NEWS

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# The world watches the disinflationary movie

As the British economy finishes the year on a high, with consumer confidence and spending rising, and unemployment falling, the same is not true for the rest of the world.

The 1990s are turning out to be a movie of the 1980s in reverse, as strong growth, high inflation and rising interest rates have been replaced by tough economic conditions, low inflation and falling interest rates. Such disinflationary pressures will persist, as the emerging economies account for a bigger slice of the world economic cake and the industrialised countries continue to struggle.

The US economy is already slowing. Japan faces stagnation next year as taxes rise and the boost from previous government spending fades away. Continental Europe faces weak growth and low inflation, not helped by tight fiscal policies ahead of Monetary Union. Thus there is no locomotive for world growth.

The US economy has been transformed in some ways. Increased investment has raised productivity, making the US the leader in new, information-related technology. This, alongside low inflation, has justified much of the surge seen in US equities. As US interest rates and bond yields are set to fall further, the US stock market could even head higher. But recent comment from Alan Greenspan about market exuberance suggests that even the Federal Reserve Board believes the stock market is discounting too good an outlook for corporate profits.

Recent US data has been mixed, but suggests a slowdown to a moderate pace of growth. The risk is it could be even weaker. A twin economy is already emerging. While skilled wages rise, and the stock market soars, the wealthy are doing well and spending heavily on luxury items. For the majority of people, though, conditions are not so rosy. Wage growth is sluggish and job insecurity remains high, despite an improvement this year. With savings low, many people have had to resort to borrowing and debt has once again become a problem and potential constraint to the economy.

In the US credit card late payments have reached the highest level since records began in 1974. And despite low interest rates, debt service to income ratios reached the high level of 11.2% in the second and third quarters of the year. Banks and credit companies, who a year ago were sending out credit card applications in the post, have changed tack. In November, the US Federal Reserve reported that bank willingness to make consumer installment loans had fallen for the third consecutive quarter, reflecting concerns about poor debt positions. Be prepared for a slowdown next year, which will eventually force the next move in US interest rates to be down.

Interest rates are already low in Japan, at only 0.5%, and are set to stay there for some time. Although the Japanese economy is showing signs of life, much of this is due to last year's policy easing and increased spending ahead of tax increases next spring. Japan will slow next year.

In fact, Japan and Germany continue to suffer from underlying structural problems. In Japan there is a need to deregulate and open up the economy, and in the process address mounting fiscal and financial problems. While in Germany the problem is an inflexible labour market, which is making it difficult to cut excessive costs without moving production to lower cost countries elsewhere, prompting surging unemployment at home. Such structural problems take time to be addressed and will affect both economies next year.

When the UK was in the Exchange Rate Mechanism, the abbreviation ERM was often referred to as Enforced Recession Mechanism. Perhaps now EMU should really stand for Even More Unemployment, and not European Monetary Union. Unemployment rates across the Continent continue to soar, as inflexible labour markets and inappropriate economic policies depress domestic demand.

There is too much optimism about the outlook for the German economy. As there has been a recent rise in exports there is a common view that Germany will experience a typical recovery, with a rise in exports being followed by increased investment and a rebound in consumption. If only it was so simple. Germany's high costs will discourage firms from investing. The only 'investment' that will take place will be linked to cost cutting. In turn, this will act as a constraint on consumer spending. Unlike Japan, which benefited from increased government spending during the last year, the German government is trying to cut spending ahead of the single currency. The result will be weak domestic demand and the need for a softer mark. Interest rates in Germany and throughout the Continent will have to fall.

Global financial markets will continue to look for inflation risks. But they are unlikely to be found. Growth will not be strong enough to trigger supply bottlenecks or higher inflation. Although oil prices could rise this winter, on account of cold weather and low inventories, commodity prices should not threaten the inflation outlook. And in most countries wage pressures will be minimal, encouraging consumers in the industrialised countries to remain price resistant. Disinflation will continue. Will the UK buck this global trend? I will reveal all in the new year.

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ECONOMICS WEEK

**Gerard Lyons** examines the prospects for the world's economies in the year to come