

# US locomotive could easily be derailed

## Gerard Lyons

### In my view



ten down the hatches. Pay off debt. Start saving. Don't be surprised by any bad economic news you hear. Least of all, don't raise your hopes that policy makers will act with speed to head off oncoming problems.

The thought of deflation stalking the world economy is not a cheery one, particularly for a rampant US stock market. It contrasts with earlier this year, when problems seemed far away. In January two films swept the board at the Oscars, *As Good As It Gets* and *Titanic*. Both could accurately describe the world's two largest economies.

For the US it has been as good as it could get, with growth strong, unemployment falling, inflation low and the stock market booming. By contrast, the Japanese economy resembles the *Titanic*, holed below the water line.

The Japanese government has taken emergency measures to change direction, but economies are like big ships, moving at a pace not fast enough for impatient financial markets, which expect instant responses.

Japan is in recession and faces a supply-side problem. The need to deregulate and open up the economy to compe-

tion. This is leading to bankruptcies and unemployment. The demand-side problem is that firms and people are not spending, so the government has to step in, spend and cut taxes.

Japan matters because it is the world's biggest saver and the largest economy in the Far East. A turnaround in Japan could trigger recovery in Asia. But why should Asia matter?

To understand Asia's problems it is important to appreciate what the region

markets and lax bank lending. The problem should have been addressed by higher interest rates in Asia, but it wasn't, because monetary policy was constrained by the need to keep currencies tied to the dollar. As we know from our ERM days, when policy is set to maintain an artificial exchange rate, it creates problems.

Prior to the crisis, half of international bank lending was to Asia. Now, international banks nurse bad loans. Asia was

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has gone through. The two biggest policy mistakes in Britain in the last decade were the Lawson Boom and the pound's membership of the ERM. Last year, many of the booming Asian economies outside of Japan hit both of these problems at the same time.

Prior to the crisis, money flowed in to Asia at an alarming rate as people tried to cash in on the region's economic miracle. This money fed buoyant domestic conditions, an investment glut, booming stock

there, cheaper goods are flooding western markets. This is hard for British exporters, who face the additional burden of a strong pound.

Asia was a big importer of commodities. Asia's slump has triggered a collapse in commodity prices. This is good for inflation but bad for Third World producers, whose export earnings have suffered.

Asia's financial panic has spread to emerging economies in Latin America and eastern Europe, leaving them vulnerable to western investors repatriating capital. Little wonder the world is suffering the fallout from Asia's regional depression.

Another lesson from Asia is that, in economics as in other walks of life, fashions change. A few years ago the World Bank produced a book on East Asia's economic miracle. But Asia's is not the first fall from grace. In the Seventies, Sweden's economic model was flavour of the month. By the mid-Eighties it was Germany and Japan we were told to follow. Few say this now.

The US economy is now the model people talk about, but there is no guarantee this will last. Early warning signals in the US suggest similar problems are

emerging as in Asia last year. As the US is the present locomotive of the world economy, any fallout from there would be particularly worrying.

America's problems are lax bank lending, asset price inflation and a deteriorating current account deficit. As the US government is in surplus, a current account deficit means Americans are getting deeper into debt. This current account deficit is financed by hot money, as international investors have bought US stocks and bonds.

As Asia showed, once sentiment shifts, hot money could leave as quickly as it arrives, leaving the dollar stranded. Were it not for Asia's problems, the US would have raised interest rates, but the next move may need to be down, to counter deflationary problems.

The trouble with deflation, like Godzilla, is we don't know when it will appear from the shadows. Life will go on as normal until it does. For the UK it is still *The Full Monty*: as a medium-sized open economy, we are exposed to any ill winds from overseas.

*Dr Gerard Lyons is chief economist at DKB International, the London subsidiary of Japan's Dai-ichi Kangyo Bank. William Keegan is on holiday.*

**G**ODZILLA hid in New York without anyone noticing. Soon he was destroying Manhattan — and it was hard to imagine the whole world had not seen him coming. Deflation, like Godzilla, is a menacing giant. In a few years the damage caused to the world economy will leave most people wondering why they did not see deflation hiding in the shadows.

The response for individuals is to bat-