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Flatlining world economies in need of intensive care

Relationship between growth and interest rates breaks down once rates fall below 2 per cent, and policymakers don't seem to have the cure

Doctors carry out triage on patients by checking the vital signs as to who can be saved or who can't. Investors can visualise economic growth by taking a "temperature", with "normal" in the region of 2.5 per cent to 3.5 per cent – perhaps double in a developing economy. Too high, and bull market passions put the patient in danger of overheating; too low and the economy shivers.

Out of 45 developed and developing economies, there are few whose vital signs look optimistic. The world has chronic fatigue syndrome and policymakers and their spin-doctors continue to look for the cure for low economic growth.

As in medicine, all of the vital signs are related in some way. Few links are as strong as inflation and interest rates. Inflation is like blood pressure: too high, it can burst the bubble; too low, it represents weak economic demand. Interest rates are the heartbeat of an economy and vary in line with inflation, as they can be controlled by central banks.

India's high 7 per cent growth relates well to relatively high 6 per cent interest rates. They are high enough to be used to manage the economy – like an effective drug. Indonesia and non-commodity-based Asean and Latin American nations have similar vital signs, as has Turkey – although it recently caught the Russian flu.

Australia has the best vital signs of all developed markets with growth and interest rates both around 2 per cent. The advantage of having relatively high interest rates is that it might provide some immunity to rising rates elsewhere.

Much of Europe, notably France, is flatlining – zero growth, zero inflation and zero interest rates. Russia and Brazil need intensive care as their economies are losing 3 to 4 per cent of their body mass this year, hit by the collapse of the oil price, falling currencies, and high interest rates.

Policymakers have not been able to treat the economic ailments because the relationship between growth and interest rates breaks down once rates fall below about 2 per cent. So the US Federal Reserve Board's attempts to stimulate the economy by lowering interest rates to fractional levels have been futile. Britain and US 2 per cent growth handle, compared to Europe's 1 per cent, is due to the former's relatively friendly business policies.

> **No surgeon would carry out microscopic surgery using a time-lagged video camera**

Central bankers have foolishly tried to nurse growth up with low interest rates for 15 years; what the market calls "pushing on a string". High inflation can be beaten with high interest rates but the vital signs prove that low inflation cannot be beaten with ever-falling interest rates.

The patient is not looking very healthy as we go into 2016 and investors have to operate with delayed and inaccurate data. No surgeon would carry out microscopic surgery using a time-lagged video camera. The markets will sense an economic turnaround well before we see them in the numbers.

So the bombed out Russian economy may improve next year as Greece did this year. If the new president can enact reforms, Argentina may finally see a volatile return to form. The emerging markets, hit hard this year, should recover.

China's prognosis is more difficult to assess. The vital signs do not look too bad, but with doubts about the true GDP growth figure and a government holding up the currency and stock market, it will not be easy to call the bottom. Europe has scope to recover, and Australia and to a lesser extent Canada seem to have their vital signs positively poised should commodity prices bottom.

The fittest economy is Ireland with an energetic 6.7 per cent growth rate, rock bottom interest rates thanks to the euro, and US companies queuing to enter the country to heal their tax liabilities.

The central banks are full of the most intelligent people in the world but they have been using the wrong medicine, hoping for interest rates as a cure that have as much impact as an overused antibiotic.

But does this mean that the Fed can push up rates from here with little impact on growth? The answer is probably yes, especially as the dividend from the oil price cuts trickles through. Sadly, investors are programmed to take fright first and think logically later. The Fed is now in a tangle where treating the patient with falling rates failed and rising rates may put the economy in danger of a secondary infection.

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