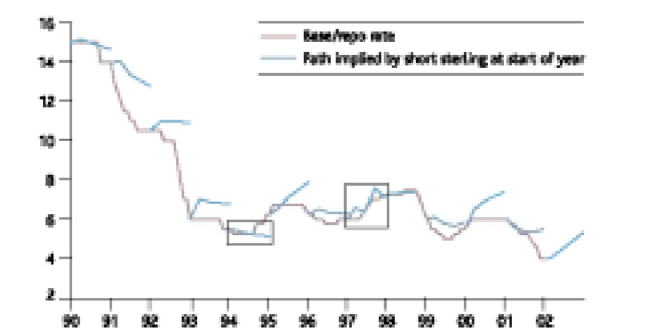
Markets have begun the New Year with their traditional pessimism towards the outlook for interest rates. After last year's aggressive reductions from 6% to a 38-year low of 4%, short sterling futures are now discounting an increase back up to almost 5.5% by the end of this year, with a further rise to 6% anticipated by the end of 2003. The clear expectation is that, having dropped to levels perceived to be 'abnormally low' last year, rates must now move fairly quickly back up to 'normal' levels. Put simply, what goes down, must come back up again, and roughly back to where it started.

Forgive me, however, if I express a little scepticism towards this neat but rather predictable view. I'll come to the factors relating specifically to interest rates in 2002 in a minute, but first a quick glance at the markets' record at forecasting interest rates in recent years should help to put things in context. In *Figure 1*, you can see that it has become customary for money markets to begin the year too pessimistic about interest rates. In January last year, for example, short sterling discounted only a very modest fall in interest rates from the then level of 6% to about 5.5% by the end of 2001 – a long way shy of the 4% rate actually reached.

RATE EXPECTATIONS. In the previous year, markets anticipated a rise from their January 2000 level of 5.5% all the way up to 7.4%, but, in the event, they rose only very modestly to 6%. In fact, you have to go back to 1997 to find the last year in which the markets' expectations for rates turned out to be too optimistic – and even then the error was very small. Rates rose from 6% to 7.25% during the year, slightly higher than the 7% level predicted at the start of the year. Altogether, markets have been too pessimistic on interest rates at the start of all but two of the 12 years since 1990 – 1994 and 1997 – as *Figure 1* shows.

Admittedly, it is possible to argue that rates implied by short sterling futures will naturally tend to overstate true interest rate expectations. This is because short sterling relates strictly to inter-bank lending rates, rather than the official repo rate, and hence should include some sort of risk premium. But this effect is unlikely to add much more than a few basis points to implied interest rates – the Bank of England points to no more than 15bp – which pales into insignificance when compared with the 1.1% (that is, 110bp) average undershoot of the rates implied by short sterling over the six-year period. Accordingly, it would appear that market interest rate expectations have simply been consistently and structurally too pessimistic in recent years.

FIGURE 1
MARKETS NEARLY ALWAYS TOO PESSIMISTIC



Why is this? The fact that inflation has been at, or below, its target through most of this period rules out unanticipated policy errors as a possible explanation – indeed, interest rates could probably have been lower still without missing the target. Neither is the growth rate of the economy to blame. If anything, the economy has probably grown more quickly than expected in recent years. The answer must therefore lie within a more favourable relationship between activity and inflation than has been anticipated at the start of each year. In turn, part of this is almost certainly to do with the continued strength of the exchange rate, which has defied predictions both in the markets and from the policymakers of a depreciation. As a result, the downward pressure on prices in the tradeable sectors of the economy has remained much stronger than expected.

However, the strong pound is unlikely to be the end of the story, not least because import prices stopped falling to any meaningful degree way back in 1999 and yet inflation has continued to surprise on the downside. Other longer-lasting forces appear to have been at work, including a general increase in competitive pressures in the high street borne – at least in part – from a heightened sense of price sensitivity among consumers.

KEY DRIVERS. While these structural forces can have – and clearly have had – important influences on policy decisions over time, in the short-term at least, it is the strength or otherwise of the economic cycle that is the key determinant of interest rates and this brings us back to this year. Current expectations that interest rates will rise sharply in 2002 rest on two premises. The first is that the global economy undergoes a decent recovery, hence relieving the pressure on the internationally exposed parts of the economy, such as manufacturing, and lessening the need for offsetting strength in the domestic economy. The second is that the domestic economy, and consumer spending in particular, do not slow of their own accord and hence require policy action to restrict them as other parts of the economy recover.

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Both of these assumptions could turn out to be correct, but in our view the risks are clearly in one direction. On the global background, recent weeks have seen some encouraging signs that the industrial slowdown in the US is past its worst. Previously, south-facing orders balances of surveys such as that from the Institute of Supply and Management (ISM), previously the National Association of Purchasing Managers (NAPM), have turned back up and, while a still large inventory overhang means that stronger demand has yet to be translated into stronger output, there are signs that while a still large inventory overhang means that this has yet to be translated into stronger output, at least demand appears to be on the mend.

Two factors suggest that the recovery in global demand could be less forthcoming than currently appears to be expected, though. The first is the danger that, even as industry begins to recover, the US economic slowdown will move into a second and potentially more serious stage, in which consumer spending weakens more dramatically. The key channel for this would be further sharp rises in unemployment as the corporate sector shakeout, continues but further declines in the equity market could also hit spending by depressing wealth. Of course, unemployment has risen in the latter stages of many previous downturns without preventing the economy from recovering, but rarely in previous cycles have households been as over-extended as they are now. Accordingly, if rising unemployment persuades households to re-build their balance sheets, its effect could be much greater than in previous cycles.

Second, even if the US recovery does continue without a hitch over the coming quarters, it could be some time before the rest of the world follows. The slowdown in Europe was already in place before the US downturn made its appearance, and it could remain in place long after the US has recovered, while the prospects of any meaningful upturn in Japan look extremely slim. The upshot is that, even with a stronger US economy, trading conditions for the UK could remain difficult for some time.

As for consumer spending at home, certainly the latest batch of data has given no indication of any self-induced slowdown. Having wobbled in the wake of 11 September, retail spending, housing activity and prices, and consumer confidence have all since strengthened again. As in the US, however, the historical context is an important one. Since the start of 1995, consumer spending has grown by a cumulative real 28% compared with the 19% increase in GDP over the same period. In other words, spending has grown by half as much again as the overall economy. Only once before in the last half century has spending outgrown the rest of the economy by such a margin over such a long period – ominously, that was in the six years to the end of 1988, immediately before spending and growth began to slow sharply as the economy moved towards recession.

This does not necessarily mean that spending is about to collapse in the way that it did in the late 1980s. Then the threat of higher inflation forced the policymakers to push interest rates sharply higher, even as households showed signs of becoming dangerously overstretched. This time, such price pressures are absent. Nonetheless, insofar as the outperformance of spending in recent years has been helped by the long downward trend in unemployment and strong gains in wealth seen in recent years – both of which have now come to at least a temporary halt – a return to at least a more normal pace of spending could soon be on the cards. Coupled with continued difficulties overseas, this means that activity overall will remain fairly sluggish this year.

But there is one more factor that might help interest rates to surprise on the downside for a fifth consecutive year in 2002 – inflation. Amidst all the focus on activity at home and abroad in recent months, the inflation outlook has not surprisingly received little attention. The recent tendency for inflation to stick remarkably close to its target has probably contributed to this lack of interest. But all of this could be about to change, if the evidence of strong deflationary pressures in the pipeline is anything to go by. Commodity prices are down sharply over the past year, and factory gate inflation has also fallen back to very low levels. With RPIx already comfortably below its target at just 1.8%, it would not take much of these weaker cost pressures to feed into the high street – usually, a fairly mechanical process – to push it below 1.5% and trigger an open explanatory letter from the Monetary Policy Committee (MPC) to the Chancellor.

MAKING HEADLINE RATE NEWS. Moreover, with the right tailwind of lower oil and food prices, it is not inconceivable that the headline rate of inflation even turns negative, delivering deflation in the UK – albeit briefly – for the first time in more than 40 years and giving inflation expectations another nudge downwards. Against this background, even if activity at home and abroad is recovering convincingly by the middle of the year, it will be difficult for the MPC to push up interest rates as sharply as the markets currently expect.

The upshot is that 2002 looks set to be a 'normal' year as far as interest rates are concerned, by which I mean that they will finish the year at significantly lower levels than the markets are currently anticipating. How much lower? An end year rate of perhaps 4% to 4.5% sounds like a very bold call, given the rate of nearly 5.5% or so currently implied by the markets – but this would be no more of a 'surprise' than those seen over the last decade. Indeed, if previous experience is anything to go by, believing what the markets tell you would be far bolder.

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