

Strategy Matters

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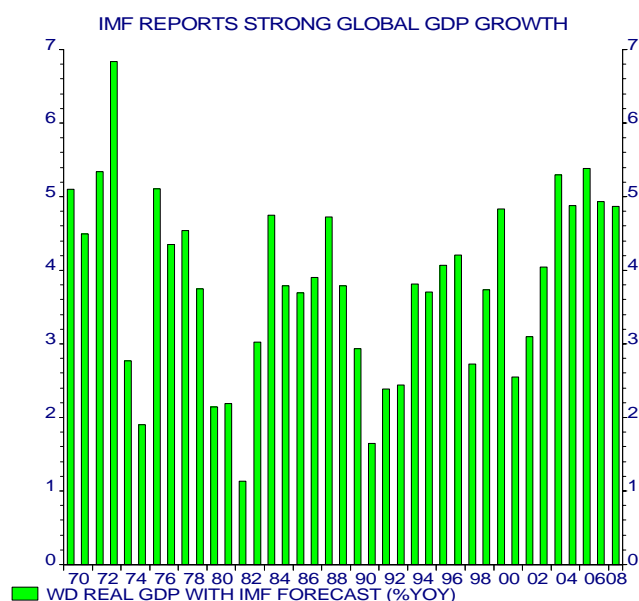
Growth, but no inflation

The world economy is experiencing an extraordinary spell of strong output growth and low consumer price inflation. This is very supportive of financial markets, especially equities. In the short-term, the risk may be unwanted disinflation, rather than a surge in inflation rates.

Strong growth, low inflation

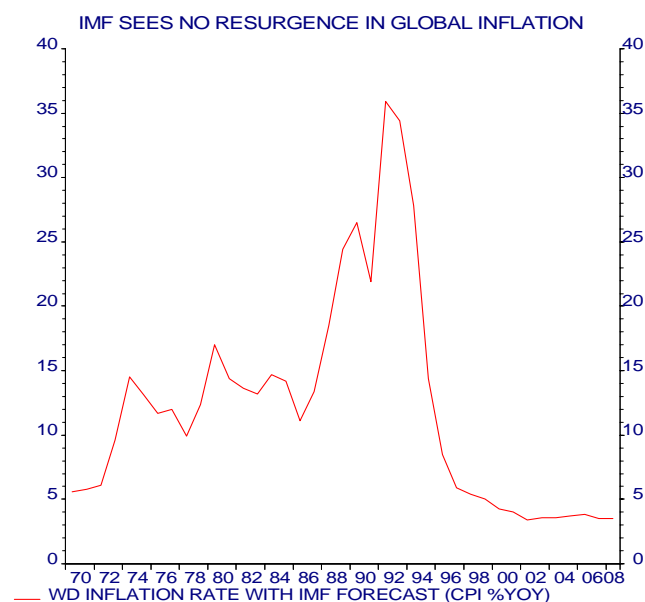
The IMF has just released its latest report on the global economy. This shows world output increased at an annual rate of 5¼% over the last three years, 2004 to 2006. This is the best three-year spell of global output growth since the early 1970s. And, if the IMF's forecasts are to be believed, output growth will be sustained, at an average rate close to 5%, in 2007 and 2008.

What is remarkable is that this surge in global output growth has not been accompanied by any significant upward pressure on consumer prices. The last time the world economy grew so rapidly, commodity prices boomed, severe consumer price inflation pressures built up and inflation rates soared in most economies in the mid-1970s. This time around commodity prices have been strong – especially for oil and metals – but consumer price inflation has stayed under control. This has enabled central banks to keep interest rates relatively low, contributing to the buoyant liquidity conditions that have supported financial markets in recent years and helped equity markets to make spectacular gains.



Source: IMF and Datastream

Source: DATASTREAM



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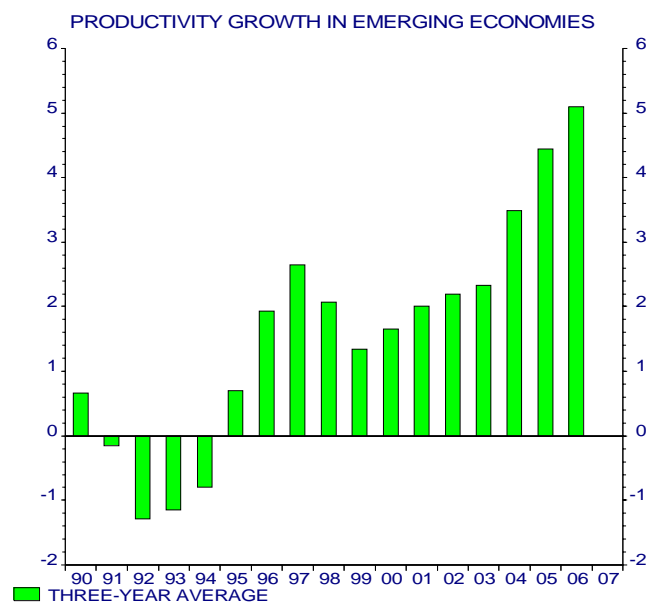
The 1970s experience

These very different inflation outcomes are explained by differences in the balance of supply and demand in the global economy. With hindsight, it is clear that in the early 1970s governments and central banks set fiscal and monetary policies too loose. Global demand surged well ahead of the capacity of the economy to meet it. Commodity producers could not increase output quickly enough to meet demand, so they pushed their prices higher. Manufacturers, faced with a similar set of circumstances, did the same. Workers extracted higher wages and this helped lead to increased prices in the service sector. Soon inflation rates in many countries were above 10%, and financial markets were tumbling.

The boost to global supply

The only part of this story that has a parallel with the current global economy is the rise in commodity prices. Once again, commodity producers are struggling to meet demand for their products and prices of many key commodities are soaring. But that is where the similarities with the 1970s end. Outside of commodity markets, it appears that supply is growing just as rapidly as demand. Indeed, it may be the rapid growth in supply that is boosting demand and ensuring that global output growth remains strong.

Two factors have boosted global supply growth in recent years. One is well-known: the integration of more countries – especially China – into the capitalist economy, which has lifted the pool of available workers. The second, highlighted in the IMF's latest *World Economic Outlook*, has attracted far less attention: a surge in productivity growth (that is output per worker) in emerging and developing economies. According to the IMF productivity in these economies is now increasing at an annual rate in excess of 5%.



Source: IMF and Datastream

Source: DATASTREAM

This is not another China story. The IMF figures show little improvement in productivity growth in China, or indeed in Asia generally, in recent years. Rather, the improvement has occurred in Emerging Europe, Latin America and Africa.

So, with more workers and faster growth in output per head, the world economy has been able to cope with stronger demand. Unlike in the early 1970s, manufacturers have been able to increase production to meet the extra demand. Prices (other than commodities) have not, on the whole, risen more rapidly. Workers have felt less need to boost their wages and have been less able to do so because of the pool of cheap labour in emerging economies. So service sector price inflation has remained moderate too.

Supply boosts demand

It is even possible to argue that demand and output growth have only been as strong as they have because of the boost to supply in emerging regions. Many emerging economies have a relatively high saving rate and they have been willing to export their excess savings to developed economies, particularly the United States. In these developed economies, consumers have been prepared to borrow more and save less, and so to maintain a high rate of spending (demand growth).

The US economy is currently going through a soft patch, largely due to weakness in the housing and auto industries. If things get worse and US growth drops further below trend, it may be that global demand does increase rapidly enough over the next year or two to match the rate of increase in supply.

It could be, therefore, that the bigger risk right now is not a surge in global inflation, but some unwanted disinflation.

Conclusion

Assuming emerging economies can continue to increase supply at the present pace, there is every reason to believe inflation risks will remain muted. This is a favourable climate for asset markets, especially equity markets, which might be expected to make further gains in such an environment. In the short-term, while the US economy is going through a sticky patch, the bigger risk to markets might be some unwanted disinflation, if global demand does not grow as fast as supply.

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