The developed world economy has slowed

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DEVELOPED world economic growth has stalled.

There was no or negative growth last quarter in Japan, Europe and Britain.

The US managed a small rise helped by the Bush tax cuts.

Yet because of high inflation, interest rates are still on hold in major countries. Unless commodity prices fall, the risks of a sharper recession in developed countries is high.

Everyone expects the Australian Reserve Bank to cut rates tomorrow despite high Australian inflation and a still expanding economy.

Not surprisingly the Australian dollar has fallen sharply.

The Reserve Bank is relying on forecasts that inflation will peak shortly and then fall. It is more worried about a sharper than expected slowdown, than inflation exceeding its forecasts.

In contrast the European and British cental banks are waiting for proof inflation has fallen before cutting rates.

Financial markets are still in meltdown with daily rumours of new problems. Equity, commercial property and housing asset prices are falling.

There will be no early recovery in developed economies.

Major countries' rates will eventually fall, given weak growth. When and by how much depends on how quickly inflation falls.

Rio Tinto and BHP Billiton have just claimed that China's economy will sail on regardless.

Whether they are right will determine what happens to inflation and interest rates.

If emerging economies keep booming, then commodity prices will stay high, as they are generating the bulk of demand growth for commodities.

That would certainly be good news for our mining companies.

It would not be good news for world inflation. It would make it harder for central banks to cut interest rates aggressively.

In Australia, rates could only fall gradually and there would be continued pressure on NSW and Victoria, which are squeezed harder than the resource-rich states by high interest rates.

Retail spending and housing would face an extended squeeze as unemployment rises.

Will emerging economies keep booming?

Chinese export growth has slowed as demand in developed economies slows.

The mining companies argue domestic infrastructure spending will keep the emerging countries growth high. In the long term they are right. In the short term more slowing is likely.

Slowing export growth reduces the need for new infrastructure and many emerging nations are raising rates to tackle inflation.

A period of below-trend world growth is needed to reduce inflation pressures. Demand has been growing too rapidly given limited supply side capacity.

If the emerging nations keep growing rapidly, that requires deeper recessions in developed economies to reduce inflation.

More likely, emerging nations' growth will slow further, taking the heat out of commodity prices and allowing rates to be cut enough in developed nations to avoid sharp recessions.

Whatever happens, the asset boom is over.

Financial firms are tightening lending criteria and commercial money markets are still frozen.

Asset prices are falling, bankrupting highly geared firms. Unemployment will rise further.

Until inflation starts falling, interest rate cuts will be constrained. The chance of central bank mistakes is high and there could still be an extended world slowdown.

Source: Herald Sun