ON THE ROAD TO RECOVERY

BUSINESS AND CONSUMER CONFIDENCE REMAINS DOWN. SO WHAT WILL IT TAKE FOR A GLOBAL ECONOMIC RECOVERY? **NEIL MACKINNON** OF MERRILL LYNCH DISCUSSES THE DECIDING FACTORS.

This year we saw the dotcom recession, in which the spectacular puncturing of the technology stock bubble paved the way for a downturn in business and consumer confidence. Indeed, the downturn was global in nature as the US, Europe and Asia faced slower growth and rising unemployment for the first time since the early 1980s. There were other contributory factors, of course, such as the spike in the oil price to a peak of $36 during the 1999-2000 period (the fourth big spike in oil prices after 1974, 1970 and 1990). Typically, it takes about 18 months before sharp increases in the price of oil start to adversely affect the real economy and push unemployment rates up. Thankfully, oil prices have since receded as demand slumps, and OPEC supply cuts have yet to prove dramatic. Lower oil prices are effectively equivalent to a tax cut for consumers and businesses. Pricing power remains weak, though, and deflationary pressures are intense. However, 11 September intensified pre-existing trends in the key economies by denting business and consumer confidence.

LOOKING FORWARD FOR THE US. The aggressive reductions in US interest rates by the Federal Reserve over the past year have yet to feed into a sustained pick-up in economic activity. Real short-term interest rates are now negative in the US (1973-80 was the last time rates were negative) and, in principle, is a powerful positive factor for global liquidity, corporate financing and equity market performance. In addition, the fiscal stimulus (1% of GDP) also provides extra fuel to promote economic expansion. The big question, though, still remains the timing and strength of the prospective upturn in the US economy.

The National Bureau of Economic Research (NBER) is officially responsible for timing the dates of recession in the US economy. Recently, it dated the start of the US recession in March 2001. The average US recession in the post-war period has lasted 11 months, with the longest recessions (in the early 1970s and 1980s) lasting 16 months. It is likely, that the current recession will fall into this category – that is, longer than the 'average' recession, given the build up of US corporate debt during the 'boom' period from 1995-2000. Corporate balance sheets will have to go through a significant restructuring in which debt returns to sustainable levels. Only then will the medicine of lower borrow costs start to favourably impact. However, a return to above trend rates of GDP growth in the US of 4%-5% looks demanding against a background of capacity overhang and an unwillingness of corporates to repeat previous investment spending patterns, especially if credit spreads widen on investor concerns relating to debt default.

HOW FARES THE EUROZONE? In the eurozone economies, the economic policy mix seems inflexible and restrictive. The ECB is seen as being reactive and unwilling to pursue an activist interest rate policy. Instead of being seen as ahead of the curve, it is often perceived as being behind the curve, especially given that its mandate seems to focus exclusively on the control of inflation. There is also little scope to use fiscal tools to help the economy given the guidelines imposed by the Stability Pact. The estimated fiscal stimulus in Europe for 2002 amounts to no more than 0.3% of GDP. As a result, any recovery in the European economies looks more limited to a 2%-3% pace by the end of 2002.

As far as the euro is concerned, it becomes a 'real' currency in Europe. FX investors have generally been disappointed by its performance against the dollar and it is unclear whether it will ever have the status of a strong currency in the medium term. For once, there is no clear or well-established consensus among the currency forecasting fraternity as to what will happen to the euro over the next months and predictions of a move to parity against the dollar are scarce. Much depends on what happens to the dollar but the factors that underpinned the bull market in the dollar since 1995, such as the investment boom and productivity surge, are fading. This gives the euro an opportunity to sustain a slightly higher trading range though any significant euro appreciation presumably won't go down well with hard-pressed German exporters. For the UK, the main challenge is to what extent the UK economy withstands the global downturn. British consumers like spending, and the role of the housing market and its sensitivity to interest rate moves complicates the management of interest rate policy. As a result, there may be scope for only limited reductions in UK interest rates during 2002.

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