Global Economic Update – August 2002

Growth or Double Dip Deflation?

- The weakness of equity markets in the past three months and the dip in certain key economic indicators in the US and Globally in the past month has raised market concerns about the potential for a double dip.
- A double dip would be defined as 2 quarters of virtually flat growth.
- **The risk of such an economic double dip has increased.** The shock to confidence from the equity market declines and the actual negative wealth effects are quite significant.
- **Given the current low inflation structural backdrop, this would also imply a rising risk of outright global deflation.**
- However at this stage we believe that, whilst global economic momentum is being negatively affected by this strong headwind, **we believe that growth is more likely to slow for a period of 1-3 months and then recover later in the year.**
- The reasons for this view are as follows:
  1. Negative wealth effects from equity market deflation are being offset to a significant degree by positive effects from house price inflation.
  2. The slowdown in economic momentum is to date more a function of falling confidence about future conditions. This can recover quickly if actual conditions are not as severe as initially perceived as seen post September 11. Watch unemployment.
  3. Slowing growth has produced a strong rally in interest rate markets, which is stimulatory for domestic consumption and housing, particularly in the US.
  4. Weak equity markets have raised the prospect of further monetary and fiscal stimulus. Easy policy settings are a necessary combination to avoid deflationary pressures.
- However, the past few months may have given us a flavor for the nature of the economic cycle over the coming year. **We have therefore reduced our growth numbers across for the US and Europe. We have kept Asian, Japanese and UK forecasts steady at this stage reflecting reasonable momentum in those economies.**
- In the absence of an acceleration in business investment and employment, both factors of which are unlikely to be notable contributors to growth soon, the pressure falls squarely on consumption demand financed out of current income, savings or wealth.
- Consumers, particularly in the US are being called upon to carry a disproportionate share of the demand load. **Outside of the US the only obvious pockets of demand are seen in the Anglo economies (UK, Canada & Australia), certain Asian economies, most noticeably China and Korea, and sporadically in parts of Europe.**
- This lack of vibrancy reflects both the difficult micro environment where confidence remains fragile and very exposed to shocks, and policy settings in regions such as Europe remain a major constraint to a significant acceleration in consumption.
- The current environment seems very similar to the early 1990's, where from 1991 to 1993 the US and global economy remained stuck in a sub-par growth environment, supported by stimulative policy settings but constrained by structural corporate instability and deleveraging.
- **The coming year is expected to see continued high levels of corporate bankruptcy and debt default acting as a headwind against accelerating growth.**

Monetary Policy

- It has been our long held view that central banks would be slower and less aggressive than markets have been expecting for most of this year in raising interest rates.
- This view reflects the concern about the reliance on household consumption to support demand.
- The past month has seen a dramatic unwinding of market expectations. Forward curves are now suggesting a strong expectation of an easing in the US, a rising chance of an easing in the UK and pricing out any previous expectation of a ECB tightening.
- **We concur that there is little chance of higher rates in the next 6-12 months, based on the sensitivity to higher interest rates seen this year.**
- **But will we actually see easier policy settings?**
- We believe that certainly within the Eurozone, the renewed rise in unemployment and sharply declining inflationary pressures is a sign that nominal interest rates are just too high.
- **Either the ECB rates significantly or else growth expectations will decline sharply. We believe that the ECB will ultimately ease rates but after data shows compelling evidence that growth has already stalled.**
- The UK would be probably more reticent in cutting rates, given quite mixed economic data and signs that the housing market is still running hot. **We have assumed no policy change by the BoE but believe that they would cut if the Fed did so first.**
- The US is a less clear cut issue. At 1.75%, rates are already well below the long term trend level of 4-4.5%, suggesting already super-easy policy settings.
- The Fed will also be looking at the stimulative effect of long bond yields having fallen towards 4.25% again. This is analogous to a sharp policy easing for the household sector.

- **The preference of the Fed would be to maintain current policy settings until it gets a clearer view of whether any slowing in household spending is a pause or a more dramatic capitulation resulting in a sharp elevation in savings. If the latter then they will ease again.**
- Similarly, the Fed will be watching the credit markets closely. We have seen a sharp widening in lesser quality corporate credit spreads, reflecting rising default risk concerns.
- Any contagion into better quality corporate spreads or banking swap rates would suggest a severe credit crunch developing and prompt a swift easing.
- **We maintain a no change view of the Fed funds rate for now but with a strong likelihood of further easings if economic data and credit markets deteriorate further in the next 1-2 month.**

US Economy

- We have revised down economic growth reflecting a weaker than expected economic growth in Q2 and cautious sounding on growth so far in Q3, although there is a strong chance that we could see a surprising strong burst of growth later in 2002 again.
- **More significantly, we have flattened the growth profile in 2003 to show sub-par growth of on average between 2.5 & 3%.** This reflects the expectations that corporate restructuring will continue to be evident well into 2003, resulting in low investment and employment growth.
- **This environment that keeps the economy very dependent on household consumption and low interest rates.**
- The past month has seen a major shock to confidence from the cumulative effects of falling equity markets.
- Measures of confidence have declined across the board. This has fed into a slump in new order activity in the manufacturing and service sectors as companies adopt a cautious wait and see approach.
- **However this is indicative of a flattening of growth rather than a reversal back into recession.**
- It is a very similar response we are seeing to that observed post September 11 which led to a sharp (but temporary) capitulation in demand and production.
- The difficulty in reading the environment at present reflects the following points:
    - On previous occasions of sharp confidence shocks we have often seen a surprisingly sharp rebound within three months.
    - Unlike the September 11 period, we have seen a more significant negative wealth effect in the past three months, albeit this is offset by housing price rises.
    - We are seeing a sharp mortgage refinancing cycle. This has unleashed new consumer demand in the US in the past. If this is spent later in 2002 then it could fuel a surprising bounce in consumption.
    - Business confidence is fragile and further downsizing is to be expected. However unlike in September 2001, inventories are starting from a lean position now. Employment has also been cut aggressively already. That means a less painful adjustment than observed through 2001.

Eurozone

- **We have revised down our forecasts for European growth in both 2002 and 2003. We are reducing the 2002 forecast from 1.1% to 0.7% growth and lowering 2003 from 2.5% to 2%.**
- Weaker external demand, falling business and consumer confidence, sluggish domestic consumption and a deteriorating labour market are the drivers of our forecast revisions
- As a consequence we are reducing our interest rate forecasts, **we now expect one 25 basis point cut in Q4, with the potential for a further 50 basis points of easing in 2003.**
- The development of our 2003 forecast will depend on the timing and magnitude of changes to monetary and fiscal policy. **An early and significant easing of monetary policy coupled with a relaxation of fiscal restraint would boost our 2003 GDP forecasts back above 2% once again, however that is not our central scenario.**
- Industrial production is stalling in Europe with Germany likely to record negative growth in Q2 as production fell in both April and May. Growth have fallen back in both France (0.3%) and Germany (-4.5%).
- Both the Ifo and Belgian Surveys of business confidence have fallen for two consecutive months. Orders data highlight the lack of domestic momentum. Belgian industrial orders fell back from flat to –8.8% yoy in May and German Factory Orders fell 3.2% in June, taking the yoy rate back into negative territory at –1.6%.
- Foreign orders fell sharply on the month (-7.0%) taking the yoy rate from 7.6% down to –0.6%. External demand has been the dominant driver of the European recovery and appears to be waning as a result of the appreciation of the Euro and the slowing of US recovery momentum.
- Domestic demand is unlikely to be able compensate for a reduced contribution from the external sector. Rising unemployment and falling consumer confidence look set to further restrain already sluggish domestic consumption.
- German unemployment has risen back to 9.9%, up 0.7% from the mid 2001 lows, vacancies have fallen consistently since Jan 01 (550k to 464k) and the number of people unemployed has risen every month for the last 18 back to above 4m (4.09m). French

unemployment has also risen by 0.4% from the cyclical low to 9%

- French consumption has been amongst the most robust in Europe, however consumer confidence has been falling since the beginning of 2001 and is now below Sept 2001 levels. Eurozone retail sales growth has been trending lower since 1998 from around 3% highs toward sub 1% growth (currently 0.7%). German retail sales have been negative throughout the year and are deteriorating (-4.1%).
- **Inflation should not be a constraint to interest rate reductions by the ECB.** The EU headline rate has stabilised at 2.5% and the core rate has fallen to 1.8% from a peak in mid 2002 of 3.3%. Germany risks slipping into deflation, the core CPI has fallen to 0.7%.
- The bond markets are signalling that the ECB needs to be more concerned about deflation than inflation. Implied 10 year breakeven inflation has fallen from 190bps to 130bps since May and traded real yields have fallen to 3.10%, below Sept 2001 levels.

UK economy

- **The GDP outlook has been tainted by June's shock IP numbers, which is "lost" growth. This will shave some GDP off our 2002 forecast (now f/c at 1.2%); 2003 is shaved lower to 2.4%.**
- On the consumer side, we assume for now that the impact on consumer and business confidence will only have a minor impact on final demand.
- Recent feedback suggests that consumer demand has slowed from the heady rate earlier in the year. How much of this is related to temporary distortions such as the World Cup and Jubilee weekend and how much is genuine slowing demand is hard to say at the moment.
- A support for future GDP growth will be fiscal policy. A significant easing is occurring via the sharp increase in real public sector wages at the moment.
- The multiplier effects from this should feed into private sector demand from middle income earners.
- **Housing price inflation is a significant offset to equity deflation with price rises of 20% oya. This should help put a floor under confidence and spending.**
- The MPC is acutely aware of the imbalance between weak manufacturing and regional growth and strong housing price increases. We believe that the latter will keep them from pre-emptively cutting rates.
- **We have removed our earlier forecast for a higher base rate in 2002, but will aim a quarter-point rise by end-Q1 2003.**
- The risk to this profile is that the world does enter into a double dip (not our strategic central case), in which case the MPC will swiftly follow the FOMC in cutting to 3.75% on an emergency basis

Japanese economy

- **Japanese growth has surprised on the upside leading us to revise up our forecasts this year.** Initially this has been driven by the upturn in traded exports and industrial production. However there are signs that the domestic data is beginning to look better.
- **The contribution to growth from domestic private demand remains sluggish but there are signs of improvement in retailing, housing, and vehicle sales. Confidence is beginning to improve – the Tankan report is reflecting this.**
- Importantly inventories, which were a major overhang in 2001, seem to be under control now.
- Also on the positive side there are signs that deflationary pressures are abating.
- It is important to remember that the structural backdrop remains grim, however Japanese growth generally turns positive in aggregate when global trade inflects up.
- As profits recover this year domestic demand should revive. Japan's recovery will remain dependent on external demand for the foreseeable future.
- Export volumes grew 12.4% yoy in June, with exports of passenger cars and industrial machinery to Asia were the key drivers. Net exports are estimated to have pushed up real GDP growth by 0.7% qoq in the April-June quarter.
- Bad news was a survey forecasting a drop of 3.7% yoy for this summer's bonuses. The drop, which reflects the plunge in corporate profits in FY2001, means capital investment is also likely to be curbed.
- Also of concern for the third quarter, Mitsubishi Motors Corp. led the eleventh straight monthly drop in domestic auto sales by Japan's automakers in July as consumers appeared more reluctant to spend summer bonuses.
- If domestic demand continues to underperform then the economy as a whole faces an increasing downside risk in the case of weak external demand or an excessively strong Yen.
- **Given the dependence of Japanese growth on export performance, sharp loss of export competitiveness would be unhelpful at the present. This would normally provoke a lowering of interest rates, to offset the shock.**
- Given this, of concern is some evidence that the recent strength of the Yen is beginning to impact export competitiveness - the yen's 11 percent gain since the start of April forced Sony Corp. and Fujitsu Ltd. to recently lower their sales forecasts.
- However given current interest rate levels, the BoJ instead continues to intervene heavily against the Yen in support of the US$. **Whilst this is sterilised intervention at present, a further push by the US**

dollar could force unsterilised intervention by the BoJ.

Global Economics Team
9 August 2002

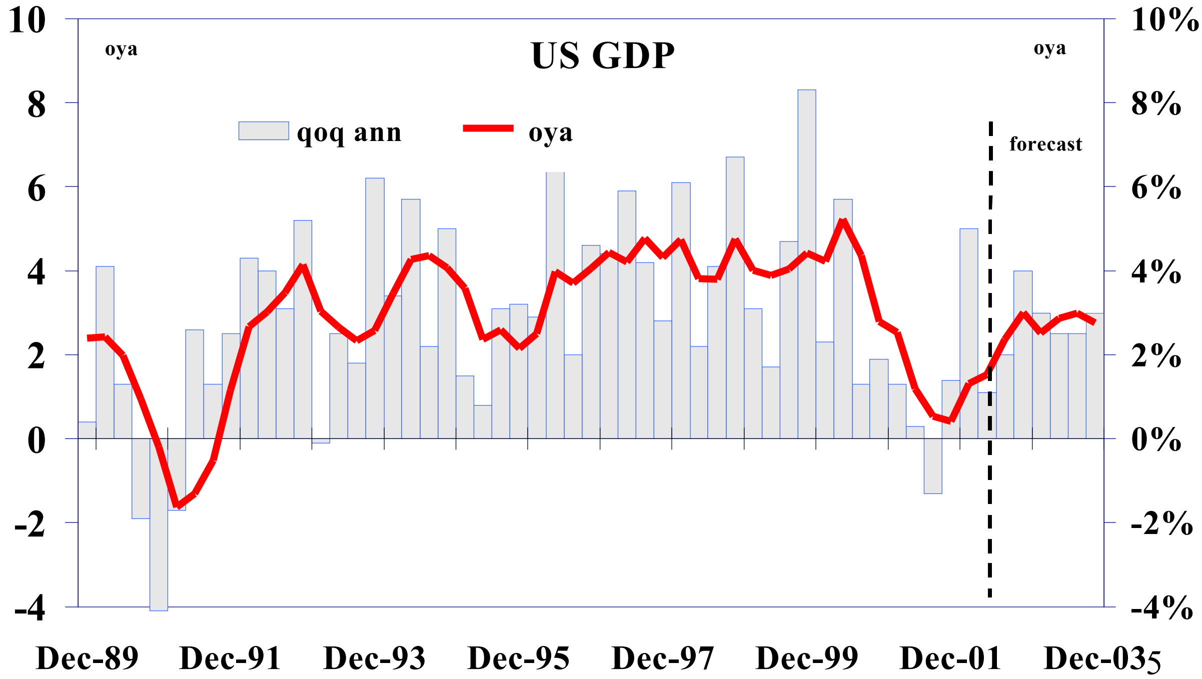
Key Economic Forecasts August 2002 (July consensus)

% ave year	GDP				CPI			
	2002	consensus	2003	consensus	2002	consensus	2003	consensus
US	2.0 ↓	2.8	2.8 ↓	3.6	1.6 ↓	1.7	2.2 ↓	2.5
Japan	0.2 ↑	-0.4	1.1 ↑	1.1	-0.7	-1.0	-0.5	-0.5
Eurozone	0.7 ↓	1.3	2.0 ↓	2.7	2.2	2.1	1.2 ↓	1.9
UK	1.2 ↓	1.8	2.4 ↓	2.8	2.0 ↓	2.3	2.4 ↓	2.4
OECD	1.3 ↓	1.8	2.3 ↓	3.0	1.5 ↓	1.5	1.5 ↓	1.9
Non-OECD	3.1	2.6	4.4 ↓	4.4	9.0 ↑	9.1	5.8 ↑	6.0
Asia (ex Japan)	5.6	5.7	6.1 ↓	6.1	1.9	1.8	2.1	2.5
Global	1.8 ↓	2.0	2.9 ↓	3.4	3.5 ↓	3.5	2.7 ↑	3.0

↑ Upgrade ↓ downgrade

Monetary Policy Forecasts August 2002

Money market rates end month	August 2002	Sep-02 Forecast	Dec-02 Forecast	Mar-03 Forecast	Jun –03 Forecast
US	1.75	1.75 ↓	1.75 ↓	1.75 ↓	1.75 ↓
Japan	0.01	0.00	0.00	0.00	0.00
ECB	3.25	3.25 ↓	3.00 ↓	3.00 ↓	3.00 ↓
UK	4.00	4.00 ↓	4.00 ↓	4.25 ↓	4.50 ↓
Australia	4.75	4.75 ↓	5.00 ↓	5.25 ↓	5.75
Canada	2.75	2.75	3.25	3.50	3.50
New Zealand	5.75	6.00	6.25	6.50	6.50



AAM Monetary Policy Expectations - August 2002