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ECONOMIC NEWS UPDATE

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If The Big US Engine Slows, Are There Little Engines That Could?

The King is dead, long live the King. Ben Bernanke finally exorcised the ghost of his predecessor, Alan Greenspan, by telling a congressional committee that the former Federal Reserve Board Chairman is wrong in contending that expansions “die of old age”. But he also told congress that he thinks current Fed policy is about right, and that he has no intention of risking an inflationary spurt by lowering interest rates, even if the US economy is slowing. Which means that the famous “Greenspan put”, thought to guarantee a rate cut in the event of a slowing economy or drooping stock prices, is no more.

Tales of woe from the housing market are too well known to need extensive repeating: sales and prices are down, inventories are up, and construction continues to fall. Business investment is not picking up the slack. With the service sector booming, unemployment low, and consumers still

willing to shore up the economy, that doesn’t add up to the recession that has Greenspan worried, but it does add up to a slowdown. “Growth ... looks likely to drop close to 1 percent in the first half of this year,” according to John Makin, economist at the American Enterprise Institute.

Until now, America has been the locomotive pulling a good part of the world economy along. Question: will the world’s economies now return the favor, and prevent a growth slowdown from morphing into a recession? In answering that question it is important to keep in mind the enormous distance between the American economy and the others in the top ten. The American economy is almost three times as large as that of second place Japan, and twelve times the size of the tenth largest, Canada. So it will take a lot of little engines that could to make up for a slowing, never mind a slumping, US economy.

Japan might make up some of the slack. Its economy grew at an annual rate of 4.8% in the last quarter of 2006, following a weak third quarter, and with private consumption relatively strong, seems sufficiently on track for the Bank of Japan to have raised interest rates a bit. Takehiko Nakao, Minister of the Finance Section of Japan's US embassy paints a rosy picture: excess production capacity has been mopped up, employers are in a mood to hire, and "excess debt and loans are ... now in the past." Deregulatory and legal reforms of the so-called lost decade of the 1990s have laid the basis for continued growth, he told a meeting of the National Economists Club in Washington last month. Citigroup agrees: its latest advisory concludes, "Japan's expansion looks somewhat better balanced, as consumption appears to be catching up to income growth, while expansion continues to expand."

Germany's economy, the world's third largest, also seems to be awakening from a rather long nap. Business confidence is close to its historic high, employment is up and unemployment is down, and, according to Citigroup, "upbeat companies' employment plans suggest that the cyclical recovery in the labour market is still under way." The overall unemployment rate obscures the huge difference between the west (8.1%) and the east (stuck at 16.5% thanks to the overvaluation of the east's currency at the time of reunification). Thanks to a bit of rather quietly executed labor-market reforms negotiated with the trade unions, fearful of further capital and job flight, labor costs are returning to competitive levels. Equally important, there seems to be a dawning if grudging

realization by voters that the country must reform its overly-generous welfare system in order to increase incentives to work and decrease incentives to stay on the dole. At least, that's the impression I had on my recent trip to Germany.

Which brings us to Britain as we work our way down the list of largest economies. Whether because of Chancellor of the Exchequer Gordon Brown's superior economic management, or the foundations for prosperity put in place by Margaret Thatcher, or because world trends -- skilled immigrants, cheap Chinese goods, a buoyant America -- have worked in Britain's favor, it has racked up a decade of solid growth. Rising interest rates and a tightening fiscal stance might cool that growth in the near-term, but only a bit. The service sector continues to grow, London claims a larger and larger share of the lucrative financial services market, and sales of do-it-yourself and household goods this month are so strong that inventories are being depleted and restocking is underway.

France is probably the weakest of the world's top economies, with growth running at a rate of less than 2%. Nicolas Sarkozy is upset that the European Central Bank's one-size-fits-all interest rate is being raised to cool inflation in Spain, and keep it under control in growing Germany, just when the French economy needs the stimulus of an interest rate cut. The future is not bright, regardless of the outcome of the mid-year elections. Ségolène Royal is an old-line socialist with a program that would surely doom France to perpetual double-digit unemployment, and Nicolas Sarkozy, who several time repeated to me his plans for "a rupture" with the past, is a protectionist whose solution to

France's problems is to persuade its international competitors to raise their taxes to French levels, erect barriers to trade, and politicize the European Central Bank.

China will, of course, continue to grow, and to suck in raw materials from producers from the Middle East to Australia. Its exports to the US might slip a bit as the American economy slows, but not enough to remove it as a force for world growth. So, too, with Spain, which has had thirteen years of solid growth. Although its economy is deemed overly dependent on the housing sector and too laden with debt, the International Monetary Fund expects the Spanish economy to grow at an annual rate of 3.5% this year and next. Australia, too, will contribute to world growth. It is in its sixteenth consecutive year of expansion, during which it has grown at the robust rate of 3.6%, and only labor shortages and inadequate port facilities -- there are currently 70 ships stalled outside of Newcastle waiting to carry coal to China -- can interrupt further growth.

Several Latin American economies are also showing some strength. Argentina has grown at an annual rate in excess of 8% in each of the last four years, and unless the massive policy errors of the past are repeated, should continue to move ahead. Growth in Chile has slowed from 5.7% in 2005 to 4% last year, but if that continues should add a bit to world prosperity. Only Venezuela might make a negative contribution to world growth as the government bureaucrats appointed to run its nationalized oil industry prove unable to maintain output.

In short, it certainly is possible that several other countries will keep the

world economy moving along as the American engine runs low on steam. But, as always, that assumes no shock to the system. Two come to mind.

Iran has recently demonstrated that it is quite capable of driving up the price of oil by taking hostages, continuing its drive for nuclear weapons, and funneling arms and terrorists to Iraq, in the knowledge that any threat of violent confrontation with the West will drive up the price of oil, to its advantage and the disadvantage of developed economies. A mere rumor that Iran had attacked a US vessel temporarily drove prices up 7%.

Then there are the protectionists -- the French farmers and the American congressmen who have scuppered the Doha Round and are poised to do other serious damage to the world trading system.

There are more potential problems, including Donald Rumsfeld's famous "unknown unknowns", but you get the idea: the lesser locomotives should continue to pull the world economy forward, unless derailed by what former British Prime Minister Harold Macmillan said he most feared, "events, dear boy, events".



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