

The world has become a much smaller place

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The world economy

Still gushing forth

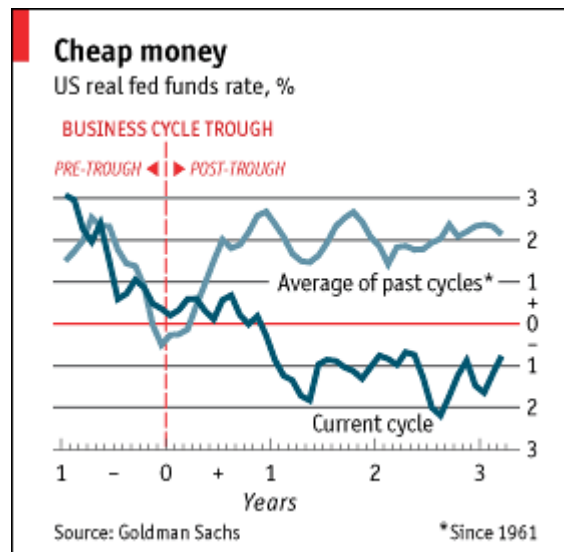
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The global economy is awash with liquidity, pumped by America

THIS week, as widely expected, Alan Greenspan and his colleagues at America's Federal Reserve raised the federal funds rate for the sixth time since last June, to 2.5%. Six rate rises at six successive meetings may sound tough, yet real interest rates (estimated by the federal funds rate less the headline rate of consumer-price inflation) are still negative. And not content with running a lax monetary policy at home, America is also exporting its super-loose ways around the globe.



America's monetary policy is still extraordinarily slack. Real interest rates are three percentage points lower than they have been, on average, at the same stage of previous economic recoveries since 1961 (see chart). Furthermore, according to an index compiled by Goldman Sachs, overall monetary conditions are still slightly easier today than when the Fed started tightening last June: a weaker dollar, lower bond yields and higher share prices have offset higher short-term interest rates. Even so, futures contracts suggest that the financial markets expect interest rates to be raised to only 3.5% by the end of 2005, leaving real rates still quite low.

Considering how loose policy is, inflation remains tame. America's headline inflation rate was 3.3% in December; the core rate (excluding food and energy) was 2.2%. However, there are plenty of other signs that easy money has led to excess, from rapid growth in credit and house prices to tight credit spreads and a widespread willingness to take greater risk. The minutes of the Fed's monetary-policy meeting in December suggested that some central-bank officials have started to worry that speculation is getting out of hand in some quarters, notably the housing market. If this carries on, the Fed may raise rates by more this year than the markets expect.

The weaker dollar, which has helped to keep overall financial conditions loose in America, will be on the agenda when finance ministers and central-bank governors of the G7 countries meet in London on February 4th and 5th. Although the dollar has rallied this year, it is still 6% weaker against the euro than when the G7 last met in October and worth 35% less than in early 2002. Yet, despite the dollar's slide, America's trade deficit continues to widen. China, which has been invited to the G7 meeting, is likely to be cast as the villain and to come under renewed pressure to revalue its currency. The Chinese are likely to turn a deaf ear.

When the G7 last met, ministers and officials celebrated the fact that the world economy was growing at an annual rate of 5%, its fastest for almost 30 years. It has since slowed, mainly because of weaker growth in America and Japan. In the fourth quarter of last year, America's GDP growth fell to 3.1% at an annual rate, from 4% in the previous quarter. But the slowdown was largely due to the widening trade deficit; consumer spending surged at an annual rate of 4.6%.

The only real remedy for America's huge external deficit is a tightening of its monetary and fiscal policies to boost domestic saving. Many Americans favour a weaker dollar as a less painful way to trim the deficit. However, a fall in the dollar alone will not make much of a dent in the trade gap. America also needs to cut its budget deficit and to raise interest rates to curb consumer spending. That could necessitate a marked slowing of economic growth. America's policymakers prefer not to contemplate this.

The global gusher

It is not just America that feels the effect of low American interest rates. America has flooded the whole world with liquidity. Its loose monetary policy has been exported to other central banks through the fall in the dollar. For example, to offset the impact of a stronger euro on growth, the European Central Bank has been forced to hold the euro area's real interest rates negative for longer than might otherwise have been prudent. Mortgage lending in the single-currency zone is rising at an annual rate of 10%. In many countries, notably France and Spain, house prices are booming.

America's easy money has also spilled beyond its borders in a second way. When central banks buy American Treasury bonds, adding to their foreign-exchange reserves, to try to hold down their currencies against the dollar, they print local money. This amplifies the Fed's lax stance. Last year, the global supply of dollars (the sum of America's monetary base plus global foreign-exchange reserves) rose by a whopping 25%. After adjusting for inflation, this is close to the fastest pace in the past three decades.

Worse still, the effects of greater global liquidity then flow back into America's economy. By buying huge amounts of American securities to prevent their currencies rising, Asian central banks depress American bond yields, lowering borrowing costs for home buyers and companies. By some estimates, Asian purchases of American bonds have reduced yields by between half and one percentage-point.

The flood of global liquidity has not, as in the past, pushed up inflation in the prices of goods and services. Instead it has inflated a series of asset-price bubbles and encouraged investors to take ever greater risks. Several structural factors, such as the IT revolution, deregulation and competition from cheaper Chinese goods, have helped to hold down traditional inflation—and hence interest rates—in rich economies. The increased credibility of central banks also means that they need to raise interest rates by less than in the past to choke off inflationary pressures.

Yet many of those very same structural forces that help to hold down inflation and interest rates, such as the entry of China into the world economy, have also increased the global return on capital and so lifted the real neutral rate of interest for which central banks need to aim—ie, the rate that neither stimulates nor reins in the economy. Inflation stays modest, but holding interest rates too low for too long creates excess liquidity, which is now more likely to spill into the prices of homes, shares or other assets than those of goods and services.

Measured by the growth in global credit or property prices, the world economy is experiencing a severe episode of inflation. Inflation has simply taken a different form. The Fed insists that it is not its job to respond to rising asset prices. But the risk is not just that asset-price and credit bubbles eventually burst but, as with traditional inflation, that surging asset prices distort relative prices and cause a misallocation of resources. For instance, because households think they are wealthier, they spend more and save and invest less. The cost is lower living standards tomorrow.

The source of the current problem is that, although the Fed refuses to constrain asset prices, it reacted to the bursting of the stockmarket bubble by pumping out yet more liquidity. The risk is that as interest rates rise the fragility of the economic recovery will be revealed. Decisions based on cheap credit will look less than wise.

Mr Greenspan, the Fed's chairman, now has less than one year left in his job. His term ends on January 31st 2006. His successor may need to think harder about the fact that the Fed is, in effect, the world's central bank, and thus about the global ramifications of its policies. He or she may at some stage also have to contend with a painful economic hangover. Does anybody really

want the job?

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