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Article

Outlook 2005: Return to Sender

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John Llewellyn

Am 17. und 18. März 2005 findet wieder in Berlin in der britischen Botschaft die »International Spring Conference – Prospects for the European Economy« statt. Am ersten Tag werden die wirtschaftlichen Perspektiven wichtiger Weltregionen behandelt. Im Mittelpunkt des zweiten Tages steht die konjunkturelle Entwicklung in bedeutenden Branchen der europäischen Industrie. *John Llewellyn*, Lehman Brothers, New York, wird einer der Referenten sein.

Nähere Informationen zur Konferenz finden Sie unter: www.cesifo.de/isc. Weitere Auskünfte erteilen auch Dr. H.-G. Vieweg, managing director, Tel.: +49(0)89/9224-1362 oder Deirdre Hall, Tel.: +49(0)89/9224-1410.

Outlook 2005: Return to Sender

Our 2004 Outlook *Two Cheers for the Recovery* noted that "Positive forces should drive the recovery into 2004; however, large imbalances point to growing downside risks."

In the event, the world has indeed seen a recovery driven by the forces of expansionary fiscal and monetary policies. But now, on cue, the imbalances – primarily the 6%-of-GDP US current account deficit – are coming to the fore. The fundamental issue now is what the consequences will be.

We address the issue in a two-pronged manner:

- The baseline forecasts, summarised in the text, have been constructed on the key assumption that, for the next two years, the principal imbalance – the large and growing US current account deficit – will prove tractable: that the falling dollar, while not solving the fundamental unsustainability of the US current account deficit, will keep the worst of the potential consequences at bay.
- However, there is a risk of a worse outcome than that depicted by our baseline forecast. Because it would stand to be not only quantitatively, but also qualitatively, different, we discuss the issue in a number of special features.

Forces acting

Fiscal policy. The OECD economy has recently seen its biggest discretionary fiscal

expansion for 30 years: 0.4% of OECD GDP in 2001; 1.6% in 2002; and 0.6% in 2003. This completely reversed the 1990s reduction in fiscal deficits.

The US fiscal swing has been enormous. In earlier decades, any swing of 1/2 a percentage point or more in a country's cyclically adjusted budget balance was a major event. Yet the recent US fiscal expansion has been about eight times that size, and the UK swing about four times. In the euro area, by contrast, and notwithstanding the clamour over the breaching of the Stability and Growth Pact, the fiscal swing has been small.

However, by 2004 fiscal policy globally had become near-neutral: there was little change in the OECD-area cyclically adjusted government budget balance, and such stands to be the case again in 2005. Thus fiscal policy is set to contribute little further to the growth of global aggregate demand.

Monetary policy. Official interest rates globally are not only historically low, but also are about 250bp lower than historical experience would have suggested that they might be in an output/inflation configuration such as the present. Again, the US has been the driver, with its rates around 425bp below those that would be expected on the basis of historical relationships; euro-area official interest rates are around 100bp below; but Japanese real rates seem broadly consistent with the cycle.

Oil. Compared with the two great oil-shock episodes, of 1973/74 and 1978/79, today's real oil price is not particularly high:



it would have to have risen to around \$ 100/bl to match where it was in 1978/79.

In 1973/4 and 1978/9 the oil price rise slowed global GDP growth to a crawl. Two principal mechanisms were involved: a weakening of consumers' real incomes and thereby consumption (the so-called "oil tax"); and the slowness of oil producers to spend their revenues, which raised the global saving rate by around 2 percentage points. This time, however, the effects may have been smaller: in particular, OPEC has been spending its revenues almost as fast as it has been taking them in. Hence, while consumers of oil have been getting hit, exporters have been doing offsettingly well.

The corollary, however, is that, should the price of oil fall substantially, it may do comparatively little to stimulate world growth. Consumers would be better off, but exporters more or less correspondingly worse off.

Major world macroeconomic models (principally those of the IMF and the OECD) suggest that the rise in the oil price to \$ 50-odd per barrel took only about 1/2 a percentage point off OECD GDP growth in 2004. If the oil price remains around \$ 40 per barrel, as we expect, lagged effects of much the same size may be felt in 2005.

The forecasts: GDP

Given these principal forces – monetary policy; fiscal policy; and oil – we expect world GDP growth to slow by around a percentage point in 2005, to 2.3%.

Within that overall picture, the US slows by around a percentage point, to 3.5% – about the growth of potential. The principal reasons: the fiscal stimulus is coming off; monetary policy is tightening; consumption seems unlikely to grow as strongly as it has been; and business investment seems unlikely to take over the running. Net exports, however, may strengthen, the result of the weaker dollar.

The euro-area recovery loses its way, with growth slowing to 1.5%, well below the 2–2½% that is generally considered to be the growth of potential. The main points underpinning the euro-area forecast: macro policy, both monetary and fiscal, is determinedly steady; consumption remains cautious in relation to its usual determinants; business investment continues to be more affected by weak sentiment abroad than we, and others, had earlier expected; and exports are hurt by the stronger euro. GDP growth in the United Kingdom may come in below potential, too, as housing weakens and consumers retrench.

Japan slows down substantially, from near-3% growth this year to 0.6% growth in 2005 (although around 1 percent-

age point of that is due to a change in the method of calculation of the price deflator). This forecast essentially reflects our judgement that the current recovery is not fundamentally different from its two predecessors, both of which aborted due to a failure of domestic demand growth to become self-sustaining. Principal reasons for this judgement on Japan's prospects include: deflation has not yet been conquered; land prices, a bedrock of banks' balance sheets, have not yet stopped falling; banking system reform is not yet complete; and yen strength may not only weaken the contribution from net exports, but may also further frustrate the ending of deflation.

Inflation

On the basis of our GDP forecast, the OECD output gap starts to re-widen in 2005. This suggests that wage inflation is unlikely to be a global problem (although it could be in depreciating economies). As regards oil, we assume, in line with the oil futures, that the price remains largely steady, ending 2005 at around \$ 40 per barrel. Non-oil commodity prices, contrary to what is sometimes asserted, are not out of line with historical experience: measured in a basket of currencies, they are much where OECD industrial demand would suggest they should be. They do, of course, seem high in dollars, but that is due to the dollar's depreciation.

Accordingly, our inflation expectations for 2005 are: US inflation holds steady at 2.7% in 2005; the euro area experiences a marked inflation deceleration, from 2.1% in 2004 to 1.5% in 2005, perhaps with most of that occurring in the second half of the year; and Japan does not get out of deflation.

Official interest rates

With OECD growth in 2005 below potential, the oil price changing little, and non-oil commodity prices doing nothing out of the ordinary, we expect central banks generally to be cautious about taking official interest rates back up towards more normal levels.

Thus in the US, we expect the Fed to hike four times, each by 25bp. The ECB seems likely to stay on hold all year, but we see a significant chance that the Bank of England cuts rates. The Bank of Japan will probably leave rates unchanged all year.

Bond yields

Bond yields are far from where they can ultimately be expected to be, once the global output gap has been closed,

inflation is back to the 2%-odd that most central banks seem to target, and due allowance is factored in for the increase in structural budget deficits – in the US, but also in the euro area and Japan.

However, with official rates increasing only slowly in 2005, we expect bond yields to make only a limited progression towards these more normal levels. In the US, we expect ten-year yields to rise by only around 90bp, to end 2005 at around 5.0%. We expect Europe, with slower growth, lower inflation, and smaller structural budget deficits, to outperform, with 10-year bund yields increasing by about 60bp, to end 2005 at around 4.1%. And in Japan's environment of slow growth, continuing deflation, and no change in official rates, we expect bond yields to rise marginally, to end 2005 at 1.5%.

particularly if the US economy is slowing. Europe will argue that Japan is stealing market share by artificially depressing its own currency; and the US may argue that it is exporting jobs to Japan, and importing unemployment.

There is a risk, however, that the dollar move goes much further. The US, Europe, and Japan so far show little sign of accepting that what needs to be done involves policy action in all three regions. The history of currency crises suggests that, until there is acceptance of a credible multi-economy plan, there is an ever-present risk of excessive currency volatility.

Stock markets

A world of below-potential growth does not offer great scope for top-line earnings growth. So: for the US, our equity analysts see the S&P ending 2005 at around 1300, over 8% higher than it is now. Given the dollar's expected fall, the best common currency equity returns are likely to be in Europe, where valuations are lower than in the US, and where we see evidence of a (somewhat belated) programme of cost reduction in at least the larger corporations. The FTSE Europe could end 2005 up by around 10%. In Japan, market valuations are also low. Nevertheless, given the disappointing economic performance that we expect, the TOPIX may well underperform European markets, but a rising Yen should still mean Japanese stocks outperform their US peers in dollar terms.

Exchange rates

Investors have now clearly decided that the US current account deficit is a matter of concern. The key issue is what change in the trend of that deficit investors wish to see. Even in our baseline forecast, the currency movements stand to be substantial. A continuing slide in the US dollar expresses itself in the first part of 2005 principally vis-à-vis the euro, which we see reaching \$ 1.45 by mid-year; and against smaller Asian currencies, which we judge likely to appreciate by 10 to 20%. However, for some months yet, the yen's potential rise will likely be held back by further, possibly large-scale, intervention – intervention funds to the value of around 5% of US GDP have already been ear-marked by the Japanese authorities.

By mid-year, however, this misalignment of the yen is likely to have provoked serious trade tensions between Europe and Japan, and possibly also between the US and Japan,