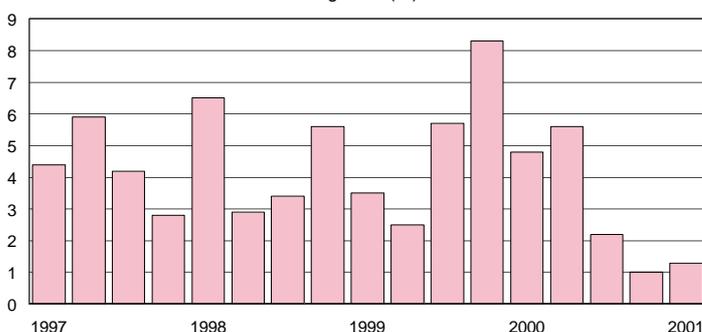


Will the USA experience a hard landing?

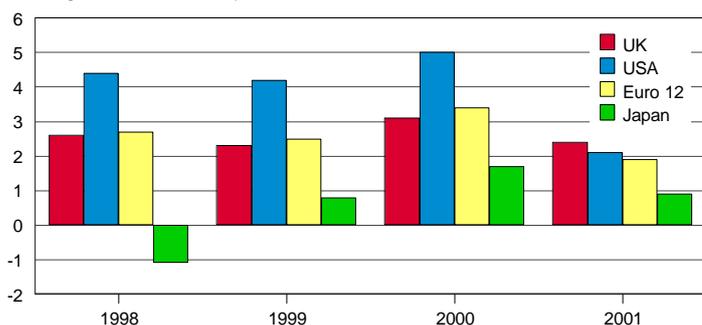
A GROWTH SLOWDOWN OR A FULL-BLOWN RECESSION?

Annual rate of United States real GDP growth (%)



THE GLOBAL ECONOMY SLOWS DOWN

% change in real national output



Source: Merrill Lynch (2001 is a forecast)

The United States is the largest economy in the world, producing in 1999, 28% of global output. It has enjoyed a period of sustained economic growth over the last nine years.

Since the last recession finished in late 1991 the American economy has enjoyed substantial gains in output, and employment together with falling unemployment and a surge in average living standards.

But the risks of recession for the USA remain strong. The juggernaut economy of the Western world has already slowed down appreciably and some sectors are already in technical recession.

Will the contagion of falling confidence spread to bring about a severe economic downturn?

Is the US heading for a hard-landing or can the Monetary and Fiscal policy measures already introduced and in the pipeline help to prevent a full-blown recession?

If the USA enters recession, how will this affect the UK economy? This weekly briefing considers the key short and medium term trends for the US economy as it heads into the next critical few months.

US ECONOMY IN THE LONG RUN

	1970s	1980s	1990s
Economic Indicator	Annual % Change		
Real GDP (National Output)	3.2	3.0	3.0
Consumer Spending	3.5	3.2	3.1
Government Spending	0.6	2.5	1.0
Fixed Capital Investment Spending	4.4	2.8	5.1
Exports of goods and services	7.7	5.8	7.0
Imports of goods and services	5.0	5.8	8.4

Consumption and Investment

Prospects for the US economy in the near-term depend crucially on whether domestic consumer spending holds up during the slowdown and whether or not the US experiences a sharp fall in capital investment spending.

Consumer Boom—but a collapse in saving

Consumers and corporations have been key driving forces behind the boom of recent years. Personal consumption grew 5.3% in both 1999 and 2000—faster than the economy as a whole. This growth in demand was encouraged by rising share and equity prices, falling unemployment and rising real incomes. Another factor was the sharp decline in personal sector saving in the US economy since the mid 1990s.

The household saving rate fell from near 4% of after-tax income in the mid-1990s to its current level of less than 1%. The collapse in savings was caused by a high level of household borrowing—on the back of a surge in consumer confidence and rising financial wealth. As share prices rocketed in 1999 and the first few months of 2000, millions of Americans borrowed some of their extra wealth and translated it into liquid spending power. Because increases in wealth do not count as disposable income, the rise in spending has out-stripped gains in after tax income.

Mortgage loans add to consumer demand

Another factor taking the savings ratio to very low levels was a boom in mortgage refinancing similar to that seen in the United Kingdom in recent years. Many homeowners have been able to improve the terms of their mortgage and turn some of the capital locked into their property into cash (or liquid spending power).

It remains to be seen whether the downturn in the US economy will lead to a long overdue correction in the household sector savings rate. Unemployment is now rising and consumer confidence remains brittle (although picking up following the recent series of interest rate cuts announced by the Federal Reserve—see page 3). Real consumption growth this year is forecast to dip to just 2% - more in line with the expected increase in real disposable income of 2.4% during 2001.

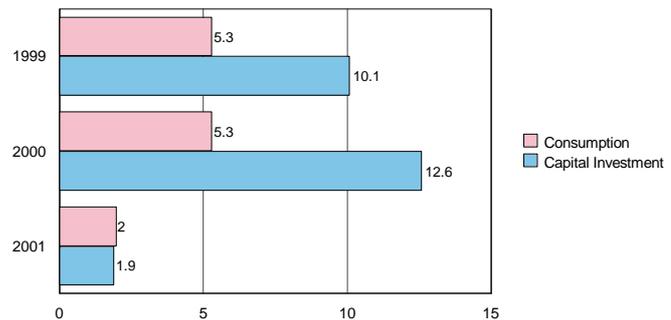
Investment

Capital spending by US businesses boomed in the final half of the last decade. Business fixed investment demand grew by 10.1% in real terms in 1999 and a staggering 12.6% in 2000.

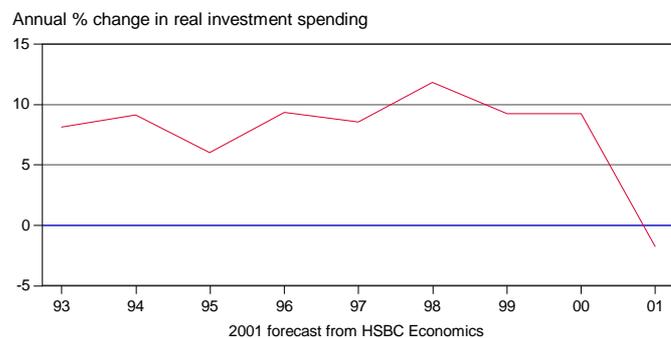
The share of national income taken up by investment has grown leading many economists to believe that higher levels of capital investment—often embodying recent improvements in technology—are providing the platform for much higher trend US economic growth in the years to come. Much of the investment has been channelled into establishing new internet businesses and expanding the capacity of the ICT systems required to run the economy.

Recession fears, which intensified last year, do not appear to have altered the trend, confounding many economists. Strong consumer spending has kept the US economy from sinking into an outright recession (Financial Times, 2 July

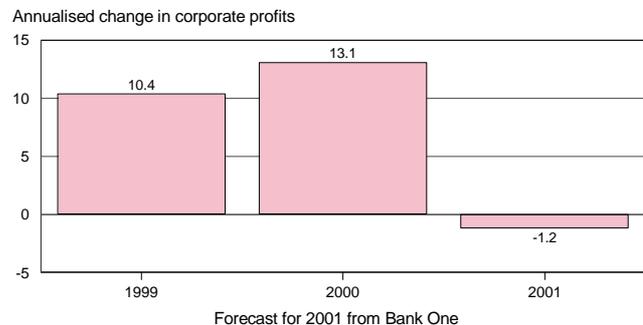
SHARP SLOWDOWN IN US DOMESTIC SPENDING THIS YEAR



US CAPITAL INVESTMENT SPENDING



US CORPORATE PROFITS FALL IN 2001



As the middle chart on this page shows, the annual growth of real capital spending has slowed right down and is forecast to move into negative territory during 2001. Capital spending has been worst affected in the ICT sector—the collapse in share valuations has increased the effective cost of capital for e-businesses wanting to raise new finance.

US profits squeeze will hit investment spending

The slowdown in demand has led to a sharp downturn in the annual growth of corporate profits (shown in the chart immediately above). Profits are forecast to fall on average by 1.2% this year—a dramatic turnaround from the last two years.

The profits-squeeze is concentrated into a few industrial sectors—but more generally, the response of firms to this is to lay-off surplus labour; cut back on excess stocks (or inventories) and introduce heavier price discounts to shed unsold output. Unless there is a clear rebound in profits next year, weak business confidence is likely to keep capital spending in the doldrums going forward into 2002.

Since the beginning of 2001, the Federal Reserve Board has cut its key federal funds interest rate six times, lowering it from 6.5% to 3.5% - a fall of 2.75% (or 275 basis points). This represents a clear attempt by the Federal Reserve under Chairman Alan Greenspan to support confidence, demand and output by providing a sufficient monetary stimulus to the US economy.

The press release issued by the Federal Reserve when making their latest interest rate cut identifies the areas where they believe the US economy is weak

“The patterns evident in recent months--declining profitability and business capital spending, weak expansion of consumption, and slowing growth abroad--continue to weigh on the economy. The associated easing of pressures on labour and product markets are expected to keep inflation contained.”

“Although continuing favourable trends bolster long-term prospects for productivity growth and the economy, the Committee continues to believe that against the background of its long-run goals of price stability and sustainable economic growth and of the information currently available, the risks are weighted toward conditions that may generate economic weakness in the foreseeable future.”

The classic symptoms of a slowing economy are when business and consumer confidence falls—and this leads to an unwanted increase in unsold stocks and a fall in planned investment. Company profits are set to dip this year after several years of double digit growth—a factor not lost on the US stock market. Many US corporations are responding to weaknesses in demand by laying-off workers and cutting back on output in the short run. This of course reduces the growth of real incomes and puts further downward pressure on aggregate demand.

Stimulating demand by cutting the cost of money

Can the monetary policy response work? The series of interest rate cuts this year takes the cost of money in the United States back to where it was in the early 1990s at the end of the last recession. This should help to cushion the sharp fall in consumer confidence seen in the first half of 2001 and may lead to some weakening of the US dollar.

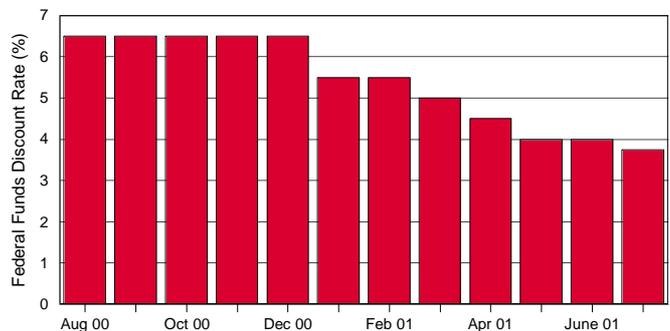
Nominal and real interest rates

But although nominal interest rates are falling, inflation remains subdued and therefore **real interest rates** are positive. The real interest rate is equal to the nominal rate of interest minus underlying inflation. For monetary policy to impart a significant boost to demand, the Federal Reserve may have to cut interest rates even further in the coming months.

With core inflationary pressures under control (the strong dollar helps in this respect) - we can expect Alan Greenspan to remain in rate-cutting mood for a few more months yet. Will the United States have to cut interest rate to 3% in order to avoid a sharp slowdown turning into a full-blown recession?

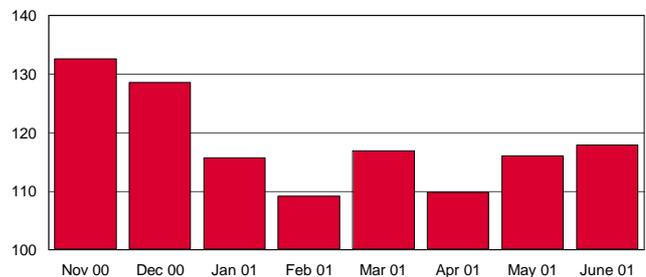
The Monetary Policy Response

GREENSPAN CUTS INTEREST RATES



US CONSUMER CONFIDENCE LEVELS OFF

Overall Index of Confidence in Present Economic Situation



Source: US Conference Board

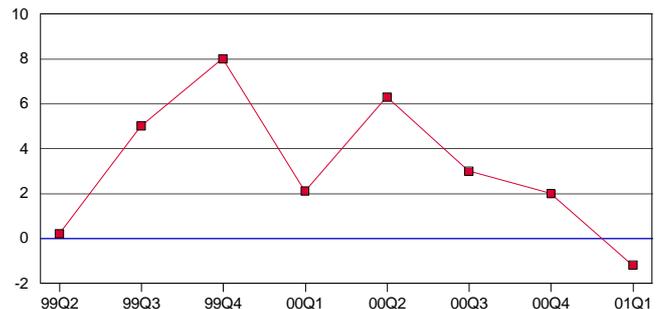
PRODUCTIVITY GROWTH IN THE US ECONOMY

The productivity boom in the US economy seems to be coming to a halt. Data for the first quarter of 2001 shows the annual growth of non-farm productivity dropping to -1.2%. A large part of this productivity slowdown is due to the decline in growth of the economy as a whole.

Productivity growth is pro-cyclical—when output is rising, many businesses make more intensive use of their factors of production. In a slowdown, there is less pressure on the labour force to meet tough output targets. Greenspan will be hoping that the downturn in productivity does not represent a long term drop in efficiency. There has been heavy investment in information technology in the US over the last ten years which should provide an important support to productivity in the period ahead.

IS THE US PRODUCTIVITY BOOM OVER?

Annual percentage change in non-farm productivity



How will the UK Be Affected?

The UK is a highly open economy. A growing share of our national output comes from exporting goods and services overseas, whilst at the same time, the share of GDP taken up by imports is also rising.

Clearly economic events in the United States can have a major impact on our own macroeconomic performance, and influence the direction of fiscal and (in particular) monetary policy.

The economic slowdown in the US is an **adverse demand shock** for the UK. In the recent past, our economic cycles have shown a high degree of convergence. The downturn in the United States has caused most city economists to downgrade their forecasts for UK economic growth this year. But the closeness of the link between US and UK cycles is difficult to gauge precisely.

There are several potential economic consequences for the UK economy of the current US slowdown:

Trade effect

The US slowdown will cause a fall in the pace of global economic growth and threaten the continued expansion of world trade.

The biggest risk is that a full-blown recession will cause the Bush administration to look inwards and introduced protectionist measures against the European Union. EU and US steel producers are on the verge of such a trade war at the moment.

Impact on tourism and global business services

A US recession and a weaker dollar would hit the UK tourist sector hard and cut-backs in business travel to and from the UK and the USA would impact on service industries.

Fall in US overseas investment into Euro Zone and UK

There is a danger that the current US slowdown will lead US multinationals to curtail their foreign investment plans over the next two to three years. This will hit several thousand jobs in the UK

Housing

The London housing market is commonly thought to be over-valued after the rapid price gains of the last five years. If the US economy goes into a worse than expected tail-spin, we might see a fall in speculative demand for real estate (housing) from US investors, together with a fall in demand for property in London bought up by US corporations and used to house their executives when in the UK.

Falling US stock market dampens investor confidence in UK stocks as well - there is a strong historical relationship between the FTSE and the Dow Jones Index

Monetary Policy—UK Interest Rates

A US recession would lead to slower growth in the UK and the likely response of the Bank of England would be to cut nominal interest rates.

However it is worth remembering that although international economic conditions are taken into account by the Monetary Policy Committee, their monthly interest rate decisions are primarily determined by the strength of demand, output and inflationary risk in the UK economy.

ANATOMY OF THE USA SLOWDOWN

- ? Rapid rise then collapse in stock prices—hit US consumers hard – high level of share ownership in the US
- ? Too much money flowed into new Internet start-ups with little hope of any rate of return—share valuations way too high to be sustainable in the long run
- ? Increased cost of capital for US corporations – harder to issue new shares (reliance on borrowed money instead)
- ? Sharp fall in business confidence
- ? Unplanned increase in stocks (inventories) – as the growth of demand fell below current production levels
- ? Decline in the growth of capital investment spending
- ? Excessive consumer debt and low level of savings—US consumers borrowed heavily on the back of a rising stock market which has suffered sharp falls since March 2000

NASDAQ STOCK INDEX JULY 1999 - JULY 2001



US ECONOMY WEB SITES

Dismal Scientist
www.dismal.com

Bank One International Economic Research
www.bankone.com

United States Federal Reserve
www.federalreserve.gov

Bureau of Economic Analysis
www.bea.doc.gov/

Stat USA
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