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Taking a Stance on the Global Picture in 2003: Our Views on Six Key Questions

To start the year, we offer our views on the six questions we see as central in the months ahead

To begin the new year, we discuss the six questions we think will be critical to the global outlook, particularly to asset markets, over the next 12 months. In each case, we see markets dividing between two sharply opposing answers. Our own views are reflected in our below-trend 2003 GDP forecasts.

A common theme throughout our answers to these questions is the view that the adjustments to the post-bubble era are still working their way through the global system. The vulnerabilities that have built up, the policy responses that are needed and the currency adjustments that are likely to occur are largely still linked to previous excesses. Even the current 'hot' topic—risks from higher oil prices—partly reflects the underinvestment in basic materials that occurred in the rush to invest in the new economy in the late 1990s.

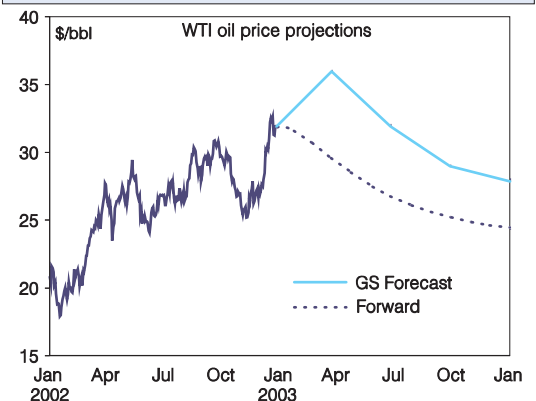
The good news is that—unlike the situation at the start of 2002—significant adjustments have already been made to both valuations and balance sheets. As a result, the risks to asset markets look more balanced than they did early last year.

Accordingly, our six questions for 2003 are as follows:

1. Oil Prices: Damaging Rise or Pleasant Surprise?

The damage from higher oil prices and the risks of a war in Iraq are the biggest wild card for investors in 2003. Pessimists have had this risk on their radar screens for nearly a year, while optimists are already anticipating the positive impact to

Oil Prices Could Stay Higher for Longer



Source: Goldman Sachs.

sentiment when the current uncertainties in Iraq and Venezuela are resolved.

Our Commodity Research Team now expects oil prices to average around US\$31-\$32/bbl in 2003, well above their US\$22/bbl forecast in early December and the \$27/bbl we assumed for most of last year. Despite concerns about a possible war in Iraq, we see the disruption in Venezuelan supplies as more worrisome. At nearly 90 million barrels, it is already larger than the anticipated disruption resulting from a quick war with Iraq, and it makes the market much more vulnerable to war-related supply losses.

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Our Economic Forecasts Are Largely Below Consensus

% growth year-on-year	GDP			Consumer Prices	
	2002	2003		2003	
		GS	Consensus	GS	Consensus
US	2.4	2.1	2.7	2.3	2.1
Euroland	0.7	1.4	1.7	1.5	1.9
Japan	-0.2	0	0.4	-0.5	-0.7
UK	1.8	2.6	2.3	2.8	2.4

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Our recent work underscores the serious risks to growth that higher oil prices pose. We estimate that a sustained 10% price hike could crimp G7 GDP growth by up to 0.3ppts over a year. Higher prices accordingly threaten to offset any positive impact of the renewed policy stimulus we hope to see in the G3 economies this year.

Also important, although harder to quantify, is the impact on risk perceptions. Anecdotal evidence suggests that ongoing concerns about Iraq are boosting risk aversion and delaying corporate decisions.

On the positive side, a smooth resolution of tensions could see risk aversion return to more normal levels and oil prices fall back, providing upside risk to our GDP forecasts.

Yet our current forecasts put oil prices higher for longer than the consensus. Much of this reflects years of underinvestment in the oil industry (as well as in other commodities), which was out of favor during the bubble era. The resulting supply problems and capital constraints will play out over the next several years. We will look at the dynamics of oil prices in greater detail in the coming weeks, but for now we caution that this wild card may not disappear with a quick resolution of the Iraqi situation.

2. Global Imbalances: Still in Trouble or Over the Bubble?

Global demand in 2003 will again be restrained by the excesses of the late 1990s bubble. Three major imbalances built up in that period: corporates overinvested, consumers overspent and the US current account deficit ballooned as US demand growth outstripped that of its trading partners. 2001 and 2002 saw some unwinding of these imbalances, but we think the process is decidedly not complete.

The most progress so far has been made on the corporate front. Plummeting capital spending and aggressive cost cutting have significantly reduced the US corporate sector's financing gap (the difference between investment and cash flow), as the first chart below shows. Similar progress is visible in Europe and Japan.

Risks for 2003 thus fall much more clearly on consumers, who have adjusted their balance sheets less. While our core view is that consumers will adjust their spending behaviour gradually, we continue to worry about a more dramatic adjustment. The risks differ across regions.

- In the US, the savings rate has not yet risen enough to compensate for the reduction in consumers' net worth, and the positive impact of mortgage refinancing may be wearing off.

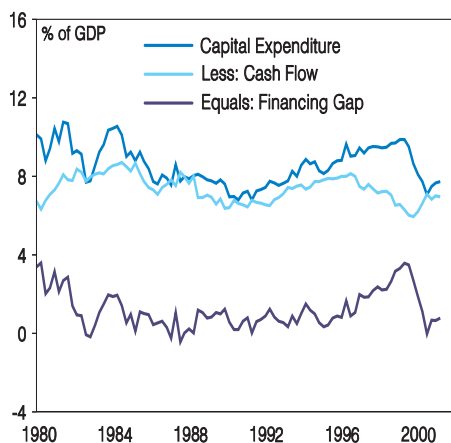
- In Europe, real income growth will stay weak if employment remains sluggish and inflation continues to erode purchasing power.

Even if US consumers hold up, there is little sign that the most prominent *global* imbalance—the US current account deficit—is set to improve. We expect this issue to be back in the spotlight in 2003. The deficit is currently around 5% of GDP, a threshold that has often triggered adjustments elsewhere, and we expect it to continue to widen throughout the year. It is still hard to see how the deficit can shrink without some very large adjustments in global spending patterns and relative prices.

The only example from US history where the current account has been reduced without a sharp slowdown in growth occurred in December 1987-June 1990, when the deficit fell by 2% of GDP. Yet that experience highlights the extreme conditions needed to improve the current account without undermining growth. That reduction was only possible against the background of a 30% decline in the real exchange rate and domestic demand growth averaging close to 4% in Europe and 6% in Japan. A repeat of these conditions seems unlikely.

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US Corporates Have Made Progress in Reversing the Financing Gap



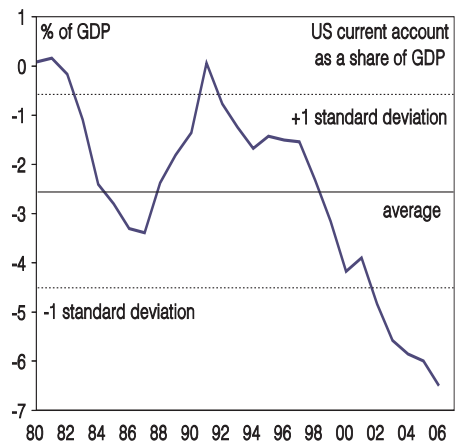
Source: US Flow of Funds.

Global Consumers Are Still Stretched



Source: Datastream; Goldman Sachs.

US Current Account Moves Out Into the Unknown



Source: US Department of Commerce.

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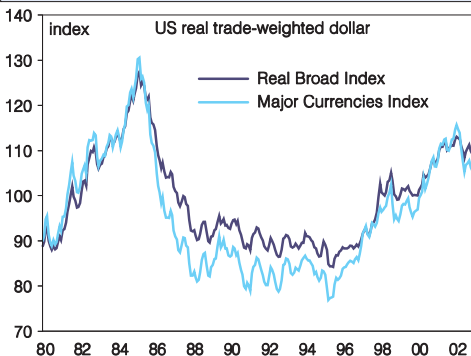
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3. The US Dollar: Continuing to Drop or Downtrend to Stop?

The fate of the dollar is likely to be a key issue again in 2003. What surprises us is how little—not how far—the dollar has already declined. Even after the dollar's sharp fall against many major currencies in 2002 and into the new year, the Fed's broad trade-weighted index is still less than 5% below its peak in February 2002.

We expect the dollar to fall further this year, as the US broad basic balance of payments deteriorates further and the new fiscal stimulus makes the financing of the current

US Dollar Still Has Room to Fall



Source: Federal Reserve Board.

account less sustainable. Our models show that the dollar remains overvalued by around 11% on a trade-weighted basis, suggesting that there is plenty of scope for further decline before valuation becomes an issue.

We see a weaker dollar, in most scenarios, as a positive for the world economy. It will ease financial conditions and deflationary pressures in the US, shift demand toward US products and ultimately help margins in manufacturing. At the same time, it should spur easier policy outside the US. By easing financing conditions, a 10% fall in the trade-weighted dollar accompanied by supportive policies elsewhere in the world could ultimately boost global GDP growth by around 0.5%-0.7%.

4. Global Policy: Poised to Reflate or Arriving Too Late?

We think 2003 could be the 'Year of Intervention' as G3 policymakers increase their efforts to stabilise the world economy. The possibility of a concerted shift towards more reflationary policy is a key upside risk for 2003, with policy changes on the table in each of the G3.

2003 Will See Less Stimulus From Fiscal Policy Than 2001 or 2002

Fiscal stimulus* (% of GDP)	2001	2002	2003
US	1.6	2.7	0.25
Japan	1.3	-0.4	-0.7
Euroland	0.3	1.3	-0.4
Advanced Economies	1.1	1.3	-0.1

* Change in the structural budget deficit. A negative number indicates a tightening in the fiscal stance.

Source: Goldman Sachs.

- The first few weeks of the new US economic team has already seen a larger-than-expected fiscal plan and a retreat in the US dollar;
- With the Bank of Japan governor retiring in March, the market is focused on his successor and the possibility of a move to inflation targeting; and
- The European Central Bank, which will also gain a new president this summer, is reviewing its strategy, raising expectations that a more accommodative approach to inflation may be forthcoming.

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Yet the key question now is not the policy choices themselves, but whether we will get the necessary changes quickly or effectively enough to provide real stimulus to a sluggish global economy. On that front, there is plenty of room for doubt.

While the overall global fiscal impulse will probably be positive, it is unlikely to match the large net stimulus delivered in 2001 and 2002, which averaged over 1% of GDP across the advanced economies in both years (see table on the previous page).

So far, monetary policy offers more hope than fiscal: our forecasts look for further rate cuts from the Fed (25bp) and the ECB (50bp) in the first half of this year. By contrast, the net fiscal impulse globally in 2003 still looks dangerously close to zero, even though the US package is likely to be larger than we initially expected. Federal stimulus in the US will be partially offset by state and local tightening, and much of the stimulus will not be effective until 2004. Moreover, Europe and Japan appear to be heading for tighter policy.

5. The World Ex-US: Helping Hand or Stuck in the Sand?

Signs of progress in restoring demand in a major area outside the US would unambiguously reduce the risks to the global economy. The most obvious hope is for an independent cyclical upturn in Euroland. Yet the signs to date are not encouraging.

In fact, there is a good risk that Euroland will repeat its role of 2002 as an independent source of weakness for the world economy. Germany still looks fragile, and its impact on other European economies seems underappreciated. The ECB's 50bp cut in December may signal a

more pragmatic approach, but further cuts are likely to be needed. A large part of the problem of unbalanced global growth comes from the secular decline in European and Japanese growth rates relative to the US, a trend that seems unlikely to reverse soon.

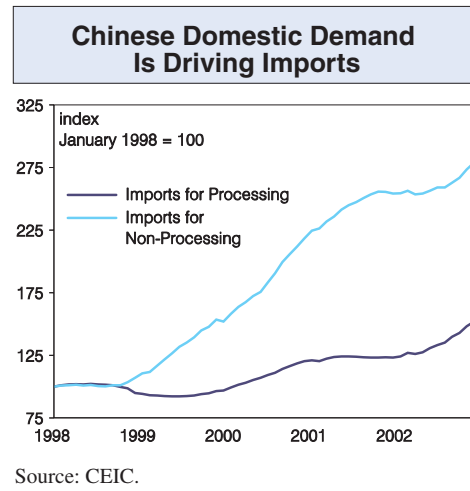
There are few other 'white knights' for the world economy. China's growth is impressive, but the country's impact will vary by sector, and its economy is too small (12% of US GDP in dollar terms) to take up much slack if the US engine falters.

6. China: Source of Deflation or Global Salvation?

Although China remains too small to lead the world out of trouble, its importance as a long-term story for investors is growing. Some emphasise the threat from China as a competitor, a magnet for FDI or an exporter of deflation. Others see the opportunity in rapidly growing Chinese markets. All broadly agree that China's impact is becoming harder to ignore.

There is no doubt that China's growing integration into the world economy is causing significant adjustment problems—but the reality is that China is affecting different sectors in different ways. Although its arrival as a major exporter in some areas may be adding to pricing pressure, Chinese demand is also an important prop for many commodities. It is hard not to be impressed by the rates of growth in Chinese imports, which have risen 16% on an annualised basis since 1998. China is already the largest export destination for Korea and Taiwan, and the second largest for Japan (after the US).

While China's role as a processing hub is part of the import story, the domestic story is at least as impressive. Imports for domestic demand have grown by a striking 24% annualised rate in US dollar terms



since 1998—well ahead of the 10% increase in imports for processing and re-export.

We recently examined the economic impact of global demographic trends and concluded that developing markets will provide around half the demand growth in the world economy over the next 30 years. (We published a summary of our research in the December 2002 issue of CEO Confidential.) Positioning for this growth will be an important part of company strategies. China is the best, though not only, example of this phenomenon. ■

The Relative Decline of the Non-US Engines					
Annual average GDP growth (%)	1960s	1970s	1980s	1990s	Last 10 years
US	4.1	3.3	3.0	3.1	3.2
Europe	4.8	3.4	3.9	2.2	2.2
Japan	10.2	4.8	2.2	1.5	1.1

Source: Datastream; Goldman Sachs.