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## World economy keeps powering ahead – risks are rising as well

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1. In its World Economic Outlook which the IMF will release tomorrow the new forecast for **world economic growth has been raised to 4.8%** (real GDP, y/y, purchasing power parity GDP weights), a revision by half a percentage point from last autumn's Outlook. **At 4.7%, the growth rate for 2007 will be almost the same.** Not surprisingly, the volume of world trade is expected to expand by almost 10% in both years. The world economy is booming. Strong output growth combined with the fact that the income distribution continues to be tilted toward capital, has resulted in a strong performance of most equity markets. Commodity prices have been even firmer, and many are heading for historical highs.
2. **To point out the risks is like spoiling the party.** The standard assumption of an institution such as the IMF is therefore that they will once again not materialize. They seem to be rather distant and not very serious because they have obviously no impact on the excellent bottom line results for growth and inflation. **There are four of them:** very high oil prices which drain purchasing power from oil importing economies, rising interest rates in key economies which make borrowing and investing less attractive, the American savings shortfall, and the possibility of an avian flu pandemic.
3. Overall, though, the **environment remains benign.** Consumer price inflation, in particular, is well contained as wage costs rise only gradually due to a large degree of labour market slack in all main countries except the Anglo Saxon ones. In spite of rapid money supply growth it is therefore **unlikely that the world economy is heading for a new decade of high inflation.** Monetary policy will not be tightened nearly as much as in earlier instances of comparable world economic growth. Even after the upward shift of yield curves over the past half year monetary conditions are not overly restrictive.
4. The IMF points out that firms are generally in good shape because profits have been strong for several years while capital expenditures have increased only moderately. Given the present growth rates of real GDP it would be surprising if **approaching capacity constraints** wouldn't force companies in the US and Japan, less so in the euro area, to step **up investment activity which in turn could boost growth by more than forecast in the mainline scenario.** In this respect it is a conservative scenario.
5. **A world GDP growth rate of 4.8% and the increasing weight of large emerging markets in the world economy imply that industrial production, the production of goods, will**

**grow by even more. This is the fundamental reason why everyone is betting on continuously high energy and other commodity price inflation.** So far, the strategy has worked. From their 2004 averages, dollar prices have increased by the following percentages: oil (Brent) 84.8%, natural gas 13.4% (down 51.0% since last December, though), copper 110.6%, aluminum 48.6%, nickel 29.2%, gold 45.4%. From one year ago, average metals prices are up 42%, and oil 20%.

6. In other words, **commodity producers are earning windfall profits while importers are suffering from a major deterioration of their terms of trade:** their import and input prices are rising much faster than their output prices. Since corporate profits in the importing countries are still rising, the loss of purchasing power is primarily felt by consumers, which is obviously a major drag on household consumption and GDP growth, now and in the future. This negative effect is probably underestimated in the IMF forecasts.
7. Another aspect of the commodity price explosion is that it leads to substitution, efforts to save, and more exploration and output. **The larger the price increase the greater is therefore the probability of a crash.** It has already happened in gas. Oil and copper may be the next candidates. In the case of major fall of oil prices, purchasing power trends would be reversed again and the economies of the OECD countries as well as those of China and India would get a boost which would, in the end, vindicate the IMF growth forecasts. However, if commodity prices do not come down, world economic growth will be less than those 4.8%.
8. **Rising interest rates, the IMF's second major risk, have not yet begun to bite. The rate hiking process is most advanced in the US:** the Fed funds rate has increased by no less than 375 basis points since June 2004. For consumers, who are mostly heavily indebted, borrowing costs have therefore increased significantly. As long as asset prices, in particular property prices, continue to rise at double digit rates, they are convinced that their net worth and thus their ability to borrow are still improving. From a subjective point of view they are probably right. In addition, the buoyant labour market (though not their stagnating real hourly wages) makes them quite optimistic.
9. **They are also convinced that house prices never really fall,** as in the past, and they believe they can live with stagnating prices for a while. The Fed would, in any case, see to it that consumers would not have to suffer too much. The Bank of England has shown the way: when British consumer confidence began to deteriorate in the wake of higher rates – 4.75% at the top - and some signs that house prices might collapse, the rate rising process was quickly halted and then reversed. House prices started to rise again. The Fed will bail out US consumers when the time comes. Will it?
10. **Monetary policy in the euro area has also a tightening bias now.** Rates are on the way up, but the ECB intends to proceed gradually and raise them by only 25 basis points per quarter, in synch with the quarterly economic projections of its staff. It is quite aware of the risks related “to potential increases in oil prices” and is concerned about global imbalances. An appreciation of the euro exchange rate is another danger as long as domestic demand is so weak. Inflation, even headline inflation, is very low. Germany just released final data for March which show that headline inflation has been 0.2% on an annualized basis over the past six months. Euro area unit labour costs are stagnating. There is no inflation as far as the eye can see. The ECB therefore seems to be prepared to stop the rate raising process once the economy shows new signs of weakness.

11. **In Japan, the zero interest rate policy continues but markets are now convinced that the first increase will come earlier rather than later, given the solid growth performance of the economy.** Government bond markets have been weak in anticipation of such a move. But the Bank of Japan is certainly aware of the risk that an aggressive tightening could lead to a new appreciation of the yen which in turn might push the economy back into deflation. It has barely escaped from this dangerous situation. By some measures, the price level is still falling in any case.
12. **For the world as a whole, the risk of monetary policy overkill is therefore limited. How about the risk that global imbalances, ie the US current account deficit, will be unwound in a violent fashion?** This is very real: non-US investors could decide that they hold too many dollars already and stop funding the American savings shortfall, the mirror image of the c/a deficit. In this case, the dollar would depreciate a lot, by 25% or more, and the Fed might be forced to raise interest rates by more than it is presently aiming for, in order to push back domestic demand (ie free resources for exports). This would mean a big decline in US imports and possibly recessions in all countries which are heavily dependent on business with America. This is a nightmare scenario which may yet become reality.
13. On the other hand, **today's precarious dynamic disequilibrium could continue for quite some while and become even bigger. From an American point of view, net foreign borrowing to the tune of \$ 800 bn per year is not such a big deal, for three main reasons:**
  - a) US foreign assets are about \$10 tr while liabilities are \$ 12.5 tr, for a net liabilities of \$2.5 tr, this pales in comparison to net domestic assets in the order of five times nominal GDP, or \$65 tr; until recently, net debt service had actually been positive;
  - b) net domestic assets have so far risen much faster than net foreign liabilities, by \$4.5 tr compared to \$0.8 tr annually;
  - c) US nominal output growth is in the order of 6 to 7% per year – borrowing from abroad at a rate of less than 5% is therefore the right thing to do; it is cheap money, and it boosts the domestic investment ratio, the growth rate of the capital stock and thus labor productivity. So Americans can live quite well with large-scale capital imports. If foreigners do not get nervous about their dollar portfolios, because of low returns or the concentration risk, for instance, the so-called imbalance can persist for many years.
14. The only problem with this Panglossian scenario is that **historical evidence suggests that current account deficits in the order of 6 to 7% of GDP have never persisted for long,** and have always led to a major correction of the exchange rate, also for various reasons: a) foreigners' (concentration) risk of holding a large share of foreign assets in the form of dollars has already been mentioned, b) invariably, as the US becomes capital-rich and the other countries correspondingly capital-poor as a result of net capital flows into the US, expected returns in own currency-denominated assets will exceed those of dollar denominated assets at some point, which leads to profit taking and a re-allocation, c) American sentiment will turn against further foreign borrowing and the "sell out" of assets (such as ports or oil companies, to cite two recent examples).
15. **So if the risks to the IMF growth forecast have to be ranked,** I would put energy and commodity price inflation first, followed by the US current account deficit and its FX and interest rate implications, followed by the tightening of monetary policies. The possibility of an avian flu pandemic seems to be a very remote risk.

**16.** In the end, I have to admit that, just as the IMF, **I am also unable to be precise about which risks will materialize, when it will happen, whether it will happen at all, and what this will do to growth and inflation in the main economies.** So the conclusion is: Things are looking very good from a macro perspective, average per capita incomes are rising briskly, inflation is well under control and does not require overly restrictive monetary measures, and the momentum caused by the catching-up processes in large emerging markets and the pro-consumer policies in the Anglo Saxon countries remains strong. **Risks are substantial and continue to rise. The need to hedge against very adverse events is therefore increasing all the time.**